White Paper No. 30

The tax on dividends: speculations on how taxation changes might affect investor strategies

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White Paper No. 30 – *The Tax on Dividends: Speculations On How Taxation Changes Might Affect Investor Strategies*

Overview

Speculation has heightened that the Bush administration will seek to reduce or eliminate the double taxation of dividends paid on corporate stocks. While the form and substance of such a policy are yet unclear it would, if enacted, impact private client portfolios in several significant ways. Most obviously, reducing or eliminating the taxes levied on dividends would improve equities' after-tax total returns relative to other non-affected asset classes such as bonds or alternative assets. In this paper we will initially seek to illustrate how a typical investor's recommended asset allocation might change if the elimination of taxes on dividends were to become a reality. Second, it is likely that such a tax law change would indirectly impact other asset classes and alter the behavior of corporate management. Such secondary affects, while not as quantifiably measurable as asset allocation changes, may in fact turn out to be more significant. We will offer our thoughts on both the nature and the potential scope of such secondary affects.

After-Tax Asset Allocation

Like most advisors today, we are believers in modern portfolio theory and employ traditional mean-variance optimization software to guide us in building more efficient portfolios on behalf of our clients. However, unlike tax-exempt institutional investors, the majority of our clients must endure the burden of paying taxes on realized investment returns. As a result, we must calculate the extent to which the expected returns from various investment categories will likely be reduced by taxes before applying our asset allocation models.

The degree to which a particular investment category's return is affected by taxes is a function of its expected dividend yield or yield-to-maturity, its expected level of capital appreciation, the expected level of securities turnover arising from active portfolio management and applicable marginal tax rates. For example, our current estimated long-term pre-tax and after-tax returns for major investment categories is as follows:

	Pre-Tax					After-Tax *
Asset Class Assumptions	Expected Total Return	Expected Yield	Mgt. Fee	Expected Turnover	Expected Risk (St .Dev.)	Expected After-Tax Total Return
US Large Stocks	9.00%	3.00%	0.20%	10.00%	16.00%	7.28%
US Small Stocks	10.50%	1.75%	0.75%	35.00%	19.00%	7.85%
International Stocks	10.00%	3.00%	0.80%	40.00%	18.00%	7.05%
Tax-Exempt Bonds	5.00%	5.00%	0.25%	35.00%	5.00%	5.00%
Emg. Mkts. Stocks	11.50%	2.00%	1.00%	40.00%	25.00%	8.33%
Non-Dir Hedge	10.00%	0.00%	1.00%	100.00%	5.00%	5.56%
Private Equity	14.00%	0.00%	1.00%	15.00%	25.00%	11.97%
90 Day T-Bill	4.00%	4.00%	0.15%	100.00%	2.00%	2.31%

**** Assumes a 10 year investment horizon, maximum federal income and short-term capital gains tax rates of 38.6%, a long-term capital gains tax rate of 20%, and no state taxes.***

Clearly, if we assume that income taxes on equity dividends are eliminated, after-tax rates of return for equities will rise relative to other non-affected asset classes. The table below illustrates the anticipated changes in after-tax returns for various asset classes assuming that income taxes on dividends are eliminated. We also show how these same asset classes would fare if the elimination of income taxes on dividends caused an investor to become subject to the alternative minimum tax (currently, 28%).[1]

	Pre-Tax	Current Tax Rates	No Income Tax on Dividends	AMT Tax Rate
Asset Class Assumptions	Expected Total Return	Expected After-Tax Total Return	Expected After-Tax Total Return	Expected After-Tax Total Return
US Large Stocks	9.00%	7.28%	8.40%	7.42%
US Small Stocks	10.50%	7.85%	8.64%	7.59%
International Stocks	10.00%	7.05%	8.31%	7.02%
Tax-Exempt Bonds	5.00%	5.00%	5.00%	5.00%
Emg. Mkts. Stocks	11.50%	8.33%	9.29%	8.07%
Non-Dir Hedge	10.00%	5.56%	5.56%	6.39%
Private Equity	14.00%	11.97%	11.97%	11.31%
90 Day T-Bill	4.00%	2.31%	2.31%	2.73%

To illustrate how different tax regulations might affect the recommended construction of client portfolios, we created a hypothetical client portfolio and examined how our optimization software suggested asset class weights would change solely as a result of altering applicable tax rates. Before we begin, however, a little background on our client is in order. First, the family has a 10-year investment horizon and plans neither to withdraw any money from the portfolio nor to add any to it. Second, they have expressed

[1] For purposes of this calculation we have assumed that dividends received interest free would be considered a preference item for AMT purposes. Congress could decide otherwise, of course.

a tolerance for risk consistent with a portfolio having 10% annual volatility. Third, they are subject to maximum federal income and capital gains tax rates but not to state income or capital gains taxes. Finally, the only constraints they have asked that we adhere to are that the combined allocation to hedge funds and private equity cannot exceed 30% and that they must hold a minimum of 1% in cash. Based on this profile and on the after-tax returns illustrated above, our client's recommended portfolio allocation is as follows:

