

Allowing the Bush Dividends Tax Cut to Expire for the Richest 2% Will Not Harm Seniors

Douglas Holtz-Eakin, chief economic adviser for John McCain’s presidential campaign and former director of the Congressional Budget Office, recently told the Senate Finance Committee that seniors at all income levels would be hurt if Congress did not make permanent the income tax cut enacted under George W. Bush for corporate stock dividends. As this report explains, only those seniors who are among the richest 2 percent of taxpayers will lose *any* portion of the Bush income tax cuts.

Nonetheless, Holtz-Eakin claims seniors at *all* income levels will be harmed. His argument is that corporations would stop paying dividends because the wealthiest individuals receiving them no longer would receive a tax break for them. The result, he argues, is that dividend income would decline for taxpayers at all income levels, particularly seniors. The former CBO director has overlooked the fact that two-thirds of the dividends paid by corporations are to tax-exempt entities, meaning they would have little, if any, incentive to change their practices for paying dividends.

The Bush Tax Break for Stock Dividends

The federal income tax applies, in theory, to all income, but certain types of income are taxed at lower rates. When President George W. Bush took office, income that takes the form of capital gains was already taxed at lower rates than “ordinary income.” President Bush and his allies in Congress reduced income tax rates for ordinary income and capital gains. They also reduced the income tax rates for corporate stock dividends, so that they would be taxed at the same low rates set for capital gains. The result is that ordinary income is now taxed at a top rate of 35 percent, while capital gains and stock dividends are taxed at a top rate of 15 percent.

Seniors, Stock Dividends and Taxes						
Extend Tax Cut for Dividends in the Top Two Income Tax Brackets (which would not include taxpayers with adjusted gross income below \$200k/\$250k), Impact on Taxpayers 65 & Older in 2011						
Income Group	Average Income	Avg Dividends as Share of Inc	Percent with Tax Cut	Average Tax Cut	Tax Cut as % of Income	Share of Tax Cut
Lowest 20%	\$ 14,000	1.2%	—	\$ —	—	—
Second 20%	25,800	1.2%	—	—	—	—
Middle 20%	42,100	1.5%	—	—	—	—
Fourth 20%	69,500	2.7%	—	—	—	—
Next 10%	105,300	4.4%	—	—	—	—
Next 5%	147,600	5.2%	—	—	—	—
Next 4%	258,400	6.9%	18.4%	-386	-0.1%	11.1%
Top 1%	1,294,300	7.5%	79.7%	-13,634	-1.1%	88.9%
ALL	\$ 66,700	4.3%	1.4%	\$ -133	-0.2%	100.0%
Bottom 60%	\$ 26,200	1.3%	—	\$ —	—	—

Source: Institute on Taxation and Economic Policy tax model, July 2010.

The Bush tax cuts expire at the end of 2010. If Congress does nothing, the top income tax rate for ordinary income will go back to the pre-Bush level of 39.6 percent, and the top rate for capital gains will go back to the pre-Bush level of 20 percent. Dividends will once again be taxed as ordinary income, meaning they will be taxed at a top rate of 39.6 percent.

What President Obama Proposes and What Congressional Democrats Are Considering

President Obama proposes to make permanent all the Bush income tax cuts for every income tax bracket except the top two. He would adjust the top two income tax brackets to ensure that no one with adjusted gross income (AGI) below \$200,000 (or \$250,000 for married couples) falls within them.

In other words, President Obama would ensure that none of the Bush income tax cuts would expire for anyone who is not among the richest 2 percent of taxpayers (the percentage of taxpayers with AGI above the \$200,000/\$250,000 threshold).

But even the richest two percent would continue to enjoy one Bush-era break that President Obama proposes to partially extend. Instead of allowing dividends to be taxed once again as ordinary income (meaning a top rate of 39.6 percent), he proposes to set the top rate for dividends at 20 percent, the same as the top rate for capital gains under his proposal. This is higher than the top rate of 15 percent that applies now, but far lower than the top rate of 39.6 percent that will apply to other income.

Republicans in Congress want to make all of the Bush tax cuts permanent, which includes making permanent the top rate of 15 percent for dividends.

