Taxation and Economics of Foreign Dividends: It Can Take a Lot of Work to Get One’s Fair Share

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This article outlines the potential tax traps investors may trip into when they invest in dividend-paying foreign stock, and especially when they hedge their investments by using puts.

Introduction

As dividends cross borders, complications abound. Holders of shares of foreign corporations are the investors most negatively affected by a tax trap when buying puts. In this brief analysis, I elaborate on the math on that and delve into other ways that investors are leaving money on the table.

Basic Withholding Tax Issues

The biggest problems with cross-border dividends are caused by withholding taxes. Countries do not withhold on dividends paid to their own residents but do withhold as dividends are paid to others. The United States does this. There are tax credits that can diminish the impact of the withholding tax. These tax credits are limited to the amounts that are withheld by treaty, although many countries routinely over-withhold. More on this later.

For example, if a dividend equaling $1 was paid by a Canadian company to a U.S. taxpayer, the U.S. investor would—because of the 15 percent withholding dictated by the Canadian-U.S. tax treaty—receive only 85 cents. But the investor would have to include the full $1 of dividend income on the tax return even though he or she only received 85 cents.

The U.S. gives taxpayers a dollar-for-dollar tax credit for amounts withheld to avoid double taxation. Note that this is a tax credit, not a tax deduction. As an example, if the dividend is “qualified,” the U.S. taxpayer would owe 20 cents to Uncle Sam. But, because the taxpayer in our hypothetical

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transaction is given credit for the 15 cents paid to Canada, the investor has to pay only 5 cents to the U.S. That seems fair enough but: (1) not all foreign dividends are qualified; (2) the 61-day minimum holding period rule that is necessary to achieve the lower tax rate relates to all dividend receipts, foreign or domestic;¹ and (3) one cannot always take a credit for all the withheld amounts.

There are rules about which countries’ dividends can be qualified. Dividends paid by our treaty partners are assumed to be qualified dividends. IRS Notice 2003-69 lists these countries.² Dividends from shares trading in non-treaty countries will not be qualified and will be taxed at the highest rate. The same set of rules, however, seems to imply that foreign shares trading here as ADRs do throw off qualified dividends by virtue of trading on a U.S. exchange.

Say Hello to Puts—And Goodbye to Favorable Tax Treatment

Now to the draconian tax impact of buying puts. In order for the withholding tax to qualify for the foreign tax credit, the investor’s shares must be held for at least 16 days over the record date.³ Any day during this period that the investor owns a put on the shares is not counted as a good day. Each and every record date has to have a “good” holding period. By owning a put on a foreign share, the investor not only disqualifies the dividend for the 61-day holding period but also gives up the foreign tax credit.

For example, a put-hedged $1 Canadian dividend will trigger a 39.6 cent tax; if the investor nets that against the 85 cents in cash received, he or she winds up keeping only 45.4 cents on the dollar. Contrast that to an unhedged $1 Canadian dividend, which, as discussed above, will net a U.S. taxpayer 80 cents after taxes.

Alternatively the put-hedged U.S. investor is allowed to elect to take the 15 cents withholding as a deduction rather than a credit, but by doing so he or she would be electing to turn all of the foreign tax credits into deductions. If the investor owns other foreign assets, or more of these shares that are unhedged, this could prove to be uneconomical. An investor electing to take a deduction instead of a credit would end up receiving and paying tax on 85 cents, thereby netting 51.34 cents on the dollar.⁴

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¹ See IRC § 1(h)(11)(B)(iii)(I).
² 2003-2 CB 851.
³ See IRC § 901(k)(1)(A).
⁴ None of the above calculations takes into account the 3.8 percent Medicare tax on net investment income. See IRC § 1411.
The State Tax Cut

One cannot forget that there are state taxes to deal with. Just as on his or her federal return, our investor must reflect $1 of dividend income on the state return, even though only 85 cents was actually received. Most states do not have a foreign tax credit mechanism. So investors end up paying a tax on that 15 percent of the dividend income to the state even though they did not receive any benefit.

Another Possible Whipsaw

It gets even worse when the actual withholding rate levied is more than the investor expected it to be under the reduced treaty rate.

As an example, when Nestle pays a dividend, things get more complicated than in the scenario set out in the previous example, because Nestle is a Swiss company. Switzerland withholds at 35 percent on dividends leaving the country. Even though the U.S. has a treaty with Switzerland that allows for a 15 percent withholding rate, the dividends are withheld at 35 percent because Switzerland doesn’t know who each individual investor is and thus assumes the investor is not a resident of a treaty country. To escape this over-withholding, investors have to go to Switzerland and prove they are deserving of treaty relief to reclaim the over-withheld amount and thus get back their money. There are specialized services that assist investors and custodians in chasing these otherwise lost funds, but of course there is a cost involved in using these services. Not pursuing these funds is throwing money away.

In some instances if an investor or his representative fills out and files all the proper paperwork beforehand, the over-withheld amount will be “refunded at source” and will not need to be further pursued. Owning a put does not interfere with the investor’s ability to reclaim his over-withheld amounts of money from the offending country.

The best positioned unhedged diligent investor living in Texas could keep 80 cents of every $1 dividend paid by Nestle. At the other end of the spectrum is a New York resident who hedges part of his Nestle shares with a put and who does not pursue any reclaim. This investor would pay about 50 cents in federal and state taxes on the $1 dividend even though he received just 65 cents of cash flow, leaving just 15 cents of every one dollar dividend in his pocket!

Conclusion

Full utilization of the foreign tax credit and the lower rate on qualifying dividends takes care. Pursuing amounts withheld above the treaty rate takes follow-through and some determination. These issues cause some investors to keep a lot less than they assumed they would keep after simply calculating the stated dividend yield of a non-U.S. share.
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