
Utility Forecaster

Tax Guide

By Roger S. Conrad

If you make money in the market, you're going to owe taxes. And when it comes to investing, dividends and other cash distributions are pretty easy to spot.

You can manage your potential liabilities, however, with a little prudent management. And the starting point for that is to know how your income is taxed.

Utility Forecaster's focus is to highlight investments in the top companies providing essential services. The majority are common stocks in US-based electric, natural gas, communications and water utilities.

But there are also superb opportunities in a whole range of other types of securities, for example bonds, preferred stocks, convertible securities, master limited partnerships (MLP), income deposit securities (IDS), foreign stocks and Canadian income trusts.

Each of these investments is taxed slightly differently. We own them primarily because they're backed by healthy, growing businesses that are going to build wealth over time. Business strength is by far the most important factor when it comes to how much money we'll make as investors. But knowing how a particular investment is taxed and acting accordingly can make a big difference when it comes to maximizing your returns.

Here in brief is how each of these groups breaks down. The table shows where each of the companies fits that we track in How They Rate. For technical questions, the best course is always to consult with your tax advisor. And remember, tax laws can and do change, often frequently.

Qualified vs. Ordinary

In 2003 with the US economy coming out of recession, President Bush and the Republican Congress passed legislation that for the first time ever attached a preferential tax rate for investment income. A top rate of 15 percent was set for both long-term capital gains and for dividends paid by "qualified corporations," declining to 5 percent for lower income individuals.

Unfortunately, in order to win the support of several recalcitrant senators, these lower rates were given a finite life, with expiration slated for Jan. 1, 2011. At that point, taxes on dividends would revert to the investor's ordinary income tax rate.

The key question now is whether Congress and the Obama administration will act to extend preferential rates or simply let them expire, effectively imposing a tax increase as the economy struggles to recover. The good news is proposals from both the administration and the US Senate have been introduced to make preferential tax rates permanent, with the caveat that the top rate will be raised from 15 to 20 percent.

The bad news is getting that done will require the Obama administration to either win over Congressional Democrats on this issue at a time when anti-Wall Street rhetoric is heating up, or else get support from Republicans. Either way will be difficult to achieve.

During the Congressional debate, proponents ascribed many benefits to the dividend tax cut. A primary argu-

ment was that reducing taxes on investment income would lower the cost of capital to business, stimulating investment and job creation. The lower cost of capital would result from a rise in US corporate equity prices.

One estimate, based on capitalizing the Congressional Budget Office projection of the annual flow of foregone dividend taxes, pegged the likely boost for US equities resulting from cutting the dividend rate at around 6 percent.

This valuation argument is likely to be central during the coming debate. Although researchers for the Federal Reserve were unable to find conclusive evidence that the dividend tax cut, specifically, impacted the overall value of the US stock market when they studied its impact in 2006, this doesn't end the argument.

"On the other hand," they wrote, "high-dividend stocks outperformed low-dividend stocks by a few percentage points over the event windows, suggesting that the tax cut did induce asset reallocation within equity portfolios."

In any case, dividends paid by "qualified corporations" have at least one more year of preferential tax rates. That's a plus for owning them.

In addition to the expiration date, the other problem with the Bush tax cuts was they didn't clearly define what a qualified corporation is. And with the tax cut billed as temporary, the Internal Revenue Service has done little beyond issuing a few general rules on what's qualified and what's not.

As a result, brokerage houses and other account custodians have been

prone to egregious errors when it comes to assessing taxes owed on investments, i.e. whether something is a “qualified corporation” or not. Our general rule is the definitive source on what’s qualified and what isn’t is the company in question. But there are a few general rules of thumb.

First, all common stocks pay qualified dividends. That’s true whether they’re domiciled in the US or anywhere else in the world. In fact, foreign companies are generally “qualified corporations,” even if they’re organized as real estate investment trusts, master limited partnerships or Canadian income trusts. The so-called equity test is simply that you’re a part owner of the company, which you are when you own equity.

