LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"I'm proud to be paying taxes in the United States. The only thing is—I could be just as proud for half the money."
– Authur Godfrey

Years ago, when we received our first dividend check from a stock investment, we were delighted to learn the first $100 of stock dividends was exempt from income taxes. The amount of tax-exempt dividend was gradually increased over the years to $400 until 1986 when dividend tax-exemption was eliminated.

It now appears that some amount of dividend will once again be exempt from income tax. The President's proposal is that corporations could pass along tax-favored income to the extent that they have paid income tax of their own. Furthermore, the proposal includes a provision whereby an investor could increase his cost basis by the amount of any corporate-taxed dividends which were not distributed. We doubt Congress will be as generous as the administration's proposal, but do expect some form of dividend tax relief.

It is worthwhile to consider the investment implications of the passage of the President's proposal to eliminate taxes on dividends, even if that proposal is eventually diluted. For example, it is likely that higher-yielding stocks will outperform non- or low-yielding shares over an extended period. Even before the President's proposal, investors were seeking dividend paying stocks in order to receive some up-front return in view of the difficult market. Adding a dividend exclusion would only accelerate the trend.

Reducing or eliminating taxes on dividends would certainly have an impact on the municipal bond market. The tax-free advantage of municipal bonds would be reduced, raising the specter of higher borrowing costs for states and municipalities, and, in some cases, could incent investors to substitute higher-yielding taxable bonds for munis.

Giving tax preference to dividends raises questions about the desirability of variable annuities. While earnings are tax sheltered during the time invested in a variable annuity, all income is taxed at ordinary income tax rates upon withdrawal. The low tax rate on capital gains, dividends free of income tax, and an increase in cost basis by the amount of taxed but undistributed profits would give individual stocks an advantage over a variable annuity.

Finally, reducing or eliminating taxes on dividends would result in companies paying out more of their earnings in dividends. Many managements now maintain they would rather return cash to shareholders in the form of stock repurchases than dividends, as the former are taxed at the lower capital gain rate and the latter at the higher ordinary income tax rate. To the extent that dividends were tax free, this argument would no longer be valid. Additionally, in competing for investor dollars, managements of non-dividend-paying companies would see that they were at a disadvantage.

Under the assumption that some but not all dividends will become tax exempt, there are implications for investors, at the margin. Should the President's proposal survive intact, the impact on investors and investment strategy would be profound. Needless to say, the progress of this proposal will be of great interest to us.

Year End 2002