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Issue Brief

The Dividend Tax Break: Taxing Logic

By Dean Baker[1]

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CENTER FOR ECONOMIC AND POLICY RESEARCH • 1621 CONNECTICUT AVE., NW, SUITE 500
WASHINGTON, D.C. 20009 • (202) 293-5380 • <WWW.CEPR.NET> • EMAIL: CEPR@CEPR.NET

[1] Dean Baker is co-Director of the Center for Economic and Policy Research.

It has been widely reported that President Bush is planning to propose a reduction in the personal income tax on income from dividends, so that only half of dividend income would be taxable. The rationale for this tax cut is that it would limit the "double taxation" of income from dividends—the argument being that this income is taxed once at the corporate level and then a second time at the individual level.

In fact, there is little basis for viewing the current tax treatment of dividends as "double taxation." Furthermore, if "double taxation" really were the issue, the proposed dividend tax cut does not address the problem for the vast majority of stockholders, who hold most of their stock through retirement accounts. Upon examination, the only obvious rationale for the proposed dividend tax cut is to redistribute more income to high income individuals.

The Myth of Double Taxation

Proponents of a tax preference for dividend income have pushed the notion that the taxation of dividend income amounts to double taxation. The basis for this claim is that corporate profits are subject to the corporate income tax. Since dividends are paid out of profits, the argument is that the personal income tax paid on dividend income amounts to a second tax on corporate profits.

This logic is dubious for two reasons. First, there is a legal and logical distinction between the corporation as an entity and the individual shareholders who own the firm. Second, the tax rates currently in place were set with the knowledge that there was both a corporate and individual income tax. This means that if there is a moral objection to "double taxation" then the appropriate remedy would also require an increase in the corporate income tax.

On the first point, a corporation is an entity apart from its shareholders, for reasons that have historically been quite important. The law has, in effect, recognized corporations as legal entities that are distinct from the individuals who happen to own its stock. This is an important privilege granted by the government for many reasons. First, the limited liability provided to shareholders means that a corporation may end up imposing damage to others in pursuit of profit, without the individual shareholders being held accountable. For example, if a chemical company dumps hazardous waste that damages the health of its workers and nearby residents, the individual shareholders cannot be held liable for the damage beyond the extent of their investment in the company. Without the privilege of limited liability granted by the government, every shareholder could be held fully responsible for all claims against the company.

A second important benefit associated with the corporate form is that the corporation can act as a legal individual, without directly involving its owners. This can be advantageous to individuals who may wish to profit from activities that they would prefer not to be publicly associated with, such as manufacturing guns, selling tobacco, or distributing pornography. The corporate form allows individuals to profit from actions that may be viewed as ethically questionable, while preserving their anonymity.

There are other benefits associated with the legal privilege of incorporation, but the best evidence of the value to individual shareholders of having corporations as separate entities is the fact that corporations exist. Individuals choose to set up corporations (with full knowledge of the tax laws) because they view the benefits as outweighing the costs. Any shareholders who felt that the corporate income tax was too great a burden have the option of maintaining a firm as a partnership. In this case, their income would only be subject to the personal income tax. The decision to create a corporation is proof that the benefits associated with this status outweigh the costs in having corporate income subject to taxation.

Since the corporation is legally and logically a separate legal entity from its shareholders, there is no sense to the claim that the taxation of dividends amounts to double taxation. The corporation is subject to taxation in exchange for the privileges granted to it by the government. The shareholders are subject to tax on their dividend income, just as workers are subject to tax on wage income. The same income—that is, income to the same people or entity—is not being taxed twice.[2]

Beyond this logical point on double taxation, there is the obvious practical point that Congress has been well aware of the fact that dividends were subject to taxation in setting the corporate tax rate. In other words, the corporate tax rate was set at its current level with the expectation that the portion of profits paid out as dividends would also be subject to taxation. If there is now a concern that the taxation of dividends is an inappropriate form of double taxation, then the remedy should include raising the corporate tax rate. If the purpose of a cut in the tax rate on dividends is simply to eliminate the "double taxation" of dividends, then it would be coupled with an increase in the corporate tax rate. If there is no accompanying increase in the corporate tax rate, then the intention must be to increase the amount of money going to the relatively small number of families who have significant dividend income.

Who Gets the Dividend Tax Break?