Second, virtually all fixed income securities’ distributions are taxed as ordinary income, i.e. at the holder’s rate. That’s true of all bonds, with the exception of municipals which are mostly federally tax free. It’s also true of most preferred stocks, with the exception of those that pay dividends from post-tax earnings.

The “capital preferred stocks” such as monthly income preferred securities—typically denominated in amounts of \$25 par value—aren’t qualified and their dividends are taxes as ordinary income. In contrast, most preferreds with par values of \$100 do pay qualified dividends.

Master limited partnerships (MLP) do not pay qualified dividends. But they do enjoy some considerable advantages. Mainly, while corporations pay dividends from post-tax income, MLPs feed investors pre-tax cash flow. That results in much higher initial distributions to investors. Tax burdens also pass through but expenses also convey, which minimizes the burden.

Another advantage is most if not all MLP distributions are classified as a return of capital (RoC). RoC isn’t taxed when distributed. Instead, it’s deducted from your cost basis and is therefore only taxed when you sell your units. Moreover, you can indefinitely postpone

taxes by willing the units to your heirs, at which time the cost basis will revert to the current price of the MLP.

Government tax policy is always at risk to change. However, last year’s heavily Democratic US Congress actually expanded the purview of the MLP structure to include ethanol. That’s a strong sign there’s bipartisan support for MLPs. And thus far MLPs have steered clear of the tax debate in Washington.

The exceptions are MLPs that utilized the concept of “carried interest” to minimize burdens. This is not true of any of the MLPs covered in *Utility Forecaster* or of any MLP set up to hold and operate energy assets.

Another key distinction between MLPs and ordinary common stocks is in the way you account for taxes. Brokers and account custodians send out Form 1099s every year showing tax burdens for common stocks and other investments.

In contrast, MLPs send out Form K-1s that detail the ins and outs of taxes owed and paid, usually in early to mid-February. Information on K-1s can be easily transferred to tax forms, just as information on 1099s can be.

Note that if you own a common stock in a dividend reinvestment plan (DRIP), you’ll owe taxes on distributions paid even though your cash is reinvested. DRIPs, ironically, lost their exemption from taxation during the administration of Ronald Reagan. They’re still superb wealth building vehicles, however, if you can afford to pay the tax. Just be sure to keep your records so you can establish a cost basis when you sell.

IRAs

One question I get asked frequently is what kind of income-generating securities are suitable for IRAs and other investment accounts where taxes are deferred.

The most important criterion is always the strength of the underlying business.

But once you can vouch for the company—and have established a balanced portfolio—there are a few simple rules for income investing in IRAs.

First, all US common stocks, bonds, preferred stocks and mutual funds recommended in *Utility Forecaster* are suitable for IRAs. The main reason is there are no additional tax forms that need to be filed and the income will pile up tax free until you withdraw funds.

Second, MLPs are also fine as holdings in IRAs. Either you or your custodian, however, will receive a Form K-1 to fill out, and there may be some taxes due in the form of unrelated business taxable income (UBTI). These are generally not material unless you hold a very large quantity of units and many people ignore them. But that decision is clearly up to the individual and we make no recommendation.

A more important reason why you might want to hold MLPs outside of an IRA is the advantage of return of capital, which is lost if you hold them inside an IRA. Income paid by MLPs held outside an IRA, as I said above, can permanently escape taxation. Income paid by MLPs inside an IRA will be taxed at your ordinary tax rate as you withdraw funds.

Foreign stocks can be held inside IRAs without complication. The chief drawback is you’ll have trouble recovering income withheld by foreign governments. Virtually every government in the world withholds a portion of dividends paid on securities held by foreigners. US investors can recover it by filing a Form 1116, but only if they hold these stocks outside an IRA.

Interestingly, the exception to the withholding rule is Canada. By the Income Tax Act (ITA) and the US-Canada Tax Treaty (Treaty), the governments of Canada and the US withhold 15 percent of distributions paid by home country companies to each others’ citizens. That’s far less than the rates imposed by most foreign governments, which can range as high as 30 percent.

