



Capital Changes

In-Depth™



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THE QUALIFIED DIVIDEND INCOME (QDI) RULES:

As a result of tax law changes enacted in 2003, dividends received by individual taxpayers are taxed (under both the regular income tax and the alternative minimum tax) at the low maximum tax rates applicable to long-term capital gains if the dividends constitute qualified dividend income (QDI). This special benefit has a limited term beginning after December 31, 2002. It is scheduled to expire after calendar 2008. Not all dividends qualify—a series of determinations must be made in order to assess whether dividends qualify. This article is a summary of these new rules.

Summary of the QDI Tests

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.
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.

Qualifying Corporations

“Dividends” must be paid on “stock” issued by “qualifying corporations.” “Qualifying corporation” is defined differently depending upon whether the corporation is a U.S. or foreign corporation.

U.S. Corporations

Dividends paid by any U.S. corporation are eligible except (1) tax-exempt entities; (2) farmer's cooperatives; (3) mutual savings banks, cooperative banks, credit unions, U.S. building & loan associations, federal savings & loan associations and similar financial institutions (in connection with dividends paid on deposits); and (4) dividends in connection with stock held by employee stock ownership plans (ESOPs).

Foreign Corporations

In general, a "qualified foreign corporation" includes (1) a corporation incorporated in a U.S. possession (such as Puerto Rico); (2) a corporation that is eligible for the benefits of a comprehensive income tax treaty with the U.S. that the Treasury Department believes is satisfactory for this purpose and that includes an exchange of information program (described in more detail in next paragraph); and (3) a corporation whose stock or American Depository Share is readily traded on an established securities market in the U.S. --(1) NYSE; (2) NASDAQ; (3) American Stock Exchange; (4) Boston Stock Exchange; (5) Cincinnati Stock Exchange; (6) Chicago Stock Exchange; (7) Philadelphia Stock Exchange; and (8) Pacific Stock Exchange. The IRS has advised that established securities markets do not currently include the OTC Bulletin Board or electronic "pink sheets." In addition, the IRS is considering whether additional requirements should be imposed, such as minimum trading or other requirements.

Treaty based eligibility is actually a two-part test: (1) the applicable treaty must be compared to an IRS list of eligible treaties (set forth in the next sentence) and (2) the corporation must be eligible for the treaty. Eligible treaties include: (1) Australia; (2) Austria; (3) Belgium; (4) Canada; (5) China; (6) Cyprus; (7) Czech Republic; (8) Denmark; (9) Egypt; (11) Estonia; (12) Finland; (13) France; (14) Germany; (15) Greece; (16) Hungary; (17) Iceland; (18) India; (19) Indonesia; (20) Ireland; (21) Israel; (22) Italy; (23) Jamaica; (24) Japan; (25) Kazakhstan; (26) Korea; (27) Latvia; (28) Lithuania; (29) Luxembourg; (30) Mexico; (31) Morocco; (32) Netherlands; (33) New Zealand; (34) Norway; (35) Pakistan; (36) Philippines; (37) Poland; (38) Portugal; (39) Romania; (40) Russian Federation; (41) Slovak Republic; (42) Slovenia; (43) South Africa; (44) Spain; (45) Sweden; (46) Switzerland; (47) Thailand; (48) Trinidad and Tobago; (49) Tunisia; (50) Turkey; (51) Ukraine; (52) United Kingdom; and (53) Venezuela.

Mere incorporation in a foreign county on the treaty list does not adequately establish that the foreign corporation is "treaty eligible" for QDI purposes because treaties include a so-called "limitation on benefits" or "anti-treaty shopping provision" that impose additional requirements that must be met in order for treaty eligibility. In certain cases, these

tests can be satisfied under a so-called "public trading test" if the corporation's common or ordinary stock is listed on an exchange covered by the public trading test in the limitation on benefits provision of the applicable treaty (such as a stock exchange in the foreign country). The IRS believes that foreign corporations have the information necessary to assess and certify whether they are eligible for treaty benefits. However, for calendar 2003 dividend reporting, the IRS used a simplified procedure-if the applicable treaty includes a limitation on benefits provision, a person could treat the foreign corporation as treaty eligible if the company's common or ordinary stock is listed on an exchange covered by the public trading test. The only exception is that a person cannot treat a foreign corporation as eligible if they know or have reason to know that the corporation is not eligible for treaty benefits-this standard is met if the corporation has so stated in its most recent SEC annual filing (if any), such as Form 20-F.

