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Via Electronic Delivery

Jonathan Weil, Wall Street Journal

Re: Dividends and Earnings

Jonathan:

I enjoyed yesterday's article pointing out that payment of dividends does not necessarily correlate with quality of GAAP earnings, but I have a few comments.

You articulate one of the strong arguments for payment of dividends: The rational investor purchases shares on the assumption that the firm can yield a higher risk-adjusted return on equity (ROE) than can be obtained by alternative investments. So long as the firm's risk-adjusted ROE meets or exceeds this threshold, the rational investor will cause the firm to retain earnings and not pay dividends, as by definition the firm is making best use of the investor's capital.[1] If, on the other hand, the firm does not meet the appropriate ROE hurdle rational investors will – in the absence of tax inefficiency – want a dividend return of free cash flow that is as great as possible.[2]

To date, because of the tax inefficiency, dividends have not been a significant component of investor return. Investors have, instead, relied on share price appreciation based on multiples of GAAP earnings. So, as your article notes, companies have paid dividends out of overstated (or non-existent) earnings.

Notice, however, that this will change if the tax treatment of dividends is normalized. Investors will focus financial performance measures primarily on ROE and free cash flow - ROE because it the measure that a rational investor will use to compare alternative investments and to determine whether a particular enterprise is performing acceptably, and free cash flow because dividends have to be paid in cash

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1 Government tax policy does not have to – and should not – provide incentives for retained earnings such as are contained in the Administration's dividend tax proposal (adjustment of basis in amounts that could have been paid as dividends). Such incentives are an unnecessary subsidy for retained earnings.

2 I have thought about how the markets might set both ROE thresholds and the amount of free cash flow that can be returned as dividends where ROE is inadequate. Since the precision and accuracy of most financial performance data are limited, these measures are likely to be fairly crude.

An appropriate ROE threshold, for example, can be estimated by multiplying the short-term, risk-free rate by the beta of the share price. And, the ratio of the current ratio to share price beta suggests the percentage of free cash flow that can be appropriately paid as dividends. [This percentage, of course, cannot be more than 100%.]

In both formulas, share price beta is a crude surrogate for business risk. It serves a second role in connection with determining the appropriate ROE threshold by adjusting the ROE to account for risk to the underlying share price. The use of current ratio in determining the percentage of free cash flow to be paid as dividends addresses liquidity concerns and counters any incentive the firm might have to use debt to achieve a higher ROE. Investors and stakeholders (particularly lenders) will watch carefully to make sure that companies are not meeting ROE hurdles by taking on debt.

and no company – no matter how profitable on a GAAP earnings basis – can consistently pay dividends in the absence of free cash flow (although some companies may, from time to time, borrow to pay dividends to adjust their weighted average cost of capital).

GAAP earnings will continue to be important, but only as a secondary measure of financial performance. After all, if the firm's ROE is unacceptable the level of earnings will not matter. While ROE ties to net income (GAAP earnings), any rational investor is going to get nervous if the non-cash portion of net income gets too large - even if the ROE is acceptable - because without cash the firm may have limited ability to pay dividends.

So, although dividend payments based on poor earnings quality have been a problem in the past, normalizing the tax treatment of dividends will provide incentives for investors and stakeholders to better police the quality of reported earnings. Additionally, to the extent that dividends become a significant component of shareholder return, share price appreciation should decline and financial performance incentives for management should transition from stock options to dividend payments on restricted stock. This trend – should it occur – will better align the risk tolerance of management with that of shareholders.

I have several criticisms of the Administration's proposal that are not addressed in your article.

Dividends are a cost of equity capital and should be treated for tax purposes in the same way as interest, the cost of debt capital. Both should be deductible from earnings before tax (EBT).

The President's plan that would not allow deduction of dividends at the enterprise level, but would exclude dividends received from individual taxable income is flawed for several reasons. First, disallowing dividend deduction at the enterprise level will do nothing to discourage the misallocation of capital caused by overweighting of debt in corporate capital structures[3]. Second, and more importantly, it will continue the misallocation of equity capital by encouraging firms to retain cash earnings that should be returned to the shareholders[4]. Third, it is unfair to lower-income investors, because the lower-income investor is effectively paying tax on dividends at the corporate rate, which is likely to be materially higher than his or her marginal individual rate. Meanwhile, the higher-income taxpayer receives a small benefit, because the highest marginal corporate rate is slightly lower than the highest individual marginal rate. Finally, to some extent excluding dividend payments from individual taxable income will cause dividend-paying stocks to compete with other tax-advantaged investments available to individuals, such as

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[3] In other words, firms would continue to prefer debt, where the cost – interest – is deductible from EBT over equity, where the cost – dividends – is not. Interest expense would reduce taxes, while dividends would have no effect on tax liability.

[4] Having paid the corporate income tax on profits, corporations will be disinclined to dividend out those profits, because doing so will not favorably affect the financial performance of the firm, however measured. Management, if not the shareholders, will be better off by retaining earnings and measuring rates of taxation over a larger base.

municipal bonds[5] (although this effect will be mitigated because dividend payments based on ROE and free cash flow metrics are likely to be variable).[6]

Again, I enjoyed your article.

/s/

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5 Contrast a system where both dividends and interest on certain fixed income investments are both not includible in the recipient's taxable income with a system in which dividends are includible in taxable income and interest on certain fixed income investments is not.

6 Robert Willens at Lehman Brothers suggested in correspondence to me that taxing dividend income to the recipient might be problematic for tax-exempt enterprises holding dividend-paying investments, and to some extent he is correct. But, rather than imposing the burden of determining the tax status of shareholders on the corporation, I suggested that rules governing tax-exempt enterprises could be adopted that would either require them to pay tax on dividend income at a specified rate, or hold investments paying dividends in taxable affiliates (as they are required to do now in other circumstances).

I believe that the "problem" of individuals receiving dividends in 401(K) and other tax-deferred accounts is a red herring, because these accounts are tax-deferred, not tax free. While models to evaluate the problem will have to be run, I suspect that individual tax liability for dividends received in a tax-deferred account will not be significantly lower – and may in fact be higher – than for dividends received directly. This is because tax-deferred accounts require withdrawals at specified rates and specified ages, and for many investors the assumption that their marginal rates of taxation in retirement will be lower than during their working years turns out to be false.