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Assessing the Tax-Cut: Part 1 -- The Dividend Windfall

Wednesday, January 22, 2003

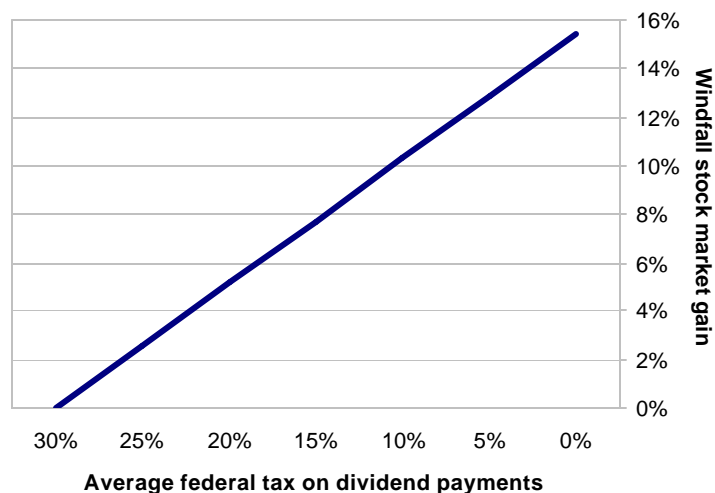
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Long-term effects aside, here's why a dividend tax-cut would be a bolt from the blue that would boost all stock prices.

We don't know if, or in what exact form, **President Bush's** tax-cut plan will be enacted. But we are sure that the markets are wrong to the extent that they seem to be ignoring it. If enacted in anything like its present proposed form and scope, the tax-cut plan will have major one-time and ongoing impacts on the growth prospects for the economy and on valuations of securities markets. This is the first in a series of reports intended to help our clients understand and anticipate those impacts.

This report will focus exclusively on the **first-order one-time effects on stock valuations arising from the provisions in the plan cutting taxes on dividends**. There will be many second-order longer term effects as well, as the incentives contained in the plan change both growth prospects and corporate behavior -- but *those* are matters for future reports.

As a first-order effect, we expect with great confidence that, all else equal, **any reduction in taxes that investors must pay on dividends, within the context of the Bush plan as it is now proposed, will trigger a one-time windfall gain for all stock prices**. The windfall, as defined here, would have nothing to do with any anticipated effects on the economy. It would be a simple mechanical effect arising from something that, from the market's perspective, would be a bolt from the blue -- an arbitrary change in the law that happens to have the effect of increasing after-tax yields.



The size of the windfall will be a simple function of the size of the tax-cut, reaching its maximum value if the tax is eliminated altogether. With small variations (which we will discuss later), the windfall will affect most stocks approximately in equal proportion, regardless of their present dividend policies (or, arguably, whether they even pay a dividend at all).

Our best point-estimate for the magnitude of the windfall is about 15% on average across the S&P 500 if dividend taxes are eliminated altogether. This estimate ignores the reduction

in capital gains tax rates implicit in the Bush plan (see "[Born-Again Growth Advocacy](#)" January 8, 2003) that would result in an increment to the windfall, which I will discuss in another report.

To see how the windfall would work in a general way, consider a stylized world in which there is a stock, trading at \$10, which pays a \$1 dividend each year. All the shares of the stock are owned or traded among taxable investors who pay a flat 50% tax rate on dividend income. The company pays the top corporate tax rate on all its income every year.

At \$10, the company trades at a 10% pre-tax yield -- but because all its investors pay a 50% tax on dividend income, the after-tax yield is 5%. But what if one day, by complete surprise, the tax on dividend income is immediately eliminated altogether. If the stock price didn't change, the after-tax yield would jump from 5% to 10%. So the stock would have to double in price to equilibrate back to its original 5% after-tax yield. If we assume away for the moment any higher-order or expected longer-term effects of the tax cut (better growth prospects, incentives to refinance, better corporate governance, different time preferences, and so on), then I believe this is precisely what would really happen.

From this example, you can see the intuition behind the formula for the windfall, expressed as a multiple of today's market value:

$$\text{Windfall} = 1 \text{ divided by } [(1 \text{ minus old tax rate}) \text{ divided by } (1 \text{ minus new tax rate})]$$

It's important to understand that the stock would double in price no matter what we assume its dividend is -- the formula for the windfall doesn't even include a term for the dividend. If the stock had originally paid a dividend of only \$0.50 instead of \$1.00, the tax-cut would still double its after-tax yield (from 2-1/2% to 5%) -- so the stock price would still have to double in order to equilibrate. This means that, contrary to many over-simplified statements in Wall Street research reports and in the media, high-yield stocks would react no differently than low-yield stocks. I will argue that this principle is functionally true (even if not literally so) even for zero-yield stocks, on the grounds that all stock values arise as the discounted present value of future dividends to perpetuity, even if no dividends happen to be paid at this time.

