What Is a Qualified Dividend?

The category of your dividend income makes a difference to the IRS.

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Depending on how you use the word, "qualified" has many different meanings in the financial world. There are qualified investors (who can put money into hedge funds and private equity), qualified opportunity funds (for spurring economic development) and qualified businesses (which include most small business owners).

And while some of us may not feel all that qualified to invest without help, figuring out the landscape of qualified dividends amounts to a fairly pain-free task. And as with so many things in life, the heart of the matter revolves around taxes.

The foundation here is built on the dividend itself: the quarterly payment public companies give to shareholders that comes from profits or reserves. Quarterly turns into qualified when that dividend is taxed at a capital gains rate lower than the income tax rates applied to other dividends – known as ordinary, or unqualified.

To be sure, qualified dividends are nice to have. But experts contend that the tax advantage represents just one of many factors shareholders should weigh as they build their portfolios.

"The tax tail should never wag the investment dog," says David Dietze, founder and president at Point View Wealth Management in Summit, New Jersey. "You invest in stocks because their returns versus volatility are something you seek and can live with, not because the dividends are qualified."

But a little knowledge insofar as the upsides you can leverage adds up to a very good thing: It all depends on what you do with the dividend you collect.

"Qualified dividends are taxed at rates generally half that of regular bond interest and non-qualified dividends," Dietze says. "So if you're working with a taxable account, all other things being equal, you'd gravitate to having qualified dividend payouts in taxable accounts." Nonqualified dividends, by contrast belong "in tax-sheltered accounts such as IRAs and 401(k)s."

"The distinction might not be that great, but it could be significant when it comes time to pay your taxes," says David Bakke, a financial writer for the Money Crashers website. "The tax rate schedule is a bit complex and based on your income. But suffice it to say that most of the time your tax burden will be less with qualified dividends compared to unqualified."

Meanwhile, institutions that award unqualified dividends shouldn't be treated the same. Here, Dietze points to some crucial distinctions for investors to consider.

"Equities that don't pay qualified dividends are generally 'pass-through entities' where the paying entity is not subject to tax at the entity level," he says. These would include real estate investment trusts and partnerships.

"Foreign stocks should also be scrutinized carefully to determine the type of dividend, as well as preferred stocks," Dietze adds.

So just what makes a dividend qualified anyway? As Bakke notes, "Qualified dividends must comply with three rules as established by the IRS."

First, they must be paid by either a domestic or U.S.-based company, or a foreign one that meets certain requirements. These run the gamut from the nation in question being covered under U.S. tax treaty to the presence of shares on the New York Stock Exchange or NASDAQ.

Second, the company's payouts must not be on IRS list of dividends considered being unqualified. (Take good note: Rarely will anything connected to the IRS be so bonehead simple.)

Finally, "There is a holding period that applies to the dividend that needs to be met," Bakke says. The payee must own the stock for a minimum of roughly 60 days for common stock and 90 days for preferred stock.

A closer look at how dividends square up against tax rates shows just how far the advantages can go.

In the seven income tax brackets between 10 and 39.6%, unqualified dividends are essentially treated the same as income: in essence, taxed at the same amount. But for those occupying that top shelf – which equals a taxable income above $406,750 (single) or $457,600 (joint) – the qualified rate comes in at 20 to 23.8%. Now, let's do the math: On a $10,000 dividend payout, you're either talking about a tax bill of $3,960 (unqualified) or $2,380 maximum (qualified).

Similar advantages apply at every level beneath as well. A couple reporting annual income between $18,150 and $73,800 would pay 15% tax on unqualified dividends, but nothing on qualified.

Yet is a qualified dividend tax strategy equivalent to free money? That, some experts say, depends on how you view any dividend in the first place.

"Generally, there is the fallacy that dividends are free money, by which I mean that many investors strictly buy dividend stocks to get the dividend income or bonus," says Dejan Ilijevski, investment advisor and president at Sabela Capital Markets in Munster, Indiana. "Rather a dividend is simply a transfer of wealth from the company's books to the shareholder."

So qualified? Or unqualified? Or perhaps another investment qualifier altogether?

"There are time periods when dividend-paying stocks have done better and times when they have underperformed growth stocks or the market," Ilijevski says. "The point can be strongly made that a dividend payout should be no more meaningful that selling shares."