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Tax Treatment of Dividends Under the 2003 Tax Cut: Fact Sheet

Jane G. Gravelle
Senior Specialist in Economic Policy
Government and Finance Division

Summary

While ordinary and preferred stock dividends, along with some foreign dividends, are eligible for dividend relief in the form of a lower tax rates, certain dividends are not eligible. Dividends retain their original character if received indirectly through mutual funds and real estate investment trusts and are eligible. Dividends which are already eligible for tax preferences and held in pensions or IRAs are not eligible. This fact sheet will not be updated.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (H.R. 2, P.L. 108-027) reduces the individual income tax rate on certain dividends and on capital gains to 15% from 2002 through 2008 (5% through 2007 and 0% through 2008 for individuals in the two lower tax brackets). The purpose of this fact sheet is to explain what types of dividends, in addition to ordinary dividends on common stock received directly by individuals, are eligible for the lower rate.

Eligible Dividends

Ordinary dividends, dividends on preferred stock, and dividends from qualified foreign corporations are eligible. Stock must have been held at least 60 days out of the 120-day period beginning 60 days before the ex dividend day.¹ Qualified foreign corporations include those traded on U.S. markets and those that do not trade but whose income tax treatment falls under a treaty with the U.S. that provides for an exchange of information, with exceptions listed below.

Dividends that are received through regulated investment companies (RICs), commonly referred to as mutual funds, are eligible for the lower rate. Note, however, that

¹ The ex dividend day is the day the stock trades without an announced dividend and is normally two business days before the record day (the date when the company determines who owns the stock) to account for settlement lags. A person who buys the stock the day before the ex dividend day will receive the dividend, while a person who buys the stock on the ex dividend day will not.

payments labeled as dividends of these funds do not always arise from dividend income, but may reflect earnings of interest bearing assets. Only the amounts reflecting dividend income are eligible for the beneficial treatment (unless 95% or more of earnings arise from dividends). A similar rule applies to real estate investment trusts (REITs). Since mutual funds have a large share of dividends, a significant fraction of earnings from mutual funds will be eligible. Most income of REITs will not be.

Dividends Not Eligible

Dividends in already tax preferred retirement and annuity plans, including payments from IRAs, 401(k) plans, and thrift plans are not eligible. Clearly, dividends from Roth IRAs are not eligible since they are currently exempt from tax. However, other pension and thrift plans have the equivalent of exemption because, although payouts are subject to tax, contributions are deductible. The deduction of the contribution offsets the present value of future taxes. Certain plans, also not eligible for the lower dividend tax rate, have a benefit that defers rather than effectively exempts from tax; that is they do not allow deductibility of contributions, but taxes on returns are deferred until received as annuity payments (at which time a portion representing return of principal is exempt). Investments taxed in this fashion include fixed and variable annuities and non-deductible traditional IRAs.

Dividends of tax exempt entities or entities for which dividend deductions are available are not eligible. These include dividends received from tax exempt organizations in general (these organizations are listed in section 501 of the Internal Revenue Code and include pension trusts mentioned above), tax exempt farmers' cooperatives, mutual savings banks that receive a dividend deduction under section 591 of the IRC, and dividends deductible by firms on employer securities (i.e. employee stock ownership plans).

Dividends of foreign corporations not traded on U.S. securities markets and not eligible for the benefits (for substantially all income) of a treaty with the U.S. that provides appropriate information sharing are ineligible. The current U.S.-Barbados treaty is specified as not appropriate for this purpose until the Treasury promulgates regulations. In addition, dividends from foreign investment companies, foreign passive investment companies, and foreign personal holding companies will not be eligible.

Payments in lieu of dividends are not eligible. These are payments associated with short sales (borrowing stock to sell and redeeming it later) which are made to the lender. However, there is a recognition that securities brokers and dealers may not easily be able to identify these payments in lieu of taxes. Dividends that are associated with an obligation to make a related payment on a similar position are not eligible. The taxpayer may not elect the preferential rate for dividends used to offset investment interest deductions.