Ineligibility of Foreign Investment Companies

However, the definition of qualified foreign corporation has an important exclusion for "foreign investment companies" (the foreign investment company exclusion test). A foreign

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corporation that is characterized as (1) a "foreign personal holding company" (FPHC); (2) a "foreign investment company" (FIC); or (3) a "passive foreign investment company" (PFIC) is ineligible and cannot qualify as a qualified foreign corporation. Accordingly, dividends paid by such an ineligible foreign corporation do not constitute QDI. In October, 2004, the IRS released a Notice clarifying the extent to which income from a controlled foreign corporation (CFC) qualifies as QDI and the limited circumstances under which income from a foreign corporation that was a PFIC in a prior year may be QDI in the case of certain shareholders or due to the application of a CFC overlap rule.

Determining PFIC Status

Determining whether a foreign corporation is a PFIC is difficult. Currently, many foreign corporations do not provide any guidance regarding whether they believe they are a PFIC. Those corporations that do, generally condition or qualify their statements. So, their advice is typically unclear. Yet, they are in the best position to make this determination because it is based on analyzing the assets and income of the foreign corporation. Occasionally, corporations disclose that they believe that they may be classified as a PFIC.

An entity is considered a PFIC if it satisfies either an income test or an asset test. The income test is satisfied if 75 percent or more of the gross income of the corporation for its tax year is "passive income." The asset test is satisfied if the average percentage of the corporation's assets held during the tax year that produce passive income or that are held for the production of passive income is at least 50 percent. "Passive income" is broadly defined for these purposes and includes: dividends; interest; royalties; rents; income equivalent to interest; income from notional principal contracts; and payments in lieu of dividends and certain gains in excess of losses. Under the PFIC asset test, if the PFIC is publicly traded, the fair market value of the stock may be used for purposes of measuring the PFIC's assets.

The PFIC rules also include a "look-through" rule under which the assets of other foreign corporations in which a foreign corporation has an investment that equals or exceeds 25 percent (in value) in such other corporations must be analyzed to see if the foreign corporation meets either the income test or the asset test. The look-through rule is particularly troubling for two basic reasons—first, by looking at the assets of the entities in which the

foreign corporation has investments, it makes it more likely that the foreign corporation will be classified as a PFIC. Second, it is difficult for an investor to consider prospectively, since it may be difficult to obtain the information regarding the assets and income of the foreign corporation and the assets and income of each of the corporations in which it holds an investment interest, which is necessary to apply the income test and asset test for purposes of determining whether the foreign corporation is a PFIC. The IRS indicates that it plans on implementing a certification requirement under which a foreign corporation may certify that it satisfies the foreign investment company exclusion test.

Is the Security "Stock" for Tax Purposes?

QDI eligibility necessarily requires that the distributions constitute "dividends" paid on "stock" for U.S. tax purposes. The determination of whether a security constitutes stock or debt for U.S. tax purposes is murky in certain cases. However, typically there is little doubt that common stock or straightforward preferred shares issued by a U.S. corporation constitutes stock for U.S. tax purposes (the difficulties typically arise in the case of derivative or complex instruments). In the case of foreign corporations, the determination regarding whether their shares constitute stock for U.S. tax purposes is more problematic. Local law in the country of incorporation may provide shareholders with rights that could make the classification of shares as stock uncertain in some cases. Accordingly, the IRS requires that for 2003, payors of dividends must make this assessment and cannot treat distributions as dividends eligible as QDI if the underlying shares are not common or ordinary shares and the company has not filed a public statement with the SEC stating that the security will more likely than not be properly classified as equity rather than debt for U.S. tax purposes. For 2004 and beyond, the IRS contemplates imposing a certification requirement under which foreign corporations must certify that a security constitutes equity in order for shareholders to treat dividends as QDI. This proposal has been controversial because of the uncertainties regarding the proper classification of some foreign shares. It is unclear what requirements will ultimately be imposed by the IRS.

