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We Have a New Tax Law – Now What?

Introduction

With great fanfare (although by the slimmest of margins, 51-50, in the Senate), Congress last week passed the Jobs and Growth Tax Relief Reconciliation Act of 2003, aimed, we are told, at providing just the fiscal stimulus the economy needs. Whatever the political motivations of its sponsors, and whatever its economic impact, the new tax law has two provisions of significance to investors. Under the new law, dividends are taxed at capital gains rates, and long-term capital gains realized on or after May 6, 2003 are to be taxed at a maximum rate of 15%, rather than 20%. President Bush signed the measure into law last Wednesday.

By taxing dividends at long-term capital gains rates rather than ordinary income rates, Congress has effectively reduced the gap between dividends and capital gains as sources of return for taxable investors. Capital gains are still preferable to dividends because investors have more control over when they receive them, but the difference is now much smaller. Dividends also now have a significant advantage over taxable interest as a source of returns for investors.

Implications for investors

I have written previously about the possible implications of a dividend tax reduction for investors and issuers ("The Dividend Tax Puzzle," February 1, 2003). At that time the proposal under consideration appeared to call for a complete elimination of the tax on dividends, but it would actually have relieved investors of taxes on income against which companies had already been taxed, whether they paid dividends or not. That proposal could have resulted in a significant reduction in the tax liability of individuals holding stocks of companies that themselves have taxable earnings.

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The new law reduces the tax rate paid on dividends not to zero, but to capital gains rates. It extends the cut to most of the taxable dividends investors receive, whether or not the companies paying them have taxable income. Investors now holding taxable bonds may consider moving toward dividend-paying stocks, but many will find that it may not be worth altering their risk profile to do so. Investors that have concentrated high-dividend stocks in tax-deferred accounts may want to consider reconfiguring those portfolios.

The change in capital gains tax rates may be of greater importance to taxable investors' strategies than the change in dividend taxation. By lowering the top long-term capital gains tax rate to 15% from 20%, the new law increases the advantage of long-term over short-term capital gains, which continue to be taxed as ordinary income (the new law also lowers ordinary income rates immediately, rather than in future years as provided under the previous tax law; the top marginal rate falls from 38.6% to 35%). Portfolio strategies that create long-term gains in lieu of short-term ones are now more attractive than under previous law, while strategies that defer long-term gains have less value. In addition, with the capital gains tax rate now at 15%, investors with concentrated holdings in low-basis stock may now consider more seriously the option of diversifying their holdings by simply selling the stock and paying the modest tax, rather than employing more sophisticated hedging and monetization strategies. Strategies that defer long-term gains at the cost of creating short-term gains in the future are now significantly less attractive.

Capital gains rates for dividends don't quite mean capital gains treatment

The new law actually moves dividends out of the category of ordinary income and changes them into a species of capital gains. It works like this. You'll start the capital gains calculation the same way you have under the previous law. First, net short-term gains and losses, and separately net long-term gains and losses. If the resulting figures are both positive, you will add the (net) short-term gain to ordinary income and pay taxes on the (net) long-term gain at the long-term gains rate. But under the new law, you will add your dividend income to the long-term gains figure, rather than to ordinary income.

The rules for losses remain unchanged. You may use net losses to reduce ordinary income by up to $3000, carrying any excess over to the following year. If you have both short-term and long-term losses, you must use short-term losses against ordinary income first. After the $3000 income reduction and the carrying forward, *then* apply the capital gains tax rate to your dividends. The law does not seem to allow offsetting dividends with long-term capital losses.

If you have long-term gains and short-term losses, you can net the two against each other, resulting in either a net long-term gain or a net short-term loss. It works the other way, too. If you have short-term gains and long-term losses, you can net those against each other, giving you either a net short-term gain or a net long-term loss. Let's take each of the four cases in turn.

A) **Long-term gain:** Add your dividends to the long-term gain, and pay tax on the sum at the new capital gains rate.
B) **Long-term loss:** Apply up to $3000 against ordinary income, carrying any excess forward. *Separately*, pay tax at capital gains rates on your dividends.
C) **Short-term gain:** Add your gains to ordinary income, and pay tax at capital gains rates on your dividends.
D) **Short-term loss:** Apply up to $3000 against ordinary income, carrying any excess forward. *Separately*, pay tax at capital gains rates on your dividends.

Dividends and interest

The new tax law alters the relative taxation of dividends and interest. Under the old law, dividends and interest were both taxed at ordinary income rates, with certain types of interest enjoying tax advantages. The new law places dividends at an advantage over taxable interest. However, investors seeking income still must choose between stocks and bonds, with the accompanying portfolio risk implications. Investors seeking income through dividend-paying stocks will still bear the risk of those stocks. For many investors requiring income, the risk of equities may be enough to deter them from substituting stocks for bonds in their portfolios. That said, from May 1 to May 27, the Utilities sector of the S&P 500 index returned +10.9%, against +3.8% for the index as a whole (*Source: Standard & Poors*). Since utilities traditionally pay significant dividends, the performance of the sector may reflect an expectation that investors will migrate to that sector, or a revaluation of the income component of the sector to adjust for the change in the taxation of dividends.

