Dividends Should Not Be Taxed Twice

James A. Kyprios / Originally published by [LA Progressive on February 27, 2021]

"Heat not a furnace for your foe so hot, that it do singe yourself."
William Shakespeare- Henry VIII

I can imagine that many readers are thinking this—why speak about taxes on dividends in a Progressive publication? Coupon clipping and dividends are of interest to the rich but not for me they would say.

Are you part of a pension plan or a retirement plan, do you have insurance policies, are you directly or indirectly investing in mutual funds? Dividends are not just for the rich.

Capitalism is often criticized on the left because rich people can make more money while sleeping than working people make while working. Investment income (capital gains and dividends) come to mind. To add insult to injury, investment income is generally taxed at lower rates than wages and other so-called ordinary income. Many of us know that Warren Buffet's secretary is charged a higher tax rate than Mr. Buffett.

We are now in a situation where ballooning government deficits require some tax increases. The Biden Administration is expected to propose increases in corporate tax rates and personal income tax rates (the latter commonly referred to as ordinary income). It is also proposing changes in taxes on investment income (capital gains and dividends) but only for very wealthy people—that is for those making more than $1 million/year. The Biden proposal would eliminate capital gains taxes for these wealthy people, and it would also eliminate preferential rates on dividends for the wealthy.

In a previous article I have dealt with capital gains taxes.

In this article, I discuss the reasons for preferential dividend rates and why the Biden proposals may very well turn out to be counterproductive. My argument in its essence is quite simple–the tax code penalizes companies which pay out dividends and perhaps unwittingly encourages companies to borrow money instead of raising money through equity (stock market). This in turn makes companies financially riskier and subjects them to stresses in difficult times which could lead to bankruptcy and laying off workers. Furthermore, if the Biden proposal goes through it may very well encourage companies to cut down on dividends. Rich people are not the only ones who benefit from dividends.

I believe there is a better way to handle the dividend problem and at the same time raise additional money. The devil is in the details as they say. For those who want to dig into the details, please continue reading.

Rationale for a lower dividend rate

The rationale for a lower tax rate on dividends is that these earnings have already been taxed at the corporate level. That being the case, it does not seem fair for dividends to be taxed again at the ordinary income tax rate. As a result, dividends are taxed a lower rate. The Biden Administration will ask for higher taxes on corporations as well as higher taxes on dividends and ordinary income for wealthy individuals. This will make the double taxation problem more obvious as will be shown later.

The purpose of this article is to explore the tax treatment of dividends and propose what seems to me to be a fairer way of dealing with this so-called "double taxation" problem.

Lower Taxation of Dividends is an attempt to mitigate the sting of Double Taxation

For those who like to play with numbers, it should be noted that the corporate tax rate and the dividend rates are lower than the tax rates on ordinary income. It can be demonstrated that these lower taxes in effect now on corporate profits and dividends compensate for the double taxation problem in most cases. But these "fixes" cause political problems. It does not seem fair that a rich person collecting dividends should be paying lower tax rates than the working man. It has been mentioned many times that Warren Buffett has complained that his secretary is taxed at a higher tax rate than he is.

The Biden Plan is Expected to Submit

- Corporate taxes would increase from 21% to 28%.
- Ordinary income taxes maximum would increase from 37% to 39.6%.
- Anyone making more than $1 million per year would have to pay ordinary income taxes on capital gains and ordinary income taxes on dividends. The maximum rate on dividends is now 20% and the Biden plan would increase this to 39.6% for those making more than $1 million a year.

What are the specific problems?

The tax code encourages companies to borrow money rather than raise money through equity. Let's assume that a company wishes to expand by raising (say) $100 million in the public markets. In plain English, this means that the company can raise equity in the stock market or debt financing in the bond market. For the sake of simplicity, we assume that the bonds will have an interest rate of 5% and the equity offering will have dividends of 5%.

