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DIVIDENDS UNDER
THE INCOME TAX

Introduction and Summary

THIS book describes and analyzes some of the more important developments in dividend taxation and the role of dividends in the tax structure. Many of these stand out in sharp relief against the historical background of almost half a century of personal income taxation, as shown primarily by the Treasury's annual tabulations of tax data, *Statistics of Income.* Part of the report concerns income tax history, with attention centered on dividends; part of it is concerned with special features of dividends and the laws under which they have been taxed. The book is organized around the following four topics:

1. The importance of dividends in personal and taxable income.
2. The extent to which dividend receipts have shown up on tax returns.
3. Tax liability traceable to dividends.
4. The "double taxation" of dividends and, more generally, the differential taxation of corporate earnings, as well as recent methods designed to provide income tax relief for stockholders.

In seeking a full answer to some of the questions raised in this study, it will be necessary to look beyond dividends per se to the corporate earnings that occasioned their payment, whether they were distributed to stockholders, paid as taxes to government, or retained in the corporate till.

Some of the data presented here go through 1958, some through 1957, and some stop even earlier, depending on the information available at the time of writing.

It may be helpful at this point to set forth our main findings in order to give the reader a sense of the scope of the study. The brief summary which follows is necessarily oversimplified, and presents the results without the qualifications that are necessary in interpreting them.

Importance of Dividends in Personal and Taxable Income

Throughout the history of the income tax a high percentage of personal dividend receipts can be traced to taxable returns. The percentage ranged between 60 and 90, even though the income tax did not become a mass levy until World War II, because dividends have always gone in large part to the upper income groups. For this reason also, aggregate dividends reported on tax returns have generally moved with total dividend payments despite sharp changes in exemption levels.

Until World War II dividends characteristically constituted a much higher percentage of taxpayers' adjusted gross income than of their total personal income. Since the wartime extension of the income tax to cover most of the population, however, the two percentages have been very close.

In every year the percentage of taxpayers' income represented by dividends rose with income class. For all income classes, the first years of World War II mark the beginning of a period of sharp decline in the importance of dividends as a component of taxpayers' income, not because dividends fell in size but because the amount of wages and salaries and entrepreneurial income subject to tax increased greatly.

The major part of dividends reported on taxable returns has gone to taxpayers with over $5,000 of income (net income through 1943, adjusted gross from 1944 on)—between 69 and 97 per cent without correction of income for changes in the value of money, and between 77 and 99 per cent when real income (i.e., income levels adjusted for changes in purchasing power) is used to mark off the income classes.

In general the number of taxable dividend returns has increased over 1934–1957, which is consistent with other evidence of growth in the number of stockholders. But in the more recent years of our study, the number of dividend returns shows a much slower growth than the estimates of stockowners.

Almost all dividend recipients had incomes of under $50,000. In all the years for which the information could be obtained, never more than 2.5 per cent and frequently less than 1 per cent had incomes greater than this. Despite their small *number,* taxpayers in income classes of $50,000 and over received a sizable proportion of total dividends. In 1956, for example, they comprised 2.5 per cent of all taxable dividend returns and received 36 per cent of the dividends reported on such returns.

Similarly, concentration shows up when dividend recipients are arrayed by size of dividend receipts. In 1950, for example, only 6 per cent of all dividend recipients reported $5,000 or more of dividends, but they received 65 per cent of all dividends reported by individuals on tax returns. No other type of income was distributed in such a concentrated fashion.

Extent to Which Dividends Have Shown Up on Tax Returns

In every year of the period 1936–1958, total dividends paid to individuals and fiduciaries (estates and trusts) exceeded the amount of dividends that could be traced to tax returns. The difference between the two is called here the dividend gap. A review of the gap over the twenty-three-year period did not disclose a tendency for the underreporting of dividends to correct itself over time. During these years, which witnessed a revolutionary conversion of the income tax from a levy on a few citizens to one that reaches almost every income recipient, the gap trended upward in absolute terms and relatively was about as important near the end of the period as at the start.

An examination of the year-to-year changes in the dividend gap suggests that its relative size roughly reflects taxpayer response to variations in tax rates, especially tax rate increases. However, the evidence on this point is not clear-cut from 1950 on.

Estimates from a sample audit by the Bureau of Internal Revenue of personal income tax returns for 1948 and from sample surveys by the Internal Revenue Service of 1958 and 1959 tax returns suggest that dividend underreporting is most serious among dividend recipients of less than $25,000.

