



Qualified Dividend Income

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White Paper

Abstract: A dividend is a cash distribution from a corporation or a mutual fund to the shareholder of that corporation or mutual fund. Normal dividends are taxed at ordinary income rates. However, since 2003, certain dividends have been denoted as 'Qualified' and are eligible for reduced taxation. This paper focuses on a specific subsection of the Internal Revenue Code, summarized in a Publication 550 (2010) clause, which eliminates qualification when risk of loss is mitigated. To accurately assess a taxpayer's dividend income, a thorough understanding of the interaction between dividends and constructive sales and straddles is needed. Complete with examples, this paper discusses those interactions.

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INTRODUCTION

On May 28, 2003, President George W. Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). This law reduces the tax rate for dividends produced by securities that have been held as long-term investments. Traditionally, dividends were taxed as ordinary income for investors and therefore this income was taxed at the highest possible rate. As a result, many investors would encourage companies to NOT pay dividends but rather use the cash for mergers and acquisitions or other activity that is exempt from taxation but which would still add value for the shareholder. In order to 'unlock' this cash for distribution to shareholders, this provision of the JGTRRA was included to encourage companies to behave more 'normally.'

To help clarify when a dividend 'qualifies' for the lower tax rate, IRS Publication 550 (2010) Investment Income and Expenses, outlines how a qualified dividend is determined:

To qualify for the 0% or 15% maximum rate, all of the following requirements must be met:

1. The dividends must have been paid by a U.S. corporation or a qualified foreign corporation.
2. The dividends are not of the type listed under Dividends that are not qualified dividends.
3. You meet the holding period.

Once a dividend is determined to be qualified, it has the following effect:

"QUALIFIED DIVIDENDS ARE SUBJECT TO THE 15% RATE IF THE REGULAR TAX RATE THAT WOULD APPLY IS 25% OR HIGHER. IF THE REGULAR TAX RATE THAT WOULD APPLY IS LOWER THAN 25%, QUALIFIED DIVIDENDS ARE SUBJECT TO THE 0% RATE."

THE ISSUES

Determining whether a dividend qualifies for the lower tax rate depends on which conditions are met. These conditions directly affect the difficulty behind these calculations.

The Good: Straightforward Cases/Calculations

If certain conditions are satisfied, qualified dividends can be straightforward to compute.

If

- Condition 1 must be determined.
- If your data does not indicate whether or not the corporation is a U.S. Corporation or qualified foreign corporation, then you will need to perform the appropriate research or hire a consultant to make the determination or purchase data from a reliable vendor.
- If you never simultaneously hold offsetting substantially similar or related property.
- The security is not preferred stock.

Then

- Condition 2 must be determined.
- Using data based on dividend details, you filter out all inappropriate dividends. Prior to JGTRRA, some cash payments were always considered Return-of-Capital or Capital Gains Distributions. In order to correctly determine which dividends are qualified, even more detail must be provided so that other kinds of dividends can also be excluded from consideration for qualification. Examples of this are tax-exempt organizations or farmer's co-ops. Since this is a black-or-white scenario, and it is necessary that tax-exempt dividends are treated differently from taxable dividends, this condition should be easy to identify. Simply put, most of this condition can be read as "you can ignore from consideration any dividend for which the income which led to it was not taxed at ordinary rates."

- You exclude all dividends on short positions.
- You exclude dividends for stocks that are not held for a long enough period of time. The holding period rule states that a dividend qualifies for the 0% or 15% minimum tax if the shareholder has held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-date of the dividend. This period of time is determined using the readily available information, such as the original open date of the stock (tax lot date) and the dividend's ex-date.

If the above conditions are met, your remaining dividends are qualified!

The Bad: More Complex Cases/Calculations

Once you have a basic mechanism in place for handling the “Good” cases, you can address the more complex cases and include processing for preferred securities. Assuming that preferred securities can be identified, the calculation process is similar to that of common stock but includes a few rule changes. For these securities, a special case is made when the dividend covers a period greater than 366 days. In this case, the holding-period window changes. The period is increased to more than 90 days, and a 181-day window is used to bracket the calendar. This also presents a new data capture problem in that the ‘applicable dividend period’ needs to be provided for dividends from preferred securities.

The Ugly: Highly Complex Cases/Calculations

Understanding whether the holding period has been met determines whether or not a qualified dividend exists. The most serious issue in determining the holding period is when the “holding period [is] reduced where risk of loss is diminished.” To make this determination, we need to consider two cases. (1) “Things that reset the holding period” and (2) “Things that suspend the holding period.”

The Box and Constructive Sales

Here we must consider the “Box.” This is where a short position is taken on the same security as the long position that produces the dividend. When both a long and a short position are held on the same security, risk of loss has been mitigated ergo affecting the qualification of a dividend that occurs to the long position in two possible mechanisms.

