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When is a dividend not a dividend?

Sometimes a distribution turns out to be a return of capital, which has its advantages

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Some dividends aren't dividends at all. Sometimes they are a distribution known as a return of capital, which are actually returns *of* an investment instead of returns *on* an investment.

There is much confusion about these payments because many companies report that the distributions don't cause immediate taxation. Many times, in fact, the distributions are described as being tax-free, but they aren't.

Returns of capital do lower an investor's cost basis, however. If an investor buys a stock at $10 a share, for example, and the company then pays a $1 ROC distribution, the investor's cost basis must be lowered to $9. If the stock were then sold at $10, the investor would realize a $1 gain.

For tax purposes, ROC distributions show up in Box 3 of Form 1099-DIV, labeled “non-dividend distributions.” ROC distributions reduce basis, and if they reduce the basis below zero, subsequent ROC distributions will be taxed as capital gains.

Why do shareholders get ROC distributions? Because dividends can only be paid out of earnings, sometimes a company is doing so poorly that all its payout to shareholders is a return of capital.

This was the case with a major utility, the Long Island Lighting Co. of Hicksville, N.Y., for many years.

Sometimes companies pay out large special distributions, and many times they don't have sufficient earnings and profits to make the entire payment a dividend.

This was the case recently when New York-based Time Warner Inc. spun off Time Warner Cable to shareholders and paid a $10.27 dividend in the process. Time Warner estimated that just 30% to 35% of the dividend will be an actual dividend out of earnings and profits and the rest will be an ROC adjustment to cost basis.

Master limited partnerships also create ROC distributions. An MLP is a non-taxed flow-through entity that issues a K1 to its investors. Through depreciation and other deductions, MLPs shelter most of their income so that their distributions don't cause immediate taxation, just an adjustment to cost basis.

According to a 2003 report from Wachovia Corp. of Charlotte, N.C., 80% to 90% of MLP distributions aren't taxable and thus are an adjustment to basis.

These ROC distributions create either a larger capital gain, or a smaller capital loss, when the security is finally sold. If the shares are held for more than a year, the adjustment to basis creates more long-term gains taxed at 15%, rather than a dividend taxed at 15%. But for an investor holding less than a year, the basis adjustment will create a short-term gain taxed at 35%, versus a dividend taxed at 15%.

For those who can hold their securities until the step-up in basis at death, shares paying ROC distributions won't incur any tax, since capital gains are forgiven at death through the step-up.

As a result, ROC-paying companies are preferred to companies whose shares pay taxable dividends. These ROC-paying shares also may be attractive to those with capital loss carryovers since a dividend can cause some tax while a capital gain won't, due to the tax shield offered by the capital-loss carry-forward.

Buying ROC-paying shares on margin may create an interest expense deduction on one side and a long-term gain caused by the lowering of the basis on the other.

Keeping track of all this can be a nightmare. Indeed, Time Warner won't be telling its shareholders the exact nature of the special “dividend” until early 2010 (in time to pay taxes).

Failure to adjust one's basis and treating the distribution as tax-free would be tax fraud if done intentionally.

Investors will have an easier time with record keeping for purchases made after Jan. 1, 2011. As of that date, broker-dealers will be responsible for reporting cost basis to investors, a job that will prove extremely challenging to brokers and their service providers, and made more difficult by ROC distributions.

For most investors, receiving an ROC distribution does no harm. For many, in fact, the distributions can be the most favorable type of corporate income to receive.

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