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QUALIFIED DIVIDENDS: DO THEY AVOID DOUBLE TAXATION OR DO THEY DOUBLE SHAREHOLDERS’ BENEFIT?

James F. Loebl*

INTRODUCTION

On May 28, 2003, President George W. Bush signed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)¹ into law. One of the most widely publicized provisions in the Act treats qualified dividend income as part of net capital gain and limits the top marginal tax rate on such income to 15%.² In addition to spurring economic growth and creating new jobs, Congress hoped to eliminate the economic distortions it observed in corporate decisionmaking as a result of corporations’ higher aggregate tax burden under prior law.³ The so-called dividend tax cut was temporary and would not apply to tax years beginning after December 31, 2008.⁴ In May 2006, the dividend tax cut was extended for two more years, through December 31, 2010, when Congress passed the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA).⁵

In the 2007 budget he submitted to Congress, President Bush proposed that the dividend tax cut become permanent.⁶ Citing growth in gross domestic product (GDP) and employment, the President, the

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* Assistant Professor of Law, Valparaiso University School of Law; B.A., Santa Clara University (1978); M.B.A., Harvard Business School (1982); J.D., University of Wisconsin Law School (1992); and LL.M., University of Florida College of Law (2000). I wish to thank Professors Susan Stuart, Jeremy Telman, and Elizabeth Bruch from the Valparaiso University School of Law for their insightful comments and suggestions during the drafting of this Article.

2. See I.R.C. § 1(h)(1)(C), (3)(B), (11) (West 2006). Qualified dividend income includes dividends received from most domestic corporations, provided the shareholder holds the stock on which the dividend was paid for at least 60 days of the 121-day period beginning 60 days before the stock became ex-dividend. Id. § 1(h)(11)(B). A domestic corporation is one that is “created or organized in the United States.” Id. § 7701(a)(4).
Department of the Treasury, and Republican congressional leaders have actively campaigned to make the dividend tax cut permanent, along with most of the other provisions in JGTRRA.7

This Article argues that the dividend tax cut in its present form should be allowed to expire because it fails to eliminate the double taxation of corporate income. This flaw could be overlooked if permanently extending the dividend tax cut would lead to increased economic growth. But there is no evidence that the tax cut caused the improvement in the economy's performance since 2003, and economic theory suggests that the tax cut will actually lower economic growth in the long run: A more effective means to ensure that corporate income is taxed only once would be to implement a modified version of the President's original proposal for dividend tax relief submitted in his 2004 budget.

Part II provides background on the problem of the double taxation of corporate income that existed before the enactment of JGTRRA.8 It discusses the Treasury Department's 1992 study on the integration of corporate and individual tax systems, and it examines the President's original proposal to eliminate the burden of double taxation, a proposal that was strongly influenced by the Department's report.9 Part III discusses the problem of the high percentage of corporations paying no U.S. corporate income tax and the inadequacy of the dividend tax cut as a substitute for integration.10 Part IV explores the likely short-term and long-term effects of the dividend tax cut on the economy.11 Part V examines the potential cost of making the JGTRRA tax cuts permanent, as well as the likely distribution of the benefits of those cuts among taxpayers.12 Finally, Part VI concludes that the dividend tax cut should be allowed to expire.13 A modified version of the President's original proposal should be used if policymakers still want to implement integration after further study of its costs and benefits.

8. See infra notes 14–23 and accompanying text.
9. See infra notes 24–52 and accompanying text.
10. See infra notes 53–77 and accompanying text.
11. See infra notes 78–213 and accompanying text.
12. See infra notes 214–232 and accompanying text.
13. See infra notes 233–241 and accompanying text.
II. BACKGROUND

A. The Problem of Double Taxation

Traditionally, the income of a so-called C corporation has been subject to taxation at two levels. First, the corporation paid tax applying the rate schedule in §11(b) of the Internal Revenue Code. Second, prior to the enactment of JGTRRA, when the corporation distributed its earnings in the form of dividends to shareholders, the individual shareholders reported the dividends as ordinary income on their individual income tax returns and paid tax on the dividends at their marginal tax rate. A simple example illustrates that the two taxes could combine for a very high marginal tax rate in the absence of any relief provision:

**EXAMPLE 1**

Assume that ABC Corporation earns $100 in taxable income and then distributes all of its after-tax income as dividends to its shareholders. Assume also that ABC must apply the top statutory income tax rate for corporations, or 35%, to determine its corporate income tax liability, and that its shareholders' marginal tax rate is the top rate for individuals, which is also currently 35%.

<table>
<thead>
<tr>
<th>Step 1: Determine the corporate income tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
</tr>
<tr>
<td>$100.00</td>
</tr>
<tr>
<td>$x$ tax rate</td>
</tr>
<tr>
<td>$x$ 35%</td>
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<tr>
<td>Tax liability</td>
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<tr>
<td>$35.00</td>
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<table>
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<tr>
<th>Step 2: Determine after-tax income available for distribution to shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax income</td>
</tr>
<tr>
<td>$100.00</td>
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<tr>
<td>Less corporate income tax</td>
</tr>
<tr>
<td>$35.00</td>
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<tr>
<td>After-tax income</td>
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<tr>
<td>$65.00</td>
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<table>
<thead>
<tr>
<th>Step 3: Determine the shareholders' individual income tax on the dividends received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
</tr>
<tr>
<td>$65.00</td>
</tr>
<tr>
<td>$x$ tax rate</td>
</tr>
<tr>
<td>$x$ 35%</td>
</tr>
<tr>
<td>Shareholders' individual income tax</td>
</tr>
<tr>
<td>$22.75</td>
</tr>
</tbody>
</table>


15. All statutory citations are to sections of the Internal Revenue Code of 1986 as amended through June 30, 2006, unless otherwise noted.

16. Ordinary income includes items such as salaries and wages, rent, interest, and income from a sole proprietorship.


18. Id. §1(i)(2).
Step 4: Determine total income taxes paid
Corporate income tax $ 35.00
Individual income tax + 22.75
Total income taxes $ 57.75

Step 5: Determine combined marginal tax rate
Total income taxes = $ 57.75 = 57.75%
Pre-tax income $100.00

As Example 1 illustrates, the traditional double tax regime had been one of the major disadvantages of organizing a business as a corporation. Companies like the hypothetical ABC Corporation had taken various measures to avoid paying a nearly 58% tax on each dollar of taxable corporate income. The first measure was to retain the $65 in after-tax income to use in financing future investments, rather than distributing the income to shareholders. While the shareholders did not receive any current return on their investment in the form of dividends, they avoided paying $22.75 in tax in the current year. But not all of the $22.75 in tax would necessarily be avoided on a permanent basis. Theoretically, the earnings retained by ABC would increase the net assets of the firm and thus the value of its stock. When the shareholders sold their stock, they would have to pay tax on the gain. Net capital gains are currently taxed at a maximum rate of 15%, which is lower than the top rate on ordinary income.\footnote{19}

The second measure corporations took to avoid double taxation was to finance investments with debt rather than equity. While dividends are not deductible for corporate income tax purposes, corporations may deduct the interest expense they incur on borrowed funds under § 163(a). Therefore, when a corporation pays interest to a lender, the corporation saves taxes in an amount equal to the tax rate multiplied by the amount of the interest expense. This compares favorably to the rate paid when the corporation pays a dividend, because the corporation saves no tax, and the amount paid is the cost to the corporation both before and after tax.

Finally, when faced with the C corporation’s double taxation regime, entrepreneurs often decided to organize their businesses as either limited liability companies, limited partnerships, or general partnerships. These organizational forms are all taxed as partnerships.

\footnote{19. See id. § 1(h)(1)(B)–(C). For taxpayers whose ordinary income would be taxed at a marginal rate of 10% or 15%, the 15% rate for net capital gain provides no tax break. Accordingly, § 1(h)(1)(B) provides that net capital gain reported by those taxpayers is taxed at a rate of 5%. From 2008 to 2010, the net capital gain tax rate will be reduced from 5% to zero. See id. § 1(h)(1)(B); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (2006).}
under Subchapter K. Partnerships are referred to as "pass-through" entities because the partnership itself does not pay tax. Instead, each partner reports a share of the partnership's income, deductions, gains, losses, and credits on the partner's individual income tax return. Owners could also form corporations but elect "small business corporation" or "S corporation" status, allowing them to be treated as pass-through entities. Since corporations with more than 100 shareholders may not elect to be taxed under Subchapter S, large publicly held corporations must be taxed as C corporations.

B. The Treasury Department Study

The problem of double taxation and the responses developed by corporate managers and business owners to avoid it have long been a concern of the Treasury Department. Pursuant to a mandate in the Tax Reform Act of 1986 to study reforms in corporate taxation under Subchapter C, the Treasury Department issued a lengthy report in 1992 discussing the problems of economic inefficiency created by the classical corporate tax structure, as well as the need to integrate individual and corporate income taxes to resolve these problems. The Treasury Department noted three economic distortions in the corporate system. First, the system caused a misallocation of capital between the corporate and noncorporate sectors. For a corporation to achieve the same after-tax rate of return on its investments as a noncorporate business, it must achieve a higher pre-tax rate of return than the noncorporate business. The need for a higher pre-tax rate of return raises the relative cost of capital for corporations; it thus discourages corporations from investing in projects that would otherwise be profitable if they were subject to one level of tax. Noncorporate businesses, meanwhile, could invest in projects whose returns exceed the noncorporate sector's cost of capital but are lower than those on projects rejected by corporations. The Treasury Department concluded that the "bias against corporate sector investments compared

21. Id. §§ 701-702.
22. Id. §§ 1361-1379.
23. See id. § 1361(b)(1)(A).
26. Id. at 3-4.
27. Id.
with investments in the noncorporate sector reduces the productivity of the nation's capital investments and reduces potential national income."

