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The Effect of the President's Dividend Relief Proposal on Corporate Tax Subsidies

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Summary

A centerpiece of the President's economic growth package is a provision to eliminate the "double tax" on corporate earnings, a measure largely aimed at dividend tax relief. The plan would create excludable dividend amounts (EDAs), whose purpose would be to identify income that has been subject to the corporate income tax and allow only that income to be eligible for dividend relief or capital gains basis adjustment at the individual income tax level.

The Joint Committee on Taxation estimates that the plan would cost \$396 billion over fiscal years 2003 to 2013. The design of the President's dividend relief proposal would produce some side effects. It could significantly reduce the value of existing corporate tax subsidies. As a result, it is likely that there will be a decrease in corporate investment in some subsidized areas.

The largest corporate subsidies include accelerated depreciation, export subsidies, exclusion of interest on public purpose state/local bonds, and research and development expenditures. Activities that rely heavily on corporate tax preferences could be negatively affected. One area that has received attention is low income housing, which relies heavily on the low income housing credit. Preference restrictions could also undermine the temporary investment stimulus enacted in 2002.

The mechanics causing these reductions in value are relatively straightforward. Under current law, the actual tax savings from a corporate tax subsidy are passed through and taxed at the individual level, whether as dividends or capital gains income. Under the President's proposal, the corporate income that generated the tax subsidy would be passed through and taxed at the individual level.

The rationale for restricting corporate tax preferences in the proposal is not stated. The efficiency argument that economists use to justify corporate tax integration is not necessarily consistent with reducing corporate tax benefits. It is possible that the treatment of corporate preferences was adopted to minimize revenue loss; such a rationale was used in a 1992 Treasury study of integration.

The reduction in the value of corporate subsidies depends on the value of preferences relative to the corporation's income, the corporation's dividend distribution policy, and the tax rate of the shareholder. In some circumstances the reduction in the value of the subsidies could be substantial.

Dividend tax relief could be designed so as to pass through the benefits of any or all corporate tax preferences. If revenue is an issue, one approach could be to allow partial exclusions for both dividends and capital gains income which would eliminate the need to calculate excludable dividend amounts.

This paper provides an economic analysis of the proposal to establish excludable dividend amounts. It does not track legislative developments and will not be updated.

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The Effect of the President's Dividend Relief Proposal on Corporate Tax Subsidies

A centerpiece of the President's economic growth package is a provision aimed at eliminating the "double tax" on corporate dividends.¹ The guiding principle of this proposal is that corporate income should be taxed only once, so if it is taxed at the corporate level it should not be taxed at the individual level. Thus, the President's plan allows corporate income that has been taxed at the corporate level to be tax free at the individual level. If the previously taxed corporate income is distributed as dividends, then when the dividends are distributed they would not be subject to tax at the individual level. If the previously taxed corporate income is retained, then shareholders would be allowed an adjustment (increase) in the basis of their stock holdings so that the previously taxed corporate income would not be subject to individual capital gains taxes when the shareholders sell their corporate stock.

The President's proposal would significantly reduce the combined taxes (corporate and individual) on corporate source income. However, the proposal's design would produce some side affects. The President's plan contains a feature called excludable dividend amounts (EDAs), whose basic purpose would be to identify income that has been subject to the corporate income tax and allow only that income to be eligible for dividend relief or basis adjustment at the individual income tax level. (This proposal has been slightly modified in H.R. 2, a bill incorporating the President's tax plan, to allow a carry over of EDAs in excess of dividends.)

The President's approach would reduce the value of existing corporate tax subsidies and preferences.

The Joint Committee on Taxation estimates that the President's plan to eliminate the double taxation of corporate earnings would cost \$396 billion over fiscal years 2003 to 2013.

The first section of this report explains how these excludable dividend amounts (EDAs) work and how they affect the value of corporate tax preferences. The second section of the report details alternative approaches and their effects on corporate tax subsidies. The next section of the report explores the rationale for EDAs. The final section concludes with a review of general policy issues, including a discussion of the general types of corporate tax preferences currently allowed and a discussion of possible alternative approaches.

¹ Background on the "double taxation" issue, the different forms of corporate double tax relief, and other issues associated with the dividend plan can be found in CRS Report RL31597, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, by Gregg A. Esenwein and Jane G. Gravelle.

