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GLOBAL X INSIGHTS

Qualified Dividend Income: Edging Out Bond Interest When it Comes to Taxes

Kenny Zhu, CFA
kzhu@globalxetfs.com

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After years of extraordinarily low interest rates, investors may be surprised by the sizable tax bills incurred on their fixed income portfolios in recent years. The changing interest rate dynamic has brought tax concerns back into the limelight, with payments to the Internal Revenue Service (IRS) historically representing a potentially material detractor to overall returns. Consequently, investors may benefit from positioning their portfolios to lessen future tax blows. Understanding which investments offer the most tax-advantaged distributions can significantly reduce one's tax bill. One possible solution is to invest in securities that pay qualified dividend income (QDI). These opportunities can provide better after-tax income distributions than bonds, and the preferential tax treatment can create substantial savings over the life of a portfolio, especially for high-income investors.

Key Takeaways

- Relative to bond interest, QDI tips the tax advantage in favor of dividend-paying equities and preferred stocks (preferreds) because it subjects eligible dividend income to preferential capital gains tax rates.
- Dividend-paying equities offer upside potential from capital appreciation and dividend growth, whereas bonds typically pay fixed coupons and return their par value at maturity. Preferred stocks blend characteristics of both, offering stable distributions along with modest upside potential.
- Preferreds might often achieve a similar return profile to high-yield bonds, but the distributions they are able to pay are eligible for treatment as QDI. Consequently, preferreds may generate better after-tax results, making them a tax-efficient high-yield alternative.

Dividend Payments Produce Better After-Tax Results Vs. Bond Interest

When comparing the merits of equities versus bonds, an oft-overlooked consideration is the tax treatment of investment income. The difference in tax liability incurred on capital gains vs. ordinary income can nearly double the tax bill for the highest income tax brackets. Consequently, whether investment income is classified as dividends or interest can have significant consequences for income-oriented investors.

Qualified dividend income is subject to advantageous long-term capital gains tax rates, which warrants a lower tax burden than interest received from bonds or certificates of deposit (CDs). Capital gains tax treatment is more tax-efficient because long-term capital gains are taxed at 0%, 15%, or 20%, depending on an investor's income tax bracket.[1] Bond interest, on the other hand, is treated as ordinary income and taxed at an investor's marginal income tax rate, which can be as high as 37%.[2]

Assuming the highest income tax bracket, the spread between ordinary income tax and long-term capital gains tax is approximately 17 percentage points. When considering the potential impact of compounding returns, bond investors who receive distributions from interest income could see their tax liabilities grow significantly faster than holders of dividend-paying equities.

To be QDI-eligible, dividends must be paid by a U.S. or qualified foreign corporation and meet specific holding requirements set by the IRS. When held within an ETF or mutual fund, the tax benefit retained by the investor depends on the proportion of QDI-eligible holdings. For U.S. dividend equity and preferred stock ETFs, that proportion can be substantial.

Taxation is only one factor to consider when comparing dividend-paying equities and bonds. Bonds can offer greater capital preservation and predictable income than equities, as they're contractually obligated to pay principal and interest when required. Equity dividends are discretionary and can be suspended by the issuer. Given their capital position, equity securities receive lower priority of repayment vs bond holders in the event of bankruptcy. Equities have also historically experienced greater price volatility than bonds, which can translate into greater upside potential but also heightened sensitivity in the event of a market downturn. Finally, individual bonds can be less liquid than equities as well incur greater trading costs in smaller quantity; both factors can be mitigated to some degree via a well-capitalized ETF wrapper.

TAX TREATMENT OF QUALIFIED DIVIDENDS VS. BOND INTEREST

Holdings	Dividend-Paying Equities & Certain Preferred Stocks	Bonds
Distribution Tax Treatment	Qualified Dividend Income	Ordinary Income
Potential Tax Liability	0% - 15%	10% - 37%

Sources: Global X ETFs with information derived from IRS. Qualified dividends may be taxed at lower capital gains tax rates. Interest is taxed at marginal tax rates. Actual tax liability will vary based on individual income and tax status. This information is not intended to be tax advice. Please consult a tax professional for more information regarding your tax situation.