28  

The second distortion of the double tax system was to encourage corporations to finance more of their new investments by using debt rather than equity. By increasing their levels of debt, corporations also increased the "risk of financial distress or bankruptcy." 29  

Finally, the Treasury Department noted that the traditional system of taxation distorted the choice between distributing earnings to shareholders and reinvesting them in the business. Furthermore, when corporations chose to distribute earnings, the taxation system encouraged corporations to repurchase shareholder stock rather than distribute dividends. Repurchases produced more favorable results at the shareholder level because the shareholder paid tax only on the gain (the excess of the repurchase price over the shareholder's basis in the shares) rather than on the total amount of the dividend distributed, and because the gain could be taxed at a lower rate than the dividend if it were a long-term capital gain. 30  

After identifying these problems, the Treasury Department discussed four different prototypes to implement the integration of the corporate and individual tax systems, to reduce distortions in the system, to improve economic efficiency, and to ensure that capital income would be taxed only once. One of these prototypes, the dividend exclusion prototype, formed the basis for President Bush's February 2003 budget proposal to eliminate the double taxation of corporate income. 31  

C. President Bush's Proposal  

Under existing law, a distribution of cash or property by a corporation to its shareholders constitutes a dividend if the distribution is deemed to have been made from the corporation's current or accumulated earnings and profits (E&P). 32  While E&P are analogous to the retained earnings reported on a company's balance sheet, they are intended to measure the corporation's ability to pay dividends based on

28. Id. at 4.  
29. Id.  
30. Id. at 11.  
the economic gains and losses it has experienced. Accordingly, § 312 specifies the items, such as depreciation, that are treated differently for purposes of computing E&P than for computing taxable income. President Bush’s proposal did not change the definition of a dividend or the rules for maintaining E&P accounts.

The President’s budget for the fiscal year 2004 proposed that dividends distributed to individual shareholders should be excluded from their gross income to the extent that the dividends were “paid out of income previously taxed at the corporate level.” To keep track of the income that could be distributed without further tax at the individual shareholder level, a corporation would have to calculate an “excludable dividend amount” (EDA) every calendar year. The corporation would determine the EDA under the following formula:

$$\text{EDA} = \frac{\text{U.S. income taxes} - \text{U.S. income taxes}}{0.35}$$

In the first part of the formula, the corporation converts the amount of U.S. income taxes shown on the return from the previous calendar year into an equivalent amount of taxable income that has been taxed at the maximum statutory rate of 35%. To obtain this equivalent amount of taxable income, the corporation divides the amount of taxes shown on the return by the 35% rate. In the second part, the corporation subtracts the taxes shown on the return from the hypothetical taxable income calculated in the first part. The result is the EDA. The following example illustrates the use of the formula:

**Example 2**

Assume that GHI Corporation filed a return on September 15, 2005, reporting U.S. income taxes of $700,000. GHI’s EDA for calendar year 2006 would be $1,300,000:

33. See id. § 312(n) (“Adjustments to earnings and profits to more accurately reflect economic gain and loss.”).
34. Id. § 312(k).
35. In discussions of budgets, all references to years mean fiscal years unless otherwise noted.
37. Id. at 13.
38. Id.
39. Although the corporate income tax rate schedule is progressive and contains four tax brackets and two surcharges, the President’s proposal, like the Treasury Department’s dividend exclusion prototype, sought to simplify the EDA calculation by assuming that all corporate taxable income is taxed at the top rate (currently 35%). See I.R.C. § 11(b). As a result of the surcharges, for every corporation with taxable income in excess of $18,333,333, the tax liability before adjustments for credits and penalty taxes may be calculated by multiplying the taxable income by 35%.
Each year, shareholders would be able to exclude dividends received from the corporation to the extent of the corporation’s EDA. In Example 2, GHI’s shareholders would be able to exclude from their gross income up to $1,300,000 in dividends distributed by the corporation in 2006. But what would happen if GHI chose to distribute only $1,000,000 in dividends during calendar year 2006? Because dividend distributions would reduce the EDA on a dollar-for-dollar basis, there would still be an EDA at the end of 2006. Under the proposal, any unused EDA generally could not be carried over to 2007.40 To prevent the permanent loss of a potential $300,000 tax benefit to GHI shareholders, the proposal permitted GHI to report to the shareholders that they should increase the basis of their GHI stock by a total of $300,000.41 The Administration’s proposal required a corporation to keep track of the total of such basis adjustments in a Cumulative Retained Earnings Basis Adjustment (CREBA) account.42

Permitting an increase in basis would accomplish two objectives. First, it would prevent earnings retained in the business from being taxed a second time when the shareholder sold the stock. As noted above, the retained earnings would increase the firm’s net assets, and thus the amount realized by the shareholder on a sale of the stock. Since a gain or loss on the sale is determined by subtracting the shareholder’s basis in the stock from the amount realized on the sale, the retained earnings would either increase the gain or decrease the loss the shareholder reported. An increase in basis for a proportionate share of the corporation’s earnings would offset the impact of those earnings on the amount realized. Second, the basis adjustment would allow corporate managers to focus on economic considerations—not simply tax considerations—in setting dividend policy.

If a corporation distributed dividends in excess of its EDA in a given year, the proposal specified how distributed amounts should be treated by the corporation and its shareholders. First, the corporation would reduce its EDA to zero.43 Shareholders would exclude an amount of dividends equal to the EDA from their gross income. Sec-

41. Id. at 13–14. GHI would use a Form 1099 to report to each shareholder the amount of the shareholder’s excludable dividends and basis adjustments. Id. at 19.
42. Id. at 14–15.
43. Id. at 15.
ond, the corporation would use the excess of the dividends paid over
the EDA to reduce its CREBA, but not below zero. The corporation
would have to advise shareholders to reduce the basis of their stock. The total amount by which shareholders would reduce their basis would equal the amount by which the corporation reduced its CREBA, but no shareholder could reduce the basis below zero. If the basis reduction reported by the corporation exceeded the shareholder's basis, the shareholder would have to report capital gain. Third, if the total dividends distributed exceeded the sum of the EDA and the CREBA, the excess would be treated by shareholders as taxable dividends. The taxable dividends would be taxed at each shareholder's marginal tax rate for ordinary income. The following example illustrates how these provisions operate:

**EXAMPLE 3**

Assume that, in 2006, GHI Corporation from Example 2 (1) had an EDA of $1,300,000, (2) distributed $1,000,000 in dividends, (3) reported to shareholders that they should increase their basis by a total of $300,000, and (4) had a CREBA at the end of 2006 of $500,000.

In 2007, GHI had $400,000 in EDA and distributed $1,000,000 in dividends to its shareholders. At all times in 2006 and 2007, there were 100,000 shares of outstanding stock. One shareholder, M, bought 100 shares for $20 each on January 2, 2006 and held those shares throughout 2006 and 2007.

2006:

The corporation would have advised the shareholders to increase their basis by $3.00 per share ($300,000 total increase in basis + 100,000 shares outstanding). Shareholder M would have increased the basis from $20 to $23 per share.

2007:

(1) GHI would reduce its EDA to zero. Its shareholders would exclude the first $400,000 of dividends received from their gross income.

(2) GHI would reduce its CREBA to zero. It would then advise shareholders that they must reduce the basis of their stock. As the CREBA was reduced by $500,000, shareholders would

44. *Id.*
46. *Id.*
47. *Id.*
48. *Id.* This assumes that the distributions in excess of the EDA and CREBA would be deemed to have been made from the corporation's current or accumulated earnings and profits. *See supra* note 32 and accompanying text.
have to reduce their basis by $500,000. The basis reduction per share would be $5.00. Shareholder M reduces the basis from $23 per share to $18 per share.

(3) GHI's dividends of $1,000,000 exceed the sum of the EDA and CREBA by $100,000. The $100,000, or $1.00 per share, must be treated as taxable dividends by the shareholders. Shareholder M has $100 in taxable dividends that must be reported as ordinary income.

In addition to economic efficiency, the President's proposal stated that ending double taxation would "reduce incentives for certain types of corporate tax planning" and "enhance corporate governance by eliminating the current bias against the payment of dividends."

The logic of the latter statement is that increased dividends reduce the financing of investments with retained earnings, which often receive less scrutiny than investments funded by new equity or debt financing.

The President's proposal might have accomplished the goal of taxing corporate income "once and only once," but achieving this goal would come at a high price. The proposal estimated a reduction in revenue of $152.7 billion over the five-year period, 2004–2008, and $385.4 billion over the ten-year period, 2004–2013. The drastic reduction in tax revenues, and the complexity of administering the basis adjustments, led Congress to draft the current version of § 1(h)(11), which taxes qualified dividends at a maximum rate of 15%.

### III. Qualified Dividends Are an Inadequate Substitute for Integration

As the Treasury Department noted in its 1992 study, integration of the corporate and individual tax systems would lessen, if not eliminate, the distortions caused by the classical corporate tax structure, including the misallocation of capital between corporate and noncorporate sectors, the preference for debt over equity in financing new investments, and the preference for retaining earnings rather than distributing dividends. The study also indicated that integration might be necessary to prevent American corporations from being placed at a competitive disadvantage, because many U.S. trading part-

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50. Id. at 11–12.
51. Id. at 12.
52. Id. at 22.
ners have already changed their tax systems to achieve some degree of integration.\textsuperscript{54}

This Part focuses on the dividend tax cut as a means of achieving the integration of corporate and individual tax systems. Consistent with the principle that corporate income should be taxed fully at least once, the tax on such income must be paid either at the corporation's marginal tax rate when the income is earned, or at the individual shareholder's marginal tax rate when the corporation distributes the income in the form of a dividend. Applying this standard, it is clear that the dividend tax cut is a flawed device for achieving integration.

While corporations with taxable income in excess of $10 million are subject to a marginal income tax rate of 35\%, a study by the General Accounting Office (GAO)\textsuperscript{55} and a joint study by the Citizens for Tax Justice and the Institute on Taxation and Economic Policy\textsuperscript{56} have shown that a significant number of corporations reporting pre-tax income in excess of $10 million in their financial statements are reporting little or no corporate income tax liability. The GAO compared the tax liabilities reported by U.S.-controlled corporations (USCCs) with those reported by foreign-controlled corporations (FCCs) during the period 1996–2000.\textsuperscript{57} The GAO found, on average, that 61\% of USCCs and 71\% of FCCs reported no tax liability during the years studied.\textsuperscript{58} The GAO also examined the data for "large" USCCs and FCCs, which were defined as companies with $250 million in assets or $50 million in gross receipts in constant 2000 dollars.\textsuperscript{59} According to the GAO, large corporations comprised only 1\% of all corporations in the study but accounted for "over 93 percent of all assets reported on corporate returns."\textsuperscript{60} On average, 38\% of large USCCs and 32\% of large FCCs reported no tax liability during the years 1996–2000.\textsuperscript{61}

\textsuperscript{54} Id. at 1–2.


