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Via Electronic Delivery

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Re: Dividend Tax Policy

Doug:

It was good speaking with you last week, and congratulations again on the new challenge.

I was not shocked that you found my explanation of my ideas on dividend taxation more than you wanted to digest with breakfast, so here is the brief summary you requested.

My Basic Conclusions

1. Dividends are a cost of equity capital and dividend payments should be deducted from earnings before tax (EBT) and treated by the recipients as taxable income.
2. Normalizing tax treatment of dividends will cause corporations with a return on equity (ROE) lower than risk adjusted alternatives to return to shareholders as dividends as much free cash flow as possible. Incentives for retained earnings are an unnecessary subsidy.
3. Tying the payment and amount of dividends to ROE means that dividends will be a more significant component of investor return and dividend amounts may vary dramatically from quarter to quarter.
4. There is no basis to accurately estimate the effects of a change in dividend policy on federal tax receipts, but there is no reason to assume that the effect would be negative.
5. Normalizing tax treatment of dividends will:
    a. Cause many companies to be valued based on free cash flow, not GAAP earnings;
    b. Make the financial reporting of these companies more transparent (as it is more difficult to manipulate cash flow than GAAP earnings);
    c. Improve corporate governance by:
        i. minimizing M&A activity motivated by the need to reinvest retained earnings that cannot be returned to shareholders tax efficiently, and
        ii. transitioning management performance measures to free cash flow generation rather than increases in share price valued on GAAP earnings.
    d. Make the equity markets more attractive to lower-income investors and possibly reinvigorate the ESOP as a viable organizational form.

Each of these points is discussed in slightly greater detail below.

1. Dividends are a cost of equity capital and dividend payments should be deducted from earnings before tax (EBT) and treated by the recipients as taxable income.

Government tax policy should, to the extent possible, not impede optimal capital allocation. In an ideal world, corporations would adopt capital structures with debt and equity components that together yielded the lowest weighted average cost of capital. Unfortunately, the tax inefficiency of dividend payments distorts corporate capital structure in several ways.

First, precluded from demanding current payment of free cash flow as dividends, the rational investor seeks a level of share price appreciation that provides compensation for the dividends that are not paid as well as for the risks that the retained earnings will not be profitably invested by the corporation or that the share price will not appreciate due to general market conditions. The firm's cost of equity capital is, therefore, burdened with a "market risk" premium making the cost of equity capital higher than it would otherwise be.

Second, an artificially high cost of equity capital causes firms to overweight debt in their capital structures and to overpay for that debt capital. The artificially high cost of equity capital supports a higher price of debt capital than would otherwise be the case. Although this is probably not a significant problem in the current interest rate environment, it can act as a constraint on growth and profitability as interest rates rise.

Dividends are a cost of equity capital and should be treated for tax purposes in the same way as interest, the cost of debt capital. Both should be deductible from EBT.

The President's plan that would not allow deduction of dividends at the enterprise level, but would exclude dividends received from individual taxable income is flawed for several reasons. First, disallowing dividend deduction at the enterprise level will do nothing to discourage the misallocation of capital caused by overweighting of debt in corporate capital structures[1]. Second, and more importantly, it will continue the misallocation of equity capital by encouraging firms to retain cash earnings that should be returned to the shareholders[2] (See point 2, below). Third, it is unfair to lower-income investors, because the lower-income investor is effectively paying tax on dividends at the corporate rate, which is likely to be materially higher than his or her marginal individual rate. Meanwhile, the higher-income taxpayer receives a small benefit, because the highest marginal corporate

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[1] In other words, firms would continue to prefer debt, where the cost – interest – is deductible from EBT over equity, where the cost – dividends – is not. Interest expense would reduce taxes, while dividends would have no effect.

[2] Having paid the corporate income tax on profits, corporations will be disinclined to dividend out those profits, because doing so will not favorably affect the financial performance of the firm, however measured. Management, if not the shareholders, will be better off by retaining earnings and measuring rates of taxation over a larger base.

rate is slightly lower than the highest individual marginal rate. Finally, to some extent excluding dividend payments from individual taxable income will cause dividend-paying stocks to compete with other tax-advantaged investments available to individuals, such as municipal bonds[3] (although this effect will be mitigated by the likely variability in dividend amounts for the reasons discussed in point 3, below).[4]

2. Normalizing tax treatment of dividends will cause corporations with a return on equity (ROE) lower than risk adjusted alternatives to return to shareholders as dividends as much free cash flow as possible. Incentives for retained earnings are an unnecessary subsidy.

The rational investor purchases shares on the assumption that the firm can yield a higher risk-adjusted return on equity than can be obtained by alternative investments. So long as the firm's risk-adjusted return on equity meets or exceeds this threshold, the rational investor will cause the firm to retain earnings and not pay dividends, as by definition the firm is making the highest and best use of the investor's capital. Therefore, tax policy does not have to – and should not – provide incentives for retained earnings such as are contained in the Administration's dividend tax proposal (adjustment of basis in amounts that could have been paid as dividends). Such incentives are an unnecessary subsidy for retained earnings.[5]

If, on the other hand, the firm's ROE does not meet the appropriate risk-adjusted hurdle, the rational investor will cause the firm to return as dividends as much free cash flow as possible so that it can be redeployed more efficiently.

