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A Higher Tax Rate for Dividends?

And What Matters Most

Unless Congress acts, today's tax rate on dividends is set to increase next year when the Bush administration tax cuts expire. Under current law, the new rate could rise as high as 43.4% from 15% for individuals earning over $200,000 and couples earning over $250,000. That rate combines an increase in the highest marginal tax rate to 39.6% with a 3.8% tax to fund the 2009 Patient Protection and Affordable Health Care Act.

Such a hike in the dividend tax comes at a time when stock market confidence and interest rates are historically low. This is an issue that confronts the vast majority of Americans -- not just the rich, since 80% of American families are invested in financial markets either directly or indirectly. The rise of the American investor class makes this a political issue and subject to the outcome of the upcoming election and subsequent negotiations in Congress. Therefore, the uncertainty of politics makes an automatic increase in the dividend tax far from certain.

But what if the Bush tax cuts expire as planned? How would this affect investors? For starters, dividend income received into taxable accounts by high income earners who are subject to U.S. tax law will be lowered by approximately one-third, after taxes are deducted. A $1.00 dividend at current tax rates leaves $0.85 of income after the current 15% dividend tax is applied. Applying a top rate of 43.4% would leave just $0.57 -- a reduction of 1/3.

What does this mean for stock prices, in general? Would a higher tax rate on dividends hurt the value of dividend paying stocks? The historic record and academic reasoning are helpful in answering these questions.

The Historical Record

During the past hundred years, dividends have been alternatively taxed, not taxed, taxed in whole or in part, and taxed at vastly different rates for some recipients compared to others and there has been little notable effect on stock market performance. A brief history may be instructive. Until 1936, dividends went untaxed. From 1936 to 1940, dividends were fully taxable as ordinary income for the first time to raise revenue for the New Deal. Between 1940 and 1954, dividends went untaxed again. Starting in 1954, dividends above a small exemption threshold were taxed at ordinary income tax rates as high as 90%. A long period of generally falling tax rates followed from the 1960s into the 2000s. In 2003, President Bush abandoned the "taxable at ordinary income tax rate" model and put forth a simpler 15% "flat tax" that we use today. Again, despite all the disjointed and varied approaches to dividend taxation over the years, there seems to have been little correlation between tax changes on dividends on the one hand and market performance on the other (see chart below).

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Academic Insight:

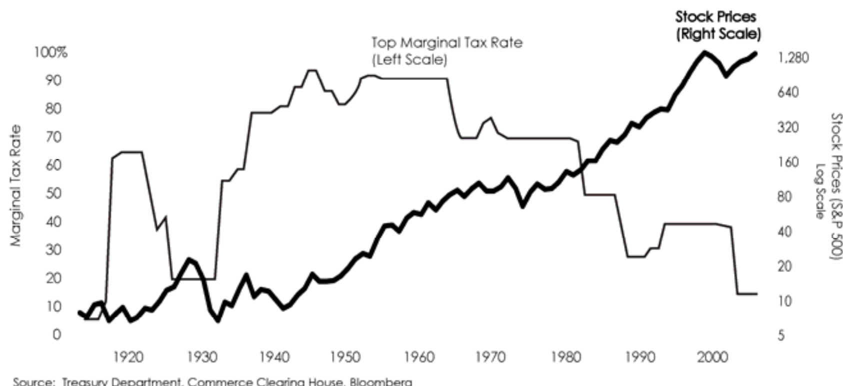
A change in taxation will have no effect on equity prices or returns.

In 1978, Nobel Prize winning economists Merton H. Miller and Myron S. Scholes argued that when investment taxes can be avoided and other tax-exempt investors are able to invest in the market, a change in taxation will have no effect on equity prices or returns.

- Merton H. Miller and Myron S. Scholes

Nobel Laureates, Economics

No Obvious Correlation between Tax Rates and Market Performance



Source: Treasury Department, Commerce Clearing House, Bloomberg

Another recent example illustrates the lack of direct correlation between dividend tax changes and stock price behavior. In 1993, President Clinton's Omnibus Budget Reconciliation Act was implemented and effectively raised the dividend tax. The law sought to cut the federal deficit by, among other things, raising the top income tax rate for individuals. The top tax rate rose to 39.6% from 31% in 1993 and was applied to dividends as well. In spite of the increase, the S&P 500 returned over 10% that year and dividend stocks returned an even greater 21% based on the performance of the Dow Jones U.S. Select Dividend Index. Dividend stocks outperformed despite the higher tax on dividends.

Why Might Stocks be Unaffected by Higher Dividend Taxes?

One answer is that there are large numbers of investors with vast amounts of money who are not affected by changes in the U.S. tax code. Their assessment of the value of shares, dividend paying or not, is completely unaffected by a change in the U.S. Federal Tax Code. So long as there are sufficient investors with sufficiently large and movable assets, there should be little change in the value of shares based on changes in dividend. We estimate that the pool of unaffected equity capital is about $46 trillion (see appendix).

