IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

August 30, 2002 **Advisory No. 133**

DIVIDEND TAX RELIEF AND OTHER MEASURES AIMED AT BOOSTING THE STOCK MARKET — METHODS AND CONSEQUENCES

Savers have been hard hit by the loss of about $7 trillion in the value of U.S. stocks since March, 2000. The economy has been feeling some of the pain as well, as people reduce consumption and businesses find it more expensive to raise capital. Much of the recent decline in federal revenues and projected budget surpluses is due to the weaker economy and lower capital gains tax revenues. Restoring growth is crucial to restoring federal finances. These issues were raised at the President's recent economic conference at Baylor University.

> ***Much of the recent decline in federal revenues and projected budget surpluses is due to the weaker economy and lower capital gains tax revenues. Restoring growth is crucial to restoring federal finances.***

Following the economic conference, President Bush announced that he is considering a number of ideas to provide tax relief for shareholders and other savers. Among the proposals under review are tax relief for dividends, an increase in the amount of capital losses that shareholders may deduct against other income, expanded contribution limits for IRA and pension arrangements, and reduced capital gains tax rates. The hope is that such actions will boost the stock market and restore a healthier rate of growth to the economy.

Boosting the stock market is not in and of itself an appropriate objective for tax policy. However, tax policies that improve the efficiency of the economy and remove tax barriers to growth would certainly raise stock prices as a consequence. Stock prices are the present value of what people expect corporations to earn, after-tax, in the future (and what people are willing to pay, today, to obtain ownership of that future income). This makes the market a good reflection of future economic conditions and a good indicator of whether the tax changes will help or hurt growth.

Dividend relief and the other proposals being hinted at would move the tax system in the direction of fundamental tax reform. They would reduce or remove artificial barriers to growth in the current tax system, and they would promote capital formation, productivity, employment and higher wages. As a side effect, they would indeed boost the stock market. These proposals are not radical or extreme. Any tax system that sought to be completely unbiased in its treatment of saving versus consumption would go even further than the proposals under discussion.

Why dividend relief?

The current tax treatment of dividends is one of the most egregious examples of the income tax bias against saving and investment.[1] Dividends are treated worse than capital gains and interest, and are the most heavily taxed form of returns on saving. They face combined federal corporate and individual income tax rates of 60% (plus state and local income taxes). (See table.) Past tax bills have cut the tax rate on capital gains. Dividends deserve some attention this time around. Redressing the unequal treatment of dividends would also improve corporate governance.

The taxation of dividends affects equity-financed investment. Returns on equity-financed investment first face the corporate income tax. Then, if the after-

tax corporate income is paid out as a dividend, shareholders must pay income tax on the dividend at normal tax rates (the so-called "double taxation of dividends"). If the after-tax corporate income is retained for reinvestment, it raises the value of the company, boosting the share price and leading to a capital gains tax when the shares are sold. Capital gains taxes can therefore be thought of as the "double taxation of retained earnings".

The capital gains tax rate is less than the tax rate on ordinary income or dividends, somewhat mitigating this added layer of taxation on reinvested income. Gains on assets held a year or more are taxed at 20% for shareholders in the upper income tax brackets, and 10% for shareholders in the 10% or 15% tax brackets. (The rates are further reduced for assets purchased in 2000 or later and held more than 5 years to 18% and 8% for upper and lower bracket taxpayers.)

Debt financed corporate investment is not treated so harshly. When a corporation raises investment money by borrowing, the portion of the resulting gross income that is paid as interest to the bondholders is a deductible expense for the business, and is not subject to the corporate tax. It is passed through to the bondholders and is only taxed one time, on the bondholders' tax returns. Consequently, the tax code favors debt finance over equity finance, and, within equity finance, it favors retained earnings over dividend payments. The heavy tax on corporate equity raises the cost of capital and reduces investment. Moreover, these tax anomalies distort behavior by encouraging excessive reliance on debt versus equity and encouraging companies to retain more earnings and pay lower dividends than they otherwise would. These distortions have several undesirable consequences.