To estimate the size of the windfall on real-world stock market values, then, we must know the size of the tax-cut. That means we first need to know **what new statutory rates will be passed by Congress.** For today's purposes, we've assumed that the new statutory rate will be zero. If it is higher, then the windfall would be smaller.

Comparing the new statutory rate to the old statutory rate will only tell us the *nominal* value of the tax-cut, not the *effective* value. The effective value will be determined by:

- **The demography of taxable and non-taxable investors who hold stocks.** To the extent the stocks are held by tax-exempt investors, or held by taxable investors who employ tax-sheltered accounts, then today's *average effective tax rates* will already be lower than the highest statutory rates. Recent published research has shown a wide range of estimates of the fraction of stocks held in tax-exempt accounts -- for today's purposes we've assumed 50%. If that number were higher, then the windfall would be smaller.

Also, for taxable shareholders, the average marginal tax rate on dividend income is necessarily less than the highest marginal rate, because there must be at least some number of shareholders reporting incomes below the top bracket. Furthermore, the rate depends on the distribution of investor domicile by state, because tax rates for dividend

income vary widely between states. For today's purposes, we've assumed a combined federal and state rate of 35%. If that number were higher, then the windfall would be greater.

Investor domicile by state is important for another reason -- even if federal taxes on dividend income are eliminated entirely, some states will continue to tax it. For today's purposes we've assumed an average residual state tax rate of 5%. If that number were higher, then the windfall would be smaller.

- **Any rules that limit the applicability of the tax-cut for certain companies or investors.** Under the Bush proposal, dividends would only be tax-free to shareholders to the extent that they are paid from a company's **excludable dividend account (EDA)**. The EDA is a calculation of notional after-tax income based on how much federal income tax a company pays in cash (or receives as credits for foreign taxes paid).

The formula for EDA is:

$$\text{EDA} = [\text{Taxes paid divided by (1 minus 35\% federal tax rate)}] \text{ minus taxes paid}$$

So if a company paid \$35 million in taxes, it would have a notional pre-tax income of \$100 million, and a notional after-tax income of \$65 million. That \$65 million would be the value of the EDA, and would set the ceiling for what the company could distribute as a dividend tax-free to shareholders. For companies who are able to shelter large fractions of their income -- through deferrals, credits, rebates, options benefits, and so on -- EDA may be substantially less than reported net income. It is difficult to obtain timely and high quality market-wide data on cash federal taxes paid and foreign tax credits received. But based on the best data available to us, for our purposes today we've assumed that 85% of dividends paid are covered by EDA. If that number were higher, then the windfall would be greater.

When all these variables are entered into the windfall formula above, the result is a 15% aggregate gain across the entire S&P 500 if federal dividend taxes were entirely eliminated. There will be some variation in the effect from stock to stock, though, depending on how the variables differ in each case. Some of these factors are amenable to analysis and forecasting, and others are not. Some are important, some are not.

- Stocks that have large institutional -- that is, tax-exempt -- shareholder bases will get a smaller share of the windfall. Companies that manage to pay no cash taxes will experience no windfall at all.
- Stocks of companies that have significant structural sheltering of taxable income will get a smaller share of the windfall.
- Stocks that tend to be held more by taxable investors who live in low-tax states will get a smaller share of the windfall.
- Stocks that tend to be held by shareholders with smaller taxable incomes, such as retirees, will get a smaller share of the windfall.

One more complicating real-world factor in trying to forecast the dividend windfall is the difficulty of knowing the "initial condition" on top of which the windfall would apply. Markets discount possible future events in a probability-weighted way -- so by the time the dividend tax cut is passed into law, the windfall may have already fallen. As of this writing the only thing that is falling is stock prices -- so there may be some reason to think that the Bush tax-cut is being discounted as a very low probability.

Finally, don't forget that the dividend windfall is only one of many interacting effects that would be driven by the enactment of Bush's tax-cut plan -- and over time, it may be among the least significant. The other effects will be discussed in future reports. **TM**