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U.S. Reduced Rates Now Apply to Dividends of Non-Corporate Taxpayers

By: Peter A. Glicklich and Abraham Leitner

The 2003 Act reduces the U.S. federal income tax rate applicable to dividends of noncorporate taxpayers to fifteen percent. This change has important ramifications for corporations and planners in the cross-border context.

On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act").[1] The Act includes a number of important changes that may have a material impact on cross-border U.S. tax planning. The most important change is a reduction in the maximum U.S. federal income tax rate on dividends earned by noncorporate taxpayers (e.g., individuals, estates and trusts) to 15 percent from 35 percent.[2] The Act also includes broad reductions in the income tax rates applicable to noncorporate taxpayers across most tax brackets. In addition, the tax rate on long-term capital gains was reduced to 15 percent (which creates a 20 percentage point differential between the maximum rates now applicable to long-term as opposed to short-term capital gains and ordinary income). Provisions that were included in a related Senate bill, which would have targeted, among other things, corporate inversions and tax shelters, were not included in the final version of the Act.[3] State income taxes in the U.S. are usually not directly affected by changes to U.S. federal income tax rates.

Corporate distributions are eligible for the 15-percent tax rate only to the extent that they constitute "dividends" for U.S. federal income tax purposes. Under the Code, a distribution by a corporation is treated as a dividend to the extent that the corporation has either current or accumulated "earnings and profits."[4] (Unlike the rules applicable for Canadian tax purposes, a corporation that has earnings and profits generally cannot avoid having its distributions characterized as dividends by designating them as capital distributions.) If a distribution exceeds the corporation's earnings and profits, then the distribution is treated as a nontaxable recovery of the shareholders' basis in their stock.[5] If the distribution exceeds the shareholders' basis, then the excess amount is treated as if it were gain realized on a sale of the stock.[6]

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[1] Pub. L. 108-27.
[2] Additional accelerated depreciation deductions were allowed as well.
[3] H.R. 2, referred to as the Jobs and Growth Tax Act and passed by the Senate on May 15, 2003.
[4] Code section 316(a).
[5] Code section 301(c)(2).
[6] Code section 301(c)(3). For a noncorporate shareholder, such gain normally would be eligible for the 15 percent capital gain rate if the shares have been held for more than one year.

In order for a dividend to qualify for the 15-percent rate, it has to constitute "qualified dividend income."[7] Most dividends paid by a domestic corporation are treated as qualified dividend income.[8] Dividends paid by a foreign corporation are also treated as qualified dividend income if the paying corporation is a "qualified foreign corporation."[9] A "qualified foreign corporation" is a foreign corporation that is either: (1) eligible for benefits of a comprehensive income tax treaty with the United States which Treasury determines is satisfactory for this purpose and which includes an exchange of information program;[10] or (2) incorporated in a possession of the United States.[11] The legislative history of the Act indicates that Congress intended that, until regulations are issued by Treasury, a foreign corporation will be treated as a qualified foreign corporation if it is eligible for the benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program other than the current U.S.-Barbados income tax treaty.[12] (The Barbados treaty was apparently excluded because Congress became aware that U.S. taxpayers were using Barbados holding company structures in connection with corporate inversion transactions.)

Furthermore, dividends paid on stock of a non-U.S. corporation that is readily tradable on a U.S. securities market are treated as paid by a qualified foreign corporation for purposes of this rule, even if the corporation does not otherwise meet the definition of such term. The legislative history of the Act indicates that a share of stock traded in the form of an American Depository Receipt (ADR) will be treated as readily tradable on a U.S. securities market as long as the ADR is so traded.

Despite the rules just described, however, a non-U.S. corporation that is a foreign personal holding company within the meaning of Code section 552 (FPHC), a foreign investment company, within the meaning of section 1246(b) (FIC), or a passive foreign investment company, within the meaning of section 1297 (PFIC), will not be treated as a qualified foreign corporation.