Dividend-Paying Equities Can Grow, While Bonds Cap the Upside

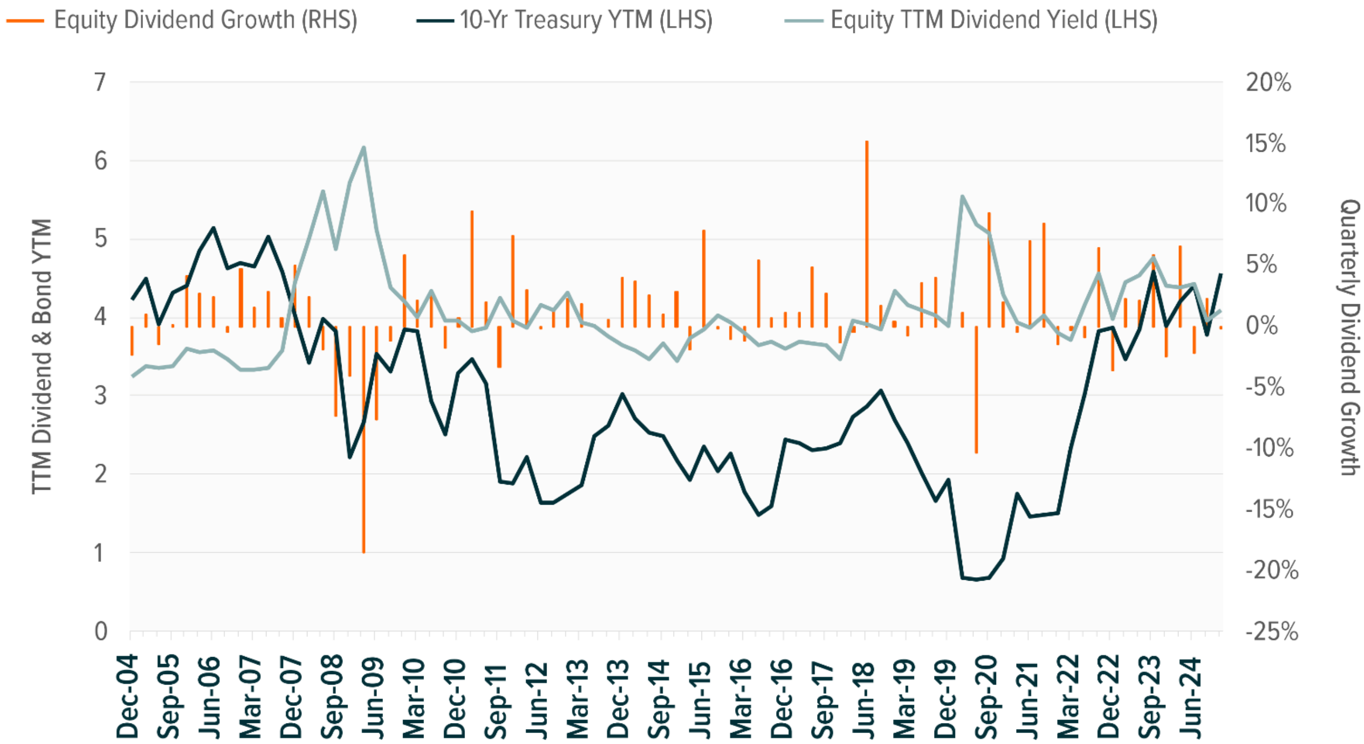
One of the benefits of dividend-paying equities is their potential for capital appreciation, a feature not typical of fixed income securities, which are typically issued and repaid at par. Dividend-paying equities may also benefit from rising dividend payouts, while interest payments on traditional fixed income securities typically do not change for the life of the issue.[3]

Taking this growth potential into consideration, returns from dividend-paying equities typically outpace bonds on a total return basis over the long run. The Dow Jones U.S. Dividend 100 Index, which consists of high dividend yielding stocks with a record of consistent dividend payouts, generated a cumulative 145.2% total return over the past 20-years ending December of 2024, or an average annualized return of ~9.4% over 20 years.[4] Meanwhile, an investor in a 10-year Treasury bond would have only received the yield on their investment, assuming it was held to maturity. We stress that outperformance is not guaranteed, particularly during periods of market volatility, however this relationship historically holds true over long periods of time.

In addition to capital appreciation, the dividend payments themselves can also grow over time. Over the past decade, the Dow Jones Select Dividend Index grew its dividend by an average of ~1.8% per quarter, raising its gross dividend per share to $9.56 in December of 2024 from $4.88 in 2014. Had an investor purchased a 10-year Treasury at the beginning of that period, the yield would have stayed flat at a constant ~2.17%, assuming purchase at the end of December 2014. While we caution that dividends can also be cut during periods of economic strife, we believe the growth illustrated further substantiates the value of dividend paying equities within a broader income portfolio.