I have thought about how the markets might set both ROE thresholds and determine the amount of free cash flow that can be returned as dividends where those thresholds are not met. Since the precision and accuracy of financial data for most firms is fairly limited, these measures are likely to be fairly crude. An

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[3] Contrast a system where both dividends and interest on certain fixed income investments are both not includible in the recipient's taxable income with a system in which dividends are includible in taxable income and interest on certain fixed income investments is not.

[4] Robert Willens at Lehman suggested in correspondence to me that taxing dividend income to the recipient might be problematic for tax-exempt enterprises holding dividend-paying investments, and to some extent he is correct. But, rather than imposing the burden of determining the tax status of shareholders on the corporation, I suggested that rules governing tax-exempt enterprises could be adopted that would either require them to pay tax on dividend income at a specified rate, or hold investments paying dividends in taxable affiliates (as they are required to do now in other circumstances).

I believe that the "problem" of individuals receiving dividends in 401(K) and other tax-deferred accounts is a red herring, because these accounts are tax-deferred, not tax free. While models to evaluate the problem will have to be run, I suspect that individual tax liability for dividends received in a tax-deferred account will not be significantly lower – and may in fact be higher – than for dividends received directly. This is because tax-deferred accounts require withdrawals at specified rates and specified ages, and for many investors the assumption that their marginal rates of taxation in retirement will be lower than during their working years turns out to be false.

[5] The Administration's proposal to adjust shareholder basis to account for dividends that could have paid, but were in fact retained is far too complex to be workable anyway.

appropriate ROE threshold, for example, can be estimated by multiplying the short-term, risk-free rate by the beta of the share price, and the percentage of free cash flow that can be returned as dividends can be estimated by the ratio of the current ratio to share price beta (but, of course, not more than 100%).[6]

In both formulas, share price beta is a crude surrogate for business risk. It serves a second role in connection with determining the appropriate ROE threshold by adjusting the ROE to account for the risk to the base share price – the investor's "principal". The use of current ratio in determining the percentage of free cash flow to be paid as dividends addresses liquidity concerns and counters any incentive the firm might have to use debt to achieve a higher ROE. (A highly leveraged company will have a lower current ratio and will be unable to pay the same percentage of free cash flow as a firm with lower leverage.) Investors will watch carefully to make sure that companies are not meeting ROE hurdles by taking on debt, because the consequences of doing so will be that dividends will be limited if the hurdles are not met.

Notice that the effect of normalizing tax treatment of dividends should inevitably focus financial performance measures on ROE and free cash flow, ROE because it the measure that a rational investor will use to compare alternative investments and to determine whether a particular enterprise is performing acceptably, and free cash flow because dividends have to be paid in cash and no company – no matter how profitable on a GAAP earnings basis – can consistently pay dividends in the absence of free cash flow (although some companies may, from time to time, borrow to pay dividends to adjust their weighted average cost of capital)[7].

The anticipated focus on free cash flow is particularly important, because it has the potential to change the fundamental share valuation measure from a multiple of GAAP earnings to a multiple of free cash flow (see point 5.a., below).

3. Tying the payment and amount of dividends to ROE means that dividends will be a more significant component of investor return and dividend amounts may vary dramatically from quarter to quarter.

The most dramatic potential consequence of normalizing tax treatment of dividends by allowing deduction from EBT is a wholesale change in how dividends are paid. Currently, dividends are a relatively small component of investor return and

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[6] These formulas suggest how the markets might set ROE thresholds and determine the appropriate amount to be paid as dividends. The actual determinations would be left to individual firms and their stakeholders (I suspect, for example, that lenders will establish limits on dividend payments in loan covenants.) There is no need for government to adopt regulations, or for the accounting profession to establish rules, on these issues.

[7] Thus, it seems to me that it is unnecessary for government to adopt complex rules defining which dividends qualify for favorable tax treatment. Just as corporations cannot pay dividends, at least not over any period of time, in the absence of free cash flow, it is difficult to see how a corporation can generate free cash flow without at the same time generating taxable earnings. Again, this is an issue that has to be modeled, but I suspect that the potential for abuse is probably *de minimis*. Remember that stakeholders – particularly lenders – will have appropriate incentives to prohibit dividend payments in the absence of free cash flow.

most companies that pay dividends do not vary significantly the dividend payments over time, except to raise them nominally on an annual basis where financial performance allows. The tax inefficiency of dividend payments causes corporations to focus on GAAP earnings and appreciation of share price.

Since share price is subject to general market risk over time (an overall decline in P/E multiples, for example) and since GAAP earnings (as compared with free cash flow) are difficult to measure with precision and accuracy, and are affected by application of accounting principles that may or may not reflect the actual performance of the underlying business, investors demand a "risk premium" that artificially raises the cost of equity capital.