Coordination With Foreign Tax Credit Rules

Foreign tax credits are generally limited in the U.S. to the U.S. tax attributable to a taxpayer's foreign source income, which is determined based on the proportion of the taxpayer's total income consisting of foreign source income.[13] Under prior law (i.e., prior to the enactment of the Act), in making this calculation, capital gains (both U.S. source and foreign source) were adjusted to account for the fact that such gains may be taxed at a lower rate than ordinary income.[14] Under the Act, a similar adjustment is required to be made for qualified dividend income in determining the taxpayer's allowable foreign tax credit.[15] One practical effect of this rule is that a taxpayer's foreign tax credit for foreign withholding taxes paid on a dividend from a foreign corporation that qualifies for the new maximum 15-percent U.S. federal income tax rate will be limited to 15 percent of the amount of the dividend, regardless of the rate of the applicable withholding tax.

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7 Code section 1(h)(11)(A).

8 Code section 1(h)(11)(B)(i)(I). Some exceptions are described below.

9 Code section 1(h)(11)(B)(i)(II).

10 Code section 1(h)(11)(C)(i)(II).

11 Code section 1(h)(11)(C)(i)(I). The term "possession" was not defined in the Act nor is it generally defined in the Code. It is normally understood to include, among other territories, the U.S. Virgin Islands, Guam and American Samoa. In addition, Code section 7701(d) provides generally that Puerto Rico is treated as a possession.

12 Conf. Rept. 108-126.

13 Code section 904(a).

14 Code section 904(b)(2)(B).

15 Code section 1(h)(11)(C)(iv).

Coordination With Investment Interest Limitations

The amount of investment interest expense of a noncorporate taxpayer allowed as a deduction is generally limited to the net investment income of the taxpayer.[16] Under the Act, qualified dividend income that is taxed at the 15-percent rate is not taken into account in determining the net investment income of the taxpayer for purposes of determining the taxpayer's allowable investment interest deduction, unless the taxpayer elects affirmatively to include it for this purpose.[17] If the taxpayer makes such an election, however, then the dividends are not eligible for the 15-percent rate.[18] This limitation is intended to prevent taxpayers from engaging in tax arbitrage by borrowing money to invest in shares that earn income that is subject to the favored rate (e.g., dividends on preferred stock) and using interest deductions to offset the taxpayer's ordinary income.[19] As suggested below, however, this limitation might be avoided.

Other Limitations

In order to qualify for the lower tax rates, the taxpayer is required to own the stock for at least 60 days during the 120-day period beginning 60 days before the ex-dividend date.[20] In the case of preferred stock, if the dividends are received with respect to a period exceeding one year, the taxpayer is required to own the stock for at least 90 days during the 180-day period beginning 90 days before the ex-dividend date.[21] In determining whether these holding period requirements are met by a taxpayer, any period in which the taxpayer's risk of loss with respect to the stock was reduced by the taxpayer's holding certain offsetting positions is not taken into account.[22] In particular, the taxpayer's holding period is reduced for any period in which: (1) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made a short sale of substantially identical stock or securities; (2) the taxpayer is the grantor of an option to buy substantially identical stock or securities; or (3) the taxpayer has diminished risk of loss by holding one or more offsetting positions with respect to substantially similar or related property.[23] The "substantially identical" standard applicable for purposes of the first two of these rules is fairly narrow and, in general, only stock in the same corporation would be considered substantially identical to the stock on which the dividends were paid.[24] The "substantially similar or related property" standard applicable under the third rule, however, is interpreted quite broadly by the applicable regulations to include any property if the fair market value of the property and the stock reflect the performance of: a single firm or enterprise; the same industry or industries; or the same economic factor or factors such as interest rates, foreign currency exchange rates, etc.[25] Special rules apply to positions that reflect the value of the stock of multiple issuers, under which a portion of such a position may be treated as substantially similar or related property to the extent there is a substantial overlap with the stock on which the dividends were paid.[26]

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[16] Code section 163(d)(1).

[17] Code section 163(d)(4)(B).

[18] Code section 1(h)(11)(D)(i).

[19] A similar rule exists for net capital gain. See Code section 163(d)(4)(B)(iii) and Treas. Reg. §1.163(d)-1(b).