\textsuperscript{57} See GAO, TAX ADMINISTRATION, supra note 55, at 2. A foreign-controlled corporation "is either a foreign corporation or a U.S. corporation with 50 percent or more of its voting stock owned by a foreign person or entity." Id. at 3.

\textsuperscript{58} Id. at 2.

\textsuperscript{59} Id. app. I at 17 tbl.6.

\textsuperscript{60} Id. at 2.

\textsuperscript{61} Id. app. I at 17 tbl.6.
The joint study by Robert McIntyre (of the Citizens for Tax Justice) and T.D. Nguyen (of the Institute on Taxation and Economic Policy) focused on a sample of 275 firms selected from Fortune's 2004 list of the 500 largest corporations in America that were profitable during all three years of the period, 2001–2003. Together, the 275 companies reported nearly $1.1 trillion in pre-tax profits to their shareholders over the three years. If they had paid tax at the statutory rate of 35% on these financial statement profits, these companies "would have paid $370 billion in income taxes over the three years." McIntyre and Nguyen determined that these corporations paid just over half that amount, and that their effective tax rate over the three years was only 18.4%. A further breakdown of the data reveals a significant decline in the effective tax rate for the 275 companies, from 21.4% in 2001 to 17.2% in 2002–2003.

McIntyre and Nguyen also discovered that, despite being profitable in each of the three years, 82 of the companies either reported no tax liability or received tax refunds in at least one of the three years. In the years that these companies reported no liability or received refunds, they reported pre-tax financial accounting income of $102 billion. But rather than pay a total of $35.6 billion in taxes at the 35% statutory rate, these companies actually received refunds totaling $12.6 billion. Further, the trend in reporting pre-tax profit to shareholders while reporting no tax liability appears to be on the rise. McIntyre and Nguyen noted that the number of companies so situated in the study increased from 33 in 2001 to 46 in 2003.

Given the differences in measuring corporate income between generally accepted accounting principles and the Internal Revenue Code, the dichotomy between corporate financial statements and tax returns established by the two studies will likely persist. For example, while corporations may record depreciation on a straight-line basis in deter-

62. See McIntyre & Nguyen, supra note 56, at 1.
63. Id.
64. See supra note 39.
65. See McIntyre & Nguyen, supra note 56, at 4.
66. Id.
67. Id. at 3.
68. Id. Although a corporation may report financial accounting profit in the current year, it is possible that the corporation may report a loss on its income tax return and be able to carry the loss back to a period in which it reported taxable income and paid taxes. See I.R.C. § 172 (West 2006). The tax loss carryback results in the government issuing a full or partial refund of taxes paid in a prior tax year. See id. § 6511(d)(2).
69. See McIntyre & Nguyen, supra note 56, at 3.
70. Id.
71. Id.
mining accounting income, § 168 permits them to expense the cost of equipment used in the business more rapidly for tax purposes.\textsuperscript{72} Similarly, the deduction for qualified production activities under § 199 lowers taxable income but not accounting income.\textsuperscript{73}

But the differences in income measurement are not the only causes of the discrepancy. Corporations can avail themselves of numerous tax credits, which may completely offset the tentative tax liability determined by applying the statutory 35% rate to the corporation's taxable income.\textsuperscript{74} Some of the activities that qualify for credits include increasing research activities, providing child care for employees, providing affordable housing, and producing electricity from renewable resources. As noted by McIntyre and Nguyen, some corporations have become the "unexpected beneficiaries" of these credits.\textsuperscript{75} For instance, Marriott International operated four coal-based synthetic fuel facilities and received credits of $159 million in 2002 and $233 million in 2003, while Kimberly-Clark and Clorox saved $115 million and $36 million, respectively, through investments in affordable housing.\textsuperscript{76}

Based on these studies and the current structure of the corporate tax system, it is clear that a substantial number—if not the majority—of large publicly held corporations will not pay income tax at their marginal rate. In many cases, in order for corporate income to be taxed fully at least once, it would have to be taxed at the shareholder's marginal tax rate. The qualified dividend income provisions, however, ensure that dividends are taxed at rates lower than the shareholder's marginal tax rate for ordinary income (either 5% or 15%).\textsuperscript{77} As a result, the qualified dividend provision violates the principle of taxing income fully at least once. Based on the studies, it would be possible for a significant number of corporations to avoid having income taxed at the corporate level and instead be taxed only once, at a maximum rate of 15%.

Because the income of many corporations is taxed at only 15%, while the income of noncorporate pass-through entities is taxed at the marginal rates of their owners, capital for funding new projects could now be misallocated in favor of the corporate sector. As many noncorporate entities are small entrepreneurial businesses that gener-

\textsuperscript{72} I.R.C. § 168.
\textsuperscript{73} Id. § 199.
\textsuperscript{74} See id. §§ 38–45F (falling under the heading "Subpart D—Business Related Credits").
\textsuperscript{75} See McIntyre & Nguyen, supra note 56, at 10.
\textsuperscript{76} Id.
\textsuperscript{77} See supra note 19.
ate employment and technological innovation, such a misallocation would have negative consequences for the economy. Thus, just as double taxation constitutes bad policy because of the distortions it causes in capital allocation, taxing corporate income at lower rates compared to other forms of business enterprise may also be unwise policy.

IV. The Impact of the Dividend Tax Cut on Economic Growth

The Bush Administration has argued that the dividend tax cut should become permanent because it has promoted strong economic growth over the past three years and will continue to do so in the future. To evaluate the merits of this argument, this Part begins with a discussion of the Administration’s assessment of the dividend tax cut. Next, two competing views of dividend taxation—the old view and the new view—are presented. These views have significant implications for dividend tax policy. Finally, this Part examines the likely effects the dividend tax relief has had in the short run, and would have in the long run, if it were extended permanently.

A. The Bush Administration’s Assessment

In 2006, the Administration issued three key reports to support its economic argument in favor of the dividend tax cut. The Treasury Department issued the first of these reports in March,78 in conjunction with a conference it hosted on “preserving the lower tax rates on dividends and capital gains.”79 The second report was the Mid-session Review of the 2007 budget released by the Office of Management and Budget (OMB) on July 11, 2006.80 The third report,81 a “dynamic analysis” of the long-term economic effects of the tax breaks under JGTRRA and the Economic Growth and Tax Relief Reconciliation

Act of 2001 (EGTRRA), was released by the Treasury Department on July 25, 2006.


According to the Treasury Department, the purpose of the dividend and capital gains tax cuts was to eliminate the double taxation of corporate income. By reducing marginal effective tax rates on corporate income, the cuts would also reduce the cost of capital for the corporate sector and the economy as a whole, leading to increases in investment, capital formation, and labor productivity over the long term. Eliminating double taxation would result in a more efficient allocation of capital between the corporate sector and other sectors of the economy; it would reduce the corporate bias toward financing projects with debt rather than equity, as well as the bias toward retaining earnings rather than distributing dividends. Based on the findings of the Treasury Department’s 1992 study, the gain in efficiency and the reduction in bias could eventually increase economic welfare by as much as “0.5 percent of national consumption, or about $43 billion per year (in 2005 dollars).” But the Treasury Department recognized that the two tax cuts did not completely eliminate double taxation, so “the economic gains [would be] likely smaller than estimated in the 1992 Treasury Integration Study.”

After discussing the economic rationale for the cuts, the Treasury Department turned to the performance of the economy since the cuts were enacted. First, it noted that dividends paid by companies included in the Standard and Poor’s 500 Index (S&P 500) totaled $203 billion in 2005, representing a 36.5% increase from the amounts distributed in 2002. In addition, the S&P 500 rose approximately 40% in the three years following the announcement of the President’s pro-

83. U.S. Dep’t of the Treasury, Investing in America’s Future, supra note 7, at 3.
84. Id. at 3–5.
85. Id. at 5–6; see also supra notes 25–30 and accompanying text.
86. U.S. Dep’t of the Treasury, Investing in America’s Future, supra note 7, at 6.
87. Id.
88. Id. at 8.
posals to alleviate double taxation. While the Treasury Department acknowledged that many factors contributed to the stock market gain, it stated that "the dividend and capital gains tax cuts likely played an important role," citing a study that estimated a 6% increase in aggregate market value due to the two provisions.

Next, the Treasury Department examined growth in real private nonresidential investment. While such investment had declined for nine consecutive quarters prior to the second quarter of 2003, it grew at an average annualized rate of 8.7% over the next eleven quarters (from the second quarter of 2003 through the fourth quarter of 2005). But the Treasury Department admitted that it could not identify the precise impact of the dividend tax cut because other factors could have influenced investment, including tax breaks such as bonus depreciation. Furthermore, it acknowledged that dividend taxation may not affect the investment decisions of corporations that finance projects through retained earnings, which would lessen the impact of the dividend tax cut on investment growth throughout the economy.


91. Id. On July 28, 2006, the Bureau of Economic Analysis released its annual revision of the national income and product accounts (NIPAs), which affected quarterly estimates of GDP, corporate profits, and personal income for the first quarter of 2003 through the first quarter of 2006. See Press Release, Bureau of Econ. Analysis, U.S. DEP'T OF COMMERCE, NATIONAL INCOME AND PRODUCT ACCOUNTS 4 (July 28, 2006), http://www.bea.gov/bea/newsrelarchive/2006/gdp206a.pdf [hereinafter Press Release, National Income]. The tables contain the previously published estimates as well as the revised estimates. Based on an arithmetic average of the revised growth rates, real private nonresidential investment grew at an average annualized rate of 6.6% during the eleven-quarter period, rather than 8.7%. See id. at 11 tbl.1A.

92. The Job Creation and Worker Assistance Act of 2002 (JCWAA) permitted taxpayers, in the year they placed certain qualified property in service, to deduct 30% of the property's adjusted basis in addition to the depreciation deduction which would otherwise be allowable under other provisions of Chapter 1 of the Internal Revenue Code. Pub. L. No. 107-147, § 101(a), 116 Stat. 21, 22 (2002). Taxpayers would subtract the 30% "bonus" depreciation from the adjusted basis to calculate the remaining basis that would be subject to the regular depreciation deduction. Id. Generally, property was qualified if it had been acquired between September 10, 2001, and September 11, 2004, and placed in service before January 1, 2005. Id. at 23. JGTRRA increased the bonus depreciation to 50% of the adjusted basis for property acquired between May 5, 2003 and January 1, 2005, and placed in service before January 1, 2005. Pub. L. No. 108-27, § 201(a), 117 Stat. 752, 756 (2003).

