



An Extraordinary Dividend Opportunity

Some dividends are large, but not too large to disqualify them for special tax treatment.

By **Robert N. Gordon**

Corporate America is changing its attitude on dividends. This past July, in fact, was the heaviest month in memory for positive dividend payout announcements. And there's still room to grow. Dividend payout ratios are only two-thirds of where they were in 1970, and just 365 of the S&P 500 equities pay dividends, versus 469 in 1980.

While larger dividends are now the order of the day, they still are not large enough to justify a mass flight to equities. But the appeal of larger-than-normal "special" dividends could prove irresistible.

Alas, with "special" dividends comes another set of rules.

A dividend is classified as "extraordinary" if it is more than 10 percent of the equity's market price. When dividends are that large, investors might have an incentive to buy shares while the stock is "pregnant" with its dividend and then sell the shares immediately after the dividend payout. This "dividend stripping" could allow the investor to capture both a dividend, taxed at 15 percent, and a short-term loss on the stock, which can be used to offset short-term gains (gains that otherwise would be taxed at 35 percent).

To discourage this practice, the law specifies that while "extraordinary" dividends on stocks held for 61 days will be taxed at only 15 percent, any capital loss on the underlying stock will be treated as a long-term loss regardless of the holding period. The reasoning behind this law was that since both long-term gains and dividends are taxed at 15 percent, investors have no incentive to "strip" large dividends. Paradoxically, the interplay of tax rules could make extraordinary dividends attractive to those possessing only short-term gains (no long-term ones).

Fortunately, the recent burst in special dividends has offered not only dividends that are too large but also several that are sized just right — bigger than a quarterly dividend but smaller than 10 percent. Since June 1, we've seen close to a dozen special dividend announcements. Two dividend record dates that are coming up — a \$5 payment from Iomega Corp. (IOM) and a euro-denominated dividend worth about \$15.88 from Gucci Group's

ADR (GUC). An analysis of these two possibilities proves instructive.

At first glance, IOM's promised payout certainly looks like an extraordinary dividend: The underlying stock currently trades at only \$11.40. But only a portion of the \$5 payment will be taxed as dividend — just the amount paid from IOM's earnings and profits, which have been taxed by the government either this year or cumulatively. The rest is treated as a return of capital, which is not currently taxable but instead lowers the

stockholder's cost basis so when you sell you'll realize more gain. It is estimated that only about \$1 of the payout will be

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classified as a dividend eligible for the 15 percent rate. But this is good news. Because IOM currently trades at \$11.40, that \$1 dividend should be classified as non-extraordinary. (A similar situation was presented by Regal Entertainment's recent jumbo-sized payout.) Someone purchasing IOM and holding it 61 days could conceivably create short-term losses (saving 35 percent) and also receive dividend income (taxed at 15 percent).

Gucci, as an ADR, could pay dividends eligible for the favorable tax rate. But first there would need to be a study of the company's earnings and profits, which might be difficult to ascertain in a foreign company. Unfortunately, another complication is present. GUC currently has in place the ability for shareholders to put their stock to another company in the future. We believe that even though GUC investors have taken no action to acquire this protection, the mere existence of this put right would destroy the investor's ability to accrue the needed 61-day holding period. As a result, any GUC dividend would be taxed at 35 percent. We wouldn't advise trying this one.

But watch Paccar, Frontline and Florida East Coast for possible future announcements of special dividends. **OWS**

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