[20] Code section 1(h)(11)(B)(iii)(I).

[21] Code section 246(c)(2). Literally, section 246(c)(2) could be read as not applying, since it merely replaces the terms "45 days" and "90-day period" appearing in section 246(c)(1) with "90 days" and "180-day period," respectively, but the Act itself replaces those terms with "60 days" and "120-day period." The legislative history of the Act indicates, however, that Congress intended to lengthen the required holding period otherwise applicable under section 246 rather than shortening it.

[22] Code section 1(h)(11)(B)(iii)(II).

[23] Code section 246(c)(4).

[24] See Treas. Reg. §1.1233-1(d), which is cross-referenced by Treas. Reg. §1.246-3(c)(2).

[25] Treas. Reg. §1.246-5(b)(1).

[26] Treas. Reg. §1.246-5(c)(1).

Short Sales

The 15-percent rate is not available if the taxpayer is under an obligation (for example, as a result of having borrowed the stock for the purpose of a short sale) to make related payments in property substantially similar or related to the stock on which the dividends are paid. Importantly, any "payments in lieu of dividends" received by a lender of stock in such a short sale would not be eligible for the 15-percent rate, since such payments are not treated as dividends for this purpose. The legislative history of the Act indicates that Congress recognized the difficulty that securities brokers would have in conforming their information reporting systems to be able to track which investors' shares have been loaned to short sellers. Therefore, the Conference Committee Report accompanying the Act states that Congress expects that for 2003 individuals will be able to report all amounts for which the individual receives a Form 1099-DIV as dividends, unless he or she has reason to know that the payments are in fact payments in lieu of dividends rather than actual dividends. The Report also states that it was intended that the IRS would waive penalties for brokers' failing to report such payments properly. Presumably, once a system is put into place to properly track which shareholders are earning payments in lieu of dividends, the market will demand that such payments be grossed up to compensate the lenders of the shares for the additional tax they will owe.[27] This may cause a reduction in short sale activity, or at least increase its costs, in stocks that pay significant dividends.

Dividends From RICS and REITs

Special limitations apply to dividends paid by regulated investment companies ("RIC"s) and real estate investment trusts ("REIT"s) because the income of such entities is typically not subject to a corporate level income tax. Specifically, dividends paid by a RIC or REIT are eligible for the 15-percent rate only to the extent that the underlying income of the RIC or REIT consists of qualified dividend income or income that was subject to federal income tax in the hands of the RIC or REIT (unless 95% or more of the entity's income consists of such income).

Non-U.S. Taxpayers

The 15-percent rate only applies to U.S. taxpayers and foreign taxpayers that earn dividends which are effectively connected to a U.S. trade or business. Dividends earned by non-U.S. investors on portfolio investments continue to be subject to a 30-percent gross withholding tax in the absence of a treaty. Under the Canada-U.S. income tax treaty, a 15-percent rate generally applies to dividends on portfolio stock investments.

Planning Issues and Opportunities

The reduction in the tax rate on dividend income raises a whole host of new issues and opportunities. Following are some examples:

Corporate Securities Issuances

Corporations seeking to raise money in the capital markets take a number of considerations into account in deciding whether to issue debt or equity securities. From a tax perspective, debt securities have traditionally had a clear advantage over preferred stock or other equity, since interest is generally deductible by the corporate issuer. Non-tax considerations tend to favor equity issuances, which are

[27] The difference between the 15-percent rate applicable to dividends and the highest marginal rate applicable for ordinary income is 20 percent. Since the additional gross-up payment would itself be taxable, however, the gross-up amount required to make the lender whole is 25 percent, before state and local income taxes are taken into account.

healthier for the issuer's balance sheet. The 15-percent rate now available for dividends will make equity issuances relatively more attractive to investors and will to some extent "level the playing field" between debt and equity issuances. Indeed, this was one of the rationales of the new legislation. Although the combined corporate and individual tax rate on earnings that are distributed as dividends is still higher than the effective single level of tax imposed on amounts paid out to investors as interest, the lower dividend rate will lead more issuers to choose equity over debt as a means of raising money in the capital markets.

