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Morning Comments

Dividends, Capital Taxation and the Cliff

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- The primary risk to financial markets from fiscal tightening is through a channel of weakening economic activity (reduced corporate income as tax increases shrink consumer demand). But barring alteration, the coming year also includes higher tax rates on capital and dividend income which should carry some valuation impact, regardless of the economy's performance.

- It is assumed that a fiscal deal will limit tax increases for both labor income and capital income. However, it seems worthwhile to consider both forms of impact independently (acknowledging that dividends and realized gains fund consumer spending too).

- Under a full "over the cliff" scenario, we estimate the tax bill for qualified dividends would rise about $40 billion initially in 2013 above the level of collections at a 15% maximum rate. Assuming the tax is permanent we estimate that the shift of income to the Treasury from shareholders is worth 7% of the U.S. stock market's value on a capitalized basis. Any related loss of value would be additive to any potential decline from a weaker path for the U.S. economy and earnings.

- Assuming instead a rise to a 20% dividend tax rate with a 3.8% expansion of healthcare taxes, we estimate a smaller impact of 3%. Note: we only value the difference in taxes actually paid by affected holders. The impact of less frequently realized capital gains is somewhat more difficult to model, but should be similar.

- Markets already appear to expect some increase in capital taxation, but not a sustained tripling in the maximum individual tax rate on dividends. Corporate decision makers who pushed up ordinary (mostly qualified) dividend payments 16% this year seem to expect action to stop the tax increase. At the same time, a high level of "special" one time dividend payments suggest fears of higher tax rates too.

Beyond the Ordinary Fiscal Tightening

Much has been lumped together under the umbrella of “fiscal cliff” for 2013. For convenience, it includes “sunset provisions” for cuts in personal income tax rates enacted about a decade ago. It also includes entirely new tax initiatives for 2013, such as the application of a 3.8% healthcare tax to dividends, capital gains and other sources of so-called “unearned income.” (Previously, only wages were subject to various aspects of the FICA tax).

We strongly suspect that markets have already braced some for an expected increase in taxation on capital. Attempts to repeal “Obama care” and its related taxes, for example, have failed repeatedly, and the probability of such a repeal fell with the reelection of the President and sitting Congress.

An increase in the maximum capital gains rate to 20% from 15% (plus the expansion of the Medicare tax to a 23.8% rate) is current law for U.S. residents in 2013. There seems to be only a modest chance that the capital gains tax rate will be kept substantially lower by an act of Congress, even if the tax code is eventually completely overhauled and a near-term fiscal deal pushes off most personal income tax increases.

The increase in the personal dividend tax rate well beyond capital gains stands out for unusual impact.

Current law also would see the top individual tax rate for so-called qualified corporate dividend income rise to 39.6% (43.4% net of the healthcare tax) from the current 15%.

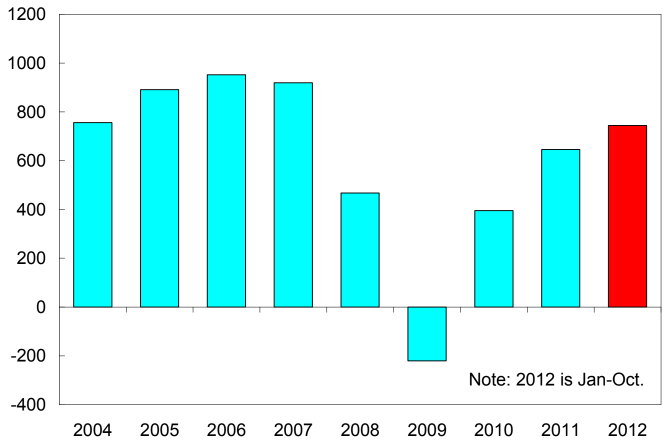
The particularly severe tax rise for dividends (which of course excludes state and local taxes), is paid from already-taxed corporate income. Much is made of the fact that the overall effective corporate tax rate has averaged below 24% in the past 10 years, well below a statutory maximum of 35%. But this includes many currently unprofitable or start-up firms not in a position to pay dividends. Firms paying dividends to shareholders more often pay closer to the statutory maximum tax rate. As such, under current law for 2013, very little corporate income might ultimately be distributed to individuals when all taxes are considered.[1]

In late July, Senate Democrats passed a bill including a maximum personal income tax rate on both dividends and capital gains of 20% for 2013, up from the current 15%. (With both forms of income still subject to the payroll tax expansion). This vote already signaled a desire to keep the capital gains and dividend tax rates paired together, rather than diverging. It also shows a strong desire to limit the rise in dividend taxes to far below the maximum of 39.6% (43.4%) in current law. While its ultimate expectations are unclear, the White House allowed for a rise in the maximum dividend tax to 39.6% in its 2013 budget and again in its initial plans to address the fiscal cliff in proposals of recent days, according to press reports.

