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Politics Point To Higher Tax On Dividends

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Equity investors seem comfortable with the idea that the existing tax rates on dividends, capital gains and earned income will stick around until at least the end of 2010 — their scheduled expiration date. The odds of that occurring are, at best, 50-50 at this point.

One side of the 50-50 is that all major Republican candidates support extending the present tax-rate structure past 2010. The other 50 is from all major Democratic candidates who have said they will not extend existing tax rates — meaning higher tax rates on earned income, capital gains and dividends for taxpayers.

Realistically, however, the existing tax rates are history post-2008 should a Democrat win control of the White House in next fall's election. That message is clear from Democrats on the House Ways and Means Committee who have already released a plan to hike personal tax rates.

Democrats are discussing possible options to fix the AMT so it doesn't snare as many taxpayers. Democratic options to offset lost AMT tax revenues range from upping the current dividend and capital-gains tax rate to hiking the top marginal income-tax rate. Any AMT fix would require that the revenue losses be offset with new tax revenues to meet the pay-as-you-go budget rule.

Election Could Decide

Democrats running for president have not shot down the trial balloons by Democratic members of Congress to hike tax rates. Message: Investors can expect higher tax rates post-2008 should a Democrat become president. None of the Democratic candidates for president has articulated a pro-growth tax policy. Instead, their orientation appears to be toward income redistribution via higher tax rates.

Sens. Hillary Clinton and John Edwards both voted against the Economic Growth and Tax Relief Reconciliation Act of 2001. That legislation, signed by President Bush during the 2001 recession, made a major contribution to the current economic expansion by lowering tax rates on earned income, thereby encouraging entrepreneurship, production, employment and productivity growth.

Their vote was "no" again in 2003 on the Job Growth and Taxpayer Relief Reconciliation Act of 2003 that, in part, reduced the tax rate on dividends from 38.6% to 15%, meaning dividends were worth 38% more to taxpayers. And taxpayers receiving capital gains after May 2003 kept 6.3% more as they kept 85% of their gain, up from 80%.

Prior to the 2003 tax package, corporate dividends were subject to a 35% corporate income tax rate and a top personal incometax rate of 38.6%. From 1989 to 2003, annual S&P 500 cash dividends — adjusted for inflation — increased by an absolute 5.9% over that entire time period. From 2003 to 2006, by comparison, real S&P 500 cash dividends increased by an absolute 31%. Corporate leaders responded to changed incentives and paid more dividends.

But dividend yields remain low — 1.8% on the S&P 500. Corporate decision makers may be delaying paying more dividends out of profits until the dividend and capitalgains tax rates are finalized. Corporate executives are no doubt concerned about paying more dividends now: If an administration in 2009 ran the dividend tax rate up to 35%, they'd have to explain to stockholders why dividend payouts need to be reduced.

Strangling Gains

There is little doubt that the lack of certainty on the current dividend tax rate policy has acted to constrain dividend gains from what they would have been if the 15% rate had been made permanent. The silence by Democratic presidential candidates in response to Democratic congressional taxhike schemes should suggest to both investors and corporate managers that 2008 will be the final year of the 15% dividend tax rate if a Democrat is elected president.

Dividends — adjusted for inflation — didn't accelerate until after President Bush signed the Job Growth and Taxpayer Relief Reconciliation Act of 2003. Investors and corporate managers may have anticipated the closeness of the vote in the Senate, which required Vice President Dick Cheney to cast the deciding positive vote for the 15% rate. Corporate leaders waited until President Bush signed the bill into law before responding to the 15% dividend tax rate.

We appear to have a similar 50-50 situation again. Or do we? Republican Sen. John McCain voted no on both the 2001 and 2003 tax rate reduction bills. So realistically, the likelihood of the 15% dividend tax rate and capital-gains tax rate remaining past 2008 is perhaps less than 50-50 at this point.

Voting records may carry more weight than promises. But it still may be close enough so that corporate managers will wait until votes are counted on Nov. 4, 2008, before altering dividend plans for the post-2008 era.

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