On July 21, 2004, Microsoft announced a $3 per share special dividend totaling $32 billion that is scheduled to be paid on December 2, 2004 to holders of record at the close of business on November 17, 2004. Microsoft has indicated that it expects that the special dividend will be taxable as a “qualified dividend” eligible for a maximum 15% tax rate for federal income tax purposes. Was Microsoft’s decision to pay this dividend motivated by qualified dividend tax treatment and the related tax benefit? Will Microsoft’s announcement spur other companies to pay more or larger dividends than they otherwise would have? What tax pitfalls or planning opportunities are presented by Microsoft’s dividend or other qualifying dividends paid by other companies? This article generally illustrates the potential tax benefits relating to the Microsoft dividend and discusses the qualified dividend income rules. And, it summarizes two important risks or planning opportunities that exist in light of the dividend.

Why Is Microsoft Paying Such A Large Dividend Now?
Some commentators have suggested that Microsoft’s decision to pay such a large dividend before the end of 2004 may have been motivated by the special tax rate afforded qualified dividends under current law. The Jobs and Growth Tax Relief Reconciliation Act of 2003 resulted in a maximum tax rate on qualified dividends of 15% for individuals, as opposed to the normally applicable maximum marginal tax rate of 35%. Note that this special benefit is scheduled to expire at the end of calendar year 2008. Thus, in a simple comparison based on potential marginal maximum rates, the tax on the $32 billion dividend could approximate $4.8 billion (15% of $32 billion) given this new special maximum rate for qualified dividends and the otherwise applicable tax could have been as high as approximately $11.2 billion -- a difference of $6.4 billion! There is speculation that potential election-triggered changes in law may have motivated Microsoft to act now and pay the dividend in the current year to beat any adverse change in law. In light of the significant potential tax savings for shareholders given the lower tax rate for qualified dividends, commentators have speculated whether other corporations will follow Microsoft’s lead and increase their dividend payments. So far, it is unclear if this will happen.

Tax Planning Opportunities & Pitfalls
In connection with Microsoft’s dividend, the tax and financial press has focused on related tax planning opportunities and pitfalls. For example, non-U.S. holders of Microsoft stock are subject to U.S. withholding tax on payments of dividends at rates of up to 30% (although applicable tax treaties often reduce the withholding tax rate). Although U.S. source dividends paid to non-U.S. holders are subject to U.S. withholding tax, U.S. source capital gains are typically not. U.S. source distributions to non-U.S. holders are not generally subject to U.S. income tax or withholding tax on the sale of capital assets unless
they are effectively connected with a U.S. trade or business or the holder is an individual present in the U.S. for 183 days or more during the tax year of sale. Thus, many non-U.S. holders who sell their Microsoft shares at a price that reflects the looming dividend payment will effectively receive the dividend (through the higher sale price for the shares) free of U.S. tax, whereas non-U.S. holders who continue to hold Microsoft stock and receive the actual dividend will be paid smaller amounts since the dividend will be reduced by withholding tax. If the non-U.S. person wants to maintain a position in Microsoft, he or she could first sell the shares before the dividend is paid to avoid the withholding tax, and then simply purchase more Microsoft shares after the dividend is paid. Of course, if the value of Microsoft shares rapidly rises, he or she would have to pay the higher market price for the new shares.

Some tax advisors have noted that the pending dividend could create a “character conversion” opportunity for some taxpayers looking for short-term capital losses. For example, a person in search of such losses could acquire Microsoft shares at a price that includes the forthcoming dividend. When the dividend is paid and received, it will be taxed as ordinary income at the maximum 15% tax rate for qualified dividends provided the holding period requirement (discussed below) is satisfied. Once the shares are ex-dividend, the sales price for the shares will drop by approximately the amount of the dividend. So, if the shareholder sells the shares at such a lower price, he or she will recognize a short-term capital loss approximately equal to the amount of the dividend (since their purchase price for the shares effectively included the amount of the dividend and their ex-dividend sales price will not). Assuming that there is no change in the value of the Microsoft shares between the date the stock is purchased and sold, the holder has taken an economically neutral transaction and obtained ordinary income taxed at a 15% maximum tax rate (the dividend) while creating an offsetting short-term capital loss in the same amount from the subsequent sale of the shares. The short-term capital loss could be used to offset short-term capital gains that would otherwise be taxed at higher tax rates.

Of course, in order to achieve this result, three sets of tax rules must be considered. First, the purchaser must hold the shares of Microsoft long enough to satisfy the holding period test of the qualified dividend income rules -- this requirement is discussed in the next section. Second, the purchaser must avoid triggering a day count prohibition (discussed below) that could result from risk-offsetting transactions (in addition, the purchaser must avoid triggering loss deferral under the wash sale rules or the straddle rules). Third, the Microsoft dividend must not be classified as an “extraordinary dividend.” Such classification would be fatal since the qualified dividend income rules provide that losses on the sale of such shares would be long-term capital loss rather than short-term, thereby depriving the holder of the desired short-term capital loss on disposition.

