EDITOR'S CORNER

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Dividends and Dividend Taxation

Two things are wrong with the double taxation of dividends. First, taxing the same income twice is not ethical. Second, taxing dividends twice discourages the payment of dividends. Two things are wrong with the taxation of the inflation component of capital gains. First, taxing fictional "gains" from inflation is not ethical. Second, taxing inflation encourages the government to permit inflation.

President George W. Bush's proposal deals, at least in part, with the problems of taxing dividends twice and, ever so slightly, with the problems with the taxation of the inflation component of capital gains. How so? He proposes allowing tax-free dividend distributions, limited to the extent that a company has taxable profits. So far, so good. Tax the income once, but not more than once. By permitting "deemed dividends," the proposal allows retained earnings, which will generally keep pace with inflation, to build the shareholder's cost basis.[1] Again, this gain is taxed once, but not more than once. For a well-diversified buy-and-hold portfolio, and assuming inflation stays reasonably under control, the effect will be roughly the same as indexation of capital gains. Again, a good thing.

What's missing, and why does it matter? Bush's proposal ignores the fact that the majority of equity assets are held by investors who are either tax exempt (pensions and endowments) or tax advantaged through a dividend exclusion (insurance companies and other corporate investors). So, the impact on equity market valuations will be modest, at best. Also, by permitting deemed dividends, the proposal actually encourages companies to retain more of their earnings. Empirical data suggest that too many companies squander their retained earnings when those retained earnings are more than is required for key projects for future survival and competitiveness. Why would a company's fifth-best idea, out of a limited roster of internal projects and priorities, be better than the shareholder's best idea, out of an essentially unlimited roster of choices? Short answer: In most cases, it isn't.

The proposed tax structure is also a boon to the accounting profession. It reopens Pandora's box by adding a layer of accounting complexity on top of already complex corporate tax accounting. One senior accounting professional observed to me that the new tax code proposal is simple—at least as easy as counting the angels on the head of a pin.

A modest proposal: Simply allow companies to deduct dividends, much as they can deduct bond coupon payments. Clearly, if the company has no taxable earnings, this deduction doesn't reduce the tax bill. So, the income is still taxed once and only once. The governance issue is also addressed: By eliminating double taxation in this fashion, mature companies no longer have a tax-based excuse for retaining all their earnings and piling them onto an ever-growing cash hoard. Dividend distributions are likely to rise, triggering taxes, which will recoup much of the lost tax revenue. This "fix" is simple, is fair, and deals with both of the problems that stem from current tax policy. The problems that stem from taxation of inflation are another matter—one best solved by some form of indexing of capital gains.

[1] Rather than paying dividends, a company could continue reinvesting earnings and issue a paper tax credit, called "deemed dividends," into an excludable dividend account. When selling their stock, investors would deduct the deemed dividends from any capital gains, thus reducing their capital gains taxes. (Information from "Many Find Dividend Tax-Cut Plan Taxing," theeagle.com, 19 January 2003.)

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