93. U.S. DEP'T OF THE TREASURY, INVESTING IN AMERICA'S FUTURE, supra note 7, at 9-10. The Treasury Department is alluding to the fact that in corporate finance and economics, there are two views of the effects of dividend taxation—an old view and a new view. Firms that finance their projects through retained earnings fit within the new view. For a discussion of the two views and their implications for dividend tax policy, see infra Part IV.B.
Finally, the Treasury Department looked at the growth in GDP and employment. It found that GDP grew at an average annualized rate of 3.9% in the ten quarters following the enactment of JGTRRA (from the third quarter of 2003 through the fourth quarter of 2005), a rate which was “dramatically” faster than the average annualized rate of 1.1% for the nine quarters preceding enactment (from the first quarter of 2001 through the first quarter of 2003). With respect to employment, “approximately 4.7 million jobs have been created since JGTRRA became law.” Again, the Treasury Department could not separate the effects of cutting dividend and capital gains taxes from other factors that might have influenced either GDP or employment. It concluded, however, that the dividend and capital gains tax cuts “likely contributed” to the accelerated growth in GDP.

2. OMB’s Mid-session Review

With the release of the Mid-session Review in July 2006, the OMB announced that it projected the budget deficit for 2006 to be $296 billion, or $127 billion lower than the $423 billion forecasted in February 2006. The improvement was due primarily to a $115 billion increase in expected total tax receipts, reflecting higher-than-anticipated collections of corporate and individual income taxes in the first eight months of 2006. While the OMB credited the President’s tax policies for “stimulating and sustaining a strong economy,” it provided no data or analysis of the effects the dividend tax cut has had on economic growth.

But the Mid-session Review is a pivotal report in the campaign to extend the dividend tax cut, as well as the other EGTRRA and JGTRRA tax breaks, for two reasons. First, its revenue projections revived the debate about whether the government is collecting more tax receipts than it would if the tax cuts had not been enacted. The tax...
cuts, in other words, might be paying for themselves. Second, the *Mid-session Review* indicated that the Treasury Department had conducted a dynamic analysis and determined that, if the EGTRRAA and JGTRRA provisions were made permanent, national income could increase by 0.7% in the long run.

3. *The Treasury Department's Dynamic Analysis*

When the Joint Committee on Taxation (JCT) and the Treasury Department’s Office of Tax Analysis prepare official revenue estimates for a tax proposal, they assume that the tax changes do not affect GDP. Thus, the process of developing these estimates is sometimes referred to as “static scoring.” To gauge the changes in gross national product (GNP), investment, employment, and other major macroeconomic variables attributable to the extension of the tax cuts, the Treasury Department conducted a so-called dynamic analysis.

The Treasury Department assumed that the decline in tax revenues over the ten-year budget window (2007–2016 for the 2007 budget) would be financed through the issuance of additional government debt. Starting in 2017, the tax cuts would have to be financed by one of two mechanisms: (1) adjusting government consumption spending to freeze the government debt-to-GNP ratio at the level that

100. At the press conference on the *Mid-session Review*, the President made the following statement: “Some in Washington say we had to choose between cutting taxes and cutting the deficit. . . . Today’s numbers show that that was a false choice. The economic growth fueled by tax relief has helped send our tax revenues soaring.” News Release, Office of the Press Sec’y, President Discusses Mid-session Review (July 11, 2006), http://www.whitehouse.gov/news/releases/2006/07/20060711-1.html. The Center on Budget and Policy Priorities noted this comment and other remarks by the President and Vice President in its analysis of the issue. See Richard Kogan & Aviva Aron-Dine, CTR. ON BUDGET & POL’Y PRIORITIES, CLAIM THAT TAX CUTS “PAY FOR THEMSELVES” IS TOO GOOD TO BE TRUE: DATA SHOW NO “FREE LUNCH” HERE 1 (2006), available at http://www.cbpp.org/3-8-06tax.pdf.

101. OFFICE OF MGMT. & BUDGET, supra note 80, at 3–4. The analysis did not incorporate the permanent repeal of the estate tax. See infra note 107 and accompanying text.


103. Id. (internal quotation marks omitted). However, the JCT and the Office of Tax Analysis do incorporate microeconomic behavioral changes into their analysis; these include shifts in the timing of income and shifts in compensation from nontaxable fringe benefits to taxable wages. Id. at 3. Economist Jason Furman believes that a more appropriate description of estimating revenues associated with tax proposals would be “dynamic micro, although static macro scoring.” Id. at 4 (internal quotation marks omitted).

104. See OFFICE OF TAX ANALYSIS, DYNAMIC ANALYSIS, supra note 81. While foreign investment in the domestic economy would cause an increase in GDP, some of the increase would have to be returned to the foreign providers of capital. Therefore, the Treasury analyzed changes in real GNP because it “more accurately reflects the resources available to U.S. citizens.” Id. at 10 n.21.

105. Id. at 6.
would exist in 2017, or (2) adjusting all income tax rates proportionally in each period after 2016 to freeze the government debt-to-GNP ratio at the level that would exist in 2017.106

The Treasury Department separated the tax breaks into three groups to identify the economic effects: (1) the dividend and capital gains tax cuts; (2) the reduction in the top four tax rates on ordinary income for individuals; and (3) the child tax credit of $1,000, the reduction in marriage penalties, and the 10% tax rate on ordinary income.107 The groups were tested on a cumulative basis (the first group alone, followed by the first and second groups, and then all three groups) under each of the two financing options mentioned above.

The report indicates that if the tax cuts were financed with a reduction in government spending starting in 2017, then extending the dividend and capital gains tax cuts would increase real GNP by 0.4% in the long run.108 This means that at some point in the future,109 GNP would be higher by approximately $50 billion dollars (in 2006 dollars) each year in perpetuity as a result of making the cuts permanent.110 If the two tax cuts were financed through a tax increase starting in 2017, real GNP would increase 0.3% in the long run.111 The report also shows that if the three groups of tax cuts were permanently extended, real GNP would increase by 0.7% in the long run, as long as the cuts were financed through a spending reduction.112 On the other hand, if the cuts were financed through a tax increase, real GNP would decrease by 0.9%.113

106. Id. at 6–7.
107. Id. at 6. The Treasury Department did not include the permanent repeal of the estate tax, which is part of the President’s budget proposal for 2007. Id. at 6 n.6. It stated that “[t]here is considerable uncertainty regarding the likely behavioral responses to repealing the estate tax,” and its inflexible model was not very capable of capturing the likely range of responses. OFFICE OF TAX ANALYSIS, DYNAMIC ANALYSIS, supra note 81, at 6 n.6.
108. Id. at 10, 20 tbl.3.
109. The report does not specify what is meant by the long run. It could take twenty years or more to achieve the additional GNP.
111. OFFICE OF TAX ANALYSIS, DYNAMIC ANALYSIS, supra note 81, at 20 tbl.3.
112. Id.
113. Id.
B. The Old View and the New View of Dividend Taxation

Because the analyses prepared by both the Administration and the opponents of extending the tax cuts rarely focus on the economic impact of the dividend tax cut alone, this Article will evaluate the dividend tax cut in terms of its likely effects in both the short run and the long run. To do this, it is necessary to understand two different views of dividend taxation that have developed in corporate finance and economics—the old view and the new view. The theories were developed to explain why corporations would distribute dividends, which were taxed more heavily as ordinary income than long-term capital gains on retained earnings.

1. The Old View

Under the old view, corporations obtain marginal funds for investment by issuing new shares, so they must distribute dividends to attract shareholders. Dividends offer non-tax benefits, such as signaling a firm's profitability and restricting managerial discretion, and the old view assumes that "firms [will] pay dividends until the tax cost on the last dollar of dividends paid exactly equals the non-tax benefit." The old view predicts that when the tax burden on dividends declines relative to capital gains, corporations will increase their dividend payments.

The old view also holds that a reduction in the dividend tax rate would lower the user cost of capital and thus increase investment and capital formation. While share prices could rise in the short

114. The old view is frequently referred to as the traditional view, while the new view is sometimes referred to as the "trapped equity" or "tax capitalization" view. See Steven A. Bank, Dividends and Tax Policy in the Long Run 28-29 (Am. Law & Econ. Ass'n, Working Paper No. 8, 2006), available at http://ssrn.com/abstract=886583.
117. Id. at 31.
118. Id.
119. Economists William Gale and Peter Orszag define the user cost of capital as "the minimum rate of return a corporation needs on an investment to break even—that is, to cover the costs of the asset's depreciation, to pay the associated taxes on the investment, and to compensate the investors for the funds they provide." William G. Gale & Peter Orszag, Deficits, Interest Rates, and the User Cost of Capital: A Reconsideration of the Effects of Tax Policy on Investment 1-2 (Urban-Brookings Tax Pol'y Ctr., Discussion Paper No. 27, 2005), available at http://www.urban.org/UploadedPDF/311211_TPC_DiscussionPaper_27.pdf [hereinafter Gale & Orszag, The User Cost of Capital].
run, a lower marginal return on the increased capital would sufficiently offset the dividend tax reduction, and share prices would return to their equilibrium level.\textsuperscript{121}

2. The New View

Under the new view, retained earnings—rather than new shares—provide the marginal funds for investment.\textsuperscript{122} The new view holds that “dividends offer no non-tax benefits,” but are “the only means of distributing funds to shareholders.”\textsuperscript{123} In addition, “all profits of the firm will eventually be distributed to the shareholders and be subject” to the dividend tax.\textsuperscript{124} Therefore, the cost of the dividend tax is capitalized into the firm’s share price.\textsuperscript{125}

If the dividend tax rate were reduced, the new view predicts that the reduced tax rate would neither lower the cost of capital nor increase the amount of investment.\textsuperscript{126} Furthermore, share prices would rise because the previously capitalized dividend taxes would be eliminated, resulting in a one-time windfall to the existing shareholders.\textsuperscript{127} With respect to dividends, the new view would not predict any change in payout policies as a result of a permanent rate cut.\textsuperscript{128} On the other