If the company chooses bonds, it will incur interest expenses of $5 million per year. If the company chooses stock, the dividend is also $5 million per year. The interest expenses are generally tax deductible, but the dividends are not. By choosing to float bonds, the company will save $1,050,000 in taxes each year (21% tax rate on $5 million). Clearly, the tax code is "subsidizing" borrowings at the expense of equity offerings. If the Biden plan goes through the 28% tax rate would allow the company to save $1,400,000 in taxes each year. Therefore, the Biden tax plan would increase the "subsidizing" of borrowings at the expense of equity offerings.

In a recent article in the LA Progressive, I have made the case that there is too much corporate debt and that we indeed appear to be having a corporate debt bubble. There are a variety of reasons for this but one of them is the fact that the tax code definitely incentivizes raising money through debt offerings.

Biden Tax Plans Would Soak the Rich But with the possible effect of Discouraging Dividends. As previously mentioned, the Biden Administration would eliminate the lower dividend tax rates for all those making $1 million or more a year. The plan would also raise the maximum personal tax rate from 37% to 39.6% and the corporate tax rate from 21% to 28%. Because the maximum dividend tax rate is now 20%, those making over $1 million/year would see their taxes on dividends double (from 20% to 39.6%). This would satisfy those who think that we should soak the rich. One of my liberal friends told me - what's the big deal, they can afford it.

Yes, the rich can afford it. But they will not like it and they can do something about it. Many can refuse to buy shares in companies that pay dividends preferring instead to put money into other companies thus increasing the value of non-dividend paying companies and thus reducing the value of dividend paying companies. These wealthy individuals can encourage companies to stop paying dividends and instead have these companies using extra cash to buy their own shares in the open market.

Many of these wealthy individuals can have a very direct effect on corporate behavior because they are CEOs, Board Members and important officers of corporations and the banks and funds that finance these companies. The net effect of "soaking the rich" will undoubtedly be to encourage borrowings and possibly discourage dividends.

Why should non wealthy investors care about this? Many pension funds and other retirement plans as well as insurance companies invest in dividend stocks. The way dividends are taxed should be a concern to the non-wealthy investor in most cases. The Biden tax plan may well have the perverse effect of diminishing the supply of dividend paying shares. There is no way to know how serious this problem might be.

Soaking the rich could easily lead to a situation where stock investments are riskier, corporate bonds would be riskier and the supply of dividend paying investments would be diminished. Punishing the wealthy may very well have serious unintended consequences on all investors.

Double taxation of income will be exacerbated. Punishing rich investors will make the double taxation of taxation absurdly ridiculous. Recall that the Biden plan would increase corporate taxes from 21% to 28%, increase ordinary income tax rates from 37% to 39.6% for wealthy investors and eliminate the 20% dividend rate for wealthy investors forcing them to pay 39.6% on dividend income.

Here is an example: a company earns say $5 million and decides to pay it out in dividends. The company (under the new Biden tax plan) would pay a 28% tax on the profits. This would leave $3.6 million for dividends. Assume all of this goes to wealthy investors who would be taxed at 39.6% (or $1.426 million in taxes). At the end, there would be $2.174 million for the wealthy investors ($3.6 million in dividends taxed at $1.426 million equals $2.174 million net proceeds to investors).

Let's reflect on what just happened. A company earned $5 million in profit and its investors received $2.174 million after taxes—that is 56.5% of the $5 million profit was taxed and the owners got to keep only 43.5% of the profits. This is obviously not fair and will not be taken kindly by the wealthy who do have power to influence economic behavior to put it diplomatically.

How Should Dividends be taxed?

We already have in effect a better and more fair way to treat dividends in some cases. A good example is the taxation of real estate investment trusts (REITs). In essence, REITs pay out practically all of their earnings in dividends and the REIT is not taxed on these earnings. Instead, the owners (dividend receivers) are taxed at the ordinary income rate. Other examples include Sub Chapter S Corporations as well as LLCs (Limited Liability Corporations). These companies pay no taxes on their profits. Only the beneficiaries of the profits (owners) pay taxes.

Why Incorporate as a C Corporation?

It seems logical to me that we should eliminate double taxation of C corporations which is what most public companies are. A C corporation is a legal structure for a corporation in which the owners, or shareholders, are taxed separately from the corporate entity. The taxing of profits from the business is at both corporate and personal levels, creating a double taxation situation.

