

ARE YOUR DIVIDENDS REALLY ELIGIBLE FOR LOWER TAX RATES?

Do you know where your stock dividend is?

One of the most publicized changes of the 2003 tax act was the reduction of tax rates on stock dividends to the point the rates equal the reduced rates on capital gains. There's just one catch: not all dividends qualify for these reduced rates—and even qualified dividends may not qualify if you overlook the fine print.

Before passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003, all dividends, including stock dividends, were subject to the taxpayer's ordinary income-tax rate. The new act reduced the tax rate to 15 percent for higher-income taxpayers and 5 percent for lower-income taxpayers for dividends received beginning January 1, 2003 (versus May 6 for capital gains). And for just the year 2008, the rate for lower-income taxpayers drops to zero—before all of these lower rates expire in 2009 and revert to taxpayers' ordinary income-tax rates.

First, the fine print. For taxpayers to even take advantage of the lower dividend rates, they must hold the dividend-paying common stock for at least 60 days before the stock's "ex-dividend" date. The ex-dividend date is that date by which a stockowner must be holding shares in order to receive the upcoming dividend. There is some question whether this rule will apply to mutual fund shareholders, but most experts believe it will. By the way, you, and not the stock company, are responsible for making sure you qualify under this provision.

Now to the more complex question: which dividends qualify for the lower rates. This is not as clear-cut as it may appear to taxpayers.

Stocks. Dividends paid from common stock generally qualify if the company is a domestic corporation or a qualified foreign corporation, with the exception of tax-exempt corporations. To qualify as a foreign corporation, the company must be traded on established U.S. securities markets, be incorporated in the United States, or incorporated in a country with a tax treaty with the United States.

Even dividends from companies that don't have current earnings or profits, or that don't pay corporate-level taxes on earnings because of sufficient tax write-offs, may still be treated as qualified dividends. Interest payments to lenders labeled as "dividends," however, won't qualify.

Preferred stocks. This falls into the "maybe" category. Some "dividends" from preferred stock are actually interest payments and don't qualify. You'll have to contact the company or your broker to find out their correct classification.

S-corporation dividends. Generally, S-corporation dividends do not qualify because earnings and profits are passed through to the shareholders every year, where they are taxed at the shareholders' tax rate. The exception is if the S-corporation converted from a C-corporation and is paying out accumulated earnings and profits from the old C-corporation.

Stock and stock/bond mutual funds. Dividends paid to the mutual fund by the stock companies it is invested in are passed to the fund's shareholders as qualified dividends. Bond and other

interest earned by the mutual fund do not qualify. Future shareholder statements should reflect which distributions qualify as dividends.

Bond and money market funds. While payments from these funds are often reported as “dividends,” it’s usually interest and will be taxed as ordinary income.

Real estate investment trusts. Most of the high “dividends” many REITs pay out will not qualify. Most dividends from real estate mutual funds that invest in REITs also won’t qualify. But qualified stock dividends received from corporations that REITs are invested in qualify, as well as any earnings retained by the REIT that are taxed at the REIT level as corporate income and later passed on to shareholders.

Others. Dividends paid by credit unions, savings and loans, cooperatives, and mutual insurance companies won’t qualify.

Retirement accounts. Like capital gains, dividends earned inside a tax-deferred retirement account do not qualify for the lower tax rate. All tax-deferred withdrawals will be taxed at the owner’s ordinary income-tax rates at the time of withdrawal, regardless of the source of the income.

So when making investment decisions, be sure you are clear whether a particular “dividend” qualifies for preferable tax treatment. Also, many investment experts caution against buying a stock or stock mutual fund solely because it pays a tax-preferred dividend. The stock or fund’s underlying fundamentals should be sound and appropriate for your investment needs.

This column is produced by the Financial Planning Association, dedicated to promote and support the financial planning process to help people achieve their goals and dreams. It is provided by The Financial Planning Association of Hampton Roads, 2001, 2002, and 2003 recipient of the Gold Level Achievement Award.

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