\textsuperscript{121} Auerbach & Hassett, \textit{supra} note 120, at 119.
\textsuperscript{122} \textit{Id.}
\textsuperscript{123} Carroll et al., \textit{supra} note 115, at 632.
\textsuperscript{124} Bank, \textit{supra} note 114, at 33.
\textsuperscript{125} See \textit{id.}
\textsuperscript{126} \textit{See Auerbach & Hassett, supra note 120, at 119.}
\textsuperscript{127} Carroll et al., \textit{supra} note 115, at 638.
\textsuperscript{128} \textit{Id.} at 633; Bank, \textit{supra} note 114, at 33–34. Professor Bank offers an excellent example, derived from an American Law Institute report, to illustrate that shareholders would be indifferent between receiving a dollar of dividends today and a future dividend equal to the dollar plus the amount earned on that dollar. \textit{Id.} at 34–36. He assumes that “a corporation has $100 in post-tax earnings in Year 1.” \textit{Id.} at 34. The corporation could distribute the $100 currently, or retain the $100 for investment and distribute both the $100 and the earnings from the $100 at some point in the future. \textit{Id.} The corporate and shareholder tax rates for both dividends and ordinary income are assumed to be 30% and the pre-tax rate of return both inside and outside the corporation is 10%. \textit{Id.} If the corporation distributes the dividend currently, the shareholders would receive $100 and pay $30 in tax, leaving the shareholders with $70 after tax. \textit{Id.} at 35. Each year, the shareholder would earn a 10% return before tax and 7% after tax. Bank, \textit{supra} note 114, at 35. To determine how much the shareholder would have accumulated after tax at the end of ten years, the $70 would be multiplied by 1.07\textsuperscript{10}. \textit{Id.} & n.164. The shareholder would have approximately $138 after tax at the end of ten years. \textit{Id.} at 35.

If the corporation retained the $100, it would earn 10% before tax and 7% after tax each year. \textit{Id.} at 34–35. To determine how much the corporation would have after ten years, the $100 would be multiplied by 1.07\textsuperscript{10}. \textit{Id.} at 35 & n.164. The corporation would have accumulated $197 at the end of ten years. \textit{Id.} at 34–35. Assuming it distributed the $197, the shareholders would have to pay a 30% tax, or slightly over $59, and would have approximately $138 after tax. Bank, \textit{supra} note 114, at 35. Thus, the shareholders should be indifferent between the two options and the dividend tax rate should not affect dividend payout policies as long as it is permanent. \textit{Id.} at 34.
hand, the new view would foresee an increase in dividend payments if the dividend tax rate was reduced temporarily.\textsuperscript{129}

3. \textit{The Prevailing View?}

Each view has its theoretical drawbacks. Critics of the old view point out that, contrary to its assumption about the marginal source of investment funds, corporations rarely issue new shares.\textsuperscript{130} On the other hand, in light of the widespread practice of repurchasing shares, many economists dismiss the new view because it assumes that firms must pay dividends to distribute their profits.\textsuperscript{131} Empirical studies have not been able to settle the debate.\textsuperscript{132} This is especially true of the studies conducted to determine the response of dividend payments and share prices to the 2003 dividend tax cut. Even if there was a consensus that dividend payments increased as a result of the tax cut, the issue of the old view versus the new view would still be unresolved.\textsuperscript{133} As discussed above, an increase in dividend payments in

\begin{itemize}
\item \textsuperscript{129} See Bank, supra note 114, at 35–36. This can be illustrated by making one minor modification to the example in note 128. The tax rate on dividends is assumed to be 30\% for Years 1–9 and then increased to 50\% for Year 10. \textit{Id.} at 35. It is also assumed that all parties are aware of this rate increase at the beginning of Year 1. \textit{Id.} If the corporation distributes the $100 to the shareholders at the beginning of Year 1, then the shareholders would still have $138 as in the previous example. \textit{Id.} If the corporation were to retain the $100 and invest it to earn 10\% before tax and 7\% after tax, it still would have accumulated $197 at the end of ten years. \textit{Id.} at 35–36. But when the shareholders receive the $197, they would have to pay tax of $98.50, or 50\% of the $197. \textit{Id.} at 36. The shareholders would be left with $98.50. Bank, supra note 114, at 36. In this case, the shareholders would prefer to have the corporation distribute the dividend in any of the years prior to Year 10 when the tax rate increases. \textit{Id.} at 35–36. Thus a temporary change in dividend tax rates, 30\% for nine years in this case, could affect the amount of dividends paid, even under the new view.

\item \textsuperscript{130} See Carroll et al., supra note 115, at 633; Bank, supra note 114, at 33.

\item \textsuperscript{131} See Carroll et al., supra note 115, at 633; Bank, supra note 114, at 37–38.

\item \textsuperscript{132} Carroll et al., supra note 115, at 633.

\item \textsuperscript{133} There is no consensus as to the tax cut’s impact on dividend payouts. Professor James Poterba determined that the long-run level of dividends would increase by 31\% above the 2002 level as a result of JGTRRA, but, under his model, only one-quarter of this effect should have occurred three years after the tax cut. Poterba, supra note 90, at 174. Professors Raj Chetty and Emmanuel Saez estimated that “nonfinancial, nonutility public corporations increased [their dividend payments] by 20\% within six quarters after the reform.” Raj Chetty & Emmanuel Saez, \textit{Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut}, 120 Q.J. \textit{Econ.} 791, 828 (2005). Chetty and Saez also noted that the dividend response occurred more quickly than would have been projected under the old view, which envisions a supply-side response leading to increased business activity and dividends in the long run. \textit{Id.}

Professor Jennifer Blouin and her colleagues found that there was an increase in the amount and frequency of regular quarterly dividends following the enactment of JGTRRA. Jennifer L. Blouin et al., The Initial Impact of the 2003 Reduction in the Dividend Tax Rate 15 (Oct. 2004) (unpublished manuscript), available at http://ssrn.com/abstract=462542. However, because they could not find a strong relationship between changes in dividend payouts and corporations with a high percentage of shares held by individuals or corporate insiders, the authors could not
response to a temporary dividend tax cut would be possible under the new view as well as the old view.\textsuperscript{134} Turning to studies of stock prices, Professor Alan Auerbach and Economist Kevin Hassett found that the dividend tax cut significantly affected equity markets; some firms behaved in conformity with the new view, while other firms behaved consistently with the old view.\textsuperscript{135} Mature firms (those firms that pay dividends and rarely issue shares) experienced increases in share prices without a reduction in the cost of capital, which is consistent with the new view.\textsuperscript{136} The tax cut appeared to encourage these firms to pay dividends rather than to increase investment.\textsuperscript{137} But immature firms (those that had never paid a dividend) and dividend-paying firms likely to issue new shares saw their share prices increase, and may have experienced a reduction in their cost of capital that encouraged them to invest.\textsuperscript{138} This response is consistent with the old view.\textsuperscript{139}

4. Tax Policy Implications

So what are the implications of the old and new views for tax policy? If the old view more accurately reflects corporate behavior, a reduction in the dividend tax rate should lower the cost of capital for the corporate sector and increase investment. Furthermore, as the cost of capital is lowered for the corporate sector, capital should be more efficiently allocated between the corporate and noncorporate sectors, resulting in gains for the economy.\textsuperscript{140} If the new view is the more accurate model, however, a reduction in the dividend tax rate would have no effect on either the corporate sector's cost of capital or investment.\textsuperscript{141} In addition, if the dividend tax has no effect on the corporate sector's cost of capital, there would be no reallocation of capital between sectors and no efficiency gains.\textsuperscript{142} The U.S. economy conclude the increased payouts were related to the tax rate reductions rather than nontax factors such as an expanding economy. \textit{Id.} at 21, 26.

Researcher Brandon Julio and Professor David Ikenberry determined that the dividend tax cut could only partly explain increased dividend payouts after JGTRRA because dividends had begun to rebound two to three years before any discussion of the tax cut. Brandon Julio & David L. Ikenberry, \textit{Reappearing Dividends}, 16 J. APPLIED CORP. FIN. 89, 93-95 (2004).

\textsuperscript{134} \textit{See supra} note 129 and accompanying text.
\textsuperscript{135} Auerbach & Hassett, \textit{supra} note 120, at 123.
\textsuperscript{136} \textit{Id.} at 119-20, 123.
\textsuperscript{137} \textit{Id.} at 120.
\textsuperscript{138} \textit{Id.} at 122-23.
\textsuperscript{139} \textit{Id.} at 123.
\textsuperscript{140} \textit{See supra} notes 85-86 and accompanying text.
\textsuperscript{141} \textit{See supra} note 126 and accompanying text.
might be a hybrid of old view and new view firms; there could be some old view firms increasing investment and efficiency gains from the reallocation of capital among sectors as a result of the dividend tax cut.

C. The Short-Term Effects of the Dividend Tax Cut

The Treasury Department has claimed that the dividend and capital gains tax cuts have significantly contributed to growth in real private nonresidential investment and GDP since the passage of JGTRRA.\footnote{143} Because the Treasury Department has offered little actual data to support this claim, one must use economic theory and literature to evaluate its merits.