If Canadian companies—including income trusts—are held outside an IRA, US investors can reclaim the withholding tax by filing a Form 1116. They can't file a Form 1116 on any security held inside an IRA. As of Dec. 15, 2008, however, those accounts are legally exempt from withholding.

Prior to that, distributions weren't treated as "dividends" within the meaning of the ITA. As a result, because Treaty Article XXI (Exempt Organizations) applies only to dividend or interest payments, the exemption from Canadian withholding tax under Article XXI of the Treaty didn't

eliminate withholdings on distributions from income and royalty trusts to US pension funds and qualified retirement plans. Rather, most distributions to non-residents from a trust were subject to withholding tax at a rate of 15 percent under Article XXII of the US-Canada Tax Treaty.

What's changed is a little-noticed interpretation contained in Annex B of the Fifth Protocol of the Treaty, which came into force on Dec. 15, 2008 and has eliminated Canadian income trusts' tax withholding if held in US IRAs. Annex B states that distributions from "income trusts and royalty trusts" that

are treated as dividends under Canadian tax law will be treated as dividends under the Treaty.

The clarification in Annex B of the Fifth Protocol means that Article XXI of the Treaty applies and that distributions from Canadian income and royalty trusts should be tax-free to US pension funds and retirement plans that qualify for the elimination of withholding under Article XXI. The job now is to bring this—the Annex B to the Fifth Protocol of the US-Canada Income Tax Convention—to the attention of Canadian transfer agents and US brokerage houses.

DIVERSIFIED ENERGY UTILITIES

Company (Exchange: Symbol)	Tax Status
AES Corp (NYSE: AES)	No Dividend
Allegheny Energy (NYSE: AYE)	Qualified
Allete (NYSE: ALE)	Qualified
Alliant Energy Corp (NYSE: LNT)	Qualified
American Electric Power (NYSE: AEP)	Qualified
Ameren Corp (NYSE: AEE)	Qualified
Black Hills Corp (NYSE: BKH)	Qualified
Centerpoint Energy (NYSE: CNP)	Qualified
Cleco Corp (NYSE: CNL)	Qualified
CMS Energy (NYSE: CMS)	Qualified
Constellation Energy Group (NYSE: CEG)	Qualified
Dominion Resources (NYSE: D)	Qualified
DPL (NYSE: DPL)	Qualified
DTE Energy (NYSE: DTE)	Qualified
Duke Energy (NYSE: DUK)	Qualified
Edison International (NYSE: EIX)	Qualified
El Paso Elec (NYSE: EE)	No Dividend
Empire District Electric (NYSE: EDE)	Qualified
Entergy Corp (NYSE: ETR)	Qualified
Exelon Corp (NYSE: EXC)	Qualified
FirstEnergy Corp (NYSE: FE)	Qualified
FPL Group (NYSE: FPL)	Qualified
Great Plains Energy (NYSE: GXP)	Qualified
Hawaiian Electric Industries (NYSE: HE)	Qualified
IdaCorp (NYSE: IDA)	Qualified
Integrus (NYSE: TEG)	Qualified
MGE Energy (NSDQ: MGEE)	Qualified
MDU Resources (NYSE: MDU)	Qualified
NiSource (NYSE: NI)	Qualified
NorthWestern Corp (NYSE: NEW)	Qualified
OGE Energy Corp (NYSE: OGE)	Qualified

ONEOK (NYSE: OKE)	Qualified
Otter Tail Corp (NSDQ: OTTR)	Qualified
PG&E Corp (NYSE: PCG)	Qualified
Pinnacle West Capital Corp (NYSE: PNW)	Qualified
PNM Resources (NYSE: PNM)	Qualified
PPL Corp (NYSE: PPL)	Qualified
Progress Energy (NYSE: PGN)	Qualified
Public Service Enterprise Group (NYSE: PEG)	Qualified
SCANA Corp (NYSE: SCG)	Qualified
Sempra Energy (NYSE: SRE)	Qualified
Southern Company (NYSE: SO)	Qualified
TECO Energy (NYSE: TE)	Qualified
UniSource Energy Corp (NYSE: UNS)	Qualified
Vectren Corp (NYSE: VVC)	Qualified
Westar Energy (NYSE: WR)	Qualified
Wisconsin Energy Corp (NYSE: WEC)	Qualified
Xcel Energy (NYSE: XEL)	Qualified

