Does It Make Sense to Pay Dividends?

THE BUSH ADMINISTRATION'S proposal to eliminate taxation of dividends for investors has rekindled the long-standing debate over dividend policy.

Dividends could decrease the volatility of your company's stock and help put a floor on its price. When stock prices go down, dividend yields—the dividend as a percent of the stock price—go up, prompting new buyers. Market results seem to support that argument. Last year, 350 of the companies included in the S&P 500 paid dividends. The share prices of those dividend payers dropped about 18% in 2002 while the stock price of nonpayers fell 30%, according to Standard & Poor's. Investors in dividend-paying stocks are less likely to sell them in a bear market. Moreover, companies that pay dividends signal to the market their earnings are real, giving investors a certain amount of comfort in the quality of earnings. But once a company begins paying a dividend, it can't turn back without signaling to investors that it can't maintain the dividend. Paying dividends also increases a company's administrative workload and reduces financial flexibility. So the decision to begin paying out a share of profits on a regular basis—what amounts to a fixed cost—should not be taken lightly.

When Microsoft Corporation's board of directors announced early this year it would begin paying a dividend, the amount was a modest eight cents per share, or a 0.3% yield, in mid-March. With no debt and $43 billion in cash and equivalents, there's little question Microsoft can maintain the payouts. In 2003, for example, the cash dividend cost the company $850 million—roughly one month of its cash flow from operations.

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Companies that can't predict their future ability to maintain dividend payouts can declare a "special" one-time dividend if they have more cash on hand than they need to pay expenses and invest in projects. Or a firm can achieve the same effect through a share buyback without commiting to future cash payouts.

Buybacks are, in theory, just another way to return cash to shareholders by buying up shares on the open market and retiring them. The reduction in the number of shares outstanding means that profits are spread over a smaller base of shares. Investors forgo a cash dividend but own more shares of increased value, which should lift share prices for investors who don't sell them back to the firm. At least that's the theory.

The firm may be indifferent to either buybacks or dividends as a means of distributing profits, but, in practice, investors currently are not. With dividends taxed as ordinary income, investors can realize the gains on a buyback at a lower capital gains tax rate. But under the White House plan, as long as dividends are paid out of profits on which a company has paid taxes, they would be tax-free to investors.

So-called double taxation of dividends—once at the corporate level and again at the investor level—may explain in part why the number of dividend-paying companies has been declining for decades. Paying dividends was the norm among publicly traded profitable companies until the late 1970s. "Only about one in four public companies currently pays dividends, in sharp contrast to 20 or 30 years ago when nearly three-fourths paid dividends," says John Graham, finance professor at Duke University's Fuqua School of Business. By 1978, 66.5% of companies listed on the major stock exchanges paid dividends. By 1999, that percentage had fallen to 20.8%, according to a study by Eugene F. Fama of the University of Chicago Business School and Kenneth French of Dartmouth College. Fama and French showed that start-ups, small companies, and high-growth companies were the least likely to pay dividends, but the practice of paying dividends had declined among all companies.

The way dividends are taxed can also have wide-ranging consequences for how capital is allocated and how a firm is run. It can influence whether a firm finances itself primarily through equity or debt. The U.S. tax code allowing interest on corporate debt to be tax deductible but dividends to be taxable makes the cost of debt financing artificially low relative to equity financing, and firms are encouraged to adopt a leveraged capital structure.

Some people argue that it would be far better to grant the tax break to corporations by letting companies take a tax deduction for the dividends they pay. This would create tax neutrality between equity and debt. But the Bush administration's tax plan was already controversial when it was sent to Congress. A tax break for corporations was untenable politically.

"It would clearly be neater to have both deducted at the corporate level," says Burton G. Malkiel, professor of financial economics at Princeton University and author of *A Random Walk Down Wall Street*. "But that would have been more expensive since dividends in retirement plans are not taxed, and the politicos thought it might have a better chance if the break went to individuals."

By late March, the Bush administration's $385 billion tax cut of dividends over 10 years was in trouble in Congress.

Double taxation of dividends may not be eliminated now, but the subject has seemed worthy of renewed debate. ■