1. Theory of Short-Term Economic Stimulus

To stimulate economic growth in the short run, fiscal policy must increase aggregate demand, which is the sum of consumption, investment, and government spending.\footnote{144} With this objective in mind, three broad propositions are useful in selecting among policy alternatives. First, the most direct and effective way to increase aggregate demand is to increase government spending on goods and services.\footnote{145} Second, if tax cuts for individuals are used, then cuts aimed at lower-income individuals will be more effective than cuts targeting higher-income individuals, because the former group saves at a lower rate and spends a higher proportion of the cut.\footnote{146} Third, tax subsidies and corporate tax cuts used to encourage investment spending will be effective only if they require new spending to obtain the subsidy or make new investments more profitable.\footnote{147}

2. Application of the Theory to the Dividend Tax Cut

Measured against these standards, the dividend tax cut is a poor short-term stimulus. Higher income individuals have received the bulk of qualified dividends.\footnote{148} The savings rate for taxpayers in the

\footnote{143} See supra notes 91–96 and accompanying text. 
\footnote{145} Id. at 1–2. 
\footnote{146} Id. at 2. 
\footnote{148} For a discussion of the distribution of qualified dividends among various income levels, see infra Part V.
top 10% of the income distribution scale is more than ten times the rate in the bottom 20% of the scale, and is almost three times the rate of the average for all taxpayers.\textsuperscript{149} It appears unlikely that the dividend tax cut has been very effective in increasing consumption.\textsuperscript{150}

It also appears unlikely that the dividend tax cut did much to spur investment spending. The investment stimulus is indirect, with the tax benefit going to the individual shareholder rather than the firm.\textsuperscript{151} Further, the tax benefit goes largely to dividends paid out of earnings on existing capital rather than earnings from new investment.\textsuperscript{152} Finally, as Economists William Gale and Peter Orszag note, the effectiveness of the dividend tax reduction with respect to investment "depends on whether the old or new view holds."\textsuperscript{153} The number of firms falling under the new view could be quite significant, which would have weakened the tax cut's ability to influence their investment decisions.\textsuperscript{154}

While the economy grew more rapidly after JGTRRA became law, neither theory nor actual data can establish a causal link between the dividend tax cut and such growth. Many other factors, such as the Federal Reserve's expansive monetary policy that lowered interest rates to historic lows and improved cash flows for businesses, might explain the economy's improved performance since 2003.\textsuperscript{155}

These conclusions are in accord with Gale and Orszag's "bang for the buck" analysis.\textsuperscript{156} In weighing the effectiveness of tax cuts, they consider the increase in national output obtained for each dollar of tax revenue lost.\textsuperscript{157} When the dividend tax cut was being considered in 2003, it had a bang for the buck ratio of 0.10.\textsuperscript{158} Thus, the dividend tax cut was expected to provide only ten cents in additional output for each dollar of revenue lost.

\textsuperscript{149} Gravelle, Tax Cuts, supra note 147, at 3.
\textsuperscript{150} See Gravelle, Dividend Tax Relief, supra note 144, at 2.
\textsuperscript{151} Id.
\textsuperscript{152} See id. at 2–3.
\textsuperscript{154} See Carroll et al., supra note 115, at 633.
\textsuperscript{156} See Gale & Orszag, Economic Assessment, supra note 153, at 1215–20.
\textsuperscript{157} Id. at 1215.
\textsuperscript{158} Id. at 1219.
D. The Long-Term Effects of the Tax Cut

In the long run, economic policy aims to increase aggregate supply, which is the quantity of goods and services the economy is capable of producing on a sustainable basis. The key is to increase national saving, which provides funds for investment in productive capital stock such as equipment and structures. The Bush Administration maintains that lowering the dividend tax rate improves incentives for saving and investment; this should ultimately result in higher output and living standards. To support this claim, the Treasury Department performed a dynamic analysis concluding that GNP would, in the long run, be approximately $50 billion higher (in 2006 dollars) each year as a result of extending both the dividend and capital gains tax cuts.

To evaluate the Administration's position, this Section examines the impact of the dividend tax cut, first on national saving and then on investment. This Section concludes with a critique of the Treasury Department's dynamic analysis. As discussed below, when the impact of financing the tax cut with government debt is considered, the prospects of the dividend tax cut for increasing saving, investment, and output are far less promising than advertised by the Administration. National saving would decline as a result of deficit-financed tax cuts. Further, the interest rate on government debt would rise, increasing the cost of capital for firms throughout the economy and actually lowering investment in the long run.

1. National Saving

Lowering the tax rate on dividends raises the after-tax return on saving. As the after-tax reward for saving increases, some individuals will be willing to increase their saving and reduce their consumption pursuant to a so-called substitution effect. But other individuals would increase their consumption as a result of having higher after-tax income, both now and in the future, under the so-called income ef-

161. See supra note 108-110 and accompanying text.
The two effects largely offset each other, so the response of saving to a tax change is generally expected to be small. But the increase in private saving explains only part of the effect on national saving. If the government were to finance the tax cut by borrowing, national saving would decline to the extent that the increase in the deficit exceeded the increase in private saving. Economists estimate that private saving would generally offset between 20% and 50% of an increase in the deficit. Therefore, a deficit-financed tax cut, such as the dividend tax cut enacted in 2003, would reduce national saving. The decline in national saving translates into lower investment in capital stock, and ultimately to lower GDP and GNP.

Economist Jane Gravelle’s study of the President’s dividend relief proposal is consistent with this analysis. Over a range of assump-
tions regarding the response of private saving, Gravelle found that the dividend relief proposal would lower output (measured in terms of income available for consumption) by small amounts over one-year, five-year, ten-year, and twenty-year timeframes, as long as it was based on deficit finance.\textsuperscript{172} On the other hand, if the proposal were offset with spending cuts starting in the year it was implemented, then output would be unchanged over one-year and five-year timeframes and would show very slight increases over ten-year and twenty-year timeframes (0.03\% and 0.05\%, respectively).\textsuperscript{173} If eliminating the deficit by means of spending cuts were delayed for ten years, however, output would decrease for thirty-six years.\textsuperscript{174}

2. Investment

The cost a firm incurs to obtain funds for investment is known as the cost of capital. In economic terms, it is the minimum rate of return a firm needs to cover the cost of the asset’s depreciation, to pay taxes associated with the investment, and to compensate investors for providing funds.\textsuperscript{175} From this definition, it is clear that the cost of capital depends upon tax provisions and the alternative rates of return that providers of funds could achieve elsewhere in the economy.\textsuperscript{176} All things being equal, a tax rate reduction should lower the cost of capital; this is the primary economic justification for enacting the dividend tax cut.\textsuperscript{177}

Economists capture the tax component of the cost of capital in a formula known as the marginal effective total tax rate (METTR). The rate is “the proportion of the investment’s pre-tax return that is needed to cover the tax cost” and includes taxes at both the company and investor levels.\textsuperscript{178} The Treasury Department claimed that the dividend and capital gains rate cuts had lowered the METTR on an economy-wide basis by 1.8 percentage points, from a pre-JGTRRA level of 19.1\% to 17.3\%.\textsuperscript{179} For the corporate sector of the economy, it

\textsuperscript{172} Id. at 3-4 & tbl.1.
\textsuperscript{173} Id. at 5, 6 tbl.3.
\textsuperscript{174} Id.
\textsuperscript{175} Gale & Orszag, The User Cost of Capital, supra note 119, at 1-2.
\textsuperscript{176} The alternative rates of return that can be earned on the funds are the opportunity costs of those funds.
\textsuperscript{177} See U.S. DEP’T OF THE TREASURY, INVESTING IN AMERICA’S FUTURE, supra note 7, at 3-6.
\textsuperscript{178} Carroll et al., supra note 115, at 634. The Treasury Department refers to the rate as the marginal effective tax rate. U.S. DEP’T OF THE TREASURY, INVESTING IN AMERICA’S FUTURE, supra note 7, at 4 & tbl.1.
\textsuperscript{179} U.S. DEP’T OF THE TREASURY, INVESTING IN AMERICA’S FUTURE, supra note 7, at 4 & tbl.1. These figures are identical to those reported by Deputy Assistant Secretary for Tax Analy-
reported a decline in the METTR from 33.5% to 29.4% as a result of JGTRRA, while the rate in the noncorporate sector remained constant at 20.0%.\(^{180}\)

Based on these figures, it appears that in response to the reduced tax rates, the overall cost of capital would decline and investment would increase. As the gap in tax costs between the corporate and noncorporate sectors narrowed, it also appears that capital would be allocated more efficiently between the two sectors.

The Treasury Department’s report does not isolate the effects of the dividend tax cut from the capital gains tax cut. It is misleading in several other respects. The first is that the Treasury Department derived its estimates under the old view of dividend taxation rather than the new view.\(^ {181}\) Because the new view assumes that the cost of capital is not affected by changes in the dividend tax rate, the figures overstate JGTRRA’s impact on the METTR (and on the cost of capital as well) to the extent that American firms fit within the new view.\(^ {182}\)

The differences between the old view and the new view affect not only the expected increase in total investment, but also the reallocation of capital among sectors. The Treasury Department indicated that the efficiency gains from eliminating the bias against the corporate sector, as well as the corporate biases in favor of retaining earnings and financing with debt, could increase national income by as much as $43 billion (in 2005 dollars) per year in perpetuity.\(^ {183}\) It noted that the dividend and capital gains tax cuts did not totally eliminate double taxation, rendering the maximum gain unattainable.\(^ {184}\) The potential gain could also have been significantly overstated, because new view firms are not placed at a competitive disadvantage for capital by the dividend tax.\(^ {185}\)

\(^{180}\) U.S. DEPT’ OF THE TREASURY, INVESTING IN AMERICA’S FUTURE, supra note 7, at 4 & tbl.1.

\(^{181}\) See Office of Tax Analysis, Dynamic Analysis, supra note 81, at 4, 8; U.S. DEPT’ OF THE TREASURY, INVESTING IN AMERICA’S FUTURE, supra note 7, at 9-10.

\(^{182}\) See supra notes 119-120, 126 and accompanying text.

\(^{183}\) See supra notes 85-86 and accompanying text.

\(^{184}\) See supra note 87 and accompanying text.

\(^{185}\) See supra note 142 and accompanying text.
The most serious drawback to the analysis is that it focuses solely on the tax cost of investments and ignores the impact of the debt incurred to finance the EGTRRA and JGTRRA tax cuts. As government debt levels increase, interest rates on government debt (bonds) also increase, and the higher interest rates mean higher opportunity costs to investors who could buy the bonds. Investors then seek higher rates of return from the firms to which they provide funds. As investors’ required rates of return increase, so does the firms’ cost of capital.

In a study analyzing the effects of deficit-financed tax cuts on the cost of capital, Gale and Orszag estimated that the federal debt would increase by over $4.4 trillion from 2001 to 2014 as a result of extending the tax cuts as proposed. The debt increase would be equal to 23.7% of GDP for 2014. Based on the estimate that real interest rates rise by three basis points (or 0.03%) for every one percentage point increase in the ratio of public debt to GDP, Gale and Orszag determined that interest rates would rise by seventy-one basis points (0.71%) by 2014.

186. See supra notes 175–176 and accompanying text.
187. See Gale & Orszag, The User Cost of Capital, supra note 119, at 1, 6.
188. Id.
189. Id. at 7 & app. tbl.1. In addition to revenue losses and interest on additional debt associated with the enacted cuts, the estimate includes projected costs for providing relief from the alternative minimum tax (AMT). See id. at 7. The AMT relief measures were not part of the President’s budget proposal. See id.

