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Recoup the Tax Hit on Foreign Dividends

BY **ROBERT GORDON** July 1, 2015

There are complications that arise when a client receives a dividend from a company that is headquartered outside the U.S.

Many times the amount received is not the full amount of the dividend because taxes are withheld as dictated by the treaty (or lack of one) between the dividend-paying company's country of residence and the U.S. The existence of a treaty also can have an impact on whether the foreign dividend receives the favorable tax treatment afforded to U.S. qualifying dividend income.

BEING MADE WHOLE

If clients have money withheld by a foreign jurisdiction, they are to be made whole by the U.S. government through a dollar-for-dollar foreign tax credit when the investor pays the tax on the foreign income.

As an example, a client invests in a Canadian corporation that pays a dividend equal to one U.S. dollar. Because of the U.S.-Canada treaty, the dividend is withheld at a rate of 15%. Without a treaty, the withholding rate would most likely be higher.

The client receives only 85 cents of the $1 dividend because of the withholding, and yet when it comes time to do her taxes, she is treated as if she received the whole $1 dividend. This foreign dividend from a treaty country could be eligible for "qualified" dividend treatment. If the client satisfied the 61-day-holding-period requirement for the dividend, the dividend would be taxed at only 20%.

The client's tax return lists the full $1 dividend as qualifying dividend income, creating a 20-cent tax liability. The client is then able to use her foreign tax credit of 15 cents generated by the withholding against the 20-cent tax liability.

At the end of the day, the client pays the same 20 cents that she would have paid on a U.S. qualifying dividend; however, in this instance she pays 15 cents to the Canadian government and 5 cents to the U.S. government.

If the client does not satisfy the 61-day-holding-period requirement, then the tax on the dividend would be 39.6%. If she can use the foreign tax credit, then the 15-cent credit can be used to help pay the 39.6% tax.

Even if the client does not satisfy the 61-day rule, she may still be able to take the tax credit. There is only a 16-day minimum required holding period in order to be entitled to the foreign tax credit.

NONTREATY COUNTRIES

If a dividend comes from a nontreaty country, then the withholding will be at 30% and the client could still get a tax credit. The rules state that dividends from nontreaty countries cannot be qualifying dividends; however, there is an exception for nontreaty country shares of companies that trade in the U.S.

So if a company has American depositary receipts traded on a U.S. exchange, the dividends from the ADRs could be taxed at 20%.

The rules that apply to federal returns may not apply to state returns. Most states do not allow a tax credit for foreign taxes withheld.

Therefore, it is quite likely that a stockholder would wind up paying tax in his state on the full $1 dividend although he has received only 85 cents and has received no credit for the foreign taxes withheld.

Clients in these states pay a phantom income tax on the 15 cents they never received.

COSTLY PUTS

Warning: there is a hidden cost when buying puts on dividend-paying stocks. Any day a client owns a put is not counted when calculating the 61-day-holding-period needed to “qualify” the dividend for the 20% tax rate.

This is directly on point when holding shares over the record date for the dividend.

The purchase of a put on a foreign stock not only disqualifies the dividend, thereby doubling the tax, but it also eliminates the 16-day minimum holding period required to be entitled to a foreign tax credit.

These rules are applied every record date, no matter how long one has held the stock unhedged before the purchase of the hedge.

A put-hedged $1 dividend from Canada will cause a 39.6 cent tax; if you net that against the 85 cents in cash received, you wind up keeping only 45.4 cents on the dollar. As a comparison, an unhedged $1 dividend from Canada will net a U.S. taxpayer 80 cents after taxes.

Alternatively, the put-hedged U.S. client could elect to take the 15 cents withholding as a tax deduction instead of a tax credit, but then she would be electing to turn all of her foreign tax credits into deductions. If she owns other foreign assets, or more of these shares, this would not be economical.