How EDAs Affect Corporate Tax Preferences

Under the President's proposal, a corporation would compute an excludable dividend amount (EDA). A corporation could distribute the EDA to its shareholders and the shareholders would not have to pay individual federal income taxes on the distributions. Alternatively, corporations could retain all or some portion of their EDA, in which case the basis of the shareholders' corporate stock would be increased to reflect the fact that a portion of the stock's value (the undistributed EDA) had already been subjected to the corporate income tax.

To calculate the EDA, corporations would convert their prior year U.S. corporate income taxes into an amount that is equivalent to the amount of prior year corporate income that was taxed at a 35% tax rate. For this calculation, U.S. corporate income taxes would be calculated on a pre-tax credit basis with respect to the foreign tax credit and the credit for the corporate alternative minimum tax. Corporate taxes would be calculated on a post-tax credit basis with respect to all other tax credits. The following formula shows how a corporation's EDA would be determined.

$$\text{EDA} = (\text{Corporate income taxes}/.35) - \text{corporate income taxes}$$

For example, if a corporation paid \$35 in corporate income taxes in the first year, then its EDA for the next year would be \$65 ($(\$35/.35) - \35). Essentially, EDAs are designed so that corporate income is taxed only once, at either the corporate or individual level. If the income is subject to tax at the corporate level then use of the EDA would ensure that it is not subsequently taxed at the individual level. (This formula is equivalent to 1.857 times the tax).

A consequence of this approach, however, is that EDAs reduce the value of corporate tax subsidies. This occurs whether the subsidy takes the form of a reduction in corporate taxable income or as a credit against corporate income tax liability. It also occurs whether the EDA is distributed to shareholders or retained and used to adjust the basis of shareholder stock holdings. The following simplified examples using tax credits as the corporate tax subsidies show how this effect occurs.

Consider a case under current law where a corporation has \$100 of net income. With a corporate tax rate of 35% the corporation would owe \$35 in federal income taxes on this income. Further assume that the corporation is eligible for a corporate tax credit of \$10. The final tax owed at the corporate level would be \$25 (\$35 tax less \$10 credit) and the corporation would have \$75 in after tax income that it could distribute to its shareholders.

If the corporation distributed the entire \$75 to its shareholders, and, it is assumed that the average tax rate at the individual level is 25%, then individuals would pay an additional \$18.75 worth of tax on this corporate source income. In effect, individual income tax is assessed on both the after tax income of the corporation (\$65) and the passed through savings from the corporate tax credit (\$10). The total tax assessed on this \$100 of corporate source income at both the corporate

and individual levels would be \$43.75 (\$25 of corporate income tax plus \$18.75 of individual income tax).

In the absence of the \$10 corporate tax credit, the corporation would have paid \$35 in corporate income taxes and would have been able to distribute only \$65 to its shareholders (\$100 income less \$35 corporate income taxes). At a 25% tax rate individuals would have paid \$16.25 in individual income taxes on their \$65 of corporate dividends. So, in the absence of the \$10 corporate tax credit, the total tax paid at both the corporate and individual levels on \$100 of corporate source income would have been \$51.25 (\$35 of corporate income tax plus \$16.25 of individual income tax).

As this example demonstrates, the current law value of the \$10 corporate tax credit is actually \$7.50 once the added effect of assessing tax at the individual level is factored into the equation. Total taxes (both corporate and individual) paid on \$100 of corporate source income is \$43.75 with the credit versus \$51.25 without the credit. That is, the tax is \$7.50 (\$51.25 minus \$43.75) less with the \$10 credit.

Now consider what happens to the value of a \$10 corporate tax credit when EDAs are employed. With a \$10 corporate tax credit, a corporation that had \$100 of net income would pay \$25 in corporate taxes (\$100 income at a 35% corporate tax rate less the \$10 credit). The corporation would have \$75 in after tax income that it could distribute to its shareholders. But a portion of this dividend distribution, the excludable dividend amount (EDA), would not be taxable at the individual level. Substituting the values from this example into the formula for calculating EDAs produces:

$$\begin{aligned} \text{EDA} &= (\$25/.35) - \$25 \\ \text{EDA} &= \$46.43 \end{aligned}$$

Hence, of the \$75 that the corporation pays out as dividends, only \$28.57 (\$75 in distributed dividends minus the \$46.43 that is excludable) is subject to tax at the individual level. Assuming a 25% rate at the individual level, then the taxes owed at the individual level would be \$7.14. The total tax paid at both the corporate and individual level on this \$100 of corporate source income would be \$32.14 (\$25 in corporate level taxes plus \$7.14 in individual income taxes).

