To: Savings & Investment Group - Savings@finance.senate.gov Date: March 23, 2015

From: Frank Kitzmiller

WHY DIVIDEND INCOME SHOULD NOT BE SUBJECT TO TAX

Many investors in dividend paying stocks assume that the dividend is income (similar to the way that bond interest is income) but do not realize that the market value of the stock decreases by the amount of the dividend on the ex-dividend date (compared with no market price decrease for a bond). The stockholder will have no economic gain unless the price of the stock increases on account of the increased demand by investors for the stock. Increased demand could result from continued or higher than expected corporate earnings or from stock purchases being made based on the presence of the dividend policy and assuming that dividends are equivalent to economic income. Consideration must be given to the following:

1. There is no economic income realized as the the amount of the cash dividend received is completely offset by an identical reduction in the value of the stock on the "ex-dividend" date. (See footnote for item 1)

2. There is too much time, effort and expense expended by the dividend paying corporation, the shareholder and investment account custodians to obtain the information required for dividend distributions to be reported for income tax purposes. (See footnote for item 2)

3. The tax on dividends represents a double tax on income that was previously taxed at the dividend paying corporation level. In the past and at the current time special lower tax rates or special exclusions or tax credits have been used to reduce the effect of this double taxation adding to the complexity of reporting taxable dividend income. (See footnote for item 3)

4. If the amount of the dividend distribution presently being subjected to income tax were instead reported as a "non dividend distribution" not subject to income tax when distributed, the economic effect of the distribution would be taxed appropriately (at capital gains rates) when the corporation's stock was disposed by the shareholder (or when the basis of the stock is less than -0-). Any reportable gain or loss would be based on the adjusted basis in the stock which has been reduced by the amount of the non dividend distributions.

   Beginning in 2011, Form 1099-B filed by investment account custodians, etc. with the IRS and security holders must report the basis of securities sold each year. Such basis reporting could include any revisions on account of treating dividend distributions as non dividend distributions requiring a reduction in stock basis.

5. Other considerations:

   A. Treatment as a non dividend distribution would defer any tax on such distribution to a future period and could affect tax revenues of Federal and State governments.

B. The wording of the special Obamacare taxes on dividends would have to be changed to either tax the current non dividend distribution or the future gains on disposition of the stock with the reduced basis.

C. State income tax laws may have to be changed to include the new Federal reporting of dividend and non dividend distributions. Also Tax Treaties with foreign countries may have to be altered.

D. Preferred stock dividends probably would be reported the same as presently done if the stock is not convertible and the stock price is not reduced on the ex dividend date by the amount of the dividend. (The common stock of the corporate issuer of the preferred stock is adjusted on the ex dividend date)

E. Pre Subchapter S corporation status undistributed earnings and profits could be reported as a non dividend distribution with stock basis reduction when distributed by the S corporation.

F. The elimination (deferral) of double taxation on dividend income could possibly allow Master Limited Partnerships (MLP) treated as publicly traded partnerships to be operated as efficiently as a corporation and avoid the extreme complexities of reporting the results of operations of these entities (as reported on Sch K-1, Form 1065) on Form 1040 and the limitations imposed on such results. This could apply if a change in the tax law would prohibit oil and gas producers or pipeline operators from using the MLP structure.

G. Capital gains distributions by Regulated Investment Companies (mutual funds, etc.) probably would be reported as presently done as this income has not been double taxed.

H. Stock analysts could still calculate "dividend yield" for comparison with other stocks purposes, but should change or redefine the term "yield" as it fails to include the effect of the reduction in stock market value on the ex dividend date. It may be more appropriate for analysts to use the term"Total Return" for comparing individual stocks as is done for stock (and bond) funds (mutual funds, exchange traded funds, etc.). Total return is equal to the sum of the dividends received plus any capital appreciation or less any capital depreciation (including the market value depreciation which occurs on the ex dividend date equal to the amount of dividend) related to the fund investments.

I. It is unclear how any changes in the taxation of dividends would affect foreign (non U.S.) investors and withholding requirements and reporting distribution information on Form 1042-S. However it appears that the distribution reporting could be coded similar to the distribution reporting on Form 1099-DIV or whatever form would be used to report the distribution. Withholding at source on the dividend may not apply but withholding on a subsequent gain on disposition of stock could apply.

It appears that this treatment could apply to the taxation of distributions to US corporations from foreign subsidiaries and would encourage the repatriation of earnings to the US. (i.e. APPLE, etc)

J. The reduction in tax basis due to the non dividend treatment of distributions may never have to be recognized as gain if the stock was held by a decedent and basis was equal to date of death value.

K. Changing the income tax treatment of dividends would appear to be a positive factor in the valuation of corporation stock ownership and could cause an increase in values for dividend paying stocks held by individuals or other entities in 401 (k) plans, pension plans or other investment vehicles. This increased value could increase borrowing capacity and provide benefits for the U.S. and world economies.

