

Double Taxation of Dividends

By Terry Price

In early January, President Bush announced a major tax cut proposal to reduce federal taxes by about \$700 billion over the next ten years. The centerpiece, or nearly half of his various proposed cuts, is the elimination of the so-called *double taxation of dividends* – long unpopular with many investors. Although a seemingly simple proposal on the surface, there are a few hidden complexities and considerations which need to be understood by investors should this change become law.

There are actually two prospects for reducing taxes under this suggestion. To better appreciate how they work, one needs to recognize the President's point of view. In the President's mind, corporate *profits* are being taxed twice. Not just dividends. The first tax is levied on corporate profits directly. For example, if a company earns \$10 a share in profits, it might pay \$3.50 in taxes. That would leave \$6.50 a share in after-tax profits which could be paid out in dividends or reinvested back into the business. Nothing is proposed to change this first level of taxation.

But currently a second layer of tax is levied on those remaining profits in one of two ways. If profits are distributed to individual investors in the form of dividends, a second tax is paid through an individual's personal income taxes. The Bush plan would eliminate those individual taxes on dividends – or on corporate profits, as he sees them.

Also under Mr. Bush's arrangement, capital gains taxes on undistributed corporate profits would likewise be eliminated. Here's how that would work. From our example above, instead of paying dividends, the company decides to reinvest the

\$6.50 a share of after-tax profits it made last year. Individual shareholders would be notified to adjust the cost basis of their stock upwards by \$6.50 a share.

For instance, a share of stock is bought for \$100 and then sold a year later for \$110. The investor is notified that his cost basis in the stock should be adjusted upward by \$6.50 a share. Thus, when the stock is sold, a capital gains tax would apply on just \$3.50 of the total stock appreciation (\$10 minus \$6.50).

Should this proposal become law, tax-exempt dividends would clearly be viewed positively by investors in portfolios subject to taxation. In fact, the current dividend

yield of many high-quality stocks offers a competitive return when compared to fixed-income alternatives. Also, dividends have traditionally been expected to grow over time. If a change is enacted, individual investors may choose to shift some money away from bonds into equities.

The following table offers a comparison of current yields from bond interest and stock dividends as of March 31st.

Bonds	Current Yield
2-Year Treasury	1.5%
5-Year Treasury	2.7%
5-Year AAA Municipal Bond	2.5%

Stocks	Current Yield
Bank of New York	3.7%
ExxonMobil	2.6%
General Electric	3.0%
Pfizer	1.9%

“The elimination of the so-called *double taxation of dividends*..”

Continued on back

Another consideration for many investors is the effect of any legislation changing the dividend tax treatment on mutual fund holdings. Typical to the industry, dividend income flowing into mutual funds is reduced by fund operating expenses. In fact, a great many stock funds do not make regular income distributions to their shareholders because all of their dividend cash flow is offset by internal expenses. So although it is possible that mutual fund investors could benefit from tax-free dividend distributions, in most cases the benefit to shareholders would be less than owning a basketful of individual, comparable stocks.

Whereas the proposed tax cuts are generally positive for individuals, we do however take exception to one argument made in support of the proposal. In a recent speech, a representative of the administration said, "Abolishing the double-taxation on dividends will ... transform corporate behavior in America and encourage responsible practices." Presumably this means more pressure to increase dividends versus throwing money at marginal, overpriced acquisitions. The main argument, however, is that a company paying dividends somehow is doing so only if they have real, not fake earnings.

However, recent history is littered with quite a few dividend-paying companies whose earnings and practices were blatantly deceptive. Enron, for example, paid over \$1/2 billion in dividends in 2000. Dynegy paid out \$100 million in 2001. Both Xerox and Waste Management and even WorldCom were dividend payers. In fact, one

of the oldest financial tricks known, the so-called Ponzi scheme, is constructed to pay out large dividends to early investors using money from later investors. This creates the illusion of above-average returns that sucks in even more investor money until the scheme eventually collapses.

As always, our security analysis places a priority on strong operating cashflows, a solid low-debt balance sheet, and a long-term consistent history of earnings combined with stable or increasing margins. We feel these measurable characteristics are much better predictors of a high-quality corporate structure which can then afford to pay a consistent and growing dividend. Indeed, the largest 10 stock positions in Clifford's client portfolios, as of December 31, 2002, have averaged an annualized dividend growth rate of 11% over the last 5 years, 3 of which were very difficult operating years.

As with any major legislative proposal, passage of this plan is far from certain. And with the country presently focused on the situation in Iraq, a final tax bill will not likely be seen for several months. However, when the debate eventually does heat up, these will be some of the issues certain to be discussed. We hope corporate dividends receive a less taxing treatment in the future.

" If a change is enacted, individual investors may choose to shift some money away from bonds into equities."