In the absence of the \$10 corporate tax credit, the corporation would pay \$35 in corporate income tax on \$100 of net income and could distribute \$65 in dividends to its shareholders. Substituting these values into the formula for calculating EDAs yields:

$$\begin{aligned} \text{EDA} &= (\$35/.35) - \$35 \\ \text{EDA} &= \$65 \end{aligned}$$

The entire \$65 in dividend income would be excluded from tax at the individual level. The total tax paid at both the corporate and individual level on the \$100 of net corporate income would be \$35 (\$35 at the corporate level and \$0 at the individual level).

Hence, with EDAs the value of the \$10 corporate tax credit is only \$2.86. Total taxes (both corporate and individual) paid on \$100 of corporate source income is

\$32.14 with the credit versus \$35.00 without the credit. The value of the \$10 tax credit falls from \$7.50 under current law to \$2.86 (\$35.00 minus \$32.14) under the President's proposal. The value of the credit is reduced by almost 62%.

After Tax Value of a \$10 Corporate Tax Credit (Assuming all corporate after tax income distributed to shareholders as dividends and average shareholder tax rate is 25%)	
Current Law	President's proposal using EDAs
\$7.50	\$2.86

The mechanics causing these results are relatively straightforward. Under current law, the actual tax savings from a corporate tax subsidy are passed through and taxed at the individual level, whether as dividends or capital gains income (the \$10 credit in the examples illustrated above). Under the President's proposal, the corporate income that generated the tax subsidy is passed through and taxed at the individual level (\$28.58 which is the corporate tax credit, \$10, divided by the statutory corporate tax rate, 35%). The result is a reduction in the value of the subsidy.

The percentage reduction in the value of the corporate tax subsidies will depend on the shareholders' actual tax rates. If the example above were computed using the top permanent individual marginal tax rate of 35%, then the value of the corporate tax credit would fall from \$6.50 under current law to \$0 under the President's proposal, or a 100% reduction. Conversely, if the shareholders were tax exempt (e.g. corporate stock was held in an IRA) then there would be no reduction in the value of the corporate subsidies under the President's plan.

The reduction in the current law value of corporate tax subsidies under the President's proposal will be less if corporations retain the income in excess of their EDAs rather than paying it out as dividends to their shareholders. This occurs simply because the amounts that exceed the EDA that are retained by the corporation are subject to capital gains tax rates when shareholders sell their corporate stock. Effective capital gains tax rates are lower than the individual tax rates applicable to distributed dividend income that exceeds the EDA, because the statutory tax rates on capital gains are lower, the taxes on capital gains income are deferred until sale of the asset, and some capital gains are never taxed because they are passed on at death.

The President's proposal to end the double taxation of corporate source income is a tax cut. Corporate shareholders will see a significant reduction in their combined (corporate and individual) income taxes under the President's plan.

The effects on the value of corporate tax subsidies will also be significant. The value of all corporate tax subsidies will fall. As a result, it is likely that there will be a decrease in corporate investment in some subsidized activities.

Alternative Approaches and Their Effects on Corporate Tax Preferences

The issue of the pass-through of corporate tax preferences has been discussed in previous studies of corporate double-tax relief. When proposals to relieve one of the levels of tax are made (either the corporate or individual level), how the relief is structured will determine the degree to which corporate tax preferences are preserved.

If the object were to eliminate the corporate level of tax, some methods of double tax relief would automatically *eliminate* the benefits of corporate tax preferences unless special measures were taken to preserve them. For instance, providing a credit against individual income tax liability to individual shareholders for corporate taxes paid on their corporate source income would eliminate all of the benefits of corporate tax preferences.

Providing relief by taxation on a partnership basis, on the other hand, would have the opposite effect: by eliminating the corporate level tax and reflecting preferences in the allocable taxable income of the partners (and allocable credits), the preferences would be preserved. This approach would treat corporate shareholders the same way as unincorporated businesses are treated under current law.