The tax bias against equity encourages firms to become more highly leveraged, and increases the level of risk for shareholders and creditors. Excessive debt can leave a business with unmanageable interest obligations in the event of a recession. Interest

Double Taxation of Corporate Income at the Federal Level: Combined Corporate and Investor Taxes Per Dollar of Earnings of Corporate Capital

	Debt Financed Investment	Equity Financed Investment	
		With dividend pay-out	Earnings retained
Federal corporate income tax (@ 35%)	None — Interest is deductible	$.35	$.35
Distribution to bondholder or shareholder	$1 paid to bank or bondholder	$.65 paid as dividend to shareholder	$.65 retained, raising share value, creating capital gain
Federal individual income tax @ 38.6% or capital gains tax @ 20%*	$.386	$.2509	$.13
Net return to saver	$.614	$.3991	$.52
Combined tax rate	38.6%	60.09%	48%

* *The top personal income tax rate is scheduled to fall to 35% in 2006 under the fully phased-in 2001 tax cut (which will expire in 2011 if not extended). At a 35% tax rate, the combined federal income tax on dividends will be 57.75%. Assets purchased in 2000 or later and held 5 years or more may receive an 18% capital gains rate, less than the regular long term gain rate of 20% on assets held a year. Adding state and local income taxes at the corporate and individual level would add several percentage points to these combined tax rates.*

obligations, unlike dividends, cannot be suspended, and may result in bankruptcy even for a business with an operating surplus.

The tax bias against dividends also gives firms and shareholders an incentive to retain earnings to obtain more favorable capital gains treatment. This is fine if the management is able to reinvest the money to best advantage. However, the ready access to internal funds sometimes leads to wasteful investment in projects with less than optimal returns. Capital allocation might be more efficient if profits were paid out and corporate management had to compete with other businesses to attract new money from the credit or stock markets. The pressure to produce good returns on more money than the firm can usefully employ can lead to questionable practices. Retaining earnings to boost the share price is especially attractive for firms that employ large amounts of stock options in their compensation packages, but this practice can work against shareholders' interests if the reinvested income does not earn a competitive return.

> ***Dividends ... face combined federal corporate and individual income tax rates of 60%... Past tax bills have cut the tax rate on capital gains. Dividends deserve some attention this time around. Redressing the unequal treatment of dividends would also improve corporate governance.***

How not to fix the problem

In 1985, the Treasury Department Report to the President, *Tax Reform for Fairness, Simplicity, and Economic Growth*, argued for eliminating the bias in favor of retained earnings by raising the tax rate on most capital gains to equal that on ordinary income and dividends. This proposal was adopted in the Tax Reform Act of 1986.[2] This action not only worsened the tax bias against equity finance in favor of debt finance, it raised the cost of capital. It was an economic and fiscal disaster. It discouraged investment and slowed the economy. It helped to crash the stock market in 1987, and ushered in a long term reduction in the rate of capital gains realizations that crippled capital gains tax receipts for years. This action was reversed by the capital gains tax rate reduction in the Taxpayer Relief Act of 1997.

A better way to even out the tax treatment of dividends and capital gains would be to lower the tax rate on dividends to capital gains levels; that would not only equalize the treatment of the two types of return on equity, it would also reduce the over-all bias against equity relative to debt. To fully remove the bias against equity finance, one would have to go further, and either eliminate the corporate tax or eliminate the individual tax on dividends and capital gains entirely.

Types of tax relief for dividends

There are several ways to provide complete or partial relief from the double taxation of dividends.

Complete relief

Allow corporations a deduction for the dividends they pay. One simple method of providing complete relief from the corporate layer of tax would be to let firms deduct dividends just as they deduct interest. By giving the deduction to the corporation, it would initially leave the tax savings with the company, but shareholders would likely demand and receive an increase in dividends as a result.

Allow shareholders a credit for the corporate tax paid on the dividends they receive. A more complex method of eliminating the corporate tax layer, used in a number of foreign countries, would be to provide shareholders with a tax credit for the corporate tax already paid on the dividends.[3] This approach would give the tax relief directly to the shareholder. The credit would have to be made refundable for low income shareholders whose tax rate is less than the corporate tax rate and who have no significant tax liability from other income to be offset by the credit.

Exempt dividends at the shareholder level. Another simple way to eliminate one of the two layers of tax on dividends is to make all dividends tax exempt for the shareholders.

The first two approaches would fully offset the double taxation of dividends by eliminating or offsetting the corporate layer of tax on earnings paid

as dividends. They would effectively tax dividends only at the individual level, at the shareholder's income tax rate, which varies according to his or her income. The third method would eliminate the individual level tax on dividends, and impose the corporate tax on dividends at the corporate tax rate before they were paid out. That rate is higher than the individual tax rate for most shareholders. All three methods of fully eliminating the double taxation of dividends would treat dividends better than retained earnings. Retained earnings increase share value and are then subject to double taxation due to the capital gains tax.

Partial relief

Tax dividends like capital gains. Partial tax relief for dividends might take as its objective reducing the tax on dividends to match the partial relief accorded capital gains. One approach would be to tax dividends at a maximum rate of 20% for shareholders in higher income tax rate brackets, and 10% for taxpayers in the 10% or 15% income tax brackets, as is done for long term capital gains. Capital gains would still have a slight tax advantage, because the capital gains tax is deferred until the stock is sold.

