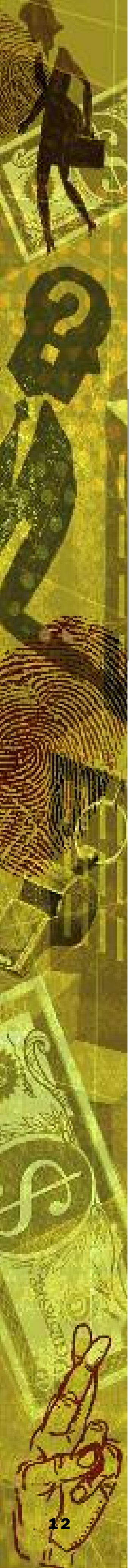

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Taxing Dividends and Capital Gains Income Fairly

The tax rates and policies on income from dividends and long-term capital gains lead to some unintended negative consequences. In trying to help stamp out fraud in financial reporting and add more fairness into the tax system, closer examination of these policies is warranted.

Income taxes have long been a divisive issue in the United States—as evidenced recently by the debates and concerns surrounding the fiscal cliff. One area that continues to be a significant source of controversy is whether both dividends and long-term capital gains should receive preferential tax treatment. In recent years, the rates of taxation on capital gains and most dividends have been progressive, perhaps designed to make high-income taxpayers pay their "fair" share. Although fairness in tax policy may undoubtedly exist only in the eye of the observer, several ethical considerations and related negative, unintended consequences of tax policy deserve discussion.

The elimination of any taxation on dividends received by shareowners has been discussed periodically, most recently by President George W. Bush in 2003. Soon thereafter, Congress included some of the cuts Bush requested, reducing the rate at which most dividends were taxed to the same rate as for long-term capital gains. In general, this is 15% for most individual taxpayers. For taxpayers in the two lowest tax brackets, taxation on this income was eliminated in 2009.

The American Taxpayer Relief Act of 2012, which helped postpone the fiscal cliff, increased the rate for most dividends to 20% for taxpayers in the highest tax bracket, but the 15% rate for taxpayers in the middle brackets and the zero rate for taxpayers in the two lowest brackets stayed the same. The Patient Protection and Affordable Care Act of 2010 also increased tax rates in 2013 for upper-bracket taxpayers by 3.8% on investment income, including both dividends and capital gains.

The economics-oriented argument for preferential tax rates on income from dividends and capital gains considers the fact that both involve previously invested capital. Incentives to invest in start-up companies—as well as established ones—are widely believed to help create additional jobs and stimulate growth in the economy. According to Mark Heesen, president of the National Venture Capital Association, "If capital gains rates go up high, venture capitalists will become more conservative."

But empirical research supporting the theory that higher taxes suppress investment or the converse is hard to find. A December 29, 2012, *New York Times* opinion article titled "Why the Economy Needs Tax Reform" states the opposite, noting that "research shows that the [preferential capital gains] tax breaks do not add to economic growth but do contribute to inequality." The top 1% of taxpayers receives more than 70% of all capital gains, according to the *Times*.

A more cogent argument for taxing capital gains lightly is because some of the gains are the result of inflation and hence don't represent increases in real wealth. But almost all of the strength of that argument is lost by the fact that the holding period for an asset to be taxed at the preferential long-term capital gains rate is only one year. If long-term capital gains were defined as those resulting from holding assets at least six to eight years, then better recognition of the effects of inflation would be appropriate.

In "The case for raising taxes on capital gains," Ezra Klein states, "It's also hard to find much evidence that cutting taxes on investment income has led to much economic growth. In the 1980s, for instance, Ronald Reagan actually raised taxes on investment income—and the economy did very, very well. George W. Bush's capital gains cuts, however, did not lead to such a strong economy." (*The Washington Post's* Wonkblog, September 25, 2012)

Klein cites tax expert Len Burman, who has found no correlation between tax rates on capital gains and economic growth. According to Burman, what's clear is that taxing capital gains at a much lower rate than that of ordinary income "incentivizes very complex tax avoidance." Transforming highly taxed compensation into more lightly taxed capital gains has led to a vast industry of lobbyists, attorneys, and accountants. The resulting actions have many negative consequences in addition to facilitating greater inequality of wealth.

One consequence is the importance of stock options in the total compensation of large-company CEOs, as illustrated by the "2012 Preliminary CEO Pay Survey" by GMI Ratings. This report states that the 10 highest-paid CEOs in terms of total realized compensation for 2011 "earned about 78% of realized compensation through [stock] option exercises and vested [stock] equity." The median total 2011 compensation of individuals in this group was $47.5 million, ranging from $40.9 million to $89.4 million. The median amount from option exercises and vesting was $42.9 million, ranging from $20.2 million to $84.4 million. In the 2011 report, the highest paid CEO received $145.3 million in total compensation, of which nearly 80%, or $112 million, resulted from exercises of stock options.

The overemphasis in executive compensation on stock options rather than bonuses or other forms results in many corporations having a focus on short-term reported financial results rather than long-term sustainability. Senior management is highly motivated to push reported quarterly results ever higher to justify increases in market price. These actions are likely to be the cause of most examples of fraudulent financial reporting. As I've discussed frequently in this column, there have been many such cases, for instance, Enron, WorldCom, and Lehman Brothers.

Corporations, especially those in the heavily regulated banking industry, appear to favor using cash to buy back shares of stock on the open market rather than paying increased dividends. Some shareowners also may prefer this strategy since dividends are taxed when received, whereas any increase in share price wouldn't be taxed until the stock was sold.

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This bias against dividends is exacerbated by management. Since upper managers receive a large portion of their total compensation in the form of stock option grants, boosting the demand for shares through repurchasing tends to increase the stock price and thus executive compensation. Management may believe that, in the short term, dividends may depress the stock price by reducing the book value of a company's stock. In addition, if managers have stock options, they don't immediately benefit from dividends because their stock options don't qualify for dividends.

On the other hand, when a stock buyback occurs, the short-term implications on the stock price are typically positive. Since this allows executives to see the most immediate effects on their compensation, it's no wonder that they prefer using cash to buy stock instead of increasing dividends.

Perhaps the most illogical and unfair aspect of this discussion involves dividends. Taxing shareowners for receiving a cash dividend from a corporation that has already been taxed on the very income that led to the dividend seems inherently inequitable. This is one of the reasons why Congress, in 1958, created the small business corporation, or S corporation, whose income is taxed only once when it is earned, like that of a partnership. According to the S Corporation Association, S corporations are "the most popular corporate structure in America. The IRS estimates that there were 4.5 million S corporation owners in the United States in 2007—about twice the number of regular or C corporations."

Additional justification for the elimination or substantial reduction of the so-called double tax on dividends has been provided by the Cato Institute, a conservative public policy think tank, which states that "high dividend taxes add to the income tax code's general bias against savings and investment." Stifling investment may discourage new business creation and consequent growth of jobs. Cato believes that "high dividend taxes cause corporations to rely too much on debt rather than equity financing." Additionally, the Institute notes that "highly indebted firms are more vulnerable to bankruptcy in economic downturns."

In summary, ethically fair considerations of taxation rates suggest that tax rates on dividend payments should be reduced to encourage their use in preference to share buybacks, which may be motivated by their tendency to increase rewards to upper management. Further, the definition of long-term capital gains should be significantly extended to mitigate against management tendencies to overemphasize stock options and focus—perhaps fraudulently—on short-term financial results to obtain greater compensation at the cost of long-term sustainability. **SF**

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