



A Few Words About Dividends

Why you should look closer at preferred dividends, MGM's special dividend and foreign dividends.

By Robert N. Gordon

Many investors seek out preferred stock as a predictable source of dividend income. They should be wary, however, because most preferred shares are not true preferred stock. Instead, they are trusts, and instead of paying dividends, they pay interest, which is taxed at ordinary income rates. In fact, trust preferreds account for the majority of all preferred shares currently traded — some \$211 billion out of about \$250 billion.

Trust preferreds are created when companies issue debentures to grantor trusts, which in turn sell preferred securities to investors. Trust preferreds are hybrid securities: Issuers treat them as debt for tax purposes and as equity for capital and accounting purposes.

QuantumOnline.com, a Web site devoted to preferred stock, offers a list of true preferred stock. This list, entitled “Tax Advantaged Dividend Preferreds Table,” is available under “stock lists.”

Much Ado About MGM

Everyone is excited about MGM's big special dividend that is coming soon. The contemplated payout of \$8 is indeed significant. And it does not cause any immediate tax. But because MGM has no “earnings and profits” (as defined by the tax code), this “dividend” will actually be a return of capital. And while this return of capital does not cause an immediate tax, it does lower your cost basis in MGM. It is as if you were getting your money back — you buy at \$21, get \$8 back and then own a \$13 stock. If you then sell MGM for \$13, you would realize no gain or loss against your new \$13 cost basis (\$21 original basis adjusted for the \$8 of your capital that has been returned).

Although heralded as a tax-free distribution, this payout is really not an opportunity at all, that is, beyond the investment merits of owning MGM without any dividends.

The ADR Advantage

U.S. tax law does not treat all foreign countries equally. As a result, investors in companies based in certain

countries are better off buying ADRs while others do better with ordinary shares. Taxes on some foreign dividends, for example can be 15 percent while others can be 35 percent. To qualify for the lower rate, a company paying the dividend must be either incorporated in a U.S. possession, an issuer of stock that is tradable on an established U.S. security market or eligible for tax treaty relief. (Eligible countries are listed in IRS Notice 2003-69).

If a company is headquartered in a non-treaty foreign country, such as Taiwan or Hong Kong, then its ordinary stock is ineligible for the reduced dividends rate. In this case, investors should purchase ADRs in the company rather than ordinary shares. The ADR format should make dividends

U.S. tax law does not treat all foreign countries equally.

on the investment eligible for the 15% dividend tax rate. By contrast, if an investor buys ordinary stock in the same company, then dividends would be taxed at 35%. Countries that offer the ADR advantage (or, conversely, an ordinary share penalty) are Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Ghana, Hong Kong, China, Malaysia, Panama, Papua New Guinea, Peru, Singapore, Taiwan and Zambia.

It is not clear whether the 15 percent dividends will be available to all ADRs traded in the United States. ADRs that trade only in the “pink sheets” or on the OTC Bulletin Board may not qualify.

Investors also should note that there is a withholding tax on most dividends paid to U.S. taxpayers. The holder can take a tax credit for the amount withheld, but only if the stock is held for a minimum of 16 days. The rules governing this holding period are the same as those governing the 46-day holding period for U.S. dividends. Under IRC Section 243, most hedging techniques would stop the holding period clock. For more on what these rules allow, see the July 2003 issue of *On Wall Street*. **OWS**

Bob Gordon is President of Twenty-First Securities Corp. (www.twenty-first.com), an adjunct professor at New York University's Graduate School of Business, a member of the Wall Street Tax Ass'n. and author of *Wall Street Secrets for Tax-Efficient Investing* (Bloomberg Press).