How to Save Big on Taxes Using Qualified Dividends

Why Invest in Dividend Stocks?

- Dividends are regular profit-sharing payments made between a company and its investors.
- A company's board of directors determines the price per share, when and how often dividend payments are made.
- Dividend stocks can provide a stream of income, which can be especially valuable during inflationary periods.

Dividend investing can be a great investment strategy. Dividend stocks have historically outperformed the S&P 500 with less volatility because dividend stocks offer two sources of return:

- **regular income** from dividend payments
- **capital appreciation** of the stock price.

This total return can add up over time.

Because of their lower volatility, dividend stocks often appeal to investors looking for lower-risk investments, especially those who are in retirement or are about to retire. But dividend stocks can still be risky if you are not careful in what you invest.

Understanding Qualified Dividends

Dividends are separated into two classes by the IRS:

A dividend is an **ordinary dividend** if you have held the shares for less than 61 days in the 121-day period that began 60 days before the **ex-dividend date**.

The ex-dividend date is one business day before a dividend is declared. If you purchase it on or before that date and hold it for 61 days or more before the dividend, it is a **qualified dividend**, which "qualifies" it for the ***lower capital gains tax rate***.

For example, imagine you owned XYZ stock, which declared a dividend payment on November 21 (a Monday). The ex-dividend date is one business day before this date, so that is November 18, the previous Friday. If you bought XYZ stock less than 60 days before November 18 and received a dividend, it is counted as **ordinary income**.

If you bought XYZ stock more than 60 days before November 18, you would receive the next dividend as a **qualified dividend** if you held it for at least 61 days in the 121-day period before the next dividend. You would then pay the capital gains tax rate on the dividend.

The **ex-dividend date** is also important for receiving dividends. If you purchase stock before the ex-dividend date, you will be eligible to receive the next dividend. If you purchase it after the ex-dividend date, you will not receive the next dividend.

To qualify for the maximum tax rates of 0%, 15%, or 20% that apply to long-term capital gains, qualified dividends must meet other requirements, as outlined by the Internal Revenue Service:

- The dividend must have been paid by a U.S. company or a qualifying foreign company
- The dividends are not listed with the IRS as those that do not qualify
- The required dividend holding period has been met

The biggest difference between **ordinary dividends** and **qualified dividends** is the tax rate:

- ordinary dividends are taxed as ordinary income
- qualified dividends are eligible for taxation at a lower rate

As with all things tax-related, there are some rules and eligibility criteria for dividends to be deemed qualified. This comparison explains all of these.

Ordinary Dividends versus Qualified Dividends comparison

Ordinary Dividends	Qualified Dividends
Taxed as ordinary income (0 - 39.6% rate)	**Taxed lower than ordinary income (0 - 23.8% rate)**

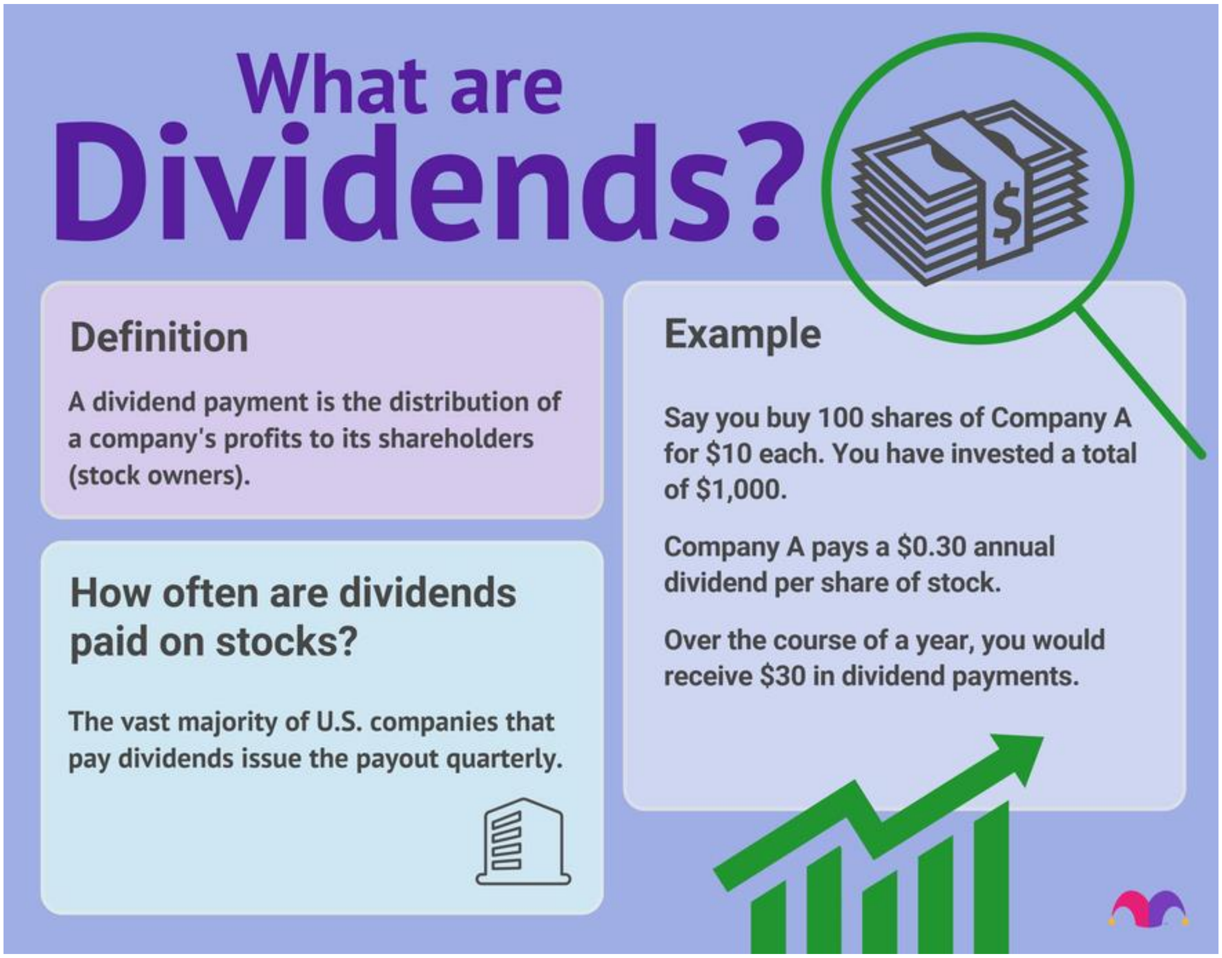
What Qualified Dividends Means to You?

