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Dividend Policy and the 2003 Tax Cut: Preliminary Evidence

By Norbert J. Michel and Ralph A. Rector

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Two recent National Bureau of Economic Research (NBER) papers begin the formal study of whether the 2003 dividend tax cuts affected corporate dividend policy. Economists have debated for years whether lowering *individuals'* taxes on dividends would lead to increased corporate payouts, and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) provides a testable event to study. This article provides a brief summary of the dividend tax law changes in JGTTRA, the debate over dividend tax policy, and the new NBER research.

The new research discussed here includes two NBER Working Papers: No. 10301, authored by Jennifer Blouin, Jana Raedy, and Douglas Shackelford, and No. 10572, by Raj Chetty and Emmanuel Saez.[1] JGTRRA dramatically reduced individual income tax rates on dividends, and the early research suggests that these tax cuts did influence corporate behavior. The NBER research also indicates that JGTRRA's phaseouts and potential repeal may have influenced corporate payout policy.

What Did JGTRRA Change?

A key feature of JGTRRA, passed in May 2003, was a decrease in the maximum individual tax rate on dividend income. Before JGTRRA's passage, dividends were taxed at rates identical to other types of "ordinary" income, such as wages and interest. Consequently, a taxpayer in the top tax bracket (in 2003) would have faced a 38.6 percent tax rate on both wage and dividend income.

JGTRRA lowered the top *individual* tax rate on dividends from 38.6 to 15 percent, and ensured that dividends and net capital gains would be taxed the same.[2] For both capital gain and dividend income, taxpayers in the top four tax brackets are now faced with a 15 percent tax rate, while taxpayers in the bottom two brackets have a rate of 5 percent. JGTRRA provides additional tax relief because this 5 percent rate for the low-income groups falls to zero after 2007.

The relief is short-lived, however, because the pre-JGTRRA dividend rates return for everyone after 2008. In addition to being set to expire on December 31, 2008, several Democratic presidential primary candidates ran on a platform of repealing the 2003 tax cuts.[3] New NBER research suggests that JGTRRA has influenced corporate dividend policies, but it also indicates that the law's "temporary" nature has not gone unnoticed.

The Debate

The debate over the impact of lowering individual tax rates on dividends ranges from the banal to the highly technical. For instance, some detractors of the 2003 dividend tax cut argued that corporations would not pay higher dividends because the law did not directly benefit corporate profits. Others felt firms would not increase their dividends because institutional shareholders, such as pension funds that don't pay taxes, hold the most sway over corporate dividend policy. Those in favor of the dividend tax cut argued that the double tax on corporate dividends lowered investment and provided a harmful incentive to keep excess cash in the firm rather than return it to shareholders.

In the circle of academia, the impact of JGTRRA can be summed up as a debate between followers of the "old view" versus the "new view." Under the old view, because dividend taxes lower the return on investment, cutting the dividend tax would lead to higher dividends and new investment. The new view, on the other hand, argues that because most new equity financing comes from retained earnings rather than selling new equity shares, cutting individual dividend taxes will not spur new investment.[4] The latest research from the NBER does

[1]Jennifer L. Blouin, Jana S. Raedy, and Douglas A. Shackelford, *Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?* (Nat'l Bureau of Econ. Research, Working Paper No. 10301, Feb. 2004); Raj Chetty and Emmanuel Saez, *Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut* (Nat'l Bureau of Econ. Research, Working Paper No. 10572, June 2004).

[2]The law did not reduce the tax on long-term capital gains from collectibles, small business stock, or section 1250 gains. *See 2003 Tax Legislation; Law, Explanation and Analysis*, CCH, 2003.

[3]The day after JGTRRA was signed into law, four Democratic presidential candidates promised to repeal (if elected) at least some of the new tax cuts. *See* Adam Nagourney, "Democratic Hopefuls Say They'd Repeal Tax Cuts," *Pittsburgh Post-Gazette*, June 1, 2003, p. A10. The eventual winner of the Democratic nomination, John Kerry, has promised to repeal the dividend tax cut for taxpayers in the top two tax brackets.

[4]According to Auerbach and Hassett (2003), there are conditions under which the "new view" would hold *and* dividend payments would increase after the tax cut. *See* Alan Auerbach

(Footnote continued on next page.)

not settle this debate, but it does suggest individual tax incentives affect corporate dividend policy.

The Most Recent Research

The two NBER papers discussed here were released in February and June of 2004, respectively. Both papers are restricted in that only a short time has elapsed since JGTTRA was signed into law. As a result, both authors acknowledge that their work only *begins* to study the issue of whether JGTRRA influenced corporate dividend policy. Still, the findings in those papers are consistent with early media accounts of increased dividend payouts and higher preferences for dividend paying stocks after JGTRRA passed.[5]

The first paper, Blouin, *et al.* (2004), finds that firms listed on the major U.S. stock exchanges increased their dividends in the quarter immediately following the passage of JGTRRA.[6] The authors report that aggregate dividends rose 9 percent in the quarter after the law was enacted. However, the Blouin paper also reports that large, ''special'' dividends (rather than regular dividend payments) are responsible for most of this dividend increase.

This last finding is particularly interesting because corporate boards go out of their way to avoid decreasing their regular dividend payments. In other words, most boards of directors are unlikely to increase their regular dividend payments (which are usually paid to shareholders each quarter) if they believe they will have to decrease those payments soon after. For shareholders' tax purposes, however, both special and regular dividends are treated the same.

