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The tax implications of special dividends

Familiarization with the complex way in which they're treated is important for investors

By Robert N. Gordon

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This year is shaping up to be a good one for special dividends, with more than 80 announced so far. A new monthly record was set last month, when a total of $34 billion in special dividends were announced.

Special dividends are above and beyond quarterly dividend payments. Many times, they are quite large in proportion to the stock price.

For example, AOL Inc., which is trading at about $34 a share, has declared a $5.15 dividend with a record date of Dec. 5.

The tax treatment of special dividends is more complex than the taxation of regular dividends. For individuals, all dividends need to be held for more than 61 (unhedged) days in order to qualify for the 15% tax rate.

However, if the dividend is more than 10% of the value of the stock at the time of the distribution, it is considered an "extraordinary dividend" as defined in Section 1059 of the Internal Revenue Code. This and other sections of the law interact to discourage "dividend stripping" by taxable investors.

However, for those with exclusively short-term gains, there still exists a trading opportunity.

A second and more elusive question is whether the dividend actually is a dividend for tax purposes.

Only dividends paid out of a corporation's earnings and profits are taxed as dividends. Payments labeled dividends that aren't paid from earnings and profits are considered a return of capital.

COST BASIS

Any amount received as an ROC is to be taken as an adjustment in the cost basis of the shares; no taxable dividend income is created. It is unusual for a regular quarterly dividend to be an ROC, but special dividends sometimes receive that treatment, if they are quite large.

Although the analysis of whether the dividend is a dividend or an ROC for tax purposes is critical, many times, the answer isn't known at the time that the dividend is earned.

The corporation must conduct an earnings-and-profit study covering not only current fiscal-year earnings and profits but cumulative earnings and profits, as well. Either can create taxable dividends.

Because of AOL's earnings history and its current outlook, guidance about the tax status of the AOL dividend isn't available at this time, either from company documents or the investor relations department.

How an investor is to be taxed on a special dividend must be analyzed before the record date so that the client can act, if indeed this “great news” can whipsaw them tax-wise.

If the dividend is all ROC, there are few immediate tax consequences unless the amount is more than the cost basis in the shares.

But assume that the dividend is paid completely out of earnings and profits, and thus is a dividend as we know it. The taxable investor who thinks that this a quick trading opportunity can wind up in the worst of all possible situations — holding fully taxable income against losses that might not be fully deductible.

AN EXAMPLE

Consider this example.

John the trader buys AOL at $34.15, holds the stock past the record date when the shares go ex-dividend by the $5.15 dividend. He sells one week later at $30, reaping a total of $35.15 after accounting for the dividend, thus making $1.

Next April, John's accountant informs him that the trade threw off $5.15 of non-qualifying dividend income, taxed at 35%, and a $4.15 capital loss that John can't utilize because he didn't have enough realized gains. That $1 pretax profit turned into a tax bill of $1.80 and a capital loss carry-forward.

An offshore hedge fund would be even more disadvantaged by trading over the ex-dividend date, due to withholding issues.

The luckier investor would be one who holds AOL over the record date, satisfies the requisite unhedged 61-day holding period and has only short-term gains for the year. This investor would receive $5.15 in tax-favored dividend income (at the 15% rate) while generating capital losses deductible against 35% gains.

The law allows the large dividend to receive the lower tax rate but makes losses from trading long-term, not short-term. This is to stop the generation of short-term losses and corresponding dividend income.

Ironically, if a taxpayer's gains are all short-term, the interactions of the various laws allow long-term losses from extraordinary-dividend trading to wind up offsetting short-term gains, dollar for dollar.

Robert N. Gordon (bob@twenty-first.com) is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.