Make dividends partially tax exempt. Alternatively, taxpayers could be allowed to exempt a fraction of dividends from tax. A 50% exclusion would lower the top tax rate on dividends from the current 38.6% to 19.3%. (After the full phase-in of the 2001 tax rate cuts, the top income tax rate will be 35%, and the rate on dividends with a 50% exclusion would be 17.5% for shareholders in the top income tax bracket. The dividend tax rate would be 5% for shareholders in the 10% bracket, 7.5% for those in the 15% bracket, 12.5% for those in the fully phased-in 25% bracket, etc.) This approach provides an incentive to save more and earn additional dividends for all dividend recipients. It is superior to excluding a fixed dollar amount (e.g., $200 for single filers, $400 for joint filers), which gives no incentive to add to savings for anyone whose dividends exceed the excluded amounts.

> ***The cap on capital loss deductions has not been increased since 1978... If the government is a "partner" in a saver's capital gains, taxing them without limit, it should in fairness also be a "partner" in capital losses as well, and without limit.***

Cost of dividend relief

Net dividend payments by the corporate sector (excluding inter-corporate dividends) were approximately $376 billion in 2000 and $409 billion in 2001, as measured in the national income and product accounts. Taxable dividends reported on individual tax returns were about $145 billion for tax year 2000. However, the latter figure includes some interest income received from mutual funds and credit unions. It is less than net dividends paid by businesses because it excludes dividends paid into tax deferred retirement accounts and pensions, dividends received by tax-exempt organizations and individuals whose income is below taxable levels, and dividends received by foreigners who are taxed via withholding at the source.

Completely exempting the (roughly) $145 billion of dividends received by shareholders from tax (in effect, according the dividends Roth IRA treatment) might cost between $40 billion and $50 billion a year before taking any additional economic growth into consideration. Allowing corporations a deduction for dividends paid would run about three times as much before allowing for any economic adjustments. These adjustments, however, would be substantial.

The actual cost of a dividend deduction (or other forms of relief) would be less than the simple immediate impact on the affected taxpayer. For example, a corporate deduction for dividends paid would increase after-tax corporate income. If that additional income were paid out as dividends, the Treasury would receive additional personal income taxes (at personal tax rates averaging about 70% of the corporate rate) on the added dividend payouts, which would offset much of the reduction in corporate taxes over time. Dividends paid to taxable recipients would yield immediate income tax reflows. Those paid into tax deferred retirement accounts would compound, and the augmented amounts would be taxable upon withdrawal. If the additional after-tax corporate income were retained, it would be capitalized in the price of the shares. The higher stock prices would reduce shareholders' capital

losses and increase reported capital gains over time, and the government would again recoup a substantial portion of the reduced corporate tax, at capital gains rates averaging 20% or higher depending on the holding period. There would be no recovery on gains received by tax-exempt shareholders, such as charities or university endowments.

Increasing the limits on contributing to IRAs and pension arrangements would help individuals to make up for the recent losses in their portfolios. The increases would be sound tax policy, and should be made permanent.

Another source of revenue feedback would be the taxes collected on higher wages and capital earnings triggered by an expansion of investment. The lower tax rate on capital income would boost capital formation, which would increase productivity, employment and wages. Personal income taxes, payroll taxes, and corporate tax payments on the earnings of additional investment would offset more of the revenue loss from the dividend tax relief. All told, dividend tax relief would cost far less than the apparent immediate impact on the affected taxpayers.

Increasing the offset of net capital losses against other income

Taxpayers must pay tax immediately on realized net capital gains (outside of pension arrangements), but they are only allowed to deduct up to $3,000 of net capital losses against other income in a given year. Any excess must be carried over to later years, reducing the present value of the tax saving. The cap on capital loss deductions has not been increased since 1978. The capital loss deduction limit would have to be lifted to $9,000 just to match subsequent inflation. To match the increase in the stock market indices, the cap would have to be about $30,000. If the government is a "partner" in a saver's capital gains, taxing them without limit, it should in fairness also be a "partner" in capital losses as well, and without limit. The higher the cap is raised, the better.

The benefits from these proposals to increase the rewards to saving would extend far beyond the affected shareholders. They would reach savers, workers and consumers at all income levels.

This proposal has been incorrectly criticized as giving relief to past losses rather than encouraging new saving and for potentially hurting the stock market by encouraging a wave of selling. In fact, it is as forward looking as any other relief provision, because it would increase the value of future loss deductions and make buying shares less risky, thus encouraging additional saving. The notion that an expanded allowance would drive the market down by encouraging selling is wrong. People would sell stock in one company and buy stock in another to maintain their portfolios. It would encourage people to reallocate their holdings more to their liking, which would also make stock ownership more rewarding and boost the market.

