Qualified Versus Non-Qualified Dividends and Examining a Dividend's Safety

For many investors, dividends are an excellent means of generating income for their portfolio. Depending on where you are in your investment lifecycle, you may reinvest those dividends or you use the income on various expenses.

AAII Weekly Survey Question

However, depending on the type of dividend being paid, you may face different tax considerations.

Regular dividends are classified as either qualified or non-qualified.

A qualified dividend is a type of dividend to which capital gains tax rates are applied. These tax rates are usually lower than regular income tax rates. Ordinary dividends that do not qualify for this tax preference are taxed at an individual's normal income tax rate.

The current tax rate on qualified dividends for those that have ordinary income taxed at 10% or 15% do not pay any tax on the dividends. Those that pay tax rates greater than 15% but less than 39.6% have a 15% rate on qualified dividends. The tax on qualified dividends is capped at 20%, which is for those individuals in the 39.6% tax bracket.

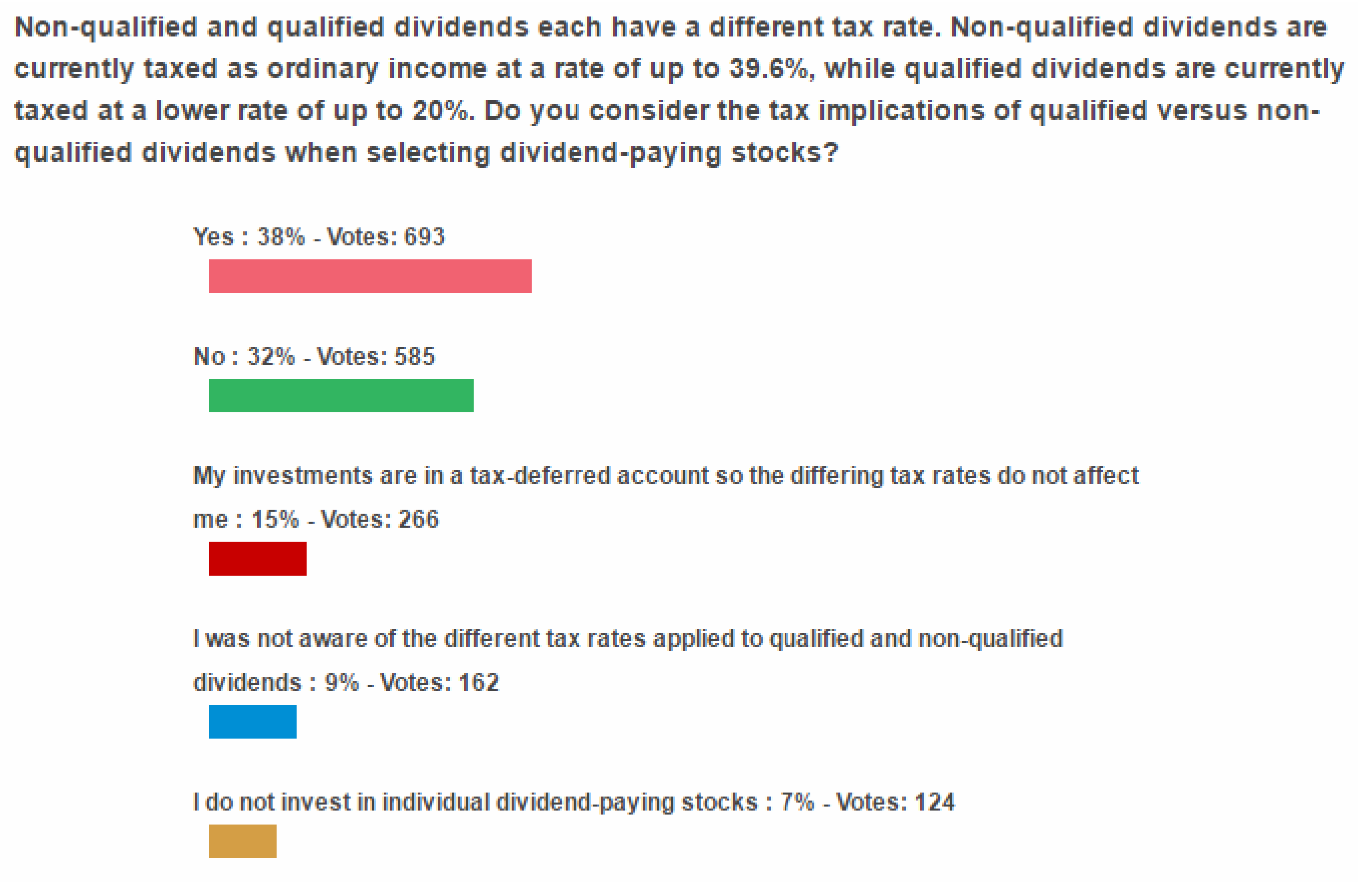
A foreign corporation is a qualified foreign corporation if it meets one of the following three conditions: the company is incorporated in a U.S. possession, the corporation is eligible for the benefits of a comprehensive income tax treaty with the United States, or the stock is readily tradable on an established securities market in the United States. A foreign corporation is not qualified if it is considered a passive foreign investment company.