When the individual level of tax is to be eliminated, there are several approaches that could be employed. Distributed corporate dividends and capital gains on corporate stock sales could be excluded from individual taxable income. Such an approach would preserve the corporate level of tax with all its preferences. It would, however, be very costly and somewhat inefficient because it would eliminate taxes on all the accumulated capital gains on existing assets, creating a windfall for individual stockholders. If the proposal simply excluded dividends, then firms (especially closely held ones) would be able to pay out dividends, have them reinvested in the firm (which increases the basis of the stock), and eliminate accumulated capital gains in that way.

Because of the revenue and windfall gain concerns, most plans for dividend relief at the individual level of tax have some method of dealing with the problems of accumulated earnings by restricting either dividend relief or basis adjustments. There are two approaches that address these concerns, both of which use approaches similar to EDAs. One passes through corporate tax preferences and one does not.

As illustrated earlier, the current proposal for dividend tax relief using EDAs does not pass through the full value of corporate tax preferences. In January 1992, the Treasury Department issued a report on corporate tax integration in which an approach was proposed that was very similar to the one currently under consideration. Apparently the reason that approach did not pass through corporate

tax preferences was because of revenue losses.² (In fiscal year 2003, corporate tax subsidies were approximately 65% of total corporate tax revenues.)

However, the Treasury subsequently proposed a dividend relief plan that did include the passthrough of corporate tax preferences. In this version, which was proposed by the outgoing George H. W. Bush Administration in December of 1992, all dividends were excludable from taxation at the individual level, but dividends paid in excess of amounts deemed non-taxable would reduce the basis of corporate stock. With such a rule, there is no advantage in paying out past accumulated earnings as dividends and reinvesting them because any increase in basis would be offset by the basis reduction rule. These accounts would be the sum of taxable corporate income plus permanent preferences (such as tax exempt interest) minus taxes paid before credits.

What Is The Rationale For EDAs?

Aside from revenue concerns, what are the justifications for not providing a passthrough of preferences? This assessment depends on the rationale for providing double tax relief in the first place.

Although some have argued for dividend relief on the grounds of fairness among investors, this argument is not consistent with economic analysis which suggests that after tax returns are equated, net of risk, by market forces. There is no need to provide dividend relief to be “fair” to investors in corporate stock (as opposed to other forms of investment); the market will produce that result left on its own.

Economic arguments for providing relief to dividends tend to rest on efficiency grounds: corporate equity investment is subject to higher taxes than non-corporate investment or debt financed capital, and the resulting misallocation of capital causes economic inefficiency. Thus, efficiency is the central rationale for considering dividend relief. Indeed, economic efficiency is stated as the principal rationale for double tax relief in the Treasury discussion of the President’s dividend tax reduction proposal.³

It is not clear that the efficiency rationale justifies restrictions on the pass-through of corporate preferences. Tax preferences will still be available for

² See Michael Graetz and Alvin C. Warren, “Interaction of the Corporate and Individual Income Tax: An Introduction to the Issues,” in *Integration of the U.S. Corporate and Individual Income Taxes*, Arlington, VA: Tax Analysts, 1998. The Treasury Integration Study published in January 1992 was quite similar to the current proposal, although it did not provide benefits for income taxed by foreign governments but not by the U.S. system (while the current proposal does). In December 1992, the outgoing Bush Administration proposed a more generous system that basically excluded all dividends and provided benefits for retained earnings reflecting a broader measure of income.

³ U.S. Department of Treasury. *General Explanation of the Administration’s Fiscal 2004 Revenue Proposal*, February 2003, p. 11.

unincorporated businesses. So tax differentials would remain with respect to preferentially treated income in the corporate versus the non corporate sector.

From an efficiency viewpoint, by choosing to reduce the value of corporate tax preferences, this approach maintains a differential tax treatment between the corporate and non-corporate sectors. In fact, the Administration's proposal actually further expands tax benefits for small unincorporated businesses by raising the limit on expensing. So at the same time it is trying to insure that corporate income is subject to at least one level of tax, other elements of the Administration's plan expand opportunities for investments in the non-corporate sector to escape tax altogether. (The proposal also expands benefits available to corporations, whose value will be reduced, perhaps substantially, by the EDA approach).

The limit on corporate preference passthrough undermines the incentive effects of those tax subsidies. If those subsidies were desirable in the first place, it seems appropriate to continue them in full strength. Of course, the change could improve overall economic efficiency if corporate tax preferences are undesirable. Still, a more effective approach would be to repeal the preferences outright.