The AMT was enacted to prevent high-income taxpayers from taking advantage of various deductions and credits in the Internal Revenue Code, and thus paying little or no income tax under the regular income tax system. Cong. Budget Office, The Alternative Minimum Tax 1 (2004), available at http://www.cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf [hereinafter CBO, Alternative Minimum Tax]. Essentially, taxpayers calculate their income tax liability under two systems, the regular tax system and the AMT system, and pay the higher of the two liabilities. Id. at 1–2. In calculating the AMT liability, individual taxpayers do not get to deduct amounts for personal exemptions, state and local taxes, unreimbursed business expenses, and other miscellaneous itemized deductions. See I.R.C. § 56(b) (West 2006). In addition, for tax years beginning after 2006, they are limited as to the use of nonrefundable personal credits to offset AMT liability. See id. § 26(a); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 302(a), 120 Stat. 345, 353 (2006). While only one million taxpayers were affected by the AMT in 2001, that number is expected to grow to approximately thirty million in 2010, absent any relief provisions for tax years after 2006 enacted by Congress. CBO, Alternative Minimum Tax, supra, at 2. In 2010, the group owing tax under the AMT system would encompass 20% of all taxpayers and 40% of all married taxpayers. Id. Gale and Orszag believe that it is highly unlikely that Congress will permit the AMT to ensnare so many taxpayers, and therefore, included cost estimates of what it would take each year in the budget window to “keep the number of AMT taxpayers the same as it would have been under pre-EGTRRA law.” Gale & Orszag, Economic Assessment, supra note 153, at 1165–66.
In keeping with traditional studies, Gale and Orszag found that when they ignored the higher interest rate on government bonds, the tax cuts lowered the cost of capital in all twenty-four cases they examined.\textsuperscript{192} But when they incorporated the higher interest rate, they found that the tax cuts raised the cost of capital in twenty-two of twenty-four cases.\textsuperscript{193} Thus, the effect of the increased deficit and higher interest rate outweighed the "effects of reductions in marginal tax rates," and the net effect of the tax cuts was to raise the cost of capital.\textsuperscript{194} The implication is that the deficit-financed tax cuts would reduce investment and long-term economic growth by raising the cost of capital.\textsuperscript{195}

The data in Gale and Orszag's study are now two years old. But recent reports suggest that the authors would draw similar conclusions if the study were conducted today. The Center on Budget and Policy Priorities (CBPP) has estimated the increase in federal debt due to the enacted and extended tax cuts at $6.5 trillion over the period 2001–2016.\textsuperscript{196} That level of debt would be 31\% of the $20.8 trillion in GDP projected for 2016 by the Congressional Budget Office (CBO).\textsuperscript{197} Consequently, the interest rate on government bonds would be expected to increase by ninety-three basis points (0.93\%) by 2016.\textsuperscript{198} The higher interest rate would likely raise the cost of capital as it did in Gale and Orszag's study.

While the dividend tax cut would contribute only a fraction of the $6.5 trillion to the federal debt,\textsuperscript{199} it seems highly unlikely that the

\begin{itemize}
  \item \textsuperscript{192} Id. at 11 & tbl.3. The twenty-four cases resulted from altering the mix of debt and equity to finance projects, whether the firm was an old or new view firm, etc. Id. at 8 & tbl.3.
  \item \textsuperscript{193} Id. at 11 & tbl.3.
  \item \textsuperscript{194} Id. at 11.
  \item \textsuperscript{195} Gale & Orszag, \textit{The User Cost of Capital}, supra note 119, at 13.
  \item \textsuperscript{196} See generally JOEL FRIEDMAN & AVIVA ARON-DINE, CTR. ON BUDGET & POL'Y PRIORITIES, \textit{Extending Expiring Tax Cuts and AMT Relief Would Cost $3.3 Trillion Through 2016 (2006)}, available at http://www.cbpp.org/2-6-06tax.pdf. The estimate includes interest costs associated with higher debt and $914 billion in revenue losses associated with extending AMT relief; no AMT relief provisions were included in the President's proposed fiscal year 2007 budget. Id. at 1 n.1, 7.
  \item \textsuperscript{197} CBO, \textit{President's Budgetary Proposals}, supra note 159, at 4 tbl.1-2.
  \item \textsuperscript{198} See supra notes 190–191 and accompanying text.
  \item \textsuperscript{199} For 2007–2016, the CBPP estimated the cost of making tax cuts permanent at $3.3 trillion, which included AMT-related revenue losses of $914 billion. See supra note 196. Over the same period, the JCT estimated the revenue loss connected with making the dividend tax and capital gains tax cuts permanent at $129.5 billion and $67.6 billion, respectively. See JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS, supra note 6, at 314. The CBO incorporated the JCT estimates into its analysis of the 2007 budget, and projected the total revenue cost of extending all of the tax cuts as proposed at $1545 billion. See CBO, \textit{President's Budgetary Proposals}, supra note 159, at 5 tbl.1-3. Thus, revenue losses for the budget window would total $2459 billion (including AMT relief), of which $129.5 billion, or 5.3\%, would be
\end{itemize}
dividend tax cut alone would be extended permanently while the other EGTRRA and JGTRRA cuts would be allowed to expire by 2010. Therefore, a substantial increase in the federal deficit is a realistic scenario, and its ramifications must be weighed before permanently extending the dividend tax cut and the other EGTRRA and JGTRRA tax cuts. Contrary to the conventional wisdom that lowering the dividend tax rate would lower the cost of capital and spur investment and economic growth, an extension of the dividend tax cut and other EGTRRA and JGTRRA cuts would actually raise the cost of capital and dampen investment and economic growth.

3. Dynamic Analysis

The Treasury Department’s dynamic analysis indicates that, if the dividend and capital gains tax cuts were financed with spending reductions commencing ten years after they were extended, GNP would be 0.4% higher in the long run. That increase translates into a gain in GNP of approximately $50 billion per year (in 2006 dollars) in perpetuity. Once again, the analysis blurs the issue as to the dividend tax cut’s contribution to long-term economic growth. The study is also unreliable as to the dividend tax cut’s impact because it rests on two highly questionable assumptions.

First, the Treasury Department’s model assumes that the old view of dividend taxation applies, despite its acknowledgment that the market could be “segmented . . . with some firms behaving in a manner consistent with the traditional view and other firms behaving in a manner consistent with the new view.” New view firms would not alter their investment in response to a dividend tax cut. And because capital would not be reallocated from the noncorporate sector to new view firms, there would be no efficiency gain. Therefore, to attributable to the dividend tax cut. Excluding the AMT cost, the dividend tax cut would account for 8.4% of the revenue loss.

200. The EGTRRA tax cuts are set to expire on December 31, 2010. Pub. L. No. 107-16, § 901(a), 115 STAT. 38, 150 (2001). TIPRA extended the dividend tax and capital gains tax cuts for two years so that they will also expire on December 31, 2010. See supra note 5 and accompanying text.

201. See supra notes 108–109 and accompanying text. The Treasury’s dynamic analysis also shows an increase of 0.3% in GNP in the long term if the tax cuts are financed by raising taxes commencing ten years after their extension. See supra note 111 and accompanying text.

202. See supra note 110 and accompanying text.

203. See supra note 181 and accompanying text.

204. OFFICE OF TAX ANALYSIS, DYNAMIC ANALYSIS, supra note 81, at 8.

205. See supra note 126 and accompanying text.

206. See supra note 142 and accompanying text. The Treasury states that the model it uses captures the economic effects of the reallocation of capital that would occur after reducing
the extent the new view accurately models corporate behavior, the growth estimate is overstated. 207

Second, the model also unrealistically assumes that, starting in 2017 (the first year after the ten-year budget window), government spending would be cut in order to maintain the debt-to-GNP ratio at the level that would exist in 2017. 208 To satisfy this assumption, if all the tax cuts were extended as proposed, the CBPP estimates that government spending would have to be lowered “by the equivalent of about 1.3% of GDP after 2017.” 209 The CBPP states that such a reduction would be the equivalent of “cutting domestic discretionary spending in half.” 210 Spending cuts of this magnitude hardly seem feasible in our political and economic climate. 211 Accordingly, the Treasury Department should have assumed a longer timeframe for financing the tax cuts to provide a more credible estimate of their impact on economic growth. 212 Because delays in financing tax cuts negatively impact economic growth, applying a longer but more realistic timeframe for financing the tax cuts is likely to reveal that the dividend and capital gains tax cuts lower economic growth in the long run. 213

V. THE COST OF THE DIVIDEND TAX CUT AND THE DISTRIBUTION OF ITS BENEFITS

Two issues that lawmakers generally consider before enacting a tax cut are its cost and the distribution of its benefits among various groups of taxpayers. Each of these factors militates against making the dividend tax cut permanent; they will be considered in turn.

double taxation of corporate income. Office of Tax Analysis, Dynamic Analysis, supra note 81, at 7.

207. See supra notes 181-185 and accompanying text.

208. See supra note 106 and accompanying text.


210. Id.

211. For a discussion of the impact of financing tax cuts with cuts in government spending on the distribution of the tax cuts’ benefits among various income groups, see infra Part V.B.

212. For example, when the CBO conducts its macroeconomic analysis of the President’s budget proposals, it assumes that the financing of the tax cuts would begin the year after the ten-year budget window, which is 2017 in this case, and would be phased in over the ten-year period from 2017-2026. CBO, President’s Budgetary Proposals, supra note 159, at 39-41; Office of Tax Analysis, Dynamic Analysis, supra note 81, at 7 n.9. This would allow the debt-to-GNP ratio to rise further after 2017. Id.

213. See Furman, supra note 209, at 5-6.
A. Cost

The cost of the dividend tax cut would hamper efforts at reducing the massive federal deficit over the next decade. The JCT has estimated the cost of permanently extending the dividend tax cut at $129.5 billion for the years 2007-2016. While the dividend tax cut accounts for only 8.4% of the projected cost of extending all of the tax cuts as proposed by the President, its cost is nevertheless substantial. Further, because the dividend tax cut was set to expire on December 31, 2008 when the JCT estimate was prepared, the bulk of the revenue loss was projected to occur during 2012-2016, averaging $20 billion per year. This annual $20 billion cost would be incurred at a time when the government would have to deal with shortfalls in the Social Security and Medicare Trust Funds, as well as deficits accumulated in this decade as a result of the EGTRRA and JGTRRA tax cuts. Given the cost estimates and the unfavorable fiscal climate the government will likely face, permanently extending the dividend tax cut is unsound policy. Justifying the cost of the dividend tax cut becomes even more difficult after considering the issue of who benefits from it.

