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Giant dividends: Bonanza or tax trap?

Consider different scenarios for owning shares of companies dispersing windfalls to shareholders

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Vodafone Group PLC (VOD) has said that it intends to sell its 45% interest in Verizon Wireless to Verizon Communications Inc. (VZ), its joint venture partner in the wireless company, for $130 billion. Verizon will pay Vodafone mainly in cash and Verizon shares.

Vodafone will distribute to its shareholders all of the Verizon shares it receives and $23.9 billion of the cash. This $84 billion dividend to Vodafone shareholders is equivalent to a little more than $17 a share. The exact amounts will depend on the relevant Verizon share price and the dollar exchange rate on completion.

Vodafone is trading at about $34, so the dividend is about 50% of the stock price.

The Verizon transaction and the subsequent dividend payment to Vodafone shareholders are expected to occur in the first quarter next year. The company thinks that it has enough earnings and profits for the dividend to be a “qualified dividend,” possibly benefiting from the lower tax rate afforded to such dividends if the requisite 61 days of unhedged holding period is satisfied.

Receiving such a large dividend sounds attractive at first, but tread lightly.

For a client with the perfect profile, this could indeed be a pleasant event. For those buying just before the record date and selling soon after, this could be a tax nightmare.

There are a number of tax rules that control the taxation of such a dividend. The United Kingdom doesn't withhold taxes on dividends paid to non-U.K. holders, so the possible complication of foreign tax credits is off the table.

Withholding tax can also be very important to tax-exempt investors and to offshore hedge funds.
Next to worry about is Internal Revenue Code Section 246, which states that a qualifying dividend gets the lower rate of tax only if the client holds the shares for a period of at least 61 days, including the record date for the dividend. The client can't be hedged during these 61 days.

Every record date is tested for the requisite holding period, no matter how long the client has held the shares. Someone not satisfying the necessary holding period could be in for a rude shock.

Let's assume that an investor buys into Vodafone paying $32 a share. She holds over the record date and soon sells the ex-dividend shares for $15.

On a pretax basis, she has broken even. On an after-tax basis, she has $17 of income taxed at the highest rate and $17 of short-term capital loss that may have little value, possibly a $7.38 out-of-pocket cost.

If she did have $17 of short-term gains to utilize the losses, there would be no out-of-pocket cost.

If instead she held the shares for 61 unhedged days, then the $17 dividend would be taxed only at 23.8%. The client would still have $17 of capital loss, but because of IRC Section 1059 (the extraordinary-dividend rule) any loss is a long-term capital loss, not a short-term capital loss.

This long-term treatment applies only to the extent that the dividend receives a lower tax rate.

The client still needs to have gains that the loss can offset for this not to turn into a tax whipsaw. If not, in this circumstance, there is possibly a $4.04 out-of-pocket cost.

If the taxpayer held unhedged for 61 days and possessed long-term gains to sop up the long-term loss, then there would be no tax whipsaw. She would have $17 of qualified dividend taxed at 23.8% and a $17 long-term loss that would shelter 23.8% of tax on her existing long-term gains.

It would be an after-tax and pretax break-even. No harm, no foul.

Ironically, if the investor had only short-term gains at the end of the year, there could be a windfall tax savings, as the long-term loss would offset the short term gains. This would apply only if the taxpayer had no long-term gains, just short-term gains.

Only in this circumstance would the client enjoy a possible bonanza.

Any taxpaying investor who bought Vodafone for $15 or more might want to consider selling Vodafone just before the dividend is paid and repurchase Vodafone after it goes ex-dividend in order to avoid the tax whipsaw. Each client's situation is unique, but all taxable Vodafone holders should understand that receiving giant dividends comes with some baggage, especially if you aren't going to hold the shares long enough for the dividend to qualify for the lower tax rate.

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