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The tax advantages of preferred stocks

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With tax day still fresh in everyone's mind, investors may be thinking about the tax efficiency of their portfolios. The potential tax advantages of certain preferred securities are often overlooked.

The qualified dividend income (QDI) tax treatment of perpetual preferred stock dividends may provide an attractive after-tax yield compared to fully taxable corporate bonds.

The QDI tax rate depends on an individual's income level, with 20% being the top rate. An additional 3.8% net investment income surtax gets applied to both dividend and interest income for individuals that have income in excess of certain thresholds. Therefore, investors in the top tax brackets pay a maximum QDI rate of 23.8%, compared to the top ordinary rate on interest income of 40.8% (37% + 3.8%). One way that investors can compare the approximate "taxable equivalent yield" (TEY) on QDI-eligible preferreds is to use an appropriate approximation factor to "gross up" the coupon.

The formula uses the traditional municipal bond TEY formula of 1 / (1-marginal tax rate) but then multiplies this result by (1 - QDI rate). So for an investor that faces the top tax bracket for both marginal and QDI rates, the factor becomes {1 / (1-.408)} * (1-.238) = 1.29x. For example, a 50/50 mix of USD 25 and USD 1000 par preferreds currently yields about 6.9%, which equates to a fully-taxable equivalent yield of 8.9% (6.9% x 1.29) for those in the highest tax brackets.

QDI Preferred TEY relative to other credit sectors. This actually compares more favorably than the yield that is attainable on high yield (HY) bonds with a lower credit rating of single B.

These QDI tax advantages apply to US holders of QDI preferreds. Non-US holders (with non-resident alien [NRA] accounts) may be subject to additional withholding when investing in QDI preferreds. For these investors, interest-paying preferreds are generally more appropriate. In addition, REIT distributions are not QDI eligible. However, after the 2017 Tax Cuts and

Jobs Act, a portion of REIT distributions may be eligible for a 20% deduction as qualified business income. This could effectively lower the tax rate on REIT preferred dividends, for example reducing the top tax rate to 29.6% from 37%.

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