It is uncertain how Congressional Democrats will address the tax cut for dividends. An exemption written into the budgetary “PAYGO” rule allows Congress to make permanent the income tax cuts for those taxpayers below the \$200,000/\$250,000 threshold without offsetting the cost, and this does not include any tax cut that would reduce the top rate for dividends below 39.6 percent. It is unclear how the PAYGO rule is influencing lawmakers’ thinking right now, since it sets budgetary rules but it can be waived or amended by Congress.

In other words, there are three ways Congressional Democrats might address the tax cut on dividends. They might let it expire entirely for the richest two percent, meaning the top rate for dividends would go back up to 39.6 percent. Or they might follow President Obama’s suggestion, and set the top rate for dividends (and capital gains) at 20 percent. Or, much more ominously, Congressional Democrats could cave to the demands of Republicans and extend all the rate cuts, even for the very richest taxpayers and including the top rate of 15 percent for capital gains and dividends, for some period of time.

Seniors Among the Bottom 98 Percent of Taxpayers Will Keep their Tax Cuts

Democrats and Republicans agree, for better or worse, that the Bush tax cuts should be made permanent for the bottom 98 percent of taxpayers. This means that no matter what Congress decides, any senior who is not among the richest 2 percent will continue to enjoy the income tax cut for stock dividends.

If they *have* dividends. The fact is that dividends account for a tiny fraction of income for seniors. In the table on the first page, the second column shows that seniors rely on dividends for just 4.3 percent of their income on average, and the poorest three fifths of taxpayers rely on dividends for just 1.3 percent of their income on average.

The table on the first page illustrates that extending the 15 percent rate for dividends for taxpayers with AGI above the \$200,000/\$250,000 threshold does very little to help seniors. About 89 percent of the benefits for seniors would go to those among the richest one percent, while the rest of the benefits would go to those among the next richest 4 percent.

Holtz-Eakin Argues that *All* Seniors Will Be Harmed if the Tax Break for Corporate Stock Dividends Is Not Extended for the Rich

Seniors who are among the bottom 98 percent of taxpayers will continue to enjoy the Bush tax cut for dividends (as well as the rest of the Bush income tax cuts) under either the Democrats' approach or the Republicans' approach. And seniors who are among the bottom 98 percent rely little on dividends anyway.

However, during his testimony to the Senate Finance Committee last week, Holtz-Eakin made a novel argument that seniors at *all* income levels would be harmed if the tax cut for dividends is not fully made permanent for all taxpayers, including the very richest. He asserted that corporations would respond to the expiration of the dividends tax break for the rich by limiting payments of dividends generally. The result, he argues, would be that even low- and middle-income seniors would receive less dividend income.

But there is virtually no chance this will happen.

- First of all, two-thirds of the dividends that are paid out by corporations to individuals (directly or indirectly) are paid to tax-exempt entities such as pension plans and other retirement vehicles. As a result, two-thirds of personal dividends already are not eligible for the special low personal income tax rate rates on stock dividends, since they are not subject to personal income tax to begin with.¹
- Second, as already noted, President Obama wants to keep the current dividend tax break for the vast majority of people who do get taxable dividends.

It seems obvious that dividend-paying corporations would not risk the ire of the vast majority of their investors by reducing dividend payments simply because a small share of their dividends go to a handful of wealthy individuals who no longer enjoy a special tax break on them.

¹According to data from the Bureau of Economic Analysis and our calculations, \$1.9 trillion in corporate stock dividends were paid, directly or indirectly, to individuals over the 2004-2008 period (excluding dividends from non-taxable, "pass-through" S corporations). But the IRS reports that only \$0.6 trillion in such corporate stock dividends were reported on individual tax returns (as "qualified" dividends). The remaining corporate stock dividends were not subject to personal income tax, because they were paid to individuals' accounts with tax-exempt pension plans, other retirement plans, and certain life insurance arrangements. That means that two-thirds of personal dividends from corporate stock are not subject to personal income tax.

(See BEA National Income and Product Account Tables 1.16 and 7.10 and the related (albeit somewhat confusing) table accompanying BEA FAQ #318, all at www.bea.gov. See also annual data on Individual Income Tax Returns for 2004-08 from the Internal Revenue Service at www.irs.gov. The size of Subchapter S dividends for years after 2004 was calculated by CTJ based on IRS data on Subchapter S corporation tax returns, using BEA's FAQ #318's table as a template.)