Among other things, we expect a radically different path for future dividend payments if the maximum tax rate does indeed nearly triple. Despite the pending “fiscal cliff,” a very healthy share of firms raised ordinary dividend payments this year, likely assuming an alteration to the pending tax rate increase (see figure 1). At the same time, however, an unusually large number of firms have paid special dividends in 2012, seeking to lock in what will most likely be the lowest rate for the foreseeable future (see figure 2).

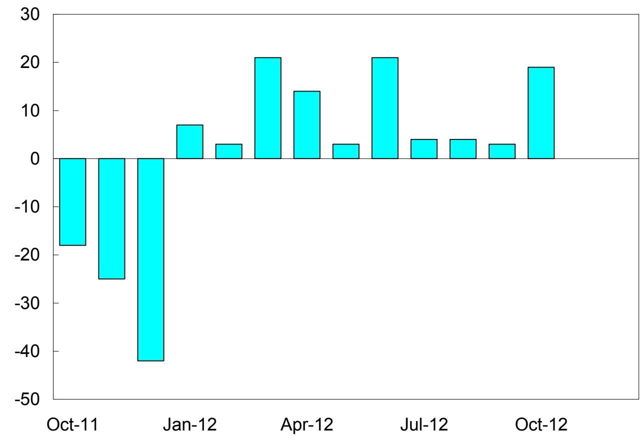
[1] For a plausible example, consider a firm paying the effective federal corporate income tax rate of 23.6% (the decade average for all corporates). If a shareholder receives $1,000,000 in dividend income from the firm under current law in 2013 with a 6% state income tax, and “head of household” filing status, only 41 cents of pre-tax corporate income will be distributed to the firms owner after taxes. This example treats the dividend as a sole source of income with no offsetting tax deductions.

Figure 1. Net Number of Firms Raising Ordinary Dividend Payouts in U.S. Market (2012 to-date).



Sources: S&P, Citi Research

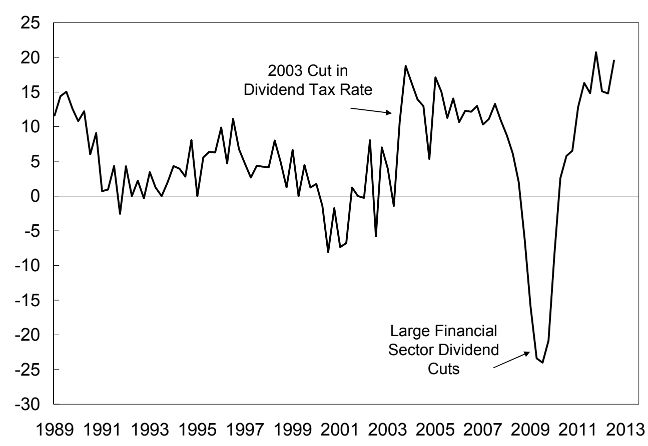
Figure 2. Number of Firms Paying Special One-Time Dividends (Year/year Difference) Monthly



Source: S&P, Citi Research

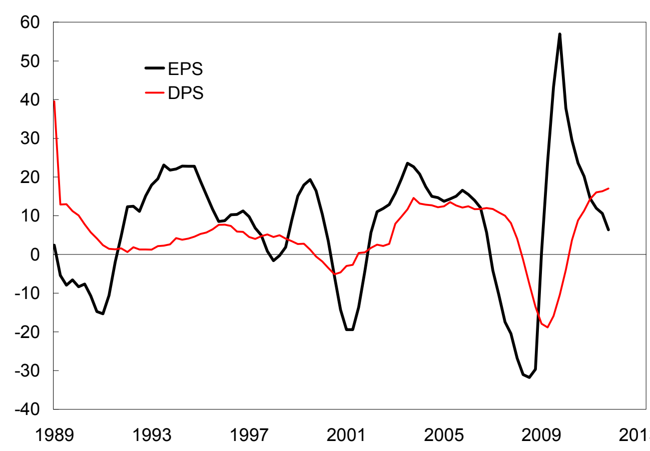
Dividends have been on a strong recovery track, with total dollar payments for ordinary dividends up an estimated 16% to a record high in 2012, apparently including those fully subject to new taxes. The gains follow the sharp upturn in profits. If the maximum dividend tax rises moderately, and in line with the capital gains tax, we would still expect solid, if slower increases in future payouts to continue, particularly given a cautious payout ratio (see figures 3-5).