One rationale may remain and is alluded to in the Treasury analysis. Some tax reductions arise from tax sheltering activities that are not intentional preferences. These tax shelters are difficult to detect and prevent. In this case, limiting the passthrough of preferences may be desirable.

Effects of EDAs on Incentives

Magnitude of Effects

As noted above the reduction in the value of the corporate subsidy depends on whether dividends are less than or greater than the EDA. The size of the EDA is itself affected by the size of corporate subsidies. The reduction in subsidy values, therefore, depend on the tax rate, the pay-out ratio, and the ratio of subsidies to income, which govern at what payout ratio the dividends will exceed EDA. Table 1 provides calculations of the percentage decrease in the value of the subsidy depending on payout rate and size of subsidy relative to income in the case of a 25% tax rate. Table 2 provides the estimates for a 35% rate. (Both assume a capital gains effective rate of 10%.)

For firms that retain all earnings, the reduction in the value of the subsidy is approximately 21%. The reduction gets smaller as more dividends are paid out (because taxes are higher under existing law but there is a constant tax penalty under the dividend relief proposal). There is a sharp break between the effect on a marginal dollar of subsidy as dividends begin to exceed the EDA, when the value of additional dollars of subsidy (holding payout ratios constant) falls substantially. When all after tax income is paid out as dividends, the reduction in the value of the tax subsidy is extremely large, and the entire subsidy disappears when the shareholder is in the same tax bracket as the firm, 35% (Table 2). In that case, what is saved at the corporate level is repaid as tax at the individual level. Thus, the firms that would be

most affected by the President's proposal are those with high payout ratios, those with significant preferences, and those whose shareholders are in high marginal tax brackets.

Table 1: Percentage Reduction in Tax Benefits at the Margin, Taxpayer in the 25% Bracket, for Different Payout Ratios and Ratios of Tax Benefits to Income

Payout Ratio	C/Y = 0.05	C/Y = 0.10	C/Y = 0.15	C/Y = 0.30
0.0	20.6	20.6	20.6	20.6
0.1	19.3	19.3	19.3	52.5
0.2	17.9	17.9	17.9	53.3
0.3	16.5	16.5	16.5	54.3
0.4	15.0	15.0	55.2	55.2
0.5	13.4	13.4	56.2	56.2
0.6	11.8	11.8	57.3	57.3
0.7	10.2	58.4	58.4	58.4
0.8	59.5	59.5	59.5	59.5
0.9	60.7	60.7	60.7	60.7
1.0	61.9	61.9	61.9	61.9

Source: CRS calculations. See appendix for details.

Table 2: Percentage Reduction in Tax Benefits at the Margin, Taxpayer in the 35% Tax Bracket, Different Payout Ratios and Ratios of Tax Benefits to Income

Payout Ratio	C/Y = .05	C/y = .10	C/Y = .15	C/Y = .30
0.0	20.6	20.6	20.6	20.6
0.1	18.4	18.4	18.4	74.3
0.2	16.0	16.0	16.0	76.4
0.3	13.4	13.4	13.4	78.8
0.4	10.7	10.7	10.7	81.3
0.5	7.8	7.8	83.8	83.8
0.6	4.7	86.7	86.7	86.7
0.7	1.6	89.7	89.7	89.7
0.8	92.9	92.9	92.9	92.9
0.9	96.3	96.3	96.3	96.3
1.0	100.0	100.0	100.0	100.0

Source: CRS calculations. See appendix for details.

Determining a typical effect on behavior is not easy. A significant fraction (more than half) of stocks are held by taxpayers who would not benefit from the President's proposal for double taxation relief, either because they are already tax exempt (pensions, IRAs, stocks held by non-profits) or because they are not eligible (foreign shareholders). If all of these taxpayers are weighted together, the effects would probably be about half of some amount between those in Table 1 and Table 2. If, on the margin however, shareholders are in high marginal income tax brackets, then the effects could be larger. If corporate managers, who own stock, give particular weight to their own circumstances, then the effects on incentives could also be more pronounced.

Economic Activities Affected

What types of economic activities that currently receive subsidies might be most affected by the reduction in value of preferences? Table 3 lists the largest corporate tax subsidies for fiscal years 2003 through 2007.

