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The Importance of Dividend Income for Low-Income Seniors

by Gerald Prante

Most debate over whether to extend the reduced rates on dividends and capital gains has focused on the tax benefits of these cuts to high-income taxpayers. What has been largely ignored is the impact these tax policies have had on corporations' decisions on how best to distribute their income to shareholders—including senior citizens, who rely most on the stable flow of income that dividends provide.

A recent Tax Foundation analysis illustrated that a large number of those benefiting from dividends are seniors and those on the verge of retirement (See www.taxfoundation.org/publications/show/1236.html). A further analysis of these seniors earning dividends reveals that lower-income seniors who file tax returns depend more heavily on dividend income than high-income seniors.

Table 1 details the distribution of capital gains and dividends among taxpayers over age 65.[1]

Table 1. Importance of Dividends and Capital Gains for Seniors 65 and over, by Income

	Senior Taxpayers Age 65 and over Who Claim Some Dividend Income	
Income	**Percentage of Income from Dividends**	**Percentage of Income from Capital Gains**
$0 - $29,999	11.3%	0.6%
$30,000 - $49,999	13.8%	4.2%
$50,000 - $99,999	7.2%	8.3%
$100,000 and over	7.7%	16.6%

Note: Income is "Total Income" from all sources as defined by the 2001 Federal Reserve Survey of Consumer Finances. A senior is classified as a "taxpayer" if his or her adjusted gross income (AGI) is greater than $0.

Source: Federal Reserve Board "Survey of Consumer Finances" (2001), Tax Foundation calculations.

As illustrated by the table, dividends are much more important for low-income seniors than are capital gains. Of those lower-income senior taxpayers who earn dividend income, dividends are responsible for over 11 percent of their income, while capital gains are less than 1 percent. On the other hand, for those dividend-claiming senior taxpayers who earn over $100,000, dividends are responsible for only 7.7 percent of income, while capital gains are almost 17 percent.

Overall, one can see that dependence on capital gains income for senior taxpayers tends to rise with total income, while reliance on dividend income tends to fall with total income. This distinction is important when evaluating different tax policies because corporations' decisions of whether to reward shareholders with dividends or with capital gains depends on their respective tax rates.

Explaining the Distributional Effects

Why does dividend income tend to be more important for low-income seniors? One reason is that high-income seniors are more likely to be active investors, buying and selling stocks more frequently. Therefore, capital gains are a more important source of income from stocks for high income seniors. On the other hand, low-income seniors tend to hold stocks in order to receive the steady source of income that dividends generally provide.

Another reason low-income seniors rely more heavily on dividend income is that many high-income seniors only fall in the high-income category because they continue to work. Those who continue to work will have a much greater portion of their income in wages and salaries, and therefore less in dividends than those who are retired.

Impact of Tax Policy on Low- and High-Income Seniors

When a corporation is deciding on a method by which to return its profits to shareholders, it can accomplish this in two ways: (1) raise the price of its stock through stock buybacks, thereby giving additional capital gains to shareholders, or (2) issue dividend payments directly to shareholders.

When these two choices are taxed at different rates, it will weigh heavily on companies' decisions. If dividends are taxed highly—for example, by treating dividend income as ordinary income subject to individual income taxes—while capital gains are subject to a lower tax rate, we would expect companies to compensate shareholders through stock buybacks instead of dividends.

Compared to pre-2003 law, current tax policy gives favorable dividend tax treatment to low-income seniors by providing them with a 5 percent tax rate on both dividends and capital gains. Allowing the 2003 dividend tax cuts to expire in 2008 would force these low-income seniors to pay a tax rate on dividends equal to their marginal income tax rate instead. Currently, that tax rate is 10 percent, but unless the tax cuts are made permanent, even that 10 percent rate will expire. So while the expiration of the reduced tax rates on dividends would raise taxes for all dividend-claiming taxpayers, we could see the tax rate on the dividends of low-income individuals triple from 5 percent to 15 percent after 2010.

This higher tax burden, combined with higher dividend taxes which may cause firms to issue fewer dividends and perform more stock buybacks, would effectively shift income from low-income seniors to high-income seniors. The end result is that after-tax incomes of low-income seniors would be disproportionately hurt by an expiration of the dividend tax cuts.

Footnotes

[1.] We do not use adjusted gross income (AGI) because a significant portion of Social Security payments, which are a key component of income for many seniors, are not included in AGI.

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