Figure 3. Quarterly S&P 500 Dividends Per Share Y/Y% Change



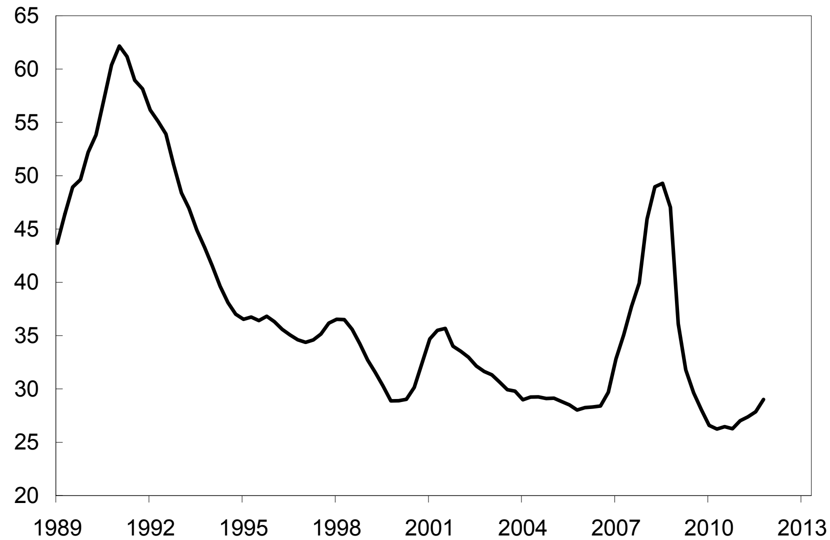
Sources: S&P, Citi Research

Figure 4. Operating EPS and DPS Y/Y%, Four-Quarter Moving Avg



Source: S&P, Thomson Financial, Citi Research

Figure 5. S&P 500 Dividend Payout Ratio (DPS as % of EPS, 4-Quarter Sums)



Source: S&P, Thomson Financial

If the rate of dividend taxation doesn't alter decision making significantly – an assumption we could only make if dividend taxes move in lock step with capital gains taxes to 23.8%, we would expect DPS to rise 13% in 2013 and 10% in 2014 as dividend increases lag behind past, strong profit gains.

Barring a large increase in the dividend tax rate, the outlook for dividend increases is quite strong in coming years, reflecting earlier increases in profits.

If, on the other hand, the tax were to rise to 43.8% for "qualified" tax payers, we expect dividend payments to rise just modestly in 2013 and grow very little thereafter.

To model the valuation impact of the dividend tax, we don't assume that immediate dividends are the sole source of valuing an enterprise. Shareholders clearly value the retained earnings and net worth of firms that pay no dividends. Instead, though, we can assess a capitalized value of the increased tax flow paid to the Treasury that reduces the after-tax return of investors.

Measuring only the qualified taxes paid by U.S. investors (payments of ordinary dividends to foreign investors or tax-deferred entities already reduce this amount), we would expect taxes paid to the U.S. Treasury would increase about $40 billion in 2013 if the maximum individual dividend tax rate were 43.4%.[2] This reflects our expectation of $182 billion in qualified dividend payments in 2013 under such a tax rate and an effective tax rate of about 34.5%, reflecting some holders paying taxes below the statutory maximum. For perspective, total dividends paid to all holders – foreign and domestic, taxable or deferred – would be about $284 billion for the S&P 500 under this scenario.

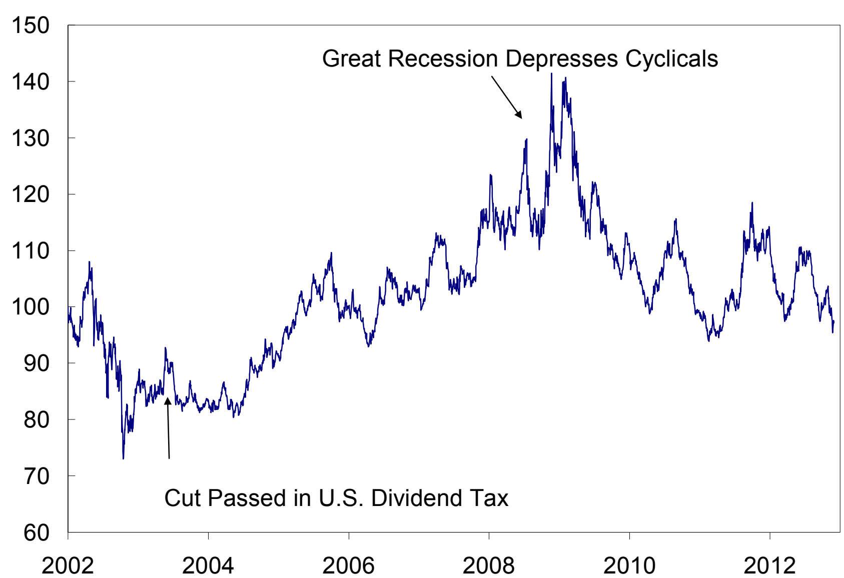
If the increased tax collection is assumed to be permanent, and under the new tax regime, dividends grow just 2% annually in the future, a capitalized (perpetual) value for this reduced after-tax income stream to investors is about $1.1 trillion. This estimate also assumes a required equity return equal to the current BBB-rated corporate bond +100 basis points, the observed premium over the past half century.