In the most recent year for which systematic estimates could be made, 1958, it appears that the Federal Government's revenue loss due to dividend underreporting was between $200 and $240 million. (This may be too high; see section in chapter 2 on 1959 survey.) This figure is small relative to total personal income tax collections, but that does not mean the problem is unimportant. A widespread feeling that some taxpayers are not bearing their share of the tax load might undermine the zeal with which many taxpayers police themselves. Thus, the importance of dividend underreporting could transcend the revenue loss directly associated with it.

Tax Liability Traceable to Dividends

In order to determine how heavily dividends have been taxed under the personal income tax alone, the aggregate tax liability of personal income taxpayers was allocated among the components of their income for every year, 1918–1957. Here we are concerned only with the personal income tax liability on dividends. The broader problem of the taxation of corporate earnings will be taken up in the next section.

Two factors have dominated the weighted average effective rate on dividends: the size of the dividend flow and its distribution, and the progressivity of the personal income tax rate schedule. The special tax provisions pertaining to dividends (their exemption from normal tax through 1935 and the exclusion and tax credit introduced in 1954) had only a slight effect.

Because dividends have always gone in large part to stockholders in the upper income brackets, the proportion of tax liability attributable to them has always been higher than the dividend share of adjusted gross income on taxable returns. Characteristically this ratio has been two to one.

Through 1941 a large fraction of total personal income tax liability —between one-fifth and one-half—was due to dividends. Since that date, with the extension of the income tax to cover most income recipients, dividend tax liability accounted for a smaller share, typically about 7 per cent of total tax liability.

In every year we observe successively higher values in going from dividends as a fraction of personal income to dividends as a fraction of adjusted gross income on taxable returns and, finally, to dividend tax liability as a fraction of total tax liability. This has imparted some revenue flexibility to the income tax, since the dividend tax liability has varied more markedly than dividends themselves. Since dividends were a much more important component of the tax base before 1941, the revenue flexibility they imparted was more significant in this earlier period.

From 1940 on, between 15 and 25 per cent of dividends paid out to individuals and others treated as such in the national income accounts went into tax payments to the Federal Government. Before 1940 the percentage was 10 or less.

We found a large difference between the average effective tax rates on dividends and the marginal rates (those that would have applied

on the average to a small increment in dividends proportionately distributed among all stockholders). As a rule, marginal rates were about twice as high as effective rates. In 1929 the effective rate was 6.1 per cent, the marginal rate 13.2 per cent; in 1952, they were 28.9 and 55.6, respectively. Thus both rates increased substantially, the marginal somewhat more than the average. In view of this, it is a puzzling financial fact that corporations tended to pay out about the same proportion of after-tax earnings in the 1950's as in the 1920's. One would expect, if tax considerations were a strong influence, that dividend pay-out rates would be lower in the more recent period.

Income tax liability may be defined to cover corporate as well as personal taxation. In this context, the personal income tax liability on dividends should be added to the corporate tax on corporate earnings to obtain the total tax liability on the earnings of corporate enterprises. In this view, the income taxes on corporate earnings make up a sizable proportion of total income taxes: in recent years, 40 per cent; in the earlier period of our study, well over 50 per cent, sometimes as much as 75 or 80 per cent. This represents, of course, a much higher fraction of income tax liability than corporate earnings represent of national income. But these figures do not necessarily mean that corporate earnings are "overtaxed." For a judgment on this matter, the earnings of corporations must be related to the income class status of the claimants thereof, i.e., the stockholders. It is to this range of questions that the next few paragraphs are directed.

The Differential Taxation of Corporate Earnings and Stockholders

In the early years of the personal income tax, corporate rates were set and dividends treated in such a manner that the corporate tax could be viewed as a withholding appendage of the personal income tax, for distributed earnings at least. Since 1919, for a number of reasons this has not applied to distributed earnings. And from its very inception, the tax treatment of retained earnings was not directly related to the income circumstances of the stockholders on whose behalf the retention took place.

The fact that the two income taxes have not been integrated has led variously to charges of "double taxation of dividends," unfairly high or unjustly low taxation of retained earnings, or, more generally, differential (unequal) taxation of corporate earnings. These and similar

charges mirror one or another aspect of a multifaceted problem which has been analyzed in successive steps. It is important to note that these charges and our analysis both assume that the corporate tax is not shifted and that present stockholders have not bought shares "free of tax," i.e., that the selling price of shares has not been lower by the present value of all expected future tax payments. (Or, perhaps, that the stream of expected future tax payments has been finite and limited to a small number of periods.)