	Applicable Tax Regime:			
Asset Class	**Pre-Tax**	**Current Tax**	**No Dividends Tax**	**AMT**
US Large Stocks	0.0%	4.7%	20.5%	27.1%
US Small Stocks	15.5%	18.8%	0.0%	0.0%
International Stocks	23.2%	14.3%	19.9%	12.8%
Tax-Exempt Bonds	25.3%	26.2%	23.6%	24.1%
Emg. Mkts. Stocks	5.0%	5.0%	5.0%	5.0%
Non-Dir Hedge	15.0%	15.0%	15.0%	15.0%
Private Equity	15.0%	15.0%	15.0%	15.0%
90 Day T-Bill	1.0%	1.0%	1.0%	1.0%
Portfolio Return	**9.9%**	**7.2%**	**7.7%**	**7.2%**
Portfolio Risk	**10.0%**	**10.0%**	**10.0%**	**10.0%**

Several interesting results are immediately apparent. First, regardless of the tax regime in effect, our client's optimal bond allocation remains fairly constant at between 23.6% and 26.2%. This should not be surprising since among the asset classes available, only cash, bonds and non-directional hedge funds possess sufficiently low levels of volatility to allow us to structure a portfolio possessing a moderate (10%) level of risk. Of these three asset classes, cash has a very low rate of return making it an unattractive choice while the amount of non-directional hedge funds has been constrained by the client. By default, this leaves bonds as the best available choice of risk-moderating asset class.

A second interesting, although not surprising, observation is that the allocation to non-directional hedge funds and private equity remains constant and at the client-constrained maximum regardless of tax considerations.[2] In the case of non-directional hedge funds, we can see that while their level of risk is equal to that of bonds, their after-tax rate of return is 56 basis points higher under current tax law and 139 basis points higher if the client falls into AMT. In the case of private equity, its high forecasted pre-tax return combined with its inherently tax-efficient nature (*i.e.*, all returns are taxed as long-term capital gains) generates expected after-tax returns well above those of other growth-oriented equity asset classes.

The truly interesting dynamic is how altering applicable tax rates changes our client's recommended allocation among traditional equity asset classes. In particular, under current tax law, actively managed small cap stocks (18.8% allocation) are favored 4:1 over

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[2] Of course, one likely reason why the client asked us to constrain the allocations to hedge and private equity is that price volatility understates the overall risks associated with these assets.

passively managed US large cap stocks (4.7% allocation). If dividends are no longer taxed, however, the recommended allocation to passively managed US large cap stocks more than quadruples to 20.5% while the allocation to US small cap stocks goes to zero. It is interesting to note that the shift in recommended allocation occurs despite the fact that the expected after-tax return of small cap stocks is still higher than that of large cap stocks. The reason for the dramatic re-allocation under a no-dividends-tax scenario is that the margin of small stocks' out performance over large stocks (only 24 basis points in a no dividend tax environment versus 47 basis points today) appears insufficient to compensate for small cap stocks higher level of risk. If our client becomes subject to the alternative minimum tax, the same general trend exists (i.e., large stocks are favored over small), but now international stocks become marginally less attractive.

In summary, although the example outlined above is somewhat artificial, it is still instructive in helping us wade through the complex interplay between returns, risk and taxes to isolate possible portfolio revisions that may need to occur if taxes on equity dividends are eliminated. Undoubtedly, the exact form and degree of dividend tax relief, if any, will not be nearly so simple as we have outlined here once it makes its way through Congress. What is clear is that taxable investors should develop a framework for evaluating how potential tax law changes might affect their portfolios so that they can react appropriately to whatever happens.

Secondary Impacts of Eliminating Taxes on Dividends

While at times complex, gauging the impact of a tax law change on taxable investors' optimal asset allocation strategies is relatively quantifiable. More difficult, however, is assessing the impact that altering the after-tax attractiveness of dividend yielding stocks may have on both investor and corporate behavior. Specifically, several questions come to mind:

- First, how would the creation of another form of tax-exempt income affect investors' appetite for tax-free bonds?
- Second, how might the creative minds on Wall Street create derivative "solutions" to exploit investor preferences for tax-exempt dividend income?
- Third, how might different types of securities fare as a result of a tax law change?
- Finally, how might corporate behavior change regarding dividend payout policy if double taxation of dividends were eliminated?

Although there is no way to answer these questions with certainty, our speculation as to possible outcomes is as follows.

Tax-exempt bonds. The creation of a competitive new form of tax-exempt dividend income could not come at a worse time for state and local issuers of tax-exempt bonds. The economic and stock market slumps that have plagued the US for several years now has drained municipal coffers and severely strained their budgets. Offsetting this situation has been the sharp decline in interest rates that has lowered their overall borrowing costs.