In the case where there is no constructive sale, days on which the box exists will not be counted towards the greater-than-60 day holding period. Effectively, the counting period is suspended during times when a (non-constructive-sale) box is in place, and resumed when the box is no longer in place. This gets complex when multiple short lots are held at different times during the counting process. It also gets even more complicated when the long and short positions are not of identical size.

If there is a constructive sale because of the box, the counter is reset to the date of the constructive sale. However, the holding period is in suspension until the short is covered because of the existence of a box. Therefore, to be considered a qualified dividend, the long position must be held for more than 60 days starting on the date the short is covered. Again, this gets very complicated when the long and short positions are not of identical size.

One final note on boxes: Pub 550 states “Dividends on any share of stock to the extent you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.” This means in the case that the entire position is not boxed, you must establish the amount of unboxed dividend on ex-date that can still qualify for preferential tax treatment. If there are more shorts than longs on ex-date, this devolves into simply disqualifying the entire amount.

The Straddle

The other mitigating case to consider is a straddle. There are different views of what constitutes a straddle when only equity positions are involved, but we will leave this to another paper. For now, we will assume a separate mechanism has determined that a straddle exists and that the position that induces the dividend has been tagged as

belonging to a straddle. In a similar fashion to the mechanism described above for boxes, inclusion in a straddle can affect the calculation of the holding period for a dividend-producing equity.

If the position was already held long enough to qualify for long-term gains, and the position becomes part of a straddle, then any days on which offsetting positions are simultaneously held are excluded from the holding-period calculation. If the position was not already long-term, the holding-period calculation resets to the date on which there are no longer any offsetting positions. In both cases, if the straddle is up and running at the start of the 121-day window, then the calculation of the holding period commences when the offsetting risk position is eliminated.

It is important to note that covered calls do NOT qualify as straddles and are not considered to diminish risk of loss. This is made explicit by section 246(c)(4) of the tax code.

One final note on straddles: A straddle might not eliminate all risk of loss, but rather cap the loss. When this occurs, the qualification process will be affected. Pub 550 reads “diminished” not “eliminated.”

EXAMPLES

Assume that in the following examples, the dividend fulfills two criteria (1) is paid by a U.S. or a qualified foreign corporation, and (2) it is not listed under Dividends that are not qualified dividends. The examples below will illustrate how to calculate whether or not a dividend qualifies for reduced taxation.

Example 1

Activity: The fund buys 1,000 shares of company ABC stock. The original purchase date (tax lot date) is 6/1/2011. ABC issued a \$0.05 dividend with an ex-date of 6/20/2011. The stock is later sold on 8/25/2011.

Result: The qualification period is: 6/20/2011 - 60 days = 4/21/2011 through 4/21/2011 + 121 days = 8/20/2011. The stock must be held for more than 60 of the days between 4/21/2011 and 8/20/2011. We see that the stock is held from 6/1/2011 through 8/25/2011 and constitutes 85 days, 80 of which fall inside the 121-day window; since 80 is greater than 60, the dividend is qualified.

Example 2

Activity: The fund buys 1,000 shares of company ABC stock. The original purchase date (tax lot date) is 5/1/2011. ABC issued a \$0.05 dividend with an ex-date of 6/1/2011. The stock is later sold on 6/10/2011.

Result: The qualification period starts on 6/1/2011 - 60 days = 4/2/2011 and completes on 4/2/2011 + 121 days = 8/1/2011. The stock must be held more than 60 of the days between 4/2/2011 and 8/1/2011. The stock is held for a total of 40 days and all of these days fall within the 121-day window, but since 40 is less than 61, this is *not* a qualified dividend.

Example 3

Activity: The fund buys 1,000 shares of XYZ preferred stock. The original purchase date (tax lot date) is 6/1/2011. XYZ issued a \$1.25 preferred dividend with an ex-date of 6/20/2011. This dividend covers a 2-year period from 6/20/2009 through 6/20/2011. The stock is later sold on 12/1/2011.

Result: Since this period is greater than one year, an expanded window applies. The qualification period starts on 6/20/2011 - 90 days = 3/22/2011 and completes on 3/22/2011 + 181 days = 9/19/2011. The stock must be held more than 90 days between 3/22/2011 and 9/19/2011. Since it is held between 6/1/2011 and 9/19/2011 and this period constitutes 102 days and 102 is greater than 90, the dividend is qualified.

Example 4

Activity: The fund buys 1,000 shares of company ABC stock. The original purchase date (tax lot date) is 1/1/2010. ABC issued a \$0.05 dividend with an ex-date of 6/20/2011.