Remember, an important pitfall that could deprive any holder of the benefits of qualified dividend income treatment for the Microsoft dividend would be the failure to satisfy the previously mentioned holding period test. Finally, holders should not forget to take the special dividend into account in determining the amount of his or her estimated tax payments, in order to avoid penalties and interest.

The Qualified Dividend Income Rules

In order for dividends to be eligible for the maximum 15% tax rate benefit under the qualified dividend income rules, a number of tests must be satisfied.
There are six basic tests:

1. Dividends must be paid by a qualifying corporation -- this test differs depending upon whether the corporation is a U.S. or foreign corporation.

2. Shares must be held for a minimum of 61 days (91 days in the case of preferred stock in certain cases) during a 121 day period (181 days for certain preferred) beginning 60 days (90 days for certain preferred) before the date the stock is ex-dividend. The law as enacted provides for 120 day and 180 day testing periods. However, IRS Pub. 550 and related IRS announcements use 121 and 181 day periods in anticipation of pending technical corrections legislation.

3. A short sale/related obligation test must be passed.

4. Dividends are not eligible if the taxpayer has included them as investment income for purposes of assessing the Code limitation on investment interest expense.

5. In the case of dividends paid by mutual funds and REITs, only a portion of such dividends may be eligible for treatment as qualifying dividends (such dividends must be designated by the payor).

6. Special rules apply to taxpayer interests in pass-through entities such as partnerships.

These rules are not discussed in detail here. Microsoft is clearly a qualifying corporation and its stock is clearly stock (and therefore distributions thereon to the extent of current and accumulated earnings and profits constitute dividends) for U.S. tax purposes.

The Holding Period Test

The holding period test requires that you must hold stock for at least 61 days during the 121 day period beginning 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock will not receive the next dividend payment. The relevant minimum holding period is 91 days during the 181 day period beginning 90 days before the ex-dividend date in the case of preferred stock if the dividends are attributable to a period or periods in excess of 366 days.

Making sure that the holding period test is satisfied is of critical importance for holders of Microsoft shares that intend to treat the special dividend as a qualified dividend. Recall that one of the potential opportunities relating to Microsoft shares discussed above involves purchasing shares to receive qualified dividends and then selling the shares to obtain an offsetting short-term capital loss. A key aspect of this proposal was that the qualified dividend should economically offset the loss on the subsequent sale of the shares. However, because of the holding period test, there is a risk that during the required period the stock must be held prior to sale, an actual economic loss could be incurred on the Microsoft shares, which would be realized when the shares are then sold. The risk of an economic loss on holding Microsoft stock may be troublesome to a person considering whether to implement this short-term capital loss generating tax strategy. Similarly, any investor holding Microsoft must consider potential market related stock value risks in deciding whether to continue to hold Microsoft shares for the 61 days needed to satisfy the holding period test.

Risk-Offsetting Transactions and the Day Count Prohibition

In trying to meet the holding period test, investors and potential purchasers of Microsoft shares may consider whether they can use risk-offsetting techniques to manage or eliminate the potential risk of economic loss on the shares. Note that there are a variety of risk management techniques that could be employed. Some of these are straightforward, involving options on Microsoft shares while others are indirect and potentially less precise, including the use of options on other stocks or baskets not including Microsoft but which could be used to offset potential adverse changes in the value of Microsoft shares. Unfortunately, the law includes a day count prohibition that is designed to restrict the use of such strategies. The IRS states that you cannot count any day during which a person meets any of the following conditions: (1) they had an option to sell, were under a contractual obligation to sell, or had made (and not closed) a short sale of substantially identical stock or securities; (2) they were a grantor (writer) of an option to buy substantially identical stock or securities; or (3) their risk of loss was diminished by...
holding one or more other positions in substantially similar or related property (see Treas. Reg. Section 1.246-5).

Thus, many direct risk management strategies may not work since for any day risk management strategies that fall under the IRS prohibition just referenced are used, such days are not counted for purposes of determining whether the Microsoft stock has been held for the requisite 61 day holding period necessary for qualified dividends. However, investors, financial advisers and tax planners may devise and implement risk management strategies that could fall outside of the “substantially identical stock or securities” and “substantially similar or related property” scope of the day count prohibition. Thus, proper planning, if successful, could permit investors and potential purchasers of Microsoft stock to satisfy the holding period test while managing to some extent the potential risk of loss that could arise if the value of Microsoft stock changes adversely.

**Short Sale/Securities Lending/Related Obligation “Payment in Lieu” Test**

Brokers and dealers engage in securities lending transactions. They may “borrow” stock from an investor and use it to meet their other obligations to deliver shares. The stock “returned” to the investor after the lending transactions is rarely the same shares as originally “lent.” In connection with securities loans, “payments in lieu” of dividends are made to the lender to compensate them for the income on the shares loaned. Typically, payments in lieu are not treated as qualifying dividends. Investors also sell their stock “short.” Dividends received in connection with a short sale where the taxpayer is obligated to make related payments in substantially similar or related property are also not qualifying dividends. The IRS has indicated that they intend to revise the Form 1099 reporting rules to require brokers to determine whether shares have been lent (and thus segregate payments in lieu of dividends with respect to such lent shares) so that individual shareholders will not incorrectly report such amounts as qualifying dividends. Here, an investor or holder simply needs to make certain that Microsoft shares they own for which they intend to receive qualified dividend treatment are not lent out in securities lending or similar transactions.

