HAPPY FISCAL CLIFF'S NEW YEAR RESOLUTION!

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Could there have been a better way to ring in 2013 and this New Year than the captivating Senate and then House of Representatives vote to resolve the Fiscal Cliff?

An 11th hour deal on New Year's Eve between President Obama and Republicans staved off a full expiration of the Bush tax cuts that were set to expire January 1, 2013. In a stunning 89-8 vote, the Senate passed a fiscal cliff resolution with strong bi-partisan approval, despite the deal angering both sides of the aisle on key terms[1]. The House of Representatives, despite protests about a lack of spending discipline introduced in this resolution, voted the next night to ratify the law.

We believe that there are two key features of the deal that should comfort investors, particularly those in dividend paying stocks:

-For those individuals with adjusted gross income less than $400,000 or couples with less than $450,000 ("highest income earners"), the Bush tax cuts were made permanent, including the 15% tax rate on dividends and capital gains[2].

-For those individuals with adjusted gross income above that threshold, the tax rates on dividends and capital gains are being increased from 15% to 20%. On top of that, one must add the 3.8% investment income surcharge that was previously placed as part of President Obama's health care law to get dividend and capital gains tax rates of 23.8% for the highest income earners[3].

Upon Obama's election, there were many who feared a worst-case scenario of dividend tax rates returning to being taxed at the same rates as ordinary income, which could have seen dividend tax rates at 43.4% for the highest income group.

Obama initially advocated for raising taxes for all households with over $250,000 in adjusted gross income. At that particular threshold, we found from Internal Revenue Service (IRS) data that approximately 40% of qualified dividends went to people below that level for the 2010 tax year—the most recent available[4]. The IRS data that we have examined does not provide the exact breakdown of qualified dividends going to tax filers above and below $450,000 in adjusted gross income. But the data does show that approximately 49% of qualified dividends went to people with incomes above $500,000[5] for the 2010 tax year. So by those numbers, it looks to me that approximately half of investors who received qualified dividends will see those tax rates being held constant at 15%—at least according to the most recently available 2010 IRS figures.

I published a paper following Obama's election that outlined what I envisioned then as the worst case scenario for dividend taxes, which would have been the Bush tax cuts expiring for those families with adjusted gross incomes above $250,000, with dividend tax rates rising to 43.4% for those qualifying within the highest tax bracket.

The deal that emerged this New Year's Eve was much better for the markets and dividend-paying stocks, as Obama preserved the preferential tax rate on dividends for many investors. I believe it is a good practice to keep the tax rate on dividends and capital gains equal, so as to not encourage companies to favor stock buybacks over dividends.[6] There has been a trend over the last 30 years for companies to reduce their dividend payout ratios , which I attribute to the heavy compensation of executives with stock options (which benefit more from buybacks than dividends).

Truthfully, I believe there is more we should do with respect to dividend tax policy to improve the attraction of our capital markets. I believe dividends should be tax deductible to corporations just like interest payments on corporate debt. Currently our tax policy incentivizes firms to issue debt financing, as firms can deduct interest payments and pay lower taxes as a result of this debt service. When firms issue equity to finance their activities, they must pay dividends out of after-tax income. This double standard encourages companies to issue more debt and less equity and this higher debt financing makes our equity markets riskier[7], in my opinion.

Obama has stated that he would like to review our corporate tax rates, which are among the highest in the world. A great way to update corporate tax policy would be to make dividends tax deductible just like interest payments. This would make our capital markets more enticing and help to lower the net tax rate of companies. Retirees who invest for dividend income would benefit from companies paying out more of their cash as dividends, especially when other sources of income are so scarce. This would also add additional corporate governance benefits as firms returned cash to their shareholders who could then decide how they wanted to deploy it.

Despite this view of the best dividend tax policy, I am very pleased our politicians came together on New Year's Eve to avert a full fall off the Fiscal Cliff.

There is much work still to do to get budget deficits and spending in line with the revenues collected. But I believe that the markets will like this deal. I believe that dividend investors will like this deal. We can now turn our attention to the debt ceiling discussion, which is when the next set of serious decisions will be made with respect to fiscal spending.

[1]"United States Avoids Calamity in 'Fiscal Cliff' Drama." Reuters. January 2, 2013.

[2]"Here's What the Senate's 'Fiscal Cliff' Deal Looks Like." Reuters. January 1, 2013.

[3]"Here's What the Senate's 'Fiscal Cliff' Deal Looks Like." Reuters. January 1, 2013.

[4]Individual Income Tax Returns 2010: Publication 1304. Internal Revenue Service. 2012.

[5]Internal Revenue Service, 2012.

[6]Source: Professor Robert Shiller, Yale University, 2012. Dividend payout ratios indicate the ratio of earnings per share divided by dividends per share. Higher numbers indicate that a firm's level of earnings can better cover its dividend payments.

[7]Debt financing can potentially increase a firm's level of risk because holders of a firm's debt must continue to be paid regardless of the firm's business prospects or market environment.

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