ENERGY DISTRIBUTION UTILITIES

Company (Exchange: Symbol)	Tax Status
AGL Resources (NYSE: AGL)	Qualified
AmeriGas Partners LP (NYSE: APU)	RoC/Ordinary
Atmos Energy (NYSE: ATO)	Qualified
Avista Energy (NYSE: AVA)	Qualified
Buckeye Partners LP (NYSE: BPL)	RoC/Ordinary
Central Vermont Public Service Corp (NYSE: CV)	Qualified
Chesapeake Utilities Corp (NYSE: CPK)	Qualified
CH Energy Group (NYSE: CHG)	Qualified
Consolidated Edison (NYSE: ED)	Qualified
Delta Natural Gas Company (NSDQ: DGAS)	Qualified
El Paso Pipeline Partners LP (NYSE: EPB)	RoC/Ordinary
Enbridge Energy Partners LP (NYSE: EEP)	RoC/Ordinary
Energy Inc (AMEX: EGAS)	No Dividend
Energy Transfer Partners LP (NYSE: ETP)	RoC/Ordinary

Enterprise Products Partners LP (NYSE: EPD)	RoC/Ordinary
Ferrellgas Partners LP (NYSE: FGP)	RoC/Ordinary
ITC Holdings Corp (NYSE: ITC)	Qualified
Kinder Morgan Energy Partners LP (NYSE: KMP)	RoC/Ordinary
Laclede Group (NYSE: LG)	Qualified
Magellan Midstream Partners LP (NYSE: MMP)	RoC/Ordinary
Maine & Maritimes Corp (AMEX: MAM)	Qualified
MarkWest Energy Partners LP (NYSE: MWE)	RoC/Ordinary
New Jersey Resources Corp (NYSE: NJR)	Qualified
Nicor Inc (NYSE: GAS)	Qualified
Northeast Utilities System (NYSE: NU)	Qualified
Northwest Natural Gas (NYSE: NWN)	Qualified
NSTAR (NYSE: NST)	Qualified
NuStar Energy LP (NYSE: NS)	RoC/Ordinary
NV Energy (NYSE: NVE)	RoC/Ordinary
ONEOK Partners LP (NYSE: OKS)	Qualified
Pembina Pipeline Income Fund (TSX: PIF-U, OTC: PMBIF)	Qualified
Piedmont Natural Gas (NYSE: PNY)	Qualified
Portland General Electric (NYSE: POR)	Qualified
Pepco Holdings (NYSE: POM)	Qualified
RGC Resources (NSDQ: RGCQ)	Qualified
South Jersey Industries (NYSE: SJI)	Qualified
Southern Union (NYSE: SUG)	Qualified
Southwest Gas Corp (NYSE: SWX)	Qualified
Spectra Energy Corp (NYSE: SE)	Qualified
Spectra Energy Partners LP (NYSE: SEP)	RoC/Ordinary
Suburban Propane Partners LP (NYSE: SPH)	RoC/Ordinary
TEPPCO Partners LP (NYSE: TPP)	RoC/Ordinary
UGI Corp (NYSE: UGI)	Qualified
UIL Holdings Corp (NYSE: UIL)	Qualified
Unitil Corp (NYSE: UTL)	Qualified
WGL Holdings (NYSE: WGL)	Qualified