Removing the tax disincentives to dividend payments will cause investors to demand return of capital from free cash flow, at least in those cases where the enterprise is not achieving an adequate risk-adjusted ROE and management has no other compelling basis to retain earnings. This means that dividend payments for many companies will increase dramatically and will vary significantly over time with fluctuation in free cash flow and ROE. As mentioned above, this fluctuation should limit the extent to which dividends on equity compete with tax-advantaged fixed income investments such as municipal bonds.

4. There is no basis to accurately estimate the effects of a change in dividend policy on federal tax receipts, but there is no reason to assume that the effect would be negative.

For those companies that come to use dividends as a more significant component of investor return, share price appreciation will become less significant because the free cash flow component of current earnings will largely be paid out to shareholders and not retained. Thus, predicting the effects of a change in dividend policy on federal tax receipts is difficult. Investors will pay tax on dividends as ordinary income at a weighted average rate based on the marginal rates of the aggregate investor class (which might change, if as suggested in point 5.d, below, a change in dividend tax policy induces greater participation by smaller and lower-income investors).

For the current cohort of equity investors, the weighted average marginal federal income tax rate exceeds the capital gains rate (particularly when the capital gains rates are reduced to present value at the risk-free rate – the Treasury's cost of capital – to take into account the delay inherent in the holding period qualifications for capital gains treatment), so unless the demographics of equity investors changes very dramatically, it is difficult to see how federal tax receipts will decline materially.

5.a. Normalizing tax treatment of dividends will cause many companies to be valued based on free cash flow, not GAAP earnings.

The reasons for this change are discussed above. The consequences, however, will be greater predictability of share prices and more orderly markets for equities. This might encourage broader participation in the equities markets, particularly by small and lower-income investors, a factor that is discussed in greater detail in point 5.d., below.

5.b. Normalizing tax treatment of dividends will make financial reporting more transparent (as it is more difficult to manipulate cash flow than GAAP earnings).

While corporations will still report GAAP earnings as they do currently, investors will demand a comparable focus on free cash flow generation. Cash flow accounting is subject to fewer subjective accounting decisions than GAAP earnings. The mirror image of a focus on generation of free cash flow will be a reduction in the use of GAAP accounting to maximize reported earnings.

5.c. Normalizing tax treatment of dividends will improve corporate governance by (i) minimizing M&A activity motivated by the need to reinvest retained earnings that cannot be returned to shareholders tax efficiently, and (ii) transitioning management incentives to free cash flow generation rather than increases in share price valued on GAAP earnings.

This is an issue related to greater transparency in financial reporting. Without the ability to tax efficiently pay dividends to shareholders, corporations retain earnings that must be reinvested. If the corporation is unable to make further investment in its core business, which is often the case, it is forced to diversify.

Often these diversification investments do not perform as well as anticipated, but these investments inevitably increase the complexity of the corporate structure and organization. Ultimately, the enterprise becomes so large and complex that even management does not fully understand all of the businesses and their interrelationships. It is difficult to expect boards of directors or institutional shareholders to develop sufficient understanding of such complex businesses to perform a meaningful management oversight role.

Diversification is costly, both because of significant transaction costs and execution risks as well as general inflation in asset prices during periods when corporate earnings are generally high and many corporations need to make acquisitions to reinvest retained earnings. The excessive costs of diversification are yet another manifestation of inefficient capital allocation driven by a tax inefficient dividend policy.

Meanwhile, since share price appreciation will become less significant as a component of investor return, the attractiveness of stock options as a management incentive compensation vehicle will decline. As a result, management incentive compensation is likely to transition to dividends from restricted stock. Management's incentive would be to focus on either meeting the risk-adjusted ROE hurdle or generating free cash flow, and these incentives coincide with the interests of the shareholders.

5.d. Normalizing the tax treatment of dividends will make the equity markets more attractive to lower-income investors and possibly reinvigorate the ESOP as a viable organizational form.

The current focus on GAAP earnings and appreciation of share price discourages investment by small and lower-income investors. Given a choice, these investors would prefer current income over a potential for appreciation in share price, both because current income is likely to be more meaningful for them and because they cannot bear the risks inherent in investing for long-term share price appreciation based on GAAP earnings. These investors do not have the ability to choose from many high-yielding equity investments now because dividends cannot be paid to investors tax efficiently. A change in dividend tax policy could provide new investment opportunities for small and lower-income investors who do not participate in the equity markets currently.

Finally, changing dividend policy might make the Employee Stock Ownership Plan (ESOP) a viable organizational form. Historically, the ESOP has not been successful because the alignment of the workers' interests and financial performance measured by GAAP earnings is so poor. Workers can understand – and affect – free cash flow generation better than GAAP earnings, and a quarterly significant dividend payout might provide an efficient incentive for workers as owners. I have suggested this in correspondence to Robert Reich, former Labor Secretary, but have not yet received a substantive response (other than an acknowledgment that my ideas are thoughtful).

Regards,

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