Given that JGTRRA's dividend tax cut is set to expire in a few years (and could be partially repealed in 2005), corporate directors could reasonably choose the special dividend as the safer way to return cash to shareholders. Both types of dividends provide the same direct benefits to shareholders, but choosing the special dividends ensures that the board won't have to cut its regular dividend payment in the face of new tax law changes. The Chetty and Saez (2004) paper also reports that special dividends increased after JGTRRA passed.[7]

The second paper includes two additional quarters of data and points out that, while special dividends did rise, many firms increased their regular dividend payments after the tax cut. Because the aggregate amount of dividends is severely affected by an outlier problem (a small number of firms with large dividend payments), the paper focuses on the number of firms paying dividends. Chetty and Saez find that ''the fraction of publicly traded firms paying dividends began to increase precisely in 2003 despite having declined for more than two decades.''

Conclusion

Economists have been debating the impact of individual dividend tax cuts for many years. It is still too early to make definitive conclusions, but the early returns suggest that JGTRRA did provide an incentive for corporate boards to increase their dividend payouts. The findings of two new NBER papers are consistent with early media accounts of increased dividend payouts and higher preferences for dividend paying stocks after JGTRRA was signed into law. Early research also suggests that because JGTRRA is set to expire in 2008 and could be partially repealed after the upcoming presidential election, the law's affect on *regular* dividend payments could be muted. It is almost certain that the law will not produce the long-run benefits its advocates hoped for if, in fact, corporate managers are treating JGTRRA as temporary.

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and Kevin Hassett, ''On the Marginal Source of Investment Funds,'' 87 *J. Pub. Econ.* 205 (Jan. 2003).

[5]*See* Craig Shaw, ''Dividends Are Climbing Since 2003 Tax Cuts; Investors Start Noticing S&P,'' *Investors Business Daily*, Mar. 30, 2004, p. A01.

[6]*Id.*

[7]*Id.*

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IRS Should Go Easy on Church Politicking

By Paul Streckfus

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Americans United wants IRS action against Jerry Falwell and I agree with their position. (''Group Asks IRS to Investigate Jerry Falwell Ministries,'' *Tax Notes*, July 26, 2004, p. 401.) But if the IRS cracks down on the Bush-supporting churches, fairness dictates that the IRS crack down on the Kerry-supporting churches, too.

The most visible group of churches usually supporting Democrats has been the black churches. Here, the situation gets tricky, because black churches have traditionally — based on the ugly racial history of this country — been one of the few relatively safe places where blacks could engage in political discussion.

If the IRS has to go after black churches to go after Falwell and friends, a tremendous uproar from left and right will ensue. And once the IRS goes down that path, where does it stop? Again, to be fair, the IRS has to go after those Catholic dioceses and parishes where zealous bishops and priests actively support from the pulpit pro-life (Republican) candidates. Once the Catholics (one-fourth of the electorate) are targeted, the IRS can't ignore those liberal Protestant churches that are actively supporting Democratic candidates.

All of that political activity by churches calls into question the value and integrity of the ban on political activity, contained in section 501(c)(3), but removal of the ban raises even more troubling issues. Turning churches into political action committees would have a devastating effect on their moral authority.

The bottom line is that politics is dirty business, and churches are supposed to appeal to our better instincts. Congregations would become identified with particular candidates and political parties. Bipartisan congregations would be split apart over political, not religious, differences. Politicians, who already seek to enlist churches in their campaigns, would become a constant presence at church gatherings. God would no doubt have to share the collection basket with Caesar.

Up to now, the IRS has mostly relied on education and persuasion to deter churches from engaging in prohibited political activity. (See, for example, IRS News Releases IR-2004-59, *Doc 2004-9050, 2004 TNT 83-5*, and IR-2004-79, *Doc 2004-12262, 2004 TNT 113-22*.) That strategy works with the willing, but not with those who believe a moral issue, such as abortion, dictates that their church must actively support pro-life candidates and oppose pro-choice candidates. Those churches are not amenable to education and persuasion.

Every once and a while, the IRS takes action against the most brazen rule-breakers. The *Church at Pierce Creek* case was an easy one in this regard, inasmuch as the violation was egregious and the defendant was not a major player. See ''Revocation of Exemption of Church That Ran Anti-Clinton Ads Upheld,'' *Tax Notes*, May 22, 2000, p. 1031. And, to be fair, the IRS is greatly limited by section 7611 in auditing churches. The reality is that in enacting section 7611, Restrictions on Church Tax Inquiries and Examinations, Congress made it extremely difficult for the IRS to examine churches, which may be a good policy decision depending on your view of separation of church and state.

So should the IRS continue its wishy-washy approach, allowing the ban on politicking to be widely ignored? It pains me to say this, inasmuch as I am a law-and-order type, but sometimes it's better to close one's eyes to a bad situation when the alternative is worse. A crackdown by the IRS against politically active churches in this country will just set off a firestorm.

Some religious zealots have already shown a tendency to violence in defense of their causes, and a government crackdown on them would just fuel this radical fringe even more. Even among the more reasonable, an IRS crackdown could seem to be an invasion of their churches and arouse fears of government-favored religions and selective enforcement.

On a practical level, it's difficult to judge how much influence preachers fulminating from their pulpits have on their flocks. Catholics, for example, are known for often having non-church-approved views on many issues. While pastors must compete with other sources of information and influence on their congregations, one would expect that a church that is actively against abortion in its moral teachings would have a congregation with similar views. Even so, church members are probably aware of where candidates stand on that issue, and probably do not need their pastor to tell them how to vote. Similarly with the black churches — it's difficult to imagine that a black congregation does not share the political views of its pastor, although being told how to vote is not something most Americans are comfortable with.

While in general I am against wishy-washiness, I can't make a case for strong IRS enforcement in this area. Yes, Jerry Falwell needs to be made an example of — he'll probably take it as a badge of honor and love the publicity — and some liberal church needs to be targeted to balance the scale, but in general benign neglect should continue to be IRS policy.

There, I've said it, even if I don't feel good about it. Sometimes mushiness is the best policy.

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