Despite the strong case for dividend-paying equities, we believe it’s important to recognize the stability that bonds can offer. Unlike equities, bonds sit higher in the capital stack, meaning that bondholders have priority on a company’s assets in the event of liquidation. Consequently, bonds have historically offered more stable returns than equities and serve as an important diversification tool within a well-balanced portfolio. In the following section, we explore preferred stocks, which blend key characteristics of both equities and bonds while occupying the middle of a firm’s capital structure.

DIVIDENDS CAN IMPROVE RETURN STABILITY AND OFFER GROWTH POTENTIAL



Sources: Global X ETFs with information derived from Bloomberg, quarterly data from December 31, 2004 to December 31, 2024. 10-Yr Treasury YTM represents the ask yield to maturity for the Generic United States 10 Year Government Note; Equity TTM Dividend Yield is represented by the trailing 12-month dividend yield for the Dow Jones Select Dividend Index; Equity Dividend Growth represents the quarterly change in dividend per share (DPS) for the Dow Jones Select Dividend Index.

Preferreds May Offer the Best of Both Worlds

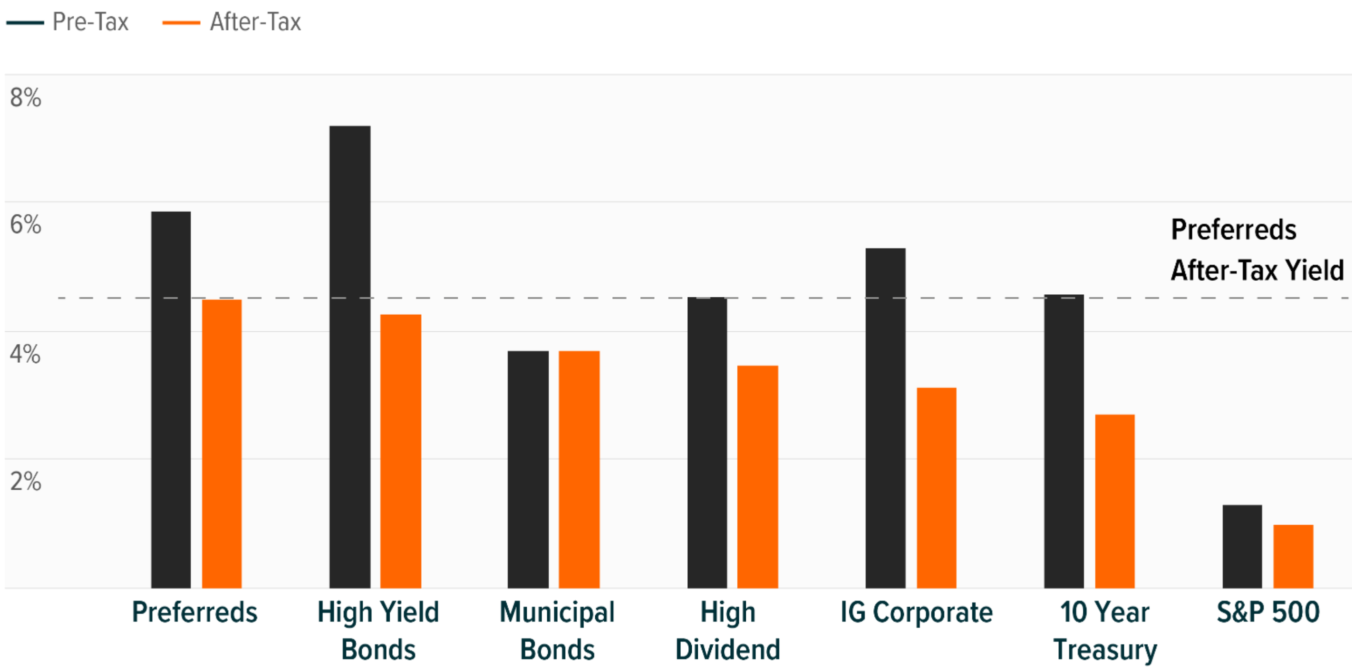
With equity- and bond-like characteristics, preferred stocks pay regular income distributions comparable to high-yield debt, but they can potentially generate better after-tax results. They combine the tax advantages of dividend payouts with the greater payment certainty of bonds, and due to their subordinated position in the capital stack, preferreds are often treated as equity investments that can treat their distributions as dividends from a tax perspective, rather than bond interest. This tax treatment may confer preferreds with a tax-advantage relative to traditional investment-grade and high-yield bonds.