B. Who Benefits from the Dividend Tax Cut?

As evidence that the tax cut is being enjoyed by taxpayers at all income levels, the Treasury Department states that 73% of the taxpayers who reported qualified dividends on their 2004 tax returns had incomes below $100,000. However, as the Treasury Department

214. See supra note 199.
215. See id.
216. See supra note 4 and accompanying text.
217. See JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS, supra note 6, at 314. While the cost would average $20 billion per year, it would grow steadily from $17.1 billion in 2012 to $22.7 billion in 2016. Id. When TIPRA was passed, the JCT scored the cost of extending the cut for two years, through December 31, 2010, at $30.8 billion. JOINT COMM. ON TAXATION, ESTIMATED REVENUE EFFECTS OF THE CONFERENCE AGREEMENT FOR THE "TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005" 1 (2006), available at http://www.house.gov/jct/x-18-06.pdf. The JCT has not prepared a new score for extending the cut beyond 2010. TIPRA was expected to have virtually no effect after 2012, however, so a projection that the cut would cost $20 billion per year appears reasonable. See id.
218. See Gale & Orszag, Economic Assessment, supra note 153, at 1166-78. As far as the deficit accumulation due to tax cuts is concerned, the Administration claims that the tax cuts have “allowed taxpayers to keep $1.1 trillion more of their own money over the past six years.” OFFICE OF MGMT. & BUDGET, supra note 80, at 4. Separately, the CBPP reported the direct cost of tax cuts enacted since 2001 as totaling $1.0 trillion through 2006. FRIEDMAN & ARON-DINE, supra note 196, 2, 3 tbl.1. The direct cost excludes interest on debt incurred to finance the tax cuts. Id.
notes, only 18.5% of all taxpayers reported qualified dividends, indicating that the benefits of the tax cut were not widespread. In fact, further examination of the 2004 data reveals that taxpayers who filed 1.7% of all returns, and whose adjusted gross incomes exceeded $200,000, reported 55% of the total qualified dividends. The group of taxpayers cited by the Treasury Department, while accounting for 73% of the returns reporting qualified dividends, received only 27.9% of the total dollar amount of qualified dividends. The 2004 tax return data lead to only one conclusion: the dividend tax cut is highly skewed in favor of high-income individuals.

As Gale and Orszag point out, however, these statistics do not tell the whole story. Lower-income individuals may not currently benefit from the tax cut because they are not receiving any dividends. But when the time comes for the government to finance the tax cut, they are likely to be worse off. This is true whether the tax cut is financed with "equal-dollar" or "lump-sum" financing, which corresponds to cuts in government spending, or with "proportional financing," which corresponds to a combination of spending cuts and progressive tax increases. In their study of the 2005 budget, Gale and Orszag found that under either financing method, after-tax income for the bottom four quintiles of the income distribution would be lower as a result of making all of the proposed tax cuts permanent. Only the top quintile would see an increase in after-tax income.

The gap between the highest and lowest quintiles in terms of percentage change in after-tax income is much greater when the equal-dollar financing method is used. Under the equal-dollar method, taxpayers in the lowest quintile would suffer a 21.7% decline in after-tax income.

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220. Id.
221. See Internal Revenue Serv., Statistics of Income, Tax Year 2004 Preliminary Data 25 tbl.1, available at http://www.irs.gov/pub/irs-soi/04implim.pdf. The percentages were calculated by the author. As many of these taxpayers would have been in marginal tax brackets of 28% or higher, their tax on qualified dividends would have declined by more than 10 percentage points. Therefore, their share of the tax cut would have been even greater than their share of qualifying dividends.
222. Id.
223. The data for 2003 yield comparable statistics. For example, taxpayers who filed 1.4% of all individual returns and had adjusted gross incomes in excess of $200,000 reported 50.6% of all qualified dividends for 2003. See Michael Parisi & Scott Hollenbeck, Internal Revenue Serv., Statistics of Income, Individual Income Tax Returns, 2003, at 25 tbl.1, available at http://www.irs.gov/pub/irs-soi/03indtr.pdf. The percentages were calculated by the author.
225. Id. at 1190.
226. Id. at 1190–91, 1243–44 tbls.7–8.
227. Id.
income on average as a result of the tax cuts, while taxpayers in the highest quintile would see their after-tax income increase by 3.1% on average.\textsuperscript{228} Under the proportional method, after-tax income for taxpayers in the lowest quintile would decrease by 2.4% on average, while after-tax income for taxpayers in the highest quintile would increase by 0.7% on average.\textsuperscript{229}

Aviva Aron-Dine and her colleagues from the CBPP examined the distribution of the TIPRA tax cuts assuming the same two financing methods. They found, on average, that the top quintile experienced an increase in after-tax income while the other four quintiles saw a decline in after-tax income.\textsuperscript{230} In addition, they found the disparity between the highest and lowest quintiles to be significantly greater when the equal-dollar method was used.\textsuperscript{231}

The studies by Gale and Orszag and Aron-Dine illustrate two important lessons about dividend tax relief and other EGTRRA and JGTRRA tax cuts. First, when financing is considered, it is clear that taxpayers in the highest quintile reap a disproportionate share of the benefits, and that taxpayers in the bottom four quintiles are actually transferring resources to those in the highest quintile.\textsuperscript{232} Further, using government spending cuts to finance the tax cuts will result in a significantly larger transfer of resources from the lowest quintile to the highest quintile than a financing method that combines spending cuts with progressive tax increases.

Whether one examines statistical data based on filed income tax returns or considers who benefits after taking the government's financing method into account, it is apparent that the dividend tax cut favors taxpayers at the highest income levels. Extending a tax cut that benefits the rich without promoting economic growth is unsound from a policy perspective.

VI. Recommendations

In its present form, the dividend tax cut is a deficient mechanism for achieving the integration of the corporate and individual income tax

\textsuperscript{228} Id. at 1243 tbl.7. Taxpayers in the top 0.1%, top 0.5%, and top 1% of the income distribution would see their after-tax incomes rise by 7.4%, 6.7%, and 6.2%, respectively.

\textsuperscript{229} Id. at 1244 tbl.8. Taxpayers in the top 0.1%, top 0.5%, and top 1% of the income distribution would see their after-tax incomes rise by 3.5%, 3.0%, and 2.5%, respectively.

\textsuperscript{230} See generally AVIVA ARON-DINE ET AL., CTR. ON BUDGET POLICIES & PRIORITIES, CONTRARY TO PRESIDENT'S CLAIM, LARGE MAJORITY OF AMERICANS ULTIMATELY ARE LIKELY TO LOSE FROM TAX RECONCILIATION BILL 2–4, 5 tbl.1 (2006), available at http://www.cbpp.org/5-17-06tax.pdf.

\textsuperscript{231} Id.

\textsuperscript{232} Gale & Orszag, Economic Assessment, supra note 153, at 1191.
systems, because it does not ensure that income will be taxed fully at least once. Nor can the dividend tax cut be justified in terms of its positive impact on economic growth—either in the short run or the long run. There is no evidence of a causal link between the dividend tax cut and the economy's improved performance since 2003, and economic theory suggests that the deficit-financed tax cut will actually lower economic growth in the long run. Therefore, the dividend tax cut should be allowed to expire.

Despite this recommendation, integration may still be an appropriate policy goal. Whether integration should be implemented, however, is a question that cannot be answered until its costs and benefits have been carefully identified and assessed. Since the revenue loss associated with an integration proposal similar to the President's 2004 budget proposal would be substantial, it should be quantified. Further, the anticipated gains from increased investment and efficient allocation of capital would have to be evaluated in light of the proportion of old view and new view firms in the economy.

Assuming that the benefits of integration are found to outweigh its costs, integration could be accomplished relatively easily with a modification of the President's 2004 budget proposal. The modification would be to return to the dividend exclusion prototype in the Treasury Department's 1992 study. Companies would still keep track of the EDA. But unlike the President's proposal, if a corporation chose to distribute less than the EDA, the corporation could carry the unused balance over to future years. This would eliminate the need for the corporation either to distribute all of the EDA each year, or to advise shareholders to adjust the basis of their stock to consume the EDA. The requirement in the President's proposal that corporations keep track of basis adjustments in a CREBA account would be eliminated.

233. See supra Part III.
234. See supra Part IV.
235. See supra notes 51–52 and accompanying text.
236. See supra notes 181–185 and accompanying text.
237. See U.S. Dep't of the Treasury, Taxing Business Income Once, supra note 25, at 17–25.
238. Id. The dividend exclusion prototype called for an excludable distribution account rather than an excludable dividend amount.
239. Id. In the dividend exclusion prototype, unused EDA amounts could be carried over to future years.
240. Firms could opt for a dividend reinvestment plan. Under such a plan, the firm could be deemed to make a distribution up to the balance of its EDA. The shareholder would exclude the amount of the deemed distribution from gross income, but then would adjust the basis of the stock as advised by the corporation. See id. at 24, 87–88.
The resulting proposal is much simpler than the President's original one. Shareholders would exclude distributions from their gross income up to the amount of the balance in the EDA. Distributions would reduce the EDA on a dollar-for-dollar basis, but not below zero. If firms made distributions in excess of the balance in the EDA, the shareholders would treat them as ordinary dividend income. Keeping track of the excludable amounts and the ordinary dividends would not burden the current dividend reporting system under Form 1099.

VII. Conclusion

Permanently extending the dividend tax cut would represent a major failure in tax policy. It would not accomplish the goal of integration to tax income fully only once, nor would it promote economic growth and well-being as proponents claim. Instead, it would be a costly tax break that would benefit taxpayers in the highest quintile of the income distribution. Accordingly, the dividend tax cut should be allowed to expire.

241. They would be treated as dividends to the extent the corporation had current or accumulated earnings and profits. See I.R.C. § 316(a)(1)-(2) (West 2006).