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The Tax-Conscious Adviser

Robert N. Gordon

Foreign dividends can be a minefield

Clients must know the implications of withholding taxes on distributions from international companies

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As dividends cross borders, complications arise. In my February column, I mentioned how shareholders of foreign corporations are the investors most negatively affected by a tax trap when buying puts. I will elaborate on the math on that and delve into other ways that investors are leaving money on the table.

The problems are caused by withholding taxes. Countries don't withhold on dividends paid to their own residents but do withhold as dividends are paid to others.

The United States does this as well.

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, though many countries routinely over-withhold.

If a dividend equaling $1 was paid by a Canadian company to a U.S. taxpayer, the U.S. investor would receive just 85 cents because of the 15% withholding dictated by the Canadian-U.S. tax treaty.

The investor includes $1 of dividend income on their tax return even though they only received 85 cents. The United States gives taxpayers a dollar for dollar tax credit for amounts withheld to avoid double taxation.

As an example, if the dividend is “qualified,” the U.S. taxpayer would owe 20 cents to Uncle Sam. But because the taxpayer is given credit for the 15 cents paid to Canada, the investor only has to pay 5 cents to the United States.

However, not all foreign dividends are qualified, and a taxpayer can't always take a credit for all the withheld amounts. There are rules about which country's dividends can be qualified.

Dividends paid by our treaty partners are assumed to be qualified dividends. Internal Revenue Service Notice 2003-69 lists these countries.

Non-treaty country dividends will be taxed at the highest rate. There is also the 61-day minimum holding period rule that relates to all dividend receipts, foreign or domestic.

My February column dealt with the tax impact of buying puts.

In order for the withholding tax to qualify for the foreign tax credit, the shares must be held for at least 16 days over the record date. Any date during this period that the investor owns a put on the shares isn't counted as a good day.

Each and every record date has to have a “good” holding period. Owning a put on a foreign share both disqualifies the dividend and gives up the foreign tax credit.

A put-hedged $1 Canadian dividend will cause a 39.6 cent tax. If a taxpayer nets that against the 85 cents in cash received he or she winds up keeping 45.4 cents on the dollar.

An unhedged $1 Canadian dividend will net a U.S. taxpayer 80 cents.

Alternatively, put-hedged U.S. investors could elect to take the 15 cents withholding as a deduction instead of a credit but they would be electing to turn all their credits into deductions. If they own other foreign assets, this wouldn't be economical.

These investors would end up receiving and paying tax on 85 cents, thereby netting themselves 51.3 cents on the dollar -- the previously mentioned 45.4 cents plus 5.9 cents, representing the deduction on the 15 cents withheld.

And then there are state taxes to deal with. Most states don't have a foreign tax credit mechanism.

Just like on a federal return, a taxpayer puts $1 of dividend income on the state return, even though he or she is receiving just 85 cents. So investors do pay a double tax on that 15% of the dividend income to the state.

It is even worse when the actual withholding rate is more than the expected reduced treaty rate.
As an example, when Nestlé pays a dividend it, gets more complicated because it is a Swiss company. Switzerland withholds at 35% on dividends leaving the country.

Even though the United States has a treaty with Switzerland that allows for a 15% withholding, the dividends are still withheld at 35% because Switzerland doesn't know who the taxpayer is and thus assumes that he or she isn't a resident of a treaty country. A taxpayer would have to go to Switzerland to reclaim the over-withheld amount.

There are specialized services that assist investors and custodians in chasing these otherwise lost funds.

Foreign dividend withholding certainly causes some investors to keep a lot less than they would assume after simply looking at the stated dividend yield.

Robert N. Gordon (bob@twenty-first.com) is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business.