**Exclusion of Dividends Included in Computing Allowed Investment Interest Expense**

Individuals are subject to a limitation on the deductibility of interest expense associated with investments based on their “net investment income.” Taxpayers can elect to include dividends in the computation of net investment income. However, the amount so included does not qualify as qualifying dividends. Accordingly, a holder of Microsoft shares that desires qualified dividend treatment must make certain that they do not elect net investment income inclusion for such dividends.

**Pass-Through Entities**

Pending technical corrections legislation would provide rules for investors holding shares indirectly through pass-through entities such as partnerships and trusts. Precise application of the qualifying dividend rules to stock held through pass-through entities (other than mutual funds and REITs) is unclear. For example, the holding period rules discussed above are apparently applied at the partnership level. The lack of clear current guidance for qualified dividend eligibility with respect to stock holdings via pass-through entities should make investors and potential purchasers carefully consider the consequences of ownership of Microsoft shares via pass-through entities in assessing qualified dividend eligibility.

**Extraordinary Dividends**

Under existing law, Code Sec. 1059 imposes special basis adjustment rules on investments in stock held by corporations if “extraordinary dividends” are received with respect to such stock. Extraordinary dividends for this purpose are generally defined as dividends in excess of ten percent of the holder’s adjusted basis in common stock (five percent on preferred stock), subject to special aggregation rules included in Code Sec. 1059(c). By mandating an adjustment to stock basis, this provision is intended to partially compensate for the “dividends received deduction” benefit that corporations holding stock typically obtain for dividends received. Here, the qualifying dividend rules create a different rule linked to the definition of extraordinary dividends under Code Sec. 1059 that is applicable to individual taxpayers that receive qualifying dividends.

Under this new rule, if dividends received constitute extraordinary dividends under the applicable tests, any loss on the sale or exchange of the related shares shall, to the extent of such dividends, be treated as long-term capital loss (rather than short-term). This rule is of particular concern with regard to the Microsoft special dividend. If the extraordinary dividend rule applies, all or a portion of any short-term capital loss on the disposition of Microsoft shares will instead be treated as long-term capital loss.

Thus, if someone is considering purchasing Microsoft shares to obtain a short-term capital loss—one of the potential tax opportunities discussed above—the application of the extraordinary dividend rule denies the desired result. Determining whether this special adverse rule is triggered requires a determination of whether the Microsoft dividends are extraordinary dividends. In turn, this depends on a comparison of the amount of the Microsoft dividends to the holder’s basis in his or her Microsoft shares.
Dividends are extraordinary if they exceed ten percent of the holder’s adjusted basis in the related shares. Generally, all dividends paid during an 85 day period (based on ex-dividend dates) must be aggregated in making this determination. However, if dividends paid during a one year period exceed twenty percent of a holder’s adjusted basis, then all of the dividends paid during such one year period must be aggregated and the applicable percentage for determining whether all such dividends are extraordinary is twenty percent rather than ten percent. Alternatively, a holder may elect under the IRS rules to use the share’s fair market value as of the day before the applicable ex-dividend date in lieu of his or her adjusted basis for determining whether the ten (or twenty) percent threshold is exceeded. So, the actual purchase price a holder pays for their Microsoft shares (which establishes their initial cost basis) or the fair market value of the shares on the day before the ex-dividend date, if elected, is a key factor in determining whether the extraordinary dividend rule applies. And this rule in turn determines whether all or a portion of any short-term capital loss recognized on the sale of Microsoft shares will be reclassified as long-term capital losses.

Because Microsoft has already indicated the amount of the dividends it intends to pay, we can add those dividends with ex-dividend dates during the relevant 85 day period (a $0.08 per share quarterly dividend with an ex-dividend date of August 23, 2004 and the special dividend of $3.00 per share with an ex-dividend date of November 15, 2004). The dividends total $3.08 per share. Dividing that total by ten percent, we can determine the minimum price an investor must pay for Microsoft shares (or have as adjusted basis) in order to avoid adverse classification of the special dividend (and the other dividends during the 85 day period) as extraordinary dividends. That price is approximately $30.81, assuming that no other changes in actual dividends occur during the relevant 85 day period.

Conclusion

The Microsoft special dividend has federal income tax significance for individual shareholders because of the potential eligibility of such dividend for qualified dividend treatment and the resultant low 15% tax rate. The Microsoft dividend presents tax planning opportunities and pitfalls for foreign holders of Microsoft shares as well as taxpayers seeking short-term capital losses. However, careful planning is necessary to obtain the desired benefits.

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