If you are not yet a shareholder, then a qualified dividend doesn't mean much to you. However, if you are considering opening a portfolio or becoming an investor, it may incentivize you. A **qualified dividend** comes with favorable tax benefits that appeal to both the stockholder and the company distributing them.

You can continue to reduce your taxes on your qualified distributions. For example, you can offset your capital losses through **tax-loss harvesting**. Or, you can put your investments in a tax-deferred investment account, like an IRA or 401(k). Many people use these dividends to support their retirement income. You do not have to pay taxes on income held in a retirement account, which can help you avoid taxes on your dividends entirely. So, reinvesting may be a valuable option. However, it is important to know how long a company may pay you dividends since it likely will not have a guaranteed term.

The Bottom Line

Qualified dividends are a way to reward long-term shareholders. They are taxed at a lower rate than ordinary dividends, giving them a tax benefit status.



The IRS and How Dividends are Reported and Taxed - Form 1099-DIV

You should receive a Form 1099-DIV, Dividends and Distributions from each payer for distributions of at least $10. If you're a partner in a partnership or a beneficiary of an estate or trust, you may be required to report your share of any dividends received by the entity, whether or not the dividend is paid out to you. Your share of the entity's dividends is generally reported to you on a Schedule K-1.

Dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of the corporation. Dividends can be classified either as **ordinary** or **qualified**. Whereas ordinary dividends are taxable as ordinary income, qualified dividends that meet certain requirements are taxed at lower capital gain rates. The payer of the dividend is required to correctly identify each type and amount of dividend for you when reporting them on your Form 1099-DIV for tax purposes. For a definition of qualified dividends, refer to Publication 550, Investment Income and Expenses.

Return of Capital

Distributions that qualify as a return of capital are not dividends. A return of capital is a return of some or all of your investment in the stock of the company. A return of capital reduces the adjusted cost basis of your stock. For information on basis of assets, refer to Topic No. 703. A distribution generally qualifies as a return of capital if the corporation making the distribution doesn't have any accumulated or current year earnings and profits. Once the adjusted cost basis of your stock has been reduced to zero, any further non-dividend distribution is a taxable capital gain that you report on Form 8949, Sales and Other Dispositions of Capital Assets and Schedule D (Form 1040), Capital Gains and Losses.

Additional Considerations

Form 1099-DIV should break down the distribution into the various categories. If it does not, please contact the payer. You must give your correct social security number to the payer of your dividend income. If you don't, you may be subject to a penalty and/or backup withholding. For more information on backup withholding, refer to Topic No. 307.

If you receive over $1,500 of taxable ordinary dividends, you must report these dividends on Schedule B (Form 1040), Interest and Ordinary Dividends. If you receive dividends in significant amounts, you may be subject to the Net Investment Income Tax (NIIT) and may have to pay estimated tax to avoid a penalty. For more information, see Topic 559, Net Investment Income Tax, Estimated Taxes or Am I Required to Make Estimated Tax Payments?

Additional Information

You may find more information on dividend income in Publication 550, Investment Income and Expenses.

Newsletter information

We publish a monthly **Newsletter**. The **October and November issues** are also online. They contain a trove of useful information. It will be free until December 2022, and then by **subscription only**. Please send us an email on **info@taxandpension.com** to make sure that you receive a notice that a new **Newsletter** issue has been published. We also have a **Blog** and **News** section. They will be constantly updated to keep you on top of the latest tax and pension news and any other news that we feel is of interest to you.

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