WILLKIE FARR & GALLAGHER

CLIENT
MEMORANDUM

QUALIFICATION FOR LOWER TAX RATE ON DIVIDENDS

It is generally known that the Jobs and Growth Tax Relief Act, signed into law by the President on May 28, reduced the maximum federal income tax rate on dividends to 15%, effective 2003 through 2008. The relief applies to dividends paid by U.S. domestic corporations, as well as dividends paid by certain non-U.S. corporations. Perhaps less well known is that investors may need to take steps to ensure qualification of dividend income for the lower rate. Initially, investors must have a minimum 60-day holding period for the shares surrounding each ex-dividend date, generally at the risk of the market.[1] Perhaps less obvious, however, is that a taxpayer's dividend will qualify for the lower tax rate only if the underlying shares have not been loaned out by the customer's broker.

As a matter of background, brokerage firms frequently loan out shares held in their customer's accounts. The borrowed shares are often used to effect short sales, and the loans are generally authorized in the customer's contract with the broker.

While the shares are on loan, the customer still receives full payment for dividends on the loaned shares. However, under the tax law, such payments – referred to as "in lieu" payments – are technically not dividends, and do not qualify for the 15% tax rate on dividend income.[2] Corporate investors, seeking to qualify for the dividends received deduction in respect of dividends earned, often have limited their brokers' authority to loan out their shares.

In light of the foregoing, investors may wish to examine the contracts with their brokers to determine whether the brokers are authorized to loan out shares held in the investor's account. If the contract authorizes such lending, elimination of such authority will be necessary to ensure that dividends on the shares qualify for the lower tax rate.

From a slightly different perspective, the restriction of brokers' authority to loan out shares may to some degree constrict the available supply of shares for use in short sales.

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1 A 120-day holding period is required in some cases. Writing a "qualified covered call" does not prevent running of the holding period.

2 The legislative history of the new act states that individual shareholders will not generally be affected during 2003 due to the fact that their shares may have been loaned out: "[I]ndividual taxpayers who receive payments in lieu of dividends …. may treat the payments as dividend income to the extent that the payments are reported to them as dividend income on their Forms 1099-DIV received for calendar year 2003, unless they know or have reason to know that the payments are in fact payments in lieu of dividends rather than actual dividends."

Please contact Richard L. Reinhold, Dwight W. Ellis, Henry M. Cohn, Andrew W. Needham or Jeffrey A. Van Hove if you have questions about the new measure.

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June 6, 2003