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Securities Law Developments NEWSLETTER

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New Reduced Tax Rate on Dividends Will Affect Securities Lending

Under the recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act"), dividend income received by an individual from a domestic corporation or a qualified foreign corporation will be taxed at a maximum rate of 15 percent.[1] The new rate is retroactively effective to January 1, 2003.

Under prior law, individuals were taxed on payments in lieu of dividends (which typically arise in securities lending, short sales, or other similar transactions) at the same ordinary income rates as dividends. The new 15 percent rate, however, will be applicable only to actual dividends, and not to payments in lieu of dividends.

This difference in the taxation of dividends and payments in lieu of dividends is expected to lead to significant impacts on individual investors, brokers, and short sellers participating in the equities markets. The new law will cause individual investors to disfavor use of their taxable accounts as a source of stock lending. Under prior law, individual investors were indifferent to the use of their stocks for lending activities, and most brokerage agreements permitted brokers to lend individual customers' securities. The new law will also require that the year-end tax reports provided by brokers to their individual customers, the IRS Form 1099, be revised to report substitute payments separately, as income not eligible for the new 15 percent maximum rate. This could require significant retooling of information technology. Brokers will also have to develop new policies (and perhaps brokerage agreement forms) that take into account the fact that individual customers may not want stocks held in their taxable accounts to be loaned. Finally, short sellers may face reduced availability of stocks to borrow, assuming individuals withdraw their taxable accounts from the lending market. The market significance of this development will depend on the portion of the potentially lendable equity pool represented by individual investors, and on whether the effect extends into nontaxable equity accounts, while brokers and others deal with the uncertainties caused by the change in law. All of these effects may be exacerbated by the fact that the law is retroactive to January 1, 2003, a point recognized by Congress in the legislative history discussed in the next paragraph.

The Conference Report accompanying the Act states that the conferees expect that the IRS will exercise its authority to waive penalties where brokers and dealers attempt in good faith to comply with the information reporting requirements, but are unable to reasonably comply because of the period necessary to conform their information reporting systems to the retroactive rate reductions on qualified dividends provided by the Act. The Conference Report also states that the conferees expect that individual taxpayers who

[1] A qualified foreign corporation includes any foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States that the Treasury Department determines to be satisfactory for purposes of this provision and that includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation with respect to stock that is readily tradable on an established securities market in the United States.

receive payments in lieu of dividends during calendar year 2003 may treat such payments as dividend income to the extent these are reported as dividends on their Forms 1099-DIV, unless they know or have reason to know that the payments are in fact payments in lieu of dividends rather than actual dividends.

Recognizing the challenge that the Act presents to the securities industry, the Conference Report requests that the Treasury Department issue guidance as rapidly as possible on information reporting with respect to payments in lieu of dividends made to individuals. Accordingly, it is expected that the Treasury Department will soon request comments from the private sector with regard to information reporting on payments in lieu of dividends and that such request will generate significant private sector commentary on the proposed content of such guidance.

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