As to distributed earnings and the problem somewhat inaccurately designated as the "double taxation" of dividends, it is important to recognize that the requirement that a corporation pay some tax to the government before it distributes the rest to stockholders does not mean that stockholders have been deprived by the full amount of the corporate income tax payment. For had it not gone to the government but to the stockholders instead, some fraction of the corporate tax would have been paid out as personal tax. The "extra" burden, then, is the corporate tax minus the personal tax that would have been due on the corporate tax. Since, for a given amount of earnings for distribution (the pre-corporate-tax counterpart of dividends), the same corporate tax applies no matter what the tax bracket (income level) of the personal income taxpayer is, and since, also, the personal tax rate that would have applied rises with the stockholder's income, the "extra" burden *falls* as shareowner income *rises*. But there will always be some extra burden because the personal rates that would have applied never equal or exceed 100 per cent.

As a numerical illustration of the "extra" burden, assume for simplicity that the corporate tax rate is 50 per cent. Thus for every $1 of dividends, there are $2 of earnings for distribution. On this $2 the 20 per cent bracket stockholder would be taxed $1.20 ($1.00 of corporate tax and 20 cents of personal tax on the dividend he received). Had all the $2 been distributed to him with no corporate tax intervening, he would have paid 40 cents of tax. Hence his "extra" burden is 80 cents. Similar calculations for a stockholder in the 90 per cent bracket give an "extra" burden of 10 cents. All other doubly taxed stockholders fall between these extremes, with their "extra" burden declining as their tax rate bracket rises. (The highest "extra" burden falls on those not subject to the personal income tax who, in this context, can be considered to fall in the zero rate bracket.)

In 1954, income tax relief for stockholders was provided by the exclusion of the first $50 of dividends ($100 for joint returns) and 4 per

cent of additional dividends as a credit against tax. Per dollar the exclusion clearly affords the greatest relief to those who are in the highest marginal rate brackets, and least to those in the lowest. (And, paradoxically, none at all to those in the zero bracket.) The credit is more democratic; it involves an equal *amount* of relief for all stockholders (except that, again, no relief is provided those who pay no personal income tax). To return to our numerical example, the credit applies 4 cents of relief to each stockholder. The 20 per cent bracket stockholder has his "extra" burden cut 5 per cent from 80 to 76 cents; the 90 per cent bracket stockholder ends up with an extra burden of 6 cents whereas it was 10 cents before the credit relief, thus experiencing a 40 per cent cut in his "extra" burden. A 10 per cent credit would completely relieve the high income stockholder, but would leave the stockholder in the 20 per cent bracket with 70 cents of overtaxation for each $2 of earnings for distribution generated on his behalf. There is no need to belabor the point further. But it is appropriate to explain why the credit works in this way.

If double taxation exists, then it could be remedied completely, definitionally and arithmetically, in one of two ways: by removing either the corporate tax on earnings or the personal tax on dividend income. Removing the personal tax would leave all stockholders subject to the flat rate corporate tax, a rate divorced from their personal income ("ability to pay"). The same consideration applies to the partial alleviation of double taxation effected via the dividend credit, since it is a step toward removal of the personal tax. If the credit were sufficient to do this fully for one particular personal income tax marginal rate bracket, it would leave all stockholders at rates above this undertaxed and all those at rates below this overtaxed compared with the rates they pay on income from other sources. However, if the credit were applied not as a fixed proportion (4 per cent) of dividends, but as a fixed fraction of the extra burden, relief would, of course, be in the same proportion for all stockholders. In terms of the illustrative figures used earlier, a credit of 10 per cent of the extra burden would cut the differentially heavier tax load for the stockholder in the 20 per cent bracket from 80 to 72 cents; for the 90 per cent bracket stockholder, the decline would be from 10 to 9 cents. A reduction in the corporate tax rate is the equivalent of a credit of this kind. For example, lowering the corporate rate from 50 to 45 per cent would cause the same change in the extra burden as a tax credit of 10 per cent of the extra burden.