NATURAL RESOURCES UTILITIES

Company (Exchange: Symbol)	Tax Status
ARC Energy Trust (TSX: AET-U, OTC: AETUF)	Qualified
Atlantic Power Corp (TSX: ATP-U, OTC: ATLIF)	Qualified
Boralex Power Income Fund (TSX: BPT-U, OTC: BLXJF)	Qualified
BP Plc (NYSE: BP)	Qualified
BP Prudhoe Bay Royalty Trust (NYSE: BPT)	RoC/Ordinary
Brookfield Renewable Power Fund (TSX: BRC-U, OTC: BRPFF)	Qualified
Calpine Corp (NYSE: CPN)	No Dividend
Chesapeake Energy Corp (NYSE: CHK)	Qualified
Chevron (NYSE: CVX)	Qualified
ConocoPhillips (NYSE: COP)	Qualified
Covanta Holding Corp (NYSE: CVA)	No Dividend
Devon Energy Corp (NYSE: DVN)	Qualified
Dominion Resources Black Warrior Trust (NYSE: DOM)	RoC
Dynegy (NYSE: DYN)	No Dividend
El Paso Corp (NYSE: EP)	RoC/Qualified
EnCana Corp (NYSE: ECA)	Qualified
Energen Corp (NYSE: EGN)	Qualified

Enerplus Resources Fund (NYSE: ERF)	Qualified
Eni (NYSE: E)	Qualified
EOG Resources (NYSE: EOG)	Qualified
Equitable Resources (NYSE: EQT)	Qualified
ExxonMobil (NYSE: XOM)	Qualified
Linn Energy LLC (NSDQ: LINE)	RoC/Ordinary
Mirant Corp (NYSE: MIR)	No Dividend
National Fuel Gas (NYSE: NFG)	Qualified
NRG Energy (NYSE: NRG)	No Dividend
Peabody Energy Corp (NYSE: BTU)	Qualified
Penn Virginia Resources (NYSE: PVR)	RoC/Ordinary
Petrobras (NYSE: PBR)	Qualified
Penn West Energy Trust (NYSE: PWE)	Qualified
Provident Energy Trust (NYSE: PVX)	Qualified
Questar Corp (NYSE: STR)	Qualified
RRI Energy (NYSE: RRI)	No Dividend
Royal Dutch Shell Plc (NYSE: RDS.A)	Qualified
Southwestern Energy (NYSE: SWN)	No Dividend
TOTAL (NYSE: TOT)	Qualified
Williams Companies (NYSE: WMB)	Qualified

COMMUNICATIONS UTILITIES

Company (Exchange: Symbol)	Tax Status
Alaska Communications Systems (NSDQ: ALSK)	Qualified
AT&T Corp (NYSE: T)	Qualified
Cablevision (AMEX: CVC)	Qualified
CenturyTel (NYSE: CTL)	Qualified
Cincinnati Bell (NYSE: CBB)	No Dividend
Comcast Corp (NSDQ: CMCSA)	Qualified
Consolidated Communications (NSDQ: CNSL)	Qualified
FairPoint Communications (OTC: FRCMQ)	No Dividend
Frontier Communications (NYSE: FTR)	Qualified
IDT Corp (NYSE: IDT)	No Dividend
Iowa Telecommunications (NYSE: IWA)	Qualified
Level3 Communications (NSDQ: LVL3)	No Dividend
Otelco (NSDQ: OTT)	Qualified/Ordinary
Qwest Communications (NYSE: Q)	Qualified
RCN Corp (NSDQ: RCNI)	No Dividend
Sprint Nextel Corp (NYSE: S)	No Dividend
Telephone & Data Systems (NYSE: TDS)	Qualified
Time Warner Cable (NYSE: TWC)	No Dividend
Verizon Communications (NYSE: VZ)	Qualified
Windstream Corp (NYSE: WIN)	Qualified

UTE TECH

Company (Exchange: Symbol)	Tax Status
American Superconductor (NSDQ: AMSC)	No Dividend
Ballard Power Systems (NSDQ: BLDP)	No Dividend
Convergys Corp (NYSE: CVG)	No Dividend
Ericsson (NSDQ: ERIC)	Qualified
FuelCell Energy (NSDQ: FCEL)	No Dividend
Insituform Technologies (NSDQ: INSU)	No Dividend

