



February 1, 2003

## **THE DIVIDEND TAX PUZZLE**

### **Background**

As a key element of his economic stimulus package, President Bush has proposed radically changing the taxation of dividends. The proposal seems destined to produce a political dogfight in Congress, and the outcome of the debate is far from certain. It comes against a backdrop of war debate and increased federal budget deficits. Its opponents say it is the wrong type of tax relief, since its most direct beneficiaries, corporations and their owners, are not exactly downtrodden.

The rationale for a dividend tax cut, beyond economic stimulus, is that the existing system creates double taxation. Corporations pay taxes on their earnings, and investors pay taxes on the dividends they receive, presumably from those earnings. Because the logic of the proposed tax cut rests on double taxation, tax relief under the plan would likely only extend to dividends tied to taxable corporate income.

The effects of a change in the taxation of dividends are difficult to predict, but we see three possibilities worth watching for. The first is a possible one-time upward revaluation of dividend-paying stocks, as the new law would eliminate a tax penalty on dividends. The second is a possible rise in the yields on municipal bonds, as they compete with common stocks as a source of tax-free income for investors. The third, more remote, possibility is a runup in prices of a few stocks perceived as offering high, stable dividends, much like the "Nifty Fifty" bubble of the 1960s. As to whether companies increase dividends in general, that depends on the market's treatment of stocks that pay them now.

### **Dividends and stock prices**

When a firm announces a dividend, it usually states that on a given date (the payment date), often a couple of months in the future, it will pay a certain amount per share to holders of record as of another given date (the record date), usually a month or so earlier. Investors owning the stock must hold it until the record date to collect the dividend. Non-holders wishing to collect the dividend must buy the stock before the record date. Because stock trades in the US settle (that is, money and ownership change

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hands) three business days after the trade, the real trading deadline is three days before the record date. The first trade date on which buyers are too late to meet settlement by the record date is the first day on which the stock trades without (ex-) the promise of this period's dividend. In Wall Street parlance, this is the *ex-dividend date*.

Say a \$20 stock pays a dividend of 25 cents per share. Just before the ex-dividend date, 25 cents of the stock's value is in the anticipated dividend. On the ex-dividend date, the stock's price change will include a drop of 25 cents to reflect the fact that 25 cents per share in cash is leaving the company, and that buyers on the ex-dividend date have a claim on 25 cents less per share than buyers the previous day. This is not just a theoretical possibility—clear evidence indicates that this actually happens.<sup>1</sup>

Because dividends create a corresponding drop in share prices, they end up substituting one type of return, income, for another type, capital gains. For long-term investors, capital gains are taxed at more favorable rates, so under current law, dividends increase taxable investors' potential tax liability. Investors also have no choice about when to receive dividends. The only way to avoid receiving a dividend is to sell the shares.

### Dividends and share repurchases

Companies have other means to return cash to shareholders. They can also repurchase shares, either through tenders or on the open market. Share repurchases distribute cash and reduce the total value of the shares outstanding – exactly the same effects as dividends. There are a couple of differences. Only shareholders wishing to sell need participate in a share buyback, whereas all shareholders receive a dividend. The selling shareholders also receive capital gains treatment, rather than income treatment, on the proceeds. Finally, since the share buyback reduces the number of shares in the hands of the public, it can potentially increase earnings per share. Some firms prefer share buybacks to dividends for just these reasons.

Dividends and share repurchases also differ in their traditional shape and uses. Common stock dividends are discretionary, and a company's Board of Directors may reduce or suspend dividends at any time. But public companies traditionally try to keep their dividend payments comparatively constant, only increasing them when they judge that they will be likely to maintain the increase.<sup>2</sup> Share repurchases, on the other hand, tend to be one-time events or part of a share repurchase program of a pre-specified size and extent. When a firm initiates or increases a dividend, it often communicates to the market that its cash flows are large and stable enough to sustain

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<sup>1</sup> This effect has been well established in the academic literature for a long time. See, for example, Edwin Elton and Martin Gruber, "Marginal Stockholder Tax Rates and the Clientele Effect," *Review of Economics and Statistics* 52, 68-74, (February 1970).