Companies often issue preferred shares to raise capital and meet regulatory capital requirements, as preferreds offer an efficient means to boost reserves without negatively impacting a company's debt-to-equity ratios. As they fall lower in the capital stack than senior debt obligations, preferred investors are often compensated with higher yields than comparable fixed-income securities on a tax-adjusted basis, outyielding high yield bonds on occasion.

When compared to high yield bonds, preferred stocks can also carry meaningfully higher credit ratings. Just over half of the rated holdings within the ICE BofA Diversified Core U.S. Preferred Securities Index are rated investment grade. As preferreds are predominantly issued by companies in highly regulated industries, such as large, diversified banks, utilities, and insurance, they often carry strong credit backing.

This contrasts favorably against high yield bonds that are generally of lower credit quality and are often exposed to highly leveraged cyclical sectors. Furthermore, over a third of preferred stocks in the index are issued by global systemically important banks (GSIBs), which constitute some of the largest integrated financial institutions in the world, such as J.P. Morgan Chase and Bank of America. When considering the income parity of after-tax yields, credit quality can tilt the argument in favor of preferreds.

PREFERREDS AND HIGH DIVIDEND EQUITIES CAN PROVIDE ATTRACTIVE YIELDS



Source: Global X ETFs with information derived from Bloomberg as of January 31, 2025. After-tax calculations apply 37% federal income tax and 3.8% Medicare surtax rates for High Yield Bonds, IG Corporate, and 10 Year Treasuries. Long-term capital gains tax of 20% and 3.8% Medicare surtax rates are applied to Preferreds, High Dividend, and S&P 500, which assume QDI-eligibility. Municipal bonds are not subject to federal income tax or Medicare surtax. The tax treatment of dividends and bond interest is subject to change based on federal tax regulations. Asset class representations are as follows: Preferreds, ICE BofA Fixed Rate Preferred Securities Index; High Yield Bonds, Bloomberg US Corporate High Yield Bond Index; Municipal Bonds, Bloomberg U.S. Municipal Bond Index; High Dividend, S&P 500 High Dividend Index; IG Corporate, Bloomberg U.S. Corporate Bond Index; 10 Year Treasuries, U.S. 10 Year Government Bond; S&P 500, S&P 500 Index. Preferreds, High Yield Bonds, IG Corporate, Municipal Bonds, and 10-Year Treasury all measured by index yields-to-worst. High Dividend and S&P 500 measured by Index dividend yields. Actual after-tax impact may vary as QDI-eligibility varies by security and holding period. The chart below is hypothetical and for illustrative purposes only; it does not represent the performance of a specific investment product, account or any actual trading, nor guarantee future results.

Conclusion: Enhancing Tax Efficiency with Dividend-Paying Equities and Preferreds

High interest rates and rising federal deficits will likely continue to make tax liabilities a big consideration for investors. While we recognize the attractiveness of current interest rates, investors may want to consider taking steps to optimize the tax efficiency of their broader income portfolios by diversifying into QDI-eligible equities and preferred stocks. As interest rate volatility and tax risks continue to proliferate, steps like these can broaden income exposures, help diversify risks and provide opportunities for capital appreciation and inflation-protection over time.

Footnotes

1. IRS. (2025, January 2). Topic no. 409, Capital gains and losses.
2. IRS. (2025, February 13). Federal income tax rates and brackets.
3. The exception being floating rate and variable rate bonds, which can see their interest payments fluctuate in relation to a benchmark. Such securities may still be subject to interest rate caps/floors and typically mature at their stated par value.
4. Outperformance is not guaranteed, especially during periods of market volatility.

Glossary

The Dow Jones U.S. Dividend 100 Index: An index measuring the performance of high-dividend yielding stocks in the U.S. with a record of consistently paying dividends.

ICE BofA Diversified Core U.S. Preferred Securities: An index measuring the performance of preferred securities in the United States. The index includes different categories of preferred stock, such as floating, variable and fixed-rate preferreds, cumulative and noncumulative preferreds, and trust preferreds.

Qualified Dividend Income (QDI): refers to dividends that meet specific IRS requirements for preferential tax treatment. QDI may be taxed at lower capital gains rates (0-15% for most investors) rather than higher ordinary income tax rates (10-37%). To qualify, dividends must be paid by U.S. corporations or qualified foreign corporations and investors must meet certain holding period requirements. Consult your tax advisor regarding your specific situation.

Global Systemically Important Banks (GSIBs): financial institutions deemed to pose systemic risk to the global financial system and are subject to additional regulatory requirements. This designation does not guarantee their financial stability or investment returns.