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On 6/1/2011, a short sale for 1,000 shares is made but this does NOT result in a constructive sale, but does result in a straddle. On 6/15/2011, the short position is fully covered. The long position is later sold on 6/30/2011.

Result: The qualification period is: 6/20/2011 - 60 days = 4/21/2011 through 4/21/2011 + 121 days = 8/20/2011. The stock must be held for more than 60 of the days between 4/21/2011 and 8/20/2011. You can count the days between the start of the eligibility bracket (4/21/2011) and the beginning of the box/straddle (6/1/2011). This period amounts to 41 days. The day-counting process is then suspended for the duration of the box (6/1/2011 through 6/15/2011) and recommences afterwards. The period from 6/15/2011 through 6/30/2011 (15 days) may be added to the original period of 41 days resulting in a total of 56 days. Unfortunately, this is less than 60 days and therefore the dividend is *not* qualified.

Example 5

Activity: The fund buys 1,000 shares of ABC stock. The original purchase date (tax lot date) is 2/1/2011. On 5/25/2011, the fund shorts the stock at a higher price than the original purchase, triggering a constructive sale. The short is then covered on the following day, 5/26/2011. The stock goes ex-dividend on 6/1/2011. The long position is later sold on 8/25/2011.

Result: The qualification period starts on 6/1/2011 - 60 days = 4/2/2011 and completes on 4/2/2011 + 121 days = 8/1/2011. The stock must be held more than 60 of the days between 4/2/2011 and 8/1/2011. Although the original tax lot date for the long position is 2/1/2011, the constructive sale forces us to consider 5/25/2011 as the acquisition date for holding period calculations. However, we don't start counting on this date as the short position is still active -- resulting in diminished risk of loss. Rather, we start counting the day after the short has been covered (5/27/2011) *inclusive*. Since 5/27/2011 is within the qualified dividend bracket (4/2/2011 through 8/1/2011), we start counting on this date. Since we hold the long position well past the end of the bracket, the final date of the bracket (8/1/2011) is the date on which we stop counting.

The total count is therefore 67 days, which is larger than 60 and therefore we have a qualified dividend.

Example 6

Activity: The fund buys 1,000 shares of ABC stock. The original purchase date (tax lot date) is 2/1/2009. On 5/1/2011, a short total return swap (TRS) is entered. The short risk nature of the TRS entangles both positions in a straddle. On 5/31/2011, the TRS is closed. The stock goes ex-dividend on 6/1/2011. On 7/15/2011, the long stock position is sold.

Result: The qualification period starts on 6/1/2011 - 60 days = 4/2/2011 and completes on 4/2/2011 + 121 days = 8/1/2011. The stock must be held more than 60 of the days between 4/2/2011 and 8/1/2011. Since any gains made on the long stock position would be categorized as long-term capital gains, we suspend rather than reset the counting period. We count the days pre-straddle from 4/2/2011 through 5/1/2011 (29 days) as eligible and then suspend counting until the TRS is closed on 5/31/2011. We can then count any days between the elimination of the TRS and when the long position is sold (7/15/2011). This period results in another 45 days. When the two periods are added, we see 74 days of eligibility and this is greater than 60, so we have a qualified dividend.

Example 7

Activity: The fund buys 1,000 shares of ABC stock. The original purchase date (tax lot date) is 2/1/2011. On 5/1/2011, a short total return swap (TRS) is entered. The short risk nature of the TRS entangles both positions in a straddle. On 5/31/2011, the TRS is closed. The stock goes ex-dividend on 6/1/2011. On 7/15/2011, the long stock position is sold.

Result: The qualification period starts on 6/1/2011 - 60 days = 4/2/2011 and completes on 4/2/2011 + 121 days = 8/1/2011. The stock must be held more than 60 of the days between 4/2/2011 and 8/1/2011. Since any gains made on the long stock position would be categorized as short-term capital gains, we reset rather than suspend the

counting period. We therefore start counting on the day on which the TRS was closed, 5/31/2011. We can then count any days between the elimination of the TRS and when the long position is sold (7/15/2011). This period results in 45 days. Since 45 is less than 60, we do not have a qualified dividend.

SUMMARY

Some dividends are subject to a reduced income tax rate if they meet the following three conditions: 1) They are issued by a U.S. corporation or qualified foreign corporation, 2) they are not listed under “Dividends that are not Qualified Dividends,” and 3) they meet the holding period requirement. Of these three conditions, the real challenge is determining the holding period. This is a challenge because boxes (constructive sales) and straddles must be identified before it’s clear that you have mitigated risk of loss, which results in a dividend that does not qualify for the lower tax rate. This paper indicates a number of precursor steps to accurately make this calculation, but it is by no means an exhaustive discussion of the interactions between qualified dividends and other sections of the tax code. We discuss a general framework around which a process can be constructed to accurately calculate these interactions.

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