By far the largest tax expenditure, \$119 billion, was the value of accelerated depreciation; this cost is particularly large because it reflects the temporary expensing provision enacted in 2002 to stimulate investment. (Because this benefit is a timing benefit, with a current loss offset by a future gain, its magnitude is overstated.) The temporary expensing provision was widely agreed upon to be the most effective way to stimulate investment;⁴ in fact, it is possible that the undermining of this provision could cause the dividend package to be contractionary initially.

Another set of provisions that would be significantly affected are two associated with export subsidies (exclusion of extraterritorial income and inventory property source rules) which together total over \$55 billion; most economists, however, would suggest that export subsidies do not add to economic efficiency. Provisions that economists are more likely to support are those relating to research and experimentation (tax credit and expensing) which sum to \$40 billion.

Also significant are revenue losses from tax exempt interest of state and local governments, provisions favoring investment abroad and investment in Puerto Rico. In addition to the variety of provisions listed in the table, many of which are specific to certain industries, there are many smaller tax subsidies that may affect a smaller set of activities.

The actual effects on a particular activity will depend on how important tax preferences are to that activity and how they benefit from the general dividend tax relief. Except for a possible timing effect, the reduction in preferences on accelerated depreciation would be more than offset by the general benefit to investment from relief of double taxation. Similarly, many firms export and would receive benefits for dividend relief on the taxed portion of export income that offset, or more than offset, the disincentive from reduction in the value of the preference.

⁴ See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle.

Table 3. Major Tax Subsidies for Corporations
(billions of dollars)

Subsidy	Estimated Revenue Cost, Fiscal Years 2003-2007
Depreciation of equipment in excess of alternative depreciation system	\$119
Exclusion of interest on public purpose state/local bonds	\$34
Inventory property sales source rule exception	\$28
Exclusion of extraterritorial income	\$27
Expensing of research and experimental expenditures	\$26
Reduced tax rates on 1 st \$10,000,000 of corporate income	\$24
Deferral of active income of controlled foreign corporations	\$24
Deduction for charitable contributions	\$20
Low income housing credit	\$16
Tax credit for qualified research expenditures	\$14
Deduction of unpaid property loss reserves for property and casualty insurance companies	\$7
Tax credit for Puerto Rico	\$5

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007*, Dec. 2002.

However, activities where preferences play a large role could experience significant contractions. One area of preferentially treated activity that has received some public attention is low income housing. A recent study predicted significant adverse effects because housing tax credits are a large source of low income housing finance and are heavily supplied by corporations.⁵ The study also argued that State and local government's ability to provide their share of financing would be adversely affected by the direct loss of benefits to tax exempt bonds held by corporations, as well as the general diversion of investment out of tax exempt bonds by individual investors who shift to corporate stock and by the loss of tax revenue to states that base their income tax system on the federal income tax base. The analysis concluded

⁵ Ernst and Young, LLP, *The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing*, Commissioned by the National Council of State Housing Agencies, Feb. 2003.

that low-income housing construction would fall by about 35%, although apparently the Treasury questions that estimate.⁶

In general, subsidized activities earn a lower pre-tax return and the reduction in the subsidy reduces the scope of investment projects which are viable. In some cases, corporations participate in a broader market where reduced activity may not materially alter those returns (or may not alter them enough to make investment viable). An example of this activity is tax exempt bonds, where both individuals and corporations invest, and which pay lower interest rates because they are not taxable. In such a market, it is possible that corporate participants would withdraw entirely.

Possible Revisions

The President's dividend relief proposal could be revised to eliminate its adverse impact on corporate tax subsidies. If there is a desire to preserve the benefits of particular credits, then one could base the EDA on tax liability prior to credits. In fact, all legislated subsidies could be passed through, which would result only in a reduction in the value of unintended tax benefits. There are also ways to pass through corporate preferences in general to the individual level (as was done in the December 1992 proposal).

If revenue is an issue, then it might be possible to provide a partial relief provision without restricting preference passthrough, and indeed without setting up accounts at all. For example, if dividends were taxed at least as much as capital gains, then there would be no way to save revenue by paying out and reinvesting dividends. One possibility would be a flat 50% exclusion for both dividends and capital gains. Capital gains are already close to a 50% exclusion for the top tax bracket (and gains are heavily concentrated in these brackets), so that a large revenue loss might not result from the capital gains exclusion.