In addition, there are investments that do not qualify. This means investors will have to pay the higher tax rate, which is the one applied to ordinary income, to the dividend income. These include dividends paid by real estate investment trusts (REITs), master limited partnerships (MLPs), those on employee stock options, and those on tax-exempt companies. Those paid from money market accounts, such as deposits in savings banks, credit unions or other financial institutions, do not qualify and should be reported as interest income. Special one-time dividends are also unqualified.

Seeing that investors face different tax handling based on the type of dividend being paid, we asked out readers if they pay attention to this when investing in dividend-paying stocks. Specifically, our weekly reader survey asked:

Do you consider the tax implications of qualified versus non-qualified dividends when selecting dividend-paying stocks?

Here are the results:



In all, 1,830 votes were cast through Monday, April 24.

Over one-third of our readers (38% in all) do consider the tax implications of qualified versus non-qualified dividends when investing in dividend-paying stocks.

Just under one-third of our readers–32%–do not consider the tax implications of qualified versus non-qualified dividends when selecting dividend-paying stocks.

Another 15% say that they do not consider the tax implications of dividend-paying stocks since their investments are in a tax-deferred account.

In addition, 9% of our readers were not aware that there are different tax rates on dividends depending on whether they are qualified or non-qualified.

Lastly, 7% of the respondents do not invest in divided-paying stocks.

Weekly Special Question

From last week's survey results, just over 93% if respondents invest in individual dividend-paying stocks. We were curious to know how they go about researching the "safety" of the dividends they are investing in. So last week's special question asked:

If you invest in dividend-paying stocks, what factor(s) do you consider when gauging the safety of the dividend stream moving forward?

In all, 220 readers replied to the question.

The biggest determinant of a dividend's safety, based on our readers' responses, is the company's dividend history. This includes how long a company has been paying a dividend, the historical growth in the dividend or whether a company has ever cut its dividend.

Coming in a very close second, our readers consider the payout ratio as an indicator of the safety of the dividend. Our readers consider the percentage of earnings, operating cash flow and free cash flow that is being paid out as dividends.

From there, we see quite a drop off in responses. With roughly half the responses of the top-two factors, our readers consider the company's cash flow when analyzing its dividend's safety. This makes sense since dividends are paid out of cash.

Rounding out the top-five responses:

- Earnings history, earnings growth, profitability, etc.
- Financial strength (quality of balance sheet)

Here is a sample of the responses:

- "I consider the history of both earnings & dividends, as well as the payout ratio."
- "I look for companies with long history of increasing dividends and a moderate dividend to cash flow ratio."
- "I look to the Dividend Aristocrats."
- "It's history of paying the dividend."
- "Sales must be increasing. Earnings must be increasing. The dividend should not be greater

than 40% of earnings. Return on Total Capital should be greater than the cost of capital.”

- “Weiss rating of the stock, how long dividends have been paid and whether they have continually increased for a reasonably long time.”
- “The company’s past record of paying their dividend and their record of increasing their dividend over time.”

Everybody has an opinion! Why not give us yours? Participate in our weekly member poll, updated every Monday, and see the results online at http://www.aaii.com/memberquestion.