Cutting the capital gains tax rate

Such proposals are always welcome, in that the tax on capital gains is double taxation. This is true whether the increase in the price of a share of stock is due to reinvested after-tax earnings or other causes. The price of a share of stock or of a non-corporate business is the present value of the share's or business's expected future after-tax earnings, whether due to reinvestment, an improved business outlook, a new technological discovery, or development of a new product. If a business's earnings outlook improves, the value of the business will increase. If that future earnings improvement comes to pass, the future earnings will be taxed when earned. To also tax the increase in the present value (as a capital gain) is to double tax the future income.

Expanding contribution or income limits on IRAs and other retirement arrangements

The Portman-Cardin provisions incorporated in the Economic Growth and Tax Relief Reconciliation Act of 2001 expanded the contribution limits on IRAs, 401(k) and 403(b) plans, and other retirement vehicles. In a fully reformed, saving/consumption neutral tax

system, all saving would get IRA or pension treatment, so the more liberal the limits the better. Increasing the limits on contributing to IRAs and pension arrangements would help individuals to make up for the recent losses in their portfolios. The increases would be sound tax policy, and should be made permanent.

Make the 30% "bonus depreciation" permanent

The 3-year 30% "bonus depreciation" provision in the 2002 stimulus package would give a big boost to investment, the economy, future corporate earnings, and the stock market if it were made permanent.

Ultimate relief — reduce, or better, eliminate the corporate income tax

Eliminating the corporate income tax would end the double taxation of both dividends and retained earnings relative to interest, and would eliminate the tax bias in favor of debt and against equity financed investment. Because of the capital gains differential, there would still be a bias against dividends in favor of retained earnings on saving done outside of retirement accounts. Going to a fully reformed saving/consumption neutral tax system in which all saving is accorded tax deferred (or equivalent) treatment would offset that bias, as well as the basic tax bias against saving.[4]

Conclusion

Tax relief for dividends, allowing greater deductions for capital losses, lower capital gains tax rates, and higher limits on contributions to retirement savings plans all make good economic and tax policy sense. Given the current tax bias against dividends and the recent losses in the stock market, the dividend and capital loss relief provisions are the most urgent. The benefits from these proposals to increase the rewards to saving would extend far beyond the affected shareholders. They would reach savers, workers and consumers at all income levels.

Stephen J. Entin
President and Executive Director

Endnotes

1. The income tax falls more heavily on income used for saving and investment than on income used for consumption. Income is taxed when earned. If it is used for consumption, there is generally no additional federal tax (except a few selected excises) on the purchase and use of the consumption goods. If the after-tax income is saved, however, there is a tax imposed on the returns to the saving, whether they are interest, dividends or capital gains. That is the basic income tax bias against saving. (The basic bias is offset for that portion of saving that is carried out in tax-favored retirement plans such as Roth IRAs, 401(k) plans, and other tax-deferred retirement arrangements, which either allow a deduction — i.e., deferral of tax — for saving or else exempt the returns.) If the saving is in corporate stock, there is an additional layer of bias due to the corporate income tax. The estate and gift taxes are yet another layer of tax on saving.

2. The Tax Reform Act of 1986 set the tax rate on capital gains equal to that of ordinary income, with a cap of 28%. The top explicit tax rate on ordinary income under the 1986 Act was 28%, but there was a 5% surcharge on taxable incomes over $71,900 (for joint filers) and $43,150 (single filers) to "recapture the benefits" of the 15% tax rate and to phase out the personal exemptions, resulting in an effective 33% tax rate "bubble" in the surtax region until a flat tax rate of 28% was achieved on total taxable income. (These income figures are for 1988 and were adjusted for inflation.) The "bubble" was superseded by the explicit tax rate of 31% enacted in 1990 and the 36% rate and 39.6% surtax rate enacted in 1993, but the 28% cap remained in place for long term capital gains.

3. Companies would report the "gross dividend" to the shareholder as taxable income, and the shareholder would get a credit for the corporate tax paid on it. The gross dividend is the pretax corporate income used for the dividend, which is equal to the actual after-tax dividend plus the corporate tax paid on the income. For example, suppose the firm earns $1.54 cents, pays $.54 in corporate tax at a 35% rate, and pays the remaining $1 as a dividend to the shareholder. The shareholder would report $1.54 as a received dividend, and pay tax on it at his regular tax rate, but he would get a tax credit of $.54 for the corporate tax payment.

4. See Endnote 1.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.