The lack of equity (or efficiency) of proposals for a dividend tax break is apparent from the fact that the vast majority of taxpayers who get dividend income will not benefit from the proposed tax break. According to data from the Federal Reserve Board, nearly half of all families now have a retirement account, such as a 401(k) type account, or Individual Retirement Account (IRA). The vast majority of these families hold stock through mutual funds in these accounts. By contrast, only 19.2 percent of families report holding stock, and 16.5 percent report holding mutual funds, outside of retirement accounts.[3] (There is considerable overlap among families that hold stock and mutual funds outside of retirement accounts.) These families are disproportionately

[2] It is understandable that proponents of tax breaks on dividend income would use the term "double taxation" to advance their cause, in the same way that opponents of the estate tax have dubbed it as the "death tax." However, the claim of "double taxation" is dubious, as noted in this discussion. The term should not be adopted by the media or other neutral parties in the debate, as it sometimes has been (e.g. "Bush Considers New Measures In a Bid to Boost the Economy," *New York Times*, August 17, 2002, Page A8).

[3] This data can be found in "Recent Changes in U.S. Family Finances: Results From the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, January, 2000, table 5B [http://www.federalreserve.gov/pubs/bulletin/2000/0100lead.pdf].

higher income families, with the bulk of individual stockholdings concentrated among the richest families. The richest 1 percent of families holds 53.2 percent of all shares held directly by individuals outside of retirement accounts, while the top 10 percent hold more than 90 percent, which means that the vast majority of families would receive nothing from the proposed dividend tax break.[4]

The bulk of stockholders, who hold their stock in retirement accounts, would not benefit at all from the dividend tax break. At the point when workers begin to draw on these accounts, the entire amount withdrawn from the account is taxed as normal income, regardless of whether the money came from wages, interest, capital gains, or dividends.

This means that a middle income worker, for example a school teacher or firefighter, who may withdraw $15,000 to $20,000 a year from a retirement account, will likely pay a 27 percent tax rate on her dividend income. On the other, if Bill Gates earns $500 million a year on dividends, he would pay tax at just a 16.5 percent rate under the proposal that half of dividend income be exempt from taxation. If the concern of those proposing a dividend tax cut is to eliminate what they claim is the double taxation of dividends, it is worth noting that their proposals do nothing at all for the vast majority of people subject to this "double taxation."

There is one last practical point worth noting about the supposed injustice associated with the double taxation of dividends. As a result of both lower rates and a proliferation of loopholes, the effective corporate tax rate is at its lowest level in the post-war period. In 2000, U.S. corporations paid 32.9 percent of their profits in taxes. By contrast, in 1959 they paid 43.9 percent of their profits in taxes. Measured as a share of capital income, which includes net interest payments from the corporate sector, the decline in the corporate tax rate has been even sharper, from 44.4 percent in 1959 to 25.6 percent in 2000.[5] Of course, the top tax rates on individuals have also been substantially lowered over this period. The top tax rate for individuals was 70 percent in the sixties (it had been 90 percent prior to the Kennedy era tax cuts). At present, the top individual tax rate is 38.6 percent. Under the Bush tax cuts it is scheduled to fall to 33 percent in 2006. Given the sharp decline in both the effective corporate tax rate and the top tax rate for individuals, there is far less basis for any concern about the "double taxation" of dividend income than at any point in the post-war era.

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[4] See "Stock Market Wealth and Consumption," James Poterba, *Journal of Economic Perspectives*, 2000 (Spring): 99-118.
[5] These data are taken from the Bureau of Economic Analysis, National Income and Product Accounts. Data on corporate profits are from table 1.14, line 20. Data on taxes and net interest are taken from table 1.16 lines 11 and 17, respectively. The years 1959 and 2000 were used because they are from peak years prior to a recession. The falloff in taxes would be sharper if 2001 data were used.

Conclusion

This discussion has briefly examined the supposed rationale for the dividend tax break that the Bush administration is expected to put forward. It shows that the claim that dividends are subject to "double taxation" is at best dubious. Furthermore, if proponents of the tax break were actually interested in avoiding double taxation, rather than just lowering tax rates for wealthy individuals, they would couple their proposals for a cut in the dividend tax rate with an increase in the corporate tax rate. In addition, the proposed tax break actually does little for the vast majority of families who are subject to the alleged double taxation of dividends, since they hold their stock primarily in retirement accounts. The main beneficiaries are the small number of wealthy families who hold large amounts of stock outside of retirement accounts. Given these facts, the only plausible rationale for the dividend tax break is to give more money to the wealthy.