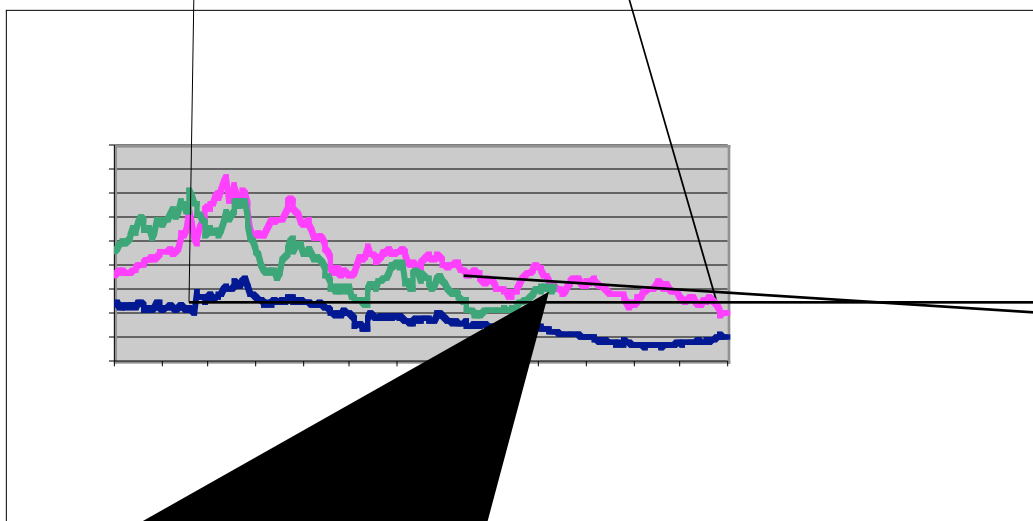
<sup>2</sup> This effect is documented in the academic literature as far back as 1956. See John Lintner, "Distribution of incomes of corporations among dividends, retained earnings, and taxes," *American Economic Review* 46, 97-113 (1956).

the dividend. In contrast, a share repurchase may simply communicate to the market that the firm's management views its stock as cheap.

### Possible effects on corporate behavior

Academic evidence supports the view that the market sees dividend increases as conveying favorable news about companies.<sup>3</sup> Under current tax law, dividend increases subject many shareholders to increased taxes. This effect could cause a *decrease* in shareholder value. Instead, academic investigators have consistently found that a dividend increase generally causes the value of a company to rise, probably because the market views dividends as a signal of strength.

We do not know whether the proposed tax changes will motivate stable companies to increase their dividend payouts. As a number of observers have noted, the dividend yield on the S&P 500 index now stands around 2%, whereas in January 1977 it was nearly 5%.<sup>4</sup> The drop is notable, but the change actually parallels two other, arguably related, changes. As the chart below shows, interest rates have fallen fairly steadily since the early 1980s. At the same time, the earnings yield on the S&P 500 (the inverse of the price/earnings ratio, here shown including companies with negative earnings) has also fallen. The payout ratio (the ratio of the dividend yield to the earnings yield) stood at 57% at the end of 2002, more or less in the middle of the range of values that ratio has taken on since 1977.<sup>5</sup>



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The figures do not suggest that low dividend yields are a problem that needs fixing, at least not by increasing payout ratios. How would firms respond to dividend tax relief? No one knows, of course, but recent events may provide clues. Microsoft recently announced that it would pay its first common stock dividend ever. The new dividend is tiny: 16 cents per share per year, or about 1/3 of 1% (based on a price of \$48 per share). Microsoft notoriously maintains colossal cash balances, and yet has never paid a dividend until now. One reason may be the double taxation problem. Many Microsoft employees hold shares in the company. If the new law removed the tax on dividends, that dividend could become a tax-efficient means for Microsoft to distribute cash to its employees and other interested parties without reducing their ownership.

