Ending the Tax on Dividends: What, Why and How Much?

By DANIEL ALTMAN

As the centerpiece of his economic plan, President Bush is about to propose that dividends paid to stockholders by corporations should be exempt from federal income taxes. Here are answers to some important questions about the issue.

Q. Who pays the taxes on dividends right now?

A. Any person who owns stock in a company, estate or trust and receives payments of cash, property or stock as a result must pay the tax. The rates are the same as for wages and other income. But individuals who own stock in an individual retirement account or a tax-deferred 401(k) plan only pay income taxes when money is withdrawn, which usually occurs many years after the dividends are paid.

Moreover, most stocks are owned by institutional investors, which are generally exempt from taxation. They include nonprofit groups like pension funds and universities, as well as for-profit companies and financial institutions. Mutual funds pass on the tax on dividends to their investors who receive cash payments or short-term capital gains in taxable accounts.

Q. So what's this "double taxation" everyone's talking about?

A. That term can be a little misleading. A company does not raise its tax burden simply by deciding to pay dividends. But companies have to pay their own income taxes before they can pay dividends.

The federal and state governments tax as much as 40 cents of every dollar in a company's profit. If the remaining 60 cents is paid to shareholders as a dividend, the governments may collect about 24 cents more — 40 percent again — as personal taxes. Most companies, of course, retain much, if not all, of their profit to reinvest in their business. But of the share that is paid to taxable owners, as little as 36 cents of every dollar in profit goes into their pockets.

By contrast, interest on debt counts as a cost, and companies pay interest out of pretax revenue. That gives many companies an incentive to hoard cash or borrow rather than distribute profits to stockholders in cash.

Q. Isn't it surprising that companies pay dividends at all, given the big tax bite?

A. Economists have been trying to answer that question for years. They have come up with at least half a dozen explanations, but two have remained especially popular.

First, investors do not necessarily trust executives to use a company's profit wisely, especially when promising investments are hard to find. Rather than leaving ready cash in the corporate coffers, where it might be squandered before a worthwhile investment opportunity comes along, many shareholders...
prefer to drain it off at regular intervals.

Alternatively, established companies may use dividends to convey information. Most companies carry some debt and must pay regular interest and repay principal at certain intervals to avoid bankruptcy. By paying a regular dividend, a company may signal confidence in its finances to investors; if there were any question about the company's ability to cover its costs, including interest, it probably would not pay a dividend.

Q. *What will eliminating the tax on dividends mean for the stock market?*

A. With no tax on dividends, shareholders would be able to keep more of the gains from their investments. All the money the government might have collected as dividend taxes, this year and in the future, would, in theory, be reflected in stock prices.

As a result, all stocks that pay dividends, and any that seem to be likely to pay dividends down the road, should become more valuable. Those that do not pay dividends would become relatively less attractive to investors, who might move their money from one type to the other. On balance, the stock market could rise sharply, increasing some Americans' wealth and, perhaps, many Americans' confidence in the economy.

Q. *If that's going to happen, isn't it a good idea to buy stocks now?*

A. The markets have already begun to rise with the news that the president will push to eliminate the tax on dividends. But that does not mean stocks will necessarily move even higher in response to the plan. For one thing, Congress may not go along or may water down the proposal before it becomes law. Still, just proposing the change sends a signal that the White House wants to help investors.

Q. *President Bush says he wants to stimulate the economy now, but he is proposing a permanent tax cut. How big will the immediate effects be?*

A. It's hard to say. Many shareholders' after-tax incomes could increase, and their wealth may receive a quick jolt. Yet the wealthy individuals with the biggest stock portfolios, who stand to benefit the most from the president's plan, do not change their spending in response to changes in income and wealth as much as the poor and middle class do.

The extra income might add $20 billion to consumers' spending relatively quickly, according to generous estimates by economists. Figuring out how much of any new wealth might be spent is more difficult. A rough and, again, generous conversion rate for stock market gains is that every dollar in additional wealth translates into about 4 cents in new spending. The Bush Administration argues that the market could gain back about $1 trillion in value, which would translate into perhaps $40 billion in extra spending.

Q. *That's great for the high rollers, but would average Americans feel the benefits?*

A. To some extent, yes. If shareholders spend more money, the overall economy would benefit; by some estimates growth might improve by about 0.6 percentage points. At the same time, everyone who owns stocks, whether in a taxable account or in a tax-deferred retirement account, would enjoy whatever gains occur. But for the typical investor who holds most of his stock market wealth in a pension fund or retirement account, it is often difficult or unprofitable to withdraw money from these accounts for spending before retirement. Any other benefits would come gradually, assuming the
economy could sustain faster growth long enough to improve wages and create jobs.

For people who are unemployed now, this particular proposal offers little. Gains in the stock market may not be enough to inspire companies to begin hiring again. The president is expected to offer other proposals to help the jobless and provide other tax cuts to middle-income taxpayers.

**Q. What could happen in the long term if the dividend tax is dropped?**

**A.** Americans might start saving more to take advantage of the higher return on stocks. That change would make more money available for capital investment, but it would not help the economy in the short term. In the longer run, conversely, companies should reap the fruits of any extra investments, both in money and in the development of technologies. Bigger profits and new ideas could raise the economy's potential for growth.

The behavior of saving, however, is notoriously difficult to predict. A higher return on the stock market might make saving more attractive. Yet in the late 1990's, Americans saved very little, preferring instead to watch as the bull market created trillions in capital gains.

**Q. How much is all this going to cost?**

**A.** The official estimates, based on the presumption that economic growth would only modestly be improved by the tax cut, suggest that the nation's debt would increase an additional $300 billion over 10 years if taxation of dividends is eliminated. In that case, future generations may foot the bill in the form of higher taxes or fewer government benefits and interest rates may be somewhat higher than otherwise. But if the economy responds in a highly favorable way to the tax cut, or picks up speed rapidly for whatever reason, it might not cost much at all. That is because rising personal and corporate incomes might add enough to other types of tax collections to offset some, perhaps all, of the cost of ending the tax on dividends. Therein lies an age-old debate.