MURRAY & YOUNG

An Accountancy Corporation
(916) 483-8300

The New Dividend Taxation Rules Explained

As you probably know, certain dividends you receive during 2003 are subject to a tax rate of 15% (5% if they'd otherwise be taxed at the 10% or 15% ordinary tax rate). With the maximum ordinary tax rate now at 35%, this is great news for many investors. However, not all dividends are created equal here—only *qualified dividends* are subject to favorable rates. Furthermore, you must hold the stock paying the dividend for a certain period of time before any of its dividends are eligible for these low rates.

Simply put, *qualified dividends* are dividends paid by domestic and certain foreign corporations. Thus, dividends (including most preferred dividends) paid by traditional C corporations will qualify for the reduced rates. So will dividends received from foreign corporations that are (1) incorporated in the U.S. or a U.S. possession, (2) readily tradable on an established U.S. securities market, or (3) eligible for benefits of a comprehensive income tax treaty with the U.S.

However, there are a number of dividends that will *not* qualify for the reduced rates, including:

• Dividends received in your IRA or qualified retirement account. Taxable distributions from these accounts continue to be taxed at ordinary income rates (unless special averaging taxes apply).

• Dividends paid on money market accounts, policy dividends paid by insurance companies, and patronage dividends paid by cooperatives.

• Any dividend to the extent you are obligated (because of a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

• Distributions from S corporations. However, distributions of accumulated earnings and profits from prior C corporation years may qualify. Also, the S corporation can pass out qualified dividends it receives on stock it owns and those dividends will qualify for the reduced rates.

• Dividends from tax-exempt corporations, mutual savings banks, and certain other savings institutions.

• Dividends on preferred stock if the issuer treats the security as debt and deducts the payments as interest expense, such as with trust-preferred securities.

• Most dividends from real estate investment trusts (REITs). However, certain distributions attributable to dividends the REIT received from taxable non-REIT corporations will qualify.

• Dividends from mutual funds to the extent attributable to interest and short-term capital gains. (Distributions attributable to qualified dividends received by the fund and long-term capital gains qualify for the reduced rates.)

• Dividends on stock lent to a short seller. (Most standard brokerage agreements allow the broker to loan stock held in a margin account without the account owner's knowledge. Thus, if you hold stock in a margin account, you could be caught off guard by this rule. Fortunately, for 2003 this rule won't apply if your dividends are reported as such on your 2003 Form 1099-DIV, and you have no reason to know the payments were not actually qualified dividends. However, we recommend removing dividend-paying stocks from margin accounts before 2004 to avoid this issue in later years.)

Finally, before the reduced rate will apply, you must have held the dividend paying stock for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date. (A stock's ex-dividend date is the day it begins trading without rights to an announced, but as yet unpaid, dividend.)

As you can see, not all dividends are created equal when it comes to the reduced the rates. Please give us a call if you have any questions or need help in determining if your dividend income will reap the benefits of these reduced rates.