As for the trend in overtaxation measured by the extra burden computed as an incremental rate on earnings for distribution, we found pronounced and continuous growth over the whole period under study for low income stockholders, a sizable but less pronounced rise for those in the middle income brackets, and a very moderate increase for those at the highest income levels (say $500,000) for whom, indeed, overtaxation is currently smaller than in 1925–1931.

We stress that this conclusion applies to the differentially heavier tax on corporate earnings. It does *not* mean that current tax rates are lower than in 1925–1931; on the contrary, they are much higher now. But the absolute increase in personal income tax rates were not as heavy for the lower and middle income stockholders as for those in the top income brackets. And this is the clue to the difference in the trend in overtaxation at the different income levels. In the most recent years of the period under study, corporate and personal rates were both higher than in 1925–1931. Other things unchanged, the higher corporate rate would mean greater overtaxation; also, other things equal, the higher personal rate would mean less overtaxation, because the higher the personal rate that would have applied, the less the stockholder is deprived when his corporation pays a tax on its earnings. At the lower and middle income levels, the rise in personal rates was not large enough to overcome the effect of the rise in the corporate rate; hence *overtaxation* increased. At the upper income levels, however, personal rates rose sufficiently to decrease overtaxation by more than it was increased by the rise in the corporate tax rate; therefore, on net balance, overtaxation decreased.

Another way to measure the degree of overtaxation of earnings for distribution is to determine how much a stockholder has left after the corporate tax on earnings plus the personal tax on dividends, compared with how much he would have had after tax if his earnings for distribution had been taxed in full by the personal income tax alone. On this basis, overtaxation has tended to increase markedly over the period studied. But if the beginning and end of the period are compared, the increase has been sharpest for the lowest tax bracket stockholders, not as sharp for those in the middle tax brackets, and even less pronounced for those at the top of the income range. (See Chapter 4 for a more detailed discussion of this point.)

Of course, more than the tax treatment of distributed earnings is involved in the extra burden on stockholders. The portion of corporate earnings which is retained can be handled in much the same way as

distributed earnings. On $2 of earnings for retention (the pre-corporate-tax counterpart of retained earnings), $1 is paid in corporate tax, while 40 cents would have been paid by the 20 per cent bracket investor had he been taxed currently on this $2, and $1.60 by the 90 per cent bracket shareowner. Here, then, we can say the "extra" burden is not the corporate tax, but the difference between the corporate tax and the personal tax that would have applied. The "extra" burden declines with stockholder income level and after a point will become negative. That is to say, the "extra" burden is positive when the corporate rate exceeds the personal rate; it is zero when the two are equal; and it is negative when the corporate rate falls short of the personal rate that would have applied. This formulation neglects the complication of capital gains taxation, which is discussed in Chapter 4. No change in principle is introduced but it does mean that the change from over- to undertaxation of earnings for retention comes at a rate greater than the actual corporate tax rate.

So far this summary has dealt with marginal dollars, but equally interesting is what happens when we take account of the aggregate amounts of earnings for distribution and earnings for retention. To do this, we imputed corporate earnings and tax payments to stockholders and compared this with what they would have paid on these imputations under the personal income tax alone, the difference between the actual and hypothetical tax burdens being the "extra" burden, or benefit, as the case may be. A quick summary for a representative year (before any account has been taken of the exclusion and credit) appears in Chart 9. As would be expected, the differential ("extra" burden computed as a rate) against earnings for distribution declines with stockholder income but is always positive; the differential against earnings for retention likewise falls with stockholder income, and changes from positive to negative. The weighted average of these two measures, the differential against net corporate earnings, follows the same pattern as the differentials that comprise it. Reflecting the greater absolute magnitude in 1951 of earnings for retention, it lies closer to that differential than the one on earnings for distribution. It too turned negative after a point.

Applying the provisions of the Internal Revenue Code of 1954 to the data for 1950 provides a picture of the relief granted average stockholders at selected income levels. The absolute amount of relief declines with income. The relative degree of relief is U-shaped with income, being higher at both the lower and upper ends of the stock-

holder income scale than in between. This seems to run counter to the findings noted above, but the reconciliation is simple. At the lower stockholder income where the average amount of earnings for distribution is small, the exclusion (which gives more relief per $1 of dividends) far outweighs the credit; hence the heavy degree of relief here. Moving up the income scale, the exclusion fades in importance, and the amount of relief in absolute terms tends to approach the constant represented by the credit. With the differential declining with rising stockholder income, after a point, once more the higher the average stockholder income, the greater is the relative degree of relief.