FOOTNOTE TO ITEM 1

The automatic stock price reduction, equal to the amount of the dividend, which occurs on the ex-dividend date has been in effect since 1934 as part of the rules and regulations of the Securities Exchange Act of 1934. Rule 10b-17 requires publicly owned corporations paying dividends to provide to the National Association of Securities Dealers (NASD) information on the dividend. Such information is then provided to the various regulated stock exchanges and over-the-counter (OTC) markets who implement the stock price reduction.

Example of effect of automatic price reduction:	STOCK - DIIDEND INCOME	BOND - INTEREST INCOME
Value of investment prior to distribution ex-dividend dates	1,000	1,000
Amount of distributions	30	30
Value of investment after distribution ex-dividend dates	970	1,000
Reported yield (Distributions divided by Value of investment before automatic decrease in value)	3.00%	3.00%
Economic income:		
Dividend / interest income	30	30
Automatic decrease in value of stock / bond	-30	0
Net economic income	0	30
Actual yield	0.00%	3.00%

FOOTNOTE TO ITEM 2

It appears that the 16th amendment to the U.S. Constitution imposed a tax on the income of individuals for periods after 2/28/1913. Dividend distributions from a corporation's "earnings and profits"were considered to be income subject to this tax. It is not known if the corporation's stock value was reduced by the amount of the distribution on the "ex dividend date" (The automatic reduction in stock value did not occur until 1934). The term "earnings and profits" apparently came into being as the only means available to exempt from taxation any post 2/28/1913 distributions of gains which were made before that time. The term has now evolved into the key element in defining what is a dividend.

For 1913, the rate of tax on corporation income was 1%. The rate of tax on idividuals was a "normal" tax of 1% applied to taxable income up to $20,000, which did not include dividends, plus "additional" taxes ranging from 1% to 6% on "net income" (which includes dividends) which exceeded $20,000. The highest 6% additional tax rate applied to net income in excess of $500,000. As a result of this tax structure, there was no double taxation on dividends in determining the "normal" tax. The 1913 (and all other years) tax form and instructions are accessible in the "Prior Year Products" section of irs.gov, the IRS website.

The provisions of the Revenue Act of 1916 and a 1920 court case (Eisner vs Macomber) appear to be the

source of the term "earnings and profits" (E & P) referred to in section 316 of the present Internal Revenue Code which defines a dividend as a distribution by a corporation (a) out of E & P accumulated after 2/28/1913 or (b) for years after 1934 out of E & P of the taxable year. A distribution by a corporation to its shareholders in excess of E & P is a non dividend distribution which is reported by the shareholder as a reduction in the basis of the corporation's stock held by the shareholder.

The term "earnings and profits" is not defined in the Internal Revenue Code. The addition of a definition was considered in the enactment of the 1954 Internal Revenue Code but was never implemented in the final version. Earnings and profits is equivalent to the corporation's taxable income (loss) (not financial income/loss) adjusted by the Federal income tax amount and other adjustments for certain depreciation, depletion, net capital losses, certain tax exempt income and nondeductible expenses and other adjustments. The calculation is made on a preliminary basis prior to January 31 of the following year in order to file annual Form 1099-DIV to the IRS and a corporation's shareholders which discloses the amount of dividends and non dividend distributions and other information for the prior year. A final calculation of the E & P is included in the corporation's income tax return on Form 4562 in Form 1120 which is due for filing on March 15 but normally filed on an extended due date of October 15 for a calendar year corporation. Any differences between preliminary and final E & P calculations which would affect the dividend and non dividend distribution amounts would require amended Form 1099-DIV to be filed and could require the shareholders to file amended individual income tax returns on Form 1040. It is common for amended Form 1099-DIV to be issued prior to the April 15 due date for Form 1040 as adjustments to the preliminary E & P amounts become known.

FOOTNOTE TO ITEM 3

This "double taxation" of a corporation's income consisting of the corporation tax and the individual tax (sometimes based on a tax higher than the corporate tax rate) appears to have been in existence since 3/1/1913. Attempts to to mitigate this situation began in 1913 for the "normal" tax calculation and were expanded in 1954 with the enactment of the 1954 Internal Revenue Code, which included a controversial change allowing exclusions and credits for dividends, and continued to present by use of:

1. An exclusion from gross income for Domestic corporation dividends in amounts of $50 per individual ($100 on joint return) for years 1954 to 1963 and $100 per individual ($200 on joint return) for years 1964 to 1986. This was repealed for years after 1986.

2. A tax credit of 4% for Domestic corporation dividends for years 1954 to 1963 per individual and 2% per individual in 1964. This was repealed for years after 1964.

3. Lower tax rates for "qualified" dividends received from Domestic or qualified foreign corporations equal to net long-term capital gain rates for years 2003 and thereafter.

Corporations which were holders of another corporation's stock were allowed relief from double taxation in the form of a "dividends received deduction".

Holding period restrictions were implemented to curtail schemes used to avoid taxation due to the preferential treatment of dividends.