Short- and long-term gains

The tax law has long distinguished between long- and short-term capital gains, generally taxing short-term gains at ordinary income rates and long-term gains at lower rates. The holding period and rates have varied, but the idea of taxing long-term holding more lightly than short-term trading has had remarkable staying power. By reducing the capital gains tax rate to 15%, the new law increases the advantage of long-term holdings. It increases the value of realizing short-term losses in time to offset short-term gains, and of deferring capital gains until they cross the holding period threshold to long-term status.

Consider an investor in the highest (now 35%) marginal tax bracket. By deferring the realization of a $1000 capital gain until it becomes a long-term gain, the investor reduces the tax from $350 (35% x $1000) to $150 (15% x $1000). This is a permanent savings of 200 real dollars. In the extreme case, this savings occurs literally overnight, because the gain flips from short- to long-term immediately after the anniversary of the start of the holding period. By contrast, if the same investor defers a $1000 , long-term gain by one year, the extra value to the investor amounts only to what the $150 in taxes can earn, after-tax, over the year. Say that gain is 10%. Then the value of the deferral is only $15, and the investor has had the $150 at risk throughout

the intervening year. So while deferring short-term gains until they become long-term will often create significant value, the advantage of merely deferring long-term gains to future periods has become smaller. The most sophisticated tax management strategies under the new law will play more heavily on the difference between short- and long-term gains.

Diversifying concentrated positions and other tax dodges

In the past several years (and particularly while the internet bubble was in full swing), Wall Street developed an array of financial structures and products aimed at allowing investors holding concentrated positions in low-basis stock to reduce their exposure without incurring immediate tax liability. These hedging and monetization transactions vary in sophistication and structure, but they generally involve creating some type of hedge, usually a short position or a combination of options on the stock, that reduces the investor's risk in the stock, and then arranging some kind of financing to allow the investor to purchase a diversified portfolio.

With long-term capital gains taxes at 15%, the value of many of these hedging and monetization strategies is questionable for all but the very largest holders. The protective aspects of the strategies typically involve short sales or options. These hedging positions are designed to increase in value if the stock falls in value. The trouble is that in many instances, if the stock falls in value the gain on the hedge will receive short-term gains treatment. In the end the investor realizes a reduced long-term gain, replaced with a short-term gain. The outcome may be that the investor successfully defers long-term gain, but at the cost of ultimately paying tax on a portion of the gain at short-term rates.

Consider again our top-bracket investor. Suppose this investor defers $100,000 in gain for three years, but during the period the stock falls, to that at the end $20,000 of the gain is taxed at short-term rates. Instead of paying $15,000 (15% x $100,000) today, our investor pays $19,000 (15% x $80,000 + 35% x $20,000) three years hence. This is equivalent to borrowing the $15,000 to pay the tax today, and paying it back in three years with 8.2% interest.

A word on preferreds – don't be confused

The reduction of the tax on dividends appears to apply both to common and preferred stock. If so, then preferreds may be more attractive as income investments than they have seemed for some time. However, it is important to understand that a large fraction of the preferred stock in the market is not traditional preferred, but a different security called, aptly, Hybrid Preferred. Hybrid Preferred looks, feels, and acts much like traditional preferred, but its "dividends" are treated as interest for tax purposes. These securities were introduced in the 1990s, and give issuers the advantage of tax-deductible interest payments, rather than non-deductible dividend payments. Under the old law, the difference was of no consequence to taxable individuals, since interest and dividends were taxed equally. The new law will continue to treat payments

from Hybrid Preferreds as interest, taxed at ordinary income rates. Only traditional preferreds, whose dividends the issuers pay from after-tax funds, enjoy the dividend tax reduction. Be certain which type you are buying. Traditional preferreds are rather scarce, though the new law may change that.

Conclusion

President Bush finally has achieved incremental dividend tax and capital gains reductions, through the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003. The major changes in the law are an immediate reduction in overall income tax rates, a reclassification of dividends so that they are taxed at capital gains rates, and a reduction in the long-term capital gains tax rate. Starting May 6, 2003, dividends and long-term capital gains will be taxed at a maximum rate of 15%.

The new tax law probably will not stimulate any major portfolio restructuring for most investors. It may affect certain strategies, however, including the allocation of high-dividend stocks to tax-deferred accounts (less desirable), deferral of long-term capital gains (still reasonable, other things being equal, but less valuable), and delay of gains to reach long-term status (more important). Certain investors who need income but are able to tolerate the risk of holding equities for long term yield may be able to doubly benefit from moving away from taxable bonds toward high-yielding stocks. And investors with concentrated positions should review carefully any strategies that result in deferral of long-term gains at the cost of creating short-term gains in the future – these are less compelling under the new law.

In all, the new tax law is beneficial to investors. It allows them to keep a greater portion of their investment earnings and provides less disincentive towards realizing long-term gains. The reduced tax rate on dividends practically removes a reason for taxable investors to shy away from high-dividend stocks, and the lower capital gains rate gives investors greater flexibility to restructure their portfolios to suit their needs, even when doing so results in realizing long-term gains. In the end, this increased freedom to restructure may turn out to be the most valuable element of all.

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Please note that the analysis in this note is based on an initial reading of the Act, and is not intended to constitute tax or investment advice. Tax laws are subject to change and interpretation, and the IRS and courts may interpret the Internal Revenue Code, as revised by the new law, differently from the analysis presented here.

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