Double Taxation of Dividends: Is the Question Resolved?

By Novella Clevenger and Ken Pfannenstiel

Introduction

No one likes to pay taxes. As congress moves to make the tax code ever more complex, tax professionals try to find loopholes in the law. It is this drive to pay as little in taxes as possible that has given rise to idea of eliminating the double taxation of dividends.

On January 7, 2003, President George W. Bush presented his economic plan to strengthen the economy. A key element of the plan was the elimination of the tax on dividend income that had already been taxed to the paying corporation.

After modification of his plan by Congress, President Bush signed legislation on May 28, 2003 reducing tax rates for dividends on certain qualified stocks to a maximum of 15% for the years 2003 through 2008, unless extended by Congress. Thus, the debate over the double taxation of dividends is far from a dead issue

Is elimination of the double taxation of dividends the best policy for our country's financial health? This article will examine both sides of the argument

Arguments For Eliminating Taxation of Dividends

Economists agree that the double taxation of dividends increases the cost of capital. Corporate earnings are subjected to two levels of tax: one at the corporate level and one at the shareholder level. The cost of capital comes from the effect of the two layers of tax on corporate earnings. The first layer is the corporate level with a maximum rate of 35 percent. The second layer consists of two parts. The first is the taxation of corporate income distributed as dividends,

which is taxed at a maximum rate of 15 percent. The second part is the capital gains tax paid on the appreciation of stock when the corporation does not distribute its earnings through dividends. Under the new law, the capital gains rate on stocks is reduced from a maximum of 20 percent to a maximum of 15 percent.

Corporate Financing Decisions

Capital is raised in three different ways, the first being the taking on of debt, followed by equity financing or the distributions of additional stock, and finally through the use of accumulated retained earnings. The tax law treats the three methods differently through the tax consequences of the method chosen.

Debt is the most favored due to the tax impact of interest. Interest payments are a deductible expense for corporations and as a result, reduce the amount of profits subject to income tax. If the lender is an individual taxpayer, the interest income will be taxed at no more than 35 percent, the new maximum rate for individuals. The tax burden is simply shifted to the lender but there is no double taxation.

Retained earnings are taxed twice in a round-about way. As the corporation retains earnings for investment purposes, share values are usually pushed upwards. When an individual sells the shares he or she owns, the sale will be subject to capital gains tax on the increased value of the shares. Under the new law, capital gains rates are 15 percent, the same as the new maximum dividend rates. The taxpayer now has more freedom to choose whether to hold a stock or dispose of it without a difference in tax consequences affecting the decision.

These differences in tax treatment can have a detrimental affect on corporate decision-making, however. The favorable treatment of debt financing encourages companies to become more heavily leveraged. A heavily leveraged company is more likely to fail during an economic

downturn such as the United States economy is presently experiencing, or in a period of rising interest rates. On the other hand, a company that uses equity financing has the flexibility to deal with business fluctuations by raising or lowering the dividends they pay out. Due to the inherent risk of leverage, one would expect to see a rise in bankruptcy and more volatility in stock prices in a declining economy.

Equity financing has been discouraged due to the tax appeal of debt financing. The number of companies that pay dividends has decreased significantly in the last few years. As the payout of dividends has decreased, individual investors have been forced to look at price appreciation as the only means to reach their rate of return goals. This influences corporate managers to undertake actions that will help sustain stock price appreciation even though the actions may not be the best decision for the long term.

The shift in focus of the investor has taken away the attention that should be paid to companies that do pay dividends. A study by Fama and French[1], which looked at companies from 1963 to 1998, found that companies that paid dividends provided a higher rate of return (7.8 % versus 5.4%) than those companies that did not pay dividends. In addition, Standard & Poor's did a study covering the bear market from 2000 to 2002 and found that companies that paid dividends in the Standard & Poor's 500 Index have maintained approximately the same value while companies that did not pay dividends have declined in value significantly[2]. Elimination of the double taxation of dividends would remove the tax bias of debt financing and help to bring equity financing back to the forefront.

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[1] E.F. Fama, and K.R. French, "Taxes, Financing Decisions and Firm Value," *Journal of Finance* 53, 1998, pp 819-843

[2] Standard & Poor's *The Outlook,* "Dividends End 2002 on a Strong Note", January 2, 2003.

Arguments Against Eliminating Taxation of Dividends

The corporation is the most successful business form even though it accounts for only 20 percent of the total number of businesses in the United States. Corporations generate 90 percent of sales and 70 percent of profits. The success of the corporation can be attributed to the security provided by the limited liability to the individual investor.

A corporation is a legal entity. As a legal entity, a corporation can own property, sue or be sued, and enter into binding contracts. The corporation is separate from its owners with a life of its own. As a separate entity, a corporation has the right to use public goods like any other individual.

Public goods have a marginal cost of virtually zero. As a result, the private sector is unable or unwilling to provide these goods due to the lack of potential profit. It therefore falls on the government to provide these goods.

In a free economy, the government does not own the implements to produce public goods. Governments rely upon tax revenue to pay the private sector to create these public goods. Corporations as individual entities have the right to use these public goods and are therefore obligated to help pay for these goods through the payment of taxes.

In the 1980's President Reagan argued that in actuality, corporations do not pay taxes but pass them through to individual consumers in the form of higher prices. President Reagan sent legislation to Congress that would have abolished the corporate income tax. Congress apparently saw the flaw in this line of thought. Having to foot the tax bill for the consumption of public goods by corporations could have been viewed as unfair by the public.

The notion of "double" taxation of dividends comes from the idea that the income itself is being taxed, rather than the corporation. The tax code is based on the concept that individual

economic units pay taxes based on their income. Corporations are individual economic units and, like individuals, have income.

Generally Accepted Accounting Principles require certain rules to be followed when accounting for the costs of goods sold. Companies are required to follow these rules when allocating costs based a standard that most appropriately disperses the costs in the most logical method to provide the most accurate picture of the true cost of the goods sold. The IRS follows this idea by applying the ability-to-pay concept. Income is used as the gage to determine the tax liability or product cost that should be allocated to each user of the public goods.

Conclusion

The President's January 7, 2003 economic plan argued for ending the double taxation of dividends in order to encourage job creation by returning about $20 billion to the 2003 economy. He characterized the double taxation of dividends as unfair because it falls hardest on senior citizens.

On the other hand, if the double taxation of dividends were totally eliminated, an individual taxpayer's tax burden would increase due to the free usage of public goods by the corporations. Individuals presumably invest in the corporate form of business in order to receive the benefit of limited liability for corporate debts. As the cost of receiving this benefit, some may argue that an individual should pay taxes on the income derived from the investment.

The legislation signed into law by President Bush on May 28, 2003, taxing dividends at a maximum rate of 15 percent, seems to be a reasonable compromise between the taxation of dividends at ordinary income rates and the total elimination of tax on dividends.

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