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# Preferred Stocks as a Tax-Advantaged Fixed Income Investment

By Randy Masel

Not quite bonds and not quite common stocks, preferred stocks are an often misunderstood asset class. While a form of equity, non-convertible preferreds generate an income stream much like a bond and are valued on the basis of this income stream, also like a bond. For investors in high tax brackets, preferreds often offer significant tax advantages, akin to municipal bonds. Many preferreds pay dividends that are qualified for federal income tax purposes. Qualified dividends are taxed at the federal level at the investor's long –term capital gains rate rather than as ordinary income. This means that for investors in the top federal tax bracket, their federal tax bill on a qualified preferred dividend will be just a little more than half of what it would be if that qualified dividend were instead taxable interest income. Put differently, a qualified dividend of 5% has a tax-equivalent yield of 6.73% for investors at the highest tax level (39.6% plus 3.8% Medicare surcharge tax).

While tax-equivalent yields on preferreds can look juicy relative to municipal bonds, there are important differences that account for these higher yields. These differences include:

- *Maturity* – Preferreds tend to have very long maturities, some are perpetual in nature. Investors can reduce duration of their preferred portfolio by buying preferreds that are likely to get called due to their coupon or structure.

- *Missed Payments* – A missed bond interest payment creates a default, and investors have remedies governed by the bond's indenture. A missed preferred dividend payment does not constitute a default and investors' rights are more limited. Often preferred investors are allowed representation on the issuer's board of directors after a period of time and the issuer cannot pay dividends on its common stock while preferred dividends are not being paid. Dividends that are cumulative in nature require the issuer to pay back any previously skipped dividends in addition to the currently missed dividend before any common dividend is paid.

- *Ratings* – Given that preferreds rank lower in a company's capital structure than its senior bonds, preferreds also have credit ratings that are lower than their respective senior ratings. For example, J.P. Morgan's current corporate senior rating is A3/A; its preferred rating is Baa3/BBB-, just above non-investment grade.

- *State Income Tax* – Qualified dividends tend to be fully taxable at the state level.

While the differences in structure and rating between bonds and preferreds are significant, more often than not investors are compensated for these differences in the form of higher yields.

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