One might ask, why would anyone want to organize a C corporation if the result is "double taxation" when it pays out dividends? Practically all major companies in the US are C corporations.

C corporations have many advantages including:

- Clear separation between ownership and management
- No restrictions on who may own shares
- Readily transferable shares
- Widespread acceptance by various types of investors (e.g., venture capitalists)
- Ability to offer stock options

Put simply, if you want to have a publicly listed and traded corporation, you need to have a C corporation. And the "price" for this is to be subject to "double taxation."

There is a Simple Solution

What can be done? I propose that double taxation of C corporations should be eliminated for any particular year. For example, assume that a corporation makes $10 million in profits in 2021 and pays out $5 million in dividends. The only profit which should be taxed would be the $5 million not paid out in dividends. In other words, the dividends paid out would be a deductible expense for income tax purposes. The $5 million profit paid out in dividends would be taxed at ordinary rates and paid by the beneficiaries of the dividends. This means that richer investors would pay higher taxes because of the progressive nature of income taxes. If the company retains any profit in any given year (i.e., does not pay dividends on part of the year's profits), that retained profit is subject to taxation on the corporation.

To recap—what I am proposing is that income paid out to equity holders (shareholders) should be treated as a deductible expense for tax purposes the same way that interest is a tax-deductible expense.

With this proposal, the tax code would not be favoring debt over equity which would give corporations less incentive to issue debt. This would undoubtedly improve the credit worthiness of many corporations. But there is one qualification—dividends for any particular year cannot exceed earnings for that particular year. Any such excess dividends would not be deductible for tax purposes.

If we decide to treat dividends as deductible expenses, then the recipient would be subject to ordinary income tax rates on these payments. This is what happens with interest payments on bonds—the recipient pays taxes on ordinary interest.

Double taxation of corporate taxes would be eliminated along with all the distortions mentioned in this article. The tax code would no longer be subsidizing debt at the expense of equity and thus corporations would not be incentivized to take on more and more debt rather than equity. Warren Buffett's secretary would not be paying higher taxes on her income than Mr. Buffett.

Reaction of Investors to Dividends being taxed as Ordinary Income?

How would investors (rich and poor) feel about dividends being taxed at ordinary rates? They would obviously not like it and many would consider this a tax increase. However, it should be noted that until the Bush Administration passed its tax bills 2001 and 2003, dividends were always considered as ordinary income. But on the other hand, the fact that corporations would pay less in taxes would increase reported net income. This in turn would tend to increase stock prices of these companies. Also, the less wealthy getting direct dividends would be subject to lower tax rates on dividend income than the wealthy.

Summary and Conclusions

Taxation of ordinary income and investment income on individuals and taxation of corporations are complicated issues. In coming up with equitable tax solutions, one should understand what the issues are. And it is important to understand what the ramifications are of government actions. I don't believe that the tax code should encourage risky financial policies (borrowings which would tend to make companies riskier investments); nor should it discourage companies from paying dividends. Investment income, whether it comes from interest on bonds or dividends on stocks, should be taxed at the same rates. I don't believe that income from investments should be taxed at lower rates than income from work.

There seems to be a consensus going back to the days of Theodore Roosevelt that a progressive tax code is a good thing. The rich can afford to pay a higher tax rate than the poor. Milton Friedman, the well-known Nobel Laureate conservative economist, proposed a negative income tax for the very poor. He thought that people making less than a low threshold amount should be given cash grants from the government. Professor Friedman was hardly a "wild eyed" socialist.

Most people believe that wealthy people should pay taxes at a higher rate than poorer people. This should be the case with dividends and other investment income as well as ordinary income. It makes no sense at all to tax the same income twice, not in ethical terms and not in economic terms.

I first got the idea of allowing the deduction of dividends by corporations as an expense for tax purposes from my teacher and mentor, the late Professor Eli Schwartz of Lehigh University. He mentioned this idea to me in informal conversations some 15 years ago. Professor Schwartz was the Dean of the Economics Department and an expert in corporate finance, public finance, and various facets of economic theory.