Stock Dividends

A Strategy for Increasing Corporate & Shareholder Wealth

By Thomas E. Nugent

Overview

The primary goal of corporate management is to increase shareholder wealth. Historically this strategy has been achieved through the implementation of a plan to grow company sales followed by profitability and the initiation and subsequent increase in cash dividends as a reward for investors. Corporate managements have been proud to announce dividend increases to shareholders because it is a sign of a corporate success and prosperity. The common stock of companies that have paid cash dividends for many years receive market recognition by being known as blue chip stocks. Traditional models designed to value equities place critical importance on cash dividends. In these models, the valuation of a common stock is predicated upon the discounted value of anticipated dividend streams[1]. Academic studies have demonstrated that above average total returns can be achieved by investing in the Dow Jones Industrial stocks with the highest cash dividends[2]. Institutional investors have created mutual funds emphasizing payment of cash dividends by focusing on the income component of equities as a primary investment goal. Investor endorsements of cash dividend strategies have provided encouragement to corporate management to pay cash dividends as the distribution medium of corporate wealth.

One Problem with Cash Dividends

The strategy of distributing corporate wealth through cash dividends is compatible with the investment objectives of tax-exempt equity investors. The tax exempt or tax-deferred investor selects securities without regard to the tax consequences of profit distribution because there are no taxes payable. Examples are participants in retirement plans or charitable entities where there is virtually no need to distinguish between increases in value brought about by capital appreciation or dividend income. On the other hand, there are many investors who are subject to both ordinary income taxes and capital gains taxes. These investors bear the brunt of tax laws that impose ordinary income taxation on dividend income. Given these two investor classes, corporate management should structure a dividend policy that benefits both shareholder classes.

The Taxation of Dividends

For many Americans, the taxation of dividends amounts to wealth confiscation. Corporate earnings are taxed twice, once at the corporate level and then again at the individual level. On average, when considering federal, state and local taxes, one dollar of pre-tax corporate earnings becomes twenty-five cents of after-tax income for the stockholder[3]. In other words, the stockholder's tax rate is approximately 75%! With the majority of Americans of the opinion that a 25% marginal tax rate is reasonable, a 75% rate is not reasonable[4].

Numerous attempts have been made to reduce or eliminate this double taxation of income. However, government bureaucrats are not about to give up a lucrative source of tax revenue even though it may be inconsistent with an equitable tax system. For taxable investors in mutual funds, the problem is compounded by the treatment of realized capital gains[5]. Each year, mutual funds must distribute to

---

[1] The Dividend Discount Model
[2] The Dogs of the Dow
[3] Nugent, Thomas E., "Dividend Reinvestment is a Bad Idea for Taxable Investors," A.B. Laffer Associates, July 1997
[4] Wall Street Journal editorial on how much taxes Americans think is fair
[5] Capital gains reflect the increase in the price of a stock from its purchase price. If a stock is sold in less than one year, the capital gain is taxed as ordinary income. Capital losses cannot be distributed to shareholders. They can only be used to offset capital gains.

shareholders as dividends the net realized capital gains of the fund. These gains occur as portfolio managers sell stocks in the portfolio at a capital gain. As a result, shareholders may be faced with ordinary income taxes on the distribution of these gains if the stocks that have been sold were held for less than one year. This problem is magnified by the possibility that new shareholders incur the taxes of old shareholders when the capital gains are distributed to all shareholders[6].

[6] While new mutual fund shareholders can be penalized by taxes on net realized capital gains in a mutual fund, the cost basis of the fund is increased by the amount of the distribution so that, when the fund shares are sold, there is an offsetting reduction in the capital gains. This strategy works against shareholders in two ways: there is no adjustment for inflation and the loss of real value if the fund is held for a long period of time. There is also the ultimate loss of the tax savings at death when fund shares are marked to market thus eliminating any capital gains liability.

4101 Main Street, Suite C
Hilton Head Island, SC 29926
Tel: 843-342-3044 Fax: 843-342-3244
tom@victoriacapitalus.com