Taking Stock of Obama's Dividend Tax Hike Proposal

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In his 2013 budget proposal, President Barack Obama is asking for what amounts to a tripling of the corporate dividends tax rate for high-income earners (individuals and households with annual incomes exceeding $200,000 and $250,000, respectively). If it were just a typical attack on the wealthy, with the usual negative side effects of transferring cash from job creators to politicians, it would be bad enough. But a huge hike in the dividend tax rate will have ripple effects throughout the economy, discouraging investments, depressing stock prices, and reducing dividend payments — all of which will harm Americans at every income level.

Writes the *Wall Street Journal*: "Mr. Obama is proposing to raise the dividend tax rate to the higher personal income tax rate of 39.6% that will kick in next year. Add in the planned phase-out of deductions and exemptions, and the rate hits 41%. Then add the 3.8% investment tax surcharge in ObamaCare, and the new dividend tax rate in 2013 would be 44.8% — nearly three times today's 15% rate."

In addition, observes *Forbes*' Tim Worstall, "it brings back the double taxation of dividend income" — something the 15 percent rate, introduced in 2003, had essentially eliminated. Under the Obama plan, corporations will be taxed on their profits up to a maximum rate of 35 percent; then shareholders will be taxed again on the dividends paid from the after-tax profits up to a maximum rate of 44.8 percent. Thus, a high-income earner will effectively be forfeiting a whopping 64.1 percent of his dividends to Uncle Sam. As Worstall points out, if the President gets what he wants, "dividends will be taxed more highly than any other form of income."

Clearly this is a major disincentive to investment. Who in his right mind would buy stock in a company knowing that the federal government will confiscate almost two-thirds of his earnings?

Furthermore, says Worstall, because no other country in the world double taxes dividends, Obama's proposal, if enacted, would discourage investment in U.S. companies. Why invest in America when you can get a higher rate of return elsewhere?

"As you increase tax on dividends, you discourage some amount of investment in stocks," David Stowell, a former UBS managing director, told Worstall's colleague Abram Brown. "As you discourage investment in stock, there's less money to fund companies to produce useful products, to employ people, and I think it really

takes some money out of the economy. It certainly seems counterproductive to building a more robust economy."

With less money available for capital investments, companies will be forced to rely increasingly on debt financing, with all the risks for the company and the financial system that such financing entails.

Alternatively, they may choose to retain and reinvest profits rather than pay dividends. This is why the*Journal* maintains that Obama's "plan gives new meaning to the term collateral damage, because shareholders of all incomes will share the pain."

It is axiomatic that taxing an activity will tend to reduce the frequency of that activity, so taxing dividends will tend to lessen the number of companies paying dividends. Certainly the opposite is true, as the *Journal* explains:

> When the [dividend tax] rate fell to 15% on January 1, 2003, dividends reported on tax returns nearly doubled to $196 billion from $103 billion the year before the tax cut. By 2006 dividend income had grown to nearly $337 billion, more than three times the pre-tax cut level.…
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> Shortly after the rate cut, Microsoft, which had never paid a dividend, distributed $32 billion of its retained earnings in a special dividend of $3 per share. According to a Cato Institute study, 22 S&P 500 companies that didn't pay dividends before the tax cut began paying them in 2003 and 2004.

It stands to reason, then, that hiking the dividend tax will reverse this trend. Fewer companies will pay dividends, and shareholders will suffer. Especially hard-hit will be "retirees and near-retirees who depend on dividend income," says the paper, noting that "almost three of four dividend payments go to those over the age of 55, and more than half go to those older than 65, according to IRS data."

"So, when Obama suggests raising the tax rate on dividends," Brown writes, "he's taking aim right at your retirement nest egg."

Retirees aren't the only ones who will be harmed by the higher rate, however. Everyone who owns stock will lose, argues the *Journal*, because

> A share of stock is worth the discounted present value of the future earnings stream after taxes. Stock prices would fall over time to adjust to the new after-tax rate of return. And if investors become convinced later this year that dividend and capital gains taxes are going way up on January 1, some investors are likely to sell shares ahead of paying these higher rates.

With over 100 million Americans owning stock directly or through mutual funds and, according to the newspaper, "tens of millions more own[ing] stocks through pension funds," anything that depresses the value of stocks will have dire financial consequences for a vast swath of the public.

One more consequence of reduced dividend payments: The revenue that Obama is counting on his tax hike to raise will not materialize, leaving the government no better off — and possibly worse off — than it is now.

There simply is nothing to be gained, and much to be lost, by raising the dividend tax rate. Fortunately, in an election year Republicans, already strongly opposed to tax increases, are unlikely to hand the President any victories. Unfortunately, if Obama is reelected and the composition of Congress changes, this dangerous proposal may get another shot at becoming a reality.