[2] This estimate assumes income tax rate increases across the board, in line with the sunset of 2001 and 2003 tax rate cuts. Alternative estimates may include lower amounts only for "upper income" tax payers.

The $1.1 trillion is about 7% of the Wilshire 5000's current market capitalization. For firms more heavily reliant on dividends as an establishment of their value, the impact would be larger.

To contrast, a rise in the dividend tax to 23.8% would by our estimates collect an additional $14 billion in taxes in 2013 from a somewhat higher dividend level. With a somewhat higher assumed future growth rate of dividends, we estimate a 3% capitalized value for reduced after-tax returns to investors. While difficult to model given that the timing of capital gains realizations are quite variable, a higher capital gains tax should have a parallel impact. As noted, some expectation of higher dividend and capital gains taxes has likely been priced into markets already, though not a very sharp increase (see figure 6).

Figure 6. S&P Utility Stock Price Index Relative to S&P 500



Source: S&P, Citi Research

Overall, we see the probability of the extreme fiscal cliff scenarios – one of complete and lasting gridlock and recession, or a true and immediate grand bargain - as falling in the aftermath of the election. However, it's not fully clear how the issue of capital and dividend taxation will be resolved, particularly as the administration has not immediately favored a similar tax rate for capital gains and dividends.

We expect a limited rise in both capital gains and dividend tax rates in 2013 on a fiscal deal, but the administration has begun bargaining at a full rise in dividends to the ordinary income tax rate.

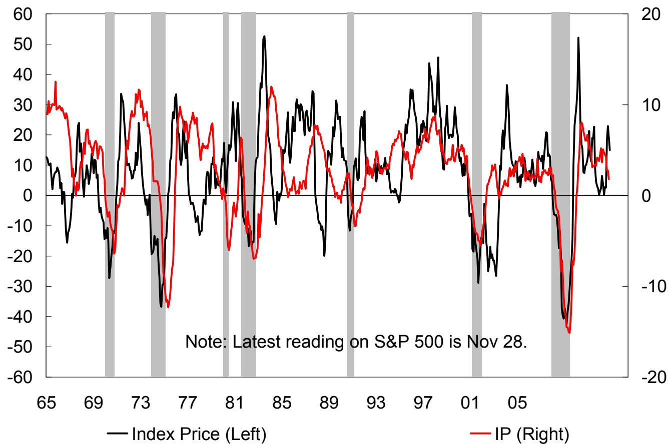
If dividend taxes are allowed to markedly differ from capital gains taxes, we expect retained earnings to rise and firms to rely more heavily on share repurchases instead to reward shareholders. But such a situation tends to increase volatility and focus performance on the short-term. As the lessons of the 1990s also suggest, it can result in worsened stewardship of retained profits.

Movements in the U.S. stock market are dominated by cyclical factors, and if the increase in new capital and dividend taxes is minimized as we still expect, it might not be discernable from the broader movements in markets, which could well rise in relief on any deal (see figures 7-8).

But with all due respect to Warren Buffett, the high levels of tax deductions and credits taken by U.S. tax payers, along with more rapid growth in dividends since

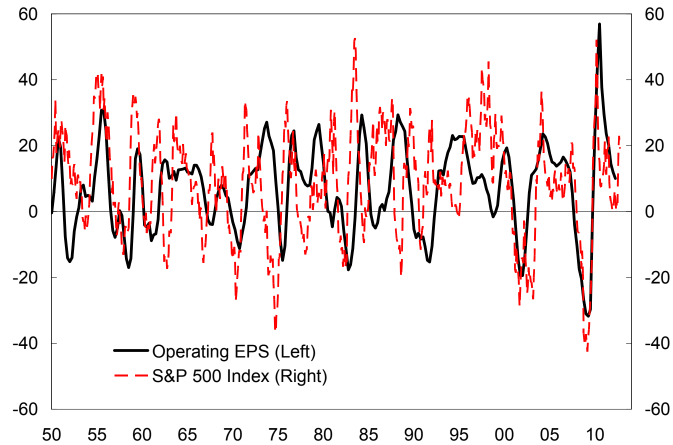
2003, illustrate that the public does indeed respond to tax incentives (again see figure 3). We had thought a tax rate for dividends substantially higher than capital gains was an idea whose time had passed.

Figure 7. S&P 500 and Industrial Production, Y/Y%



Sources: Standard and Poor's and Federal Reserve Board.

Figure 8. S&P 500 Operating EPS (4-Qtr Rolling Sum)and Index, Y/Y%



Sources: Standard and Poor's and Citi Research.

Appendix A-1

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