

What Dividends qualify for new tax rates?

In a recent article, I addressed the decreased tax rates applicable to dividends. Since then, I received numerous questions about precisely what dividends qualify. I believe that there remains a great deal of confusion about the law and how to apply it. This article will clarify the former and offer suggestions for the latter.

Qualified Dividend Income

The reduced tax rates apply to “qualified dividend income”. Qualified dividend income is derived from domestic corporations and qualified foreign corporations. A domestic corporation is one incorporated in the US. A qualified foreign corporation is one incorporated in a possession of the US, is eligible for benefits of a comprehensive income tax treaty with the US or its stock trades on a US exchange. (How are investors supposed to know whether a foreign corporation is eligible for benefits of a comprehensive income tax treaty with the US?) I suggest investors examine where the stock is traded. If in the US, it qualifies. If not, it most likely does not qualify.

This step defines what entities can pay qualified dividend income, but it does not determine whether the dividends received qualify. A dividend received from a regulated investment company (RICs, most mutual funds) or a real estate investment trust (REIT), will be considered “qualified dividend income” to the investor if the entity complies with the requirements of sections 854 and 857, as modified. These sections examine whether the entity’s income is from dividends that are eligible for qualified dividend income treatment, thus we are back to the beginning. Fortunately for investors, 1099-DIVs will have a box indicating whether the dividends qualify. Unfortunately, the tax treatment to an investor does not end there, there are more steps.

Holding Period Requirements

IRC section 1(b)(11)(B)(iii)(1) provides that qualified dividend income shall not include any dividend on stock if certain holding periods of IRC sec. 246, as modified, are not met. Generally, sec. 246, as modified, requires the underlying stock to be held for more than 60 days during the 120 day period beginning 60 days prior to the ex-dividend date.

Thus, even if a 1099-DIV indicates that the dividends qualify, each investor will have to review the purchase dates of the underlying stock. For example, suppose that we have two investors both owning IBM. One purchased the stock years ago and one purchased the stock in 2003. On each 1099-DIV, the box will be checked. The former investor will have only qualified dividend income, but the latter will not, because the latter failed the holding period requirement. The complexity is compounded when one considers that most corporations pay dividends quarterly. Thus for stock purchased during the year, one of the dividends may be tainted, but the other dividends will qualify.

Many individual investors do not know what an ex-dividend date is, let alone how to determine the ex-dividend dates for all dividends received on stock held throughout the year. The rules require surgical precision. Many investors will face the decision of what

to do, because it does not make sense to spend all of the time necessary to properly apply the rules. I believe that many investors will treat all dividends as either qualified or not qualified and play the “audit lottery”. Obviously, each position is incorrect and I do not recommend either.

Miscellaneous and Advice

The new rules apply to all dividends received after December 31, 2002 and also apply for Alternative Minimum Taxation; thus, investors get to apply the rules twice, what a pleasure. The rules do not apply to dividends received from charitable corporations, mutual insurance companies, mutual savings banks or extraordinary dividends. Additionally, the reduced tax rates do not apply to dividend income that a taxpayer elects to treat as investment income. Finally, there are numerous anti-abuse provisions and other aspects of the new rules that I have not addressed. A final issue to be thankful for is that the rules only apply through 2008, so after spending six years mastering them, you can forget them.

Mutual fund companies and other companies that have received income on behalf of investors have strict obligations to provide investors with the information necessary to correctly prepare their income taxes. I suggest that investors start by examining their 1099-DIVs or other tax material carefully for qualified dividend income. Then investors should apply the myriad of additional rules to determine the correct tax treatment and what election options are available. As always, I advise you to seek competent assistance in applying these cumbersome and confusing rules.

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