

HASHEM and SIMMS, PLLC
CERTIFIED PUBLIC ACCOUNTANTS

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Dear Client,

In general, there are three types of distributions that can be received from a corporation: ordinary dividends; capital gain distributions; and nontaxable distributions.

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are taxed as ordinary income to you. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend, unless the paying corporation tells you otherwise. Amounts received from money market funds are also dividend income, not interest income. Similarly, dividends on capital stock of organizations such as savings and loan associations are considered ordinary dividends, not interest income. However, ordinary dividends received from domestic corporations and qualifying foreign corporations are considered "qualifying dividend" income and are taxed at the preferential capital gain rates. This treatment is effective for tax years beginning after 2002 through tax years beginning before 2011.

Amounts paid to you or credited to your account by regulated investment companies, mutual funds, and real estate investment trusts (REIT) are capital gain distributions or dividends. Such distributions that are not derived in the ordinary course of a trade or business are treated as portfolio income and are not considered income from a passive activity. Capital gain distributions paid to you during the year are reported as long-term capital gains, regardless of how long you owned the stock in the regulated investment company, mutual fund or REIT.

One type of nontaxable distribution is a return of capital, that is, a distribution that is not paid out of the earnings and profits of a corporation. Instead, it is a return of your investment in the stock of the company. Such a return of capital reduces your basis in the stock and is not taxed until your basis in the stock is fully recovered. Once your basis has been fully recovered, you must report any further return of capital as either a long-term or short-term capital gain, depending on how long you have held the stock.

Another type of nontaxable distribution is a liquidating distribution, that is, a distribution you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, a return of capital, and are not taxable to you until you have recovered the basis in your stock. After your basis has been recovered, you must report the liquidating distribution as a capital gain.

Most corporations use Form 1099-DIV to show you the distributions you received from them during the year. If the distribution is a capital gain distribution, that information should be contained on the form. If the distribution is a return of capital, you will find it in the box titled "nontaxable distributions." Keep in mind that if you have already recovered your entire basis in



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the stock, the amount you receive as a distribution is taxed as capital gain regardless of whether the payor lists it as nontaxable.

There are various other special rules relating to the treatment of distributions received from corporations. If you have any questions about the matters discussed in this letter, or wish to discuss the specifics of your situation further, please give us a call.

Sincerely,

George K Hashem

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