How do we come up with such a large number? We start with the value of equity assets in the world today, which is approximately $50 trillion. From that number we subtract the value of dividend paying stocks held in taxable U.S. taxpayer accounts either directly or through mutual funds. We estimate this number to be about $4 trillion, at most. This math suggests just 8% of global equity capital is affected at all by the dividend tax ($4 trillion / $50 trillion) and a much larger 92% of global equity capital is effectively "tax-exempt."

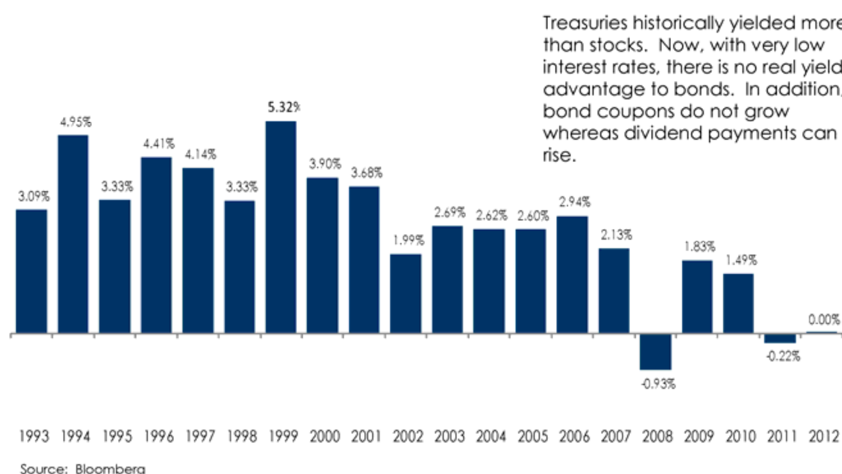
Since "tax-exempt" investors' assessment of the value of U.S. dividend paying stocks is completely unchanged by U.S. tax treatment, and since they represent a large and mobile pool of investable capital, there should be no reason for them to change their assessment of share value. The dividend tax could be 0% or 100% and it would not matter one iota to these investors or change their subjective valuation of shares. In the final analysis, the value of shares should be exactly the same to these marginal buyers and, therefore, there should be no appreciable change in the way the “market” values the shares.

Where Would the Money Go Anyway?

For the remaining $4 trillion of assets held by U.S. taxpayers in taxable accounts, another question arises. Where to go with the money for yield? Back in 1993, the 10-year Treasury yielded 3.1% more than the yield on the S&P 500. The Treasury yield was 5.8% and the S&P dividend yield was 2.7% back then. Today, the Treasury yield is about the same as the S&P 500 and does not offer the potential growth that dividends offer. The $4 trillion of assets that would be affected by a potential dividend tax change will be hard pressed to find a better source of income to replace dividend yield. Therefore, it is far from clear that even fully taxable investors will significantly change their behavior with respect to dividend paying stocks.

Treasury Yields Offer no Better Yield than Stocks

Spread between Dividend Yield and 10-Year U.S. Treasury Yield (1993-2012)



Summing Up

So as you can see, if Congress fails to prevent the dividend tax rate from rising next year, there would be a significant reduction of after-tax income to U.S. dividend stock investors when the stocks are held in taxable accounts. However, there is at least some historic evidence and sound academic reasoning to question whether the change in dividend tax will have any lasting impact on the value or performance of U.S. dividend-paying shares. Furthermore, it is premature to conclude that the dividend tax increase will ultimately go into effect given the political landscape.

In our long-held view, buying a stock merely for its dividend yield is not a sufficient reason to make an investment. A better course is to seek a balance of income and capital appreciation by focusing on stocks that are consistently retaining, and profitably investing, more earnings than returning to investors as dividends. Those same companies may then be able to both boost their dividend payments over time and create value for shareholders.

Seeking a balance between capital appreciation and a rising income stream makes sense in this environment.

Appendix
Estimation of Size of Affected Market

Estimating the Scope of Impact from a Dividend Tax Hike

U.S. Taxpayer Holdings Subject to Tax

Household Direct Equity Holdings:	$8 Trillion
Household Mutual Fund Holdings: *	$3 Trillion
	===========
A) Equals U.S. Taxpayer Equity Holdings:	$11 Trillion
Less U.S. Taxpayer Holdings Not Subject to Tax:	
Value Held in Non-Taxable Accounts:	$6 Trillion
Value of Non-Dividend Paying Stocks:	$1 Trillion
	===========
B) Equals U.S. Tax Exempt Holdings:	$7 Trillion
Value Affected by Dividend Tax Increase (A-B):	$4 Trillion
C) Value of Global Equity Capital:	$50 Trillion
Value of Global Equity Capital Unaffected by Tax (C-B):	$46 Trillion

Source: Federal Reserve Flow of Funds Report; Investment Company Institute; Bloomberg; Washington Crossing Advisors estimates

** Assumes 50% of mutual fund holdings are equity based on ICI 2012 Fact Book mutual fund data*

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.