Tax treatment of dividend income

The special qualified dividend treatment can increase your after-tax return

Investors find dividend-paying stocks and mutual funds attractive because their total return includes both the dividend and any market price appreciation. Adding to the appeal of some dividends is the special tax treatment they receive. Taxpayers whose income exceeds certain thresholds should be aware of the additional 3.8% Medicare surcharge on excess investment income.

For tax purposes, dividends are considered either "qualified" or "nonqualified." Qualified dividends and nonqualified dividends are taxed as follows:

Qualified Dividends Tax Rates

Qualified dividends are taxed at the long-term capital gains rates as per the following table. Nonqualified dividends are taxed at ordinary income tax rates.

	Long-term capital gain rate (held longer than one year)		
Filing Status	0.0%	15.0%	20.0%
Married filing jointly and surviving spouse	$0–$80,000	$80,001–$496,600	Over $496,600
Single	$0–$40,000	$40,001–$441,450	Over $441,450

See example on page 2 for application of the above rates.

Taxpayers filing as single or head of household with Modified Adjusted Gross Income (MAGI) of $200,000 and married taxpayers filing a joint return with MAGI in excess of $250,000 may also be subject to an additional 3.8% Medicare surcharge on net investment income (which includes all taxable dividends).

What is a "qualified dividend"?

Qualified dividends are paid by U.S. corporations or by entities incorporated in a U.S. possession to their preferred or common shareholders. Dividends passed through by mutual funds or other regulated investment companies can be qualified or nonqualified, depending on the underlying securities held by the fund. If a fund receives a qualified dividend, that dividend will maintain its qualified status when passed through to shareholders.

Dividends paid by certain foreign corporations may also be qualified.

Examples of qualified foreign dividends include dividends from:

- Shares represented by a publicly traded American Depositary Receipt (ADR)
- Shares that are otherwise readily tradable on an established U.S. securities market
- Corporations incorporated in a U.S. possession
- Corporations incorporated in a country that has an income-tax treaty withthe United States that contains an exchange of information program approvedby the U.S. Treasury

Keep in mind that the foreign corporate dividend may remain subject to foreign tax withholding.

You can count on us

Although there are tax advantages to owning a qualified-dividend-paying stock, that in itself does not make that stock appropriate for your portfolio. Before you make an investment, your Financial Advisor will work with you to consider a variety of factors, such as your long-term goals, time horizon and risk tolerance, in addition to the tax implications.

Distributions from partnerships and real estate investment trusts typically are not characterized as qualified dividends. Also, qualified dividends do not include distributions from preferred debt.

Individuals, estates, and trusts may be able to deduct 20% of qualifying dividends from Real Estate Investment Trusts (REITs). Eligible dividends are REIT dividends which are not characterized as a capital gain distribution or qualified dividend.

It is critical to obtain proper tax classification of an investment to determine whether the dividend is qualified.

How does the qualified dividend tax treatment work?

For example, Jake has $35,000 in 2020 taxable income, excluding qualified dividends of $10,000. His $10,000 in qualified dividends pushes his total taxable income above $40,000, the threshold of the 0% long-term capital gain rate for a single filer. As a result, $5,000 of Jake's qualified dividends would be tax-free, while the remaining $5,000 [$45,000 (his total income) – $40,000] would be taxed at 15%.[1]

Is there a required holding period?

To qualify for the special tax treatment, shareholders must satisfy a certain holding period[2] based on the type of stock held:

- For **common stock**, shareholders must own the stock for more than a 60-day period containing the ex-dividend date.
- For **preferred stock**, the owner must hold the shares for more than a 90-day period including the ex-dividend date.

Active traders should monitor their holding periods carefully to benefit from the qualified-dividend tax treatment.

Can long-term capital losses be used to offset qualified dividends?

Although dividends and long-term capital gains are taxed at the same rates, this does not mean that capital losses can be used to offset dividends. However, if you have a net capital loss after offsetting all capital gains, up to $3,000 per year of capital loss may offset regular taxable income which may include dividends.

Talk with your tax advisor

It's important that you understand how dividends are taxed, and this is only a brief summary. For more detailed information, contact your tax advisor. However, keep in mind that although taxes certainly affect investment returns, the effects of taxes should be only one of many factors you consider when making investment decisions.

1. Although this example is conceptually accurate, the actual tax calculation Jake would perform on his tax forms would involve a separate worksheet to determine the amount of the qualified dividends that would be categorized and taxed at various rates.

2. When a stock trades ex-dividend, the dividend, when paid, goes to the seller. In general, the exchange designates a stock as ex-dividend a few days before the record date. Certain hedge positions may suspend the holding period for this purpose.