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Is the Distribution a “Dividend” for Tax Purposes?

Only dividends are eligible for characterization as QDI. However, distributions with respect to a corporation's stock do not necessarily constitute dividends for U.S. tax purposes. Distributions with respect to stock only constitute dividends to the extent of the corporation's current and accumulated “earnings and profits.” Distributions in excess are a return of capital (to the extent of the taxpayer's basis in their shares) and then any remainder is treated as capital gain. In the case of foreign corporations, the difficult threshold issue is whether distributions on stock qualify as dividends because they are paid out of current and accumulated earnings and profits. Earnings & profits must generally be separately accounted for under special U.S. tax rules. These rules apply to distributions from foreign corporations. However, their incentive to maintain books and records and calculate earnings and profits-U.S. tax concepts that may otherwise not conform to applicable foreign country financial or tax accounting requirements, is limited. The IRS requires that payors treat the entire amount of payments with respect to stock as dividends for Form 1099-Div purposes if they are unable to determine the portion of such payment that constitutes a dividend by applying the earnings and profits rules.

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. Mutual fund shares that pay qualified dividends are also subject to these holding period rules. 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 shares, which would be realized when the shares are then sold. Any investor holding stock must consider potential market related stock value risks in deciding whether to continue to hold their 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 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 shares while others are indirect and potentially less precise, including the use of options on other stocks or baskets not including the stock held but which could be used to offset potential adverse changes in the stock's value. 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 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 stock to satisfy the holding period test while managing to some extent the potential risk of loss that could arise if the value of their 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 shares they own for which they intend to receive qualified dividends 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 shares that desires qualified dividend treatment must make certain that they do not elect net investment income inclusion for such dividends.

Special Rules for Dividends from Mutual Funds and Real Estate Investment Trusts

Mutual funds and real estate investment trusts (REITs) are taxed as corporations under special rules but their dividends are subject to special limitations. Both can pay dividends that are designated as "capital gain dividends." These are not eligible for QDI treatment. Mutual fund dividends can relate to investment by the fund in stock or debt instruments. Only "qualified dividends" (relating to mutual fund holdings in stock) designated by the fund can qualify as QDI. In the case of REITs, only dividends with respect to which the REIT paid corporate income tax are eligible as QDI.

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 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).

Determining whether this special adverse rule is triggered requires a determination of whether dividends paid on any shares are extraordinary dividends. In turn, this depends on a comparison of the amount of the dividends to the holder's adjusted basis in his or her 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 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. Fair market value is based on the closing price of the stock the day before the ex-dividend date. For purposes of determining fair market value when counting multiple dividend payments during an 85 day period, the fair market value immediately before the first ex-dividend date in the period is used. For purposes of the one year/twenty percent test, a weighted average of the fair market values of the stock on the days before each ex-dividend date is used.

The critical relationship is the amount of the dividends paid during the relevant period (85 days or one year) measured as a percentage of the holder's adjusted basis in (or, if elected, the fair market value of) the related shares of stock. So, the actual purchase price a holder pays for his or her shares (which establishes his or her initial cost basis and which in turn will determine his or her adjusted 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 such shares will be reclassified as long-term capital losses.

Conclusion

Dividends have federal income tax significance for individual shareholders because of their potential eligibility for qualified dividend treatment and the resultant low 15% tax rate. They present tax planning opportunities and pitfalls for foreign

holders of stock as well as taxpayers seeking short-term capital losses. However, careful planning is necessary to obtain the desired benefits. Investors must satisfy the 61-day holding period requirement and avoid risk-offsetting transactions that trigger the day count prohibition. And, potential purchasers considering the purchase of stock in order to obtain short-term capital losses must carefully consider the price (and adjusted basis) of the desired shares in order to avoid triggering the extraordinary dividend rule.

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