Going forward, however, it is likely that not only will the general level of interest rates rise, but issuers will, in the face of a tax law change, also need to increase the yields they offer to investors in order to compete with tax-exempt dividend income. As anyone who has spent time in the tax-exempt bond arena knows, investor demand is relatively inelastic and therefore the pricing of bonds is heavily influenced by available supply. We suspect that the creation of an enormous alternative source of tax-exempt income will cause tax-exempt bonds to trade permanently closer to Treasuries than they have in the past. The net affect of this change will be equivalent to an interest rate increase and will result in short-term losses to bond investors.

Masters of the Universe. As a former derivatives marketing manager, I never found a problem that a derivative product couldn't solve. It is virtually certain that the whiz kids of Wall Street will seize upon opportunities to synthetically separate equity dividends from equity capital appreciation to create new synthetic forms of tax-exempt fixed income securities. In fact, this has already been tried. In the mid-1990's Lehman Brothers created synthetic securities known as Primes and Scores. These securities separated the cash flow components of given stocks into dividend income and capital appreciation. Specifically, a Prime entitled the holder of the security to receive the dividends on an underlying stock plus the market value of the stock at a specified future date (up to a pre-specified amount). Scores entitled the holder to receive all of the market value of the stock above the Prime holder's termination value.

Despite much fanfare and much to Lehman's chagrin, these innovative securities never became popular. In the wake of tax-exempt dividends, however, developing vehicles to arbitrage the differing degrees of dividend attractiveness between taxable private clients and non-taxable institutions would be powerfully compelling. Of course, there is no guarantee that even if income taxes on dividends were eliminated, the IRS would permit Primes and Scores as they exist today to qualify for tax-exempt dividend treatment. Rest assured, however, that Wall Street's creative minds will find a way!

Winners and Losers. We have already seen that certain equity asset classes would become relatively more attractive to taxable investors following a tax law change. We speculate, however, that certain types of higher yielding equity sub-classes might benefit more than others. A Credit Suisse First Boston study noted that, "Prior to 1986 when dividend was partially exempted, companies increasing their dividends consistently outperformed companies reducing or not paying dividends."[3] The study concluded that:

> "A priori we would expect stocks with a high dividend yield to rise more than stocks with a low dividend yield upon the introduction of dividend imputation.

[3] Paddy Jilek, Krishna Memani, Michael Mauboussin, *Impact of Potential Dividend Tax Cut*, Facts & Focus (Credit Suisse First Boston, December 17, 2002), p. 3.

> Some of the low yielding stocks, especially in technology where free cash flow is so high, could immediately respond to a tax change by announcing the introduction of a dividend. Tax changes could have an impact on the perennial tug-of-war between growth and value [with value being the winner over growth]."[4]

This same study also suggests that a beneficiary of a tax law change would be preferred stock:

> "A reduction in dividend tax rates will bring traditional preferred stock, now virtually defunct as a corporate finance vehicle, back in vogue. With their reduced tax rates, preferred stock from well-known companies will once again become attractive to individual investors. Right now, most preferred securities sold to investors are really debt instruments masquerading as preferred stock. The reduction in tax rates will make traditional preferred stock a viable substitute for Muni bonds in individual investor portfolios. The scope of this ought not to be underestimated."[5]

Corporate Behavior. During the past decade corporate managers have reduced the percentage of earnings paid out to shareholders in the form of dividends to approximately 30%, down sharply from an historic average of 45% to 50%. In part, managers have justified this reduction by citing the negative effects of the double taxation of dividends. We are skeptical of this logic since a large percentage of equities, if not a majority, is held by non-taxable investors. Nevertheless, the elimination of dividend taxation will likely pressure corporate managers to increase payout ratios. Not only will this have the effect of increasing dividends but it will also correspondingly reduce the magnitude of share buybacks and/or earnings reinvestment. As a result, the future magnitude of equity capital appreciation will likely be reduced. It will also be interesting to note whether non-US corporations would follow the lead of US managers and change their dividend policies as well. If they do not, then international equities may become higher growth, lower yielding securities than US stocks.

Conclusion

Now that the Republicans control both the White House and Congress it seems likely that some form of tax relief will be forthcoming. Rumblings from Washington indicate that this relief will, in part, include a reduction in or elimination of the double taxation of equity dividends. We have seen that, for private investors, passage of such a policy would affect the relative attractiveness of different types of equity asset classes. We further speculate that certain equity sub-asset classes such as large cap stocks, high-yielding value stocks and preferred stocks would benefit. Other asset classes, most notably tax-exempt bonds, would suffer. While we would suggest that it is still too early to restructure private client

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[4] Ibid., p. 2.

[5] Ibid., p. 3.

portfolios, it is a useful planning exercise to understand how portfolios might need to be restructured if such tax law changes do in fact occur.

We will be happy to discuss this paper at your convenience.

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January 2003

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