One version of the Bush proposal contains a curious provision that highlights the complexity of the issue, and the need for expert analysis. This feature would create the concept of a “deemed dividend,” which creates benefits to shareholders of companies that pay taxes, whether or not they pay dividends. A firm would be “deemed” for tax purposes to have paid out all its after-tax earnings in dividends, whether or not it actually paid them. That portion of the earnings the company retains (does not pay out in dividends) would increase the tax basis of shareowners’ holdings. This change in the tax status to investors of earnings after corporate taxes could potentially increase the value to investors of those earnings. It will not drive dividend policy. Regardless of dividend policy, earnings on which corporations actually paid taxes would translate into some kind of tax benefit for their shareholders—either tax-free dividends, or increases in the tax basis of their holdings, which would reduce their capital gains taxes when they finally sold the stock. In the end, companies will respond to the market. If they perceive that the market pays up for dividends, we will see more of them.

### **Possible effects on investor behavior**

Under current law, dividend-paying stocks are somewhat more attractive to tax-exempt institutions than to taxable individuals. Some institutions even pursue strategies tilting portions of their portfolios toward dividend-paying stocks, reasoning that they are relatively cheap because some taxable investors avoid them. The proposed change in dividend taxes would seem likely to eliminate that imbalance, and some dividend-paying stocks may have a one-time pop in price if the proposal becomes law. Under this reasoning, the one-time price effect would merely equalize otherwise equivalent dividend and non-dividend stocks.

The most interesting effect on investor behavior may be among those investors that rely on their holdings for current income. Under today’s law, the main choices for these investors are dividend-paying stocks (with dividends taxed as ordinary income), corporate bonds (with interest taxed as ordinary income), US government bonds (interest taxed at ordinary income rates at the federal level, but exempt from state and local taxes), and municipal bonds (generally, though not entirely, tax-exempt). If the law changes, investors seeking income may well choose to allocate an increased portion of their portfolios to stocks they perceive to have attractive, and stable, dividend yields. These may ultimately look like old-fashioned portfolios of “blue chip” stocks.

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If taxable, income-seeking investors really do try to build portfolios of high-yielding, blue chip stocks, two worries arise. One is that these investors may gravitate toward a small group of stocks perceived to be of particularly high quality, creating an artificially inflated demand for them. The result could be sort of a blue-chip asset bubble much like the “Nifty Fifty” phenomenon of the late 1960s, during which many portfolio managers settled on a group of about fifty blue chip stocks as the “only” stocks investors should need, creating an excessive demand for this small group. Some argue that the dreadful bear market of 1973-74 was a reaction to the bursting of a bubble in these Nifty Fifty stocks.

A second potential effect of the proposed legislation concerns the municipal bond market. As noted, some investors may reallocate their portfolios away from munis in favor of high-dividend equities. The extent of such a shift is impossible to predict, but if the new law does make stocks more attractive to some investors, one likely result – with possible ramifications for local economies – is that the interest rates states and localities must pay to attract investors to their municipal bonds could rise.

### Conclusion

President Bush’s well-publicized initiative to reduce the taxation of dividends on common stocks creates an interesting set of issues for taxable investors. The overall effects of such a change are always difficult to predict, but we believe that investors should watch for three possible effects: a one-time relative increase in the value of high-dividend stocks, a rise in the yields on municipal bonds, and the possible start of a latter-day “Nifty Fifty” phenomenon, in which a relatively small group of high-dividend, blue chip stocks become excessively popular, potentially resulting in some unusual price behavior in those stocks. Corporations are likely to follow the dictates of the market in adjusting dividend policies to any new law. The likely effect of the proposed change on long-term asset allocation strategies is minor, except among those investors that look to their taxable portfolios to generate current income, but otherwise would prefer to invest in equities. For those investors, the proposed new law could create an important impetus to reallocate their portfolios somewhat more heavily toward equities.

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