Itron (NSDQ: ITRI)	No Dividend
Ormat Technologies (NYSE: ORA)	Qualified
Plug Power (NSDQ: PLUG)	No Dividend
Power-One (NSDQ: PWER)	No Dividend
Sasol Ltd (NYSE: SSL)	Qualified
SunPower Corp (NSDQ: SPWRA)	No Dividend
Vestas Wind Systems (OTC: VWSYF)	No Dividend

WATER

Company (Exchange: Symbol)	Tax Status
American States Water (NYSE: AWR)	Qualified
American Water Works (NYSE: AWK)	Qualified
Aqua America (NYSE: WTR)	Qualified
Artesian Resources Corp (NSDQ: ARTNA)	Qualified
California Water Service Group (NYSE: CWT)	Qualified
Connecticut Water Service (NSDQ: CTWS)	Qualified
Middlesex Water (NSDQ: MSEX)	Qualified
Pennichuck Corp (NSDQ: PNNW)	Qualified
SJW Corp (NYSE: SJW)	Qualified
SouthWest Water (NSDQ: SWWC)	Qualified
York Water (NSDQ: YORW)	Qualified

FOREIGN COMMUNICATIONS UTILITIES

Company (Exchange: Symbol)	Tax Status
America Movil (NYSE: AMX)	Qualified
BCE (NYSE: BCE)	Qualified
Bell Aliant Income Fund (TSX: BA-U, OTC: BLIAF)	Qualified
BT Group (NYSE: BT)	Qualified
Chunghwa Telecom (NYSE: CHT)	Qualified
Deutsche Telecom (NYSE: DT)	Qualified
France Telecom (NYSE: FTE)	Qualified
Nippon Telegraph & Telephone (NYSE: NTT)	Qualified
Partner Communications (NSDQ: PTNR)	Qualified
Philippine Long Distance (NYSE: PHI)	Qualified
Portugal Telecom (NYSE: PT)	Qualified

Singapore Telecom (OTC: SGAPY)	Qualified
South Korea Telecom (NYSE: SKM)	Qualified
Telecom Italia (NYSE: TI)	Qualified
Telecom Corp of New Zealand (NYSE: NZT)	Qualified
Telefonica (NYSE: TEF)	Qualified
Telefonos de Mexico (NYSE: TMX)	Qualified
Vivo Participacoes (NYSE: VIV)	Qualified
Vivendi (OTC: VIVEF)	Qualified
Vodafone (NYSE: VOD)	Qualified

FOREIGN UTILITIES

Company (Exchange: Symbol)	Tax Status
CEMIG (NYSE: CIG)	Qualified
CLP Holdings (OTC: CLPHY)	Qualified
Consolidated Water (NSDQ: CWCO)	Qualified
CPFL Energia SA (NYSE: CPL)	Qualified
Electricite de France (OTC: ECIFF)	Qualified
ENEL (OTC: ESOEF, ENLAY)	Qualified
Energis (NYSE: ENI)	Qualified
E.ON (OTC: EONGY)	Qualified
Fortum OYJ (OTC: FOJCF)	Qualified
GDF Suez (OTC: GDSZF)	Qualified
Huaneng Power (NYSE: HNP)	Qualified
Iberdrola (OTC: IBDRY)	Qualified
Korea Electric Power (NYSE: KEP)	No Dividend
National Grid (NYSE: NGG)	Qualified
RWE (OTC: RWEQY)	Qualified
Severn Trent (OTC: SVTRF)	Qualified
Suez Environnement (OTC: SZEVF)	Qualified
TransAlta Corp (NYSE: TAC)	Qualified
TransCanada Corp (NYSE: TRP)	Qualified
United Utilities Group (OTC: UUGRY)	Qualified
Veolia Environnement (NYSE: VE)	Qualified