Leveraged Arbitrage

As noted above, the Act seeks to prevent taxpayers from engaging in leveraged arbitrage transactions by providing that in order to obtain the 15-percent rate for dividends, taxpayers are required to exclude the dividend income from their investment income for purposes of determining their investment interest limitation. An individual taxpayer who otherwise holds assets that generate current investment income will, however, be able to use leverage to buy dividend paying stocks and deduct the associated interest expense, to the extent the interest does not exceed the taxpayer's other (e.g., non-qualified dividend) investment income.

S Corporation Issues

Shareholders of S corporations will generally not be affected by the new dividend rate, since distributions by an S corporation are generally not taxable to the recipient.[28] Income of an S corporation flows through to the corporation's shareholders, but such income retains its character in the hands of the corporation and would not be treated as qualified dividend income unless it results from qualified dividend income earned by the corporation.[29] This result should be helpful in structuring investments by U.S. noncorporate taxpayers into Canada, since such structures often rely on S corporations to obtain the five-percent intercompany dividend withholding rate.

In at least one respect, though, the Act may make an S corporation election a less desirable alternative than continuing C corporation treatment. Consider the situation in which an existing C corporation becomes an S corporation. Such a conversion does not trigger immediate tax, but any unrealized gain that exists on the date of the conversion will trigger a corporate-level tax (as well as a shareholder-level tax) if the gain is triggered within the following ten-year period.[30] In addition, any such gain would flow through to the corporation's shareholders under the normal S corporation rules and retain its character in the shareholders' hands. If the gain is an ordinary income item (determined at the corporate level), then it will be subject to tax at ordinary income rates in the hands of the shareholders. By comparison, if the corporation remains a C corporation, then the distributed amounts would generally be eligible for the 15-percent rate on dividends.[31]

Cross-border Planning Issues and Opportunities

Additional issues and opportunities exist in the cross-border context. Since, as noted above, the 15-percent rate is generally applicable only to U.S. noncorporate taxpayers, most of these issues can be expected to arise in planning their non-U.S. investments. In the absence of regulations adopting an anti-abuse rule, query whether it might be possible to migrate or reorganize a corporation, formed in a low-tax

[28] Code section 1368. The shareholders may recognize gain, however, to the extent the distribution exceeds their basis in their stock.

[29] Code section 1366(b) provides that the character of any item that flows through to an S corporation's shareholders shall be determined as if such item were realized directly from the source from which realized by the corporation.

[30] Code section 1374.

[31] Another, less significant, benefit to remaining a C corporation in this situation (which existed even before the Act) is that the corporation may be able to defer the distribution of the earnings and thereby defer the shareholder level tax.

jurisdiction with large accumulated low-taxed or non-taxed earnings, into a corporation formed in a country that has a comprehensive income tax treaty with the United States, which could possibly thereafter make distributions of qualified dividend income. Any withholding taxes incurred may be credited against the U.S. tax on the dividends to the extent of 15 percent (as noted above). Another possibility would be to structure a holding company in a favorable holding company jurisdiction such as Denmark, Luxembourg or Spain to own subsidiaries in lower-tax jurisdictions, also allowing access to the new U.S. 15-percent rate on qualifying dividends. Of course, abus de droit and other tax principals in the dividend paying nation will have to be considered in this connection.

Effective Date and Sunset Provision

The 15-percent rate for dividends applies to all taxable years beginning after December 31, 2002. The 15-percent long term capital gains rates are effective for sales occurring after May 5, 2003. For budgetary reasons, however, both rate reductions are scheduled to expire on December 31, 2008, unless they are extended or made permanent before then.

Conclusion

The Act's reduction in the maximum U.S. federal income tax rate applicable to dividends received by noncorporate taxpayers can be expected to have a significant impact on future U.S. tax planning for individuals and corporations in both the domestic and cross-border contexts. In particular, consideration must be given to structuring outbound investments by U.S. individuals to ensure that the maximum 15-percent rate will apply to dividends.