

Securities Lending Alert

A report
for clients
and friends
of the firm

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Manufactured Dividends in Securities Loans Continue To Be Treated As Ordinary Income

The new tax bill excludes payments received by a lender of stock that is equivalent to a dividend paid during the term of the loan. The bill states in relevant part that the following are not qualified dividends:

Such term shall not include any dividend on any share of stock . . . to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Furthermore, Regulation 1.1058-1(d) (relating to "transfers of securities under certain agreements") states that:

"an amount received by the lender that is equivalent to a dividend paid during the term of the loan shall not constitute a dividend to the lender for the purposes of the Internal Revenue Code, but shall be taken into account as ordinary income."

This treatment will particularly affect mutual funds who will be unable to flow through qualifying dividends to individual investors based on receipt of manufactured dividends while securities are out on loan. As a result, mutual funds engaged in securities lending may elect to recall securities prior to record date or seek to receive from the borrower a grossed-up manufactured dividend. Neither alternative, from a borrower's perspective, will enhance the desirability of using mutual funds as a source of lendable supply.

In addition, the bill provides longer holding periods to take advantage of the lower tax rate. A shareholder must hold the stock for 60 days during the 120-day period beginning 60 days before the ex-dividend date. This may impact securities lending arbitrage strategies.

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Client Alert

Proskauer's Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individual serves as a contact person and would welcome any questions you might have.

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