Appendix

This appendix formalizes the treatment of preferences under the EDA and explains how the treatment reduces the value of preferences. In this example, we capture all tax preferences that deviate from economic income as a credit equivalent, c . This amount may actually be a credit, or it can be construed as the tax saving from a deduction or exclusion.

Under current law, after tax income which can be either paid to shareholders as dividends or retained for reinvestment is:

$$(1) \text{ After Tax Corporate Income} = Y(1-u) + c$$

where Y is economic income before tax, u is the corporate tax rate, and c is the credit.

⁶ Tax Analysts. "Taxwriters Examine Effect of Dividend Exclusion on Housing, Retirement Saving." *Tax Notes Today*, March 7, 2003.

After tax accrued income (either retained or distributed) to shareholders is:

$$(2) \text{ After Tax Individual Income} = Y(1-u)+c - xt(Y(1-u)+c) - (1-x)t_g(Y(1-u)+c)$$

where x is the share of earnings paid out as dividends, t is the tax rate of the shareholder and t_g is the accrual equivalent tax on capital gains (a rate that takes into account that some gains tax will never be paid because stock is held until death). For those above the 15% rate, the tax on capital gains is 20% if held for a year and 18% if held for five years. Typically, the tax rate is roughly halved to reflect the fraction of gain that is never taxed and the advantage of deferring the tax on that which is. In the calculations below, we use a rate of 10%.

If we separate out the terms associated with preferences, or c , we see that a credit, other things equal, increases after tax income by:

$$(3) \text{ Increase in income due to credit} = c(1-xt-(1-x)t_g)$$

As this formula indicates under the present law treatment individual shareholder taxes are effectively paid on the value of the tax credit, an effect that occurs because of the normal reduction in shareholder tax that occurs when the firm incurs additional costs due to paying taxes.

Under the new system, the EDA is defined as:

$$(4) \text{ EDA} = T/u - T = T(1-u)/u$$

Since:

$$(5) T = (uY - c),$$

one can rewrite (4) as:

$$(6) \text{ EDA} = (uY - c)(1-u)/u = Y(1-u) + c - c/u$$

The EDA is after tax income reduced by the income excluded from tax due to the credit (c/u).

With the new system, there are two cases, one where dividends are less than the EDA and one where they are more than the EDA.

$$\text{Case I. } x(Y(1-u)+c) < Y(1-u) + c - c/u$$

In this case,

$$(7) \text{ After tax income} = Y(1-u)+c - xt(Y(1-u)+c) - (1-x)t_g(Y(1-u)+c) + tD + t_g(EDA - D)$$

where D is the level of dividends, equal to $x(Y(1-u)+c)$

The second and fourth term cancel, and by recombining terms:

$$(8) \text{ After tax income} = Y(1-u) + c - t_g(Y(1-u) + c - \text{EDA})$$

Or,

$$(9) \text{ After tax income} = Y(1-u) + c - t_g c/u$$

If we isolate the c terms again:

$$(10) \text{ Increase in income due to credit} = c(1-t_g/u)$$

If we compare this amount to the amount in (3) we can see that the value of the credit falls. Recall that this case only applies when the value of x meets the conditions for Case I, which by some manipulation, can be expressed as:

$$(11) x < \frac{u(1-u) - (1-u)c/y}{u(1-u) + uc/y}$$

At one extreme, if $x = 0$, the value of the credit under current law is $c(1-t_g)$ and the value under the new system is $c(1-t_g/u)$. With t_g set at 0.1 and u at 0.35, the value per dollar of additional credit is \$0.90 in the old system and the value would be \$0.71 in the new system. Note that as long as the distributions fall into case I, the after tax benefits will be constant under the new system, but it will decline under the old system as the share paid out as dividends increases. (These calculations apply only to the margin, as changes in the credit affect the cut-off point between Case 1 and Case II.

$$\text{Case II: } x(Y(1-u)+c) > Y(1-u) + c - c/u$$

In this case:

$$(13) \text{ After tax income} = Y(1-u)+c - xt(Y(1-u)+c) - (1-x)t_g(Y(1-u)+c) + t\text{EDA}$$

Note that in this case an additional credit results in an additional distribution taxed partially at the capital gains tax rate and partially at the dividend tax rate, and also reduces the EDA amount (for a dollar of credit, the account falls by $\$1/u$).

After some manipulation, the value of c can also be expressed as:

$$(14) \text{ After tax value of credit} = c(1+(t-t_g)(1-x) - t/u)$$