Proposed Dividend Tax Exemptions: A Ticket to Shangri La, or the End of the REIT Revolution?

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So, What's the Story?

- Pres. Bush has requested $726B of tax cuts to stimulate the economy.
- Nearly $400B of that amount represents the elimination of tax on dividends received by individuals.
- Since dividends are essential to qualifying as a REIT, the President's plan could have far-reaching effects on the REIT industry.

Why dividends?

- Dividends have accounted for nearly 50% of the S&P’s total return of 9.59% annually over the course of the last 100 years.
- Dividends have lost some of their luster in recent years.

Why Exempt Dividends from Tax?

- To correct a historical imbalance
  - 52% of American households own shares in public companies.
  - Corporate earnings are currently taxed twice: once at the corporate level, and again when distributed to shareholders as a dividend.
- Eliminating tax at the investor level would return about $20B to the economy in 2003.

To Correct Distortions

- Firms are encouraged to use debt rather than equity.
  - Companies can deduct interest payments, but not dividend payments.
  - Higher debt levels result in greater vulnerability to economic downturns.

To Stimulate the Economy

- Reducing or eliminating the tax on dividends may encourage more companies to pay dividends or boost existing payouts, reducing the risk of equities and making them a more attractive investment.

To Stimulate the Economy (cont.)

- Dividend paying companies will be valued more highly by the market
  - Companies will increase their hiring and investment
- Elimination of tax will push market up by as much as 10%, promoting economic growth.
- Money lost from eliminating tax on dividends would be recouped through increased sales and income taxes.

To Instill Confidence

- Companies that pay dividends have fared better
  - Dividend payers in S&P 500 averaged a 13.5% decline in 2002 vs. 30.3% decline for non-dividend paying stocks.
  - Between March 2000 and December 2002, non-dividend paying stocks dropped 66.2% vs. 15.6% decline on dividend paying stocks (on a total return basis).

To Enhance Corporate Governance

- Eliminates bias against paying dividends
  - Share repurchases permit the corporation to distribute earnings at reduced capital gains tax rates
  - Buybacks generally push the stock price higher
    - Shares might be substantially overpriced
    - Buyback might mask dilutive effects of massive stock option program.

To Enhance Corporate Governance (cont.)

- Investments will be subject to greater scrutiny if corporations need to issue stock or bonds to raise money for big initiatives.
  - May keep companies from hoarding cash or squandering money on ill-conceived mergers or new products.
  - Investors will have more of a check on corporate excesses.

To Remove Taxes from the Equation

- Reduces incentive for corporations to engage in transactions simply to reduce taxes.
  - Tax break applies only to companies that pay taxes, and only to the extent of taxes paid.
  - Corporations will have good reason to pay taxes; the less tax paid, the less tax-free cash that can be paid to shareholders.

But, Will it Work?

- Dividend Proposal is estimated to cost $396B alone
- Democrats attacked the proposal as a gift to the wealthiest Americans.
  - Bush 2001 savings: $44,500
  - Cheney 2001 savings: $326,555

Who Really Benefits?

- Wealthiest Americans – Over $1M/Yr.
  - $25.4B in dividends in 2001 – ¼ of all dividends for US taxpayers.
- Households with < $50K/Yr.
  - $26.9B in dividends in 2001
- Richest 5% would receive > 2/3 of the benefit from the tax cut
- Payout to top 2% = Payout of bottom 90%.

Not All Dividends are Created Equal

- Only certain dividends qualify for the tax break
  - Investments held in tax-free or deferred pension plans would be unaffected.
  - Possible that instead of new money being invested in the market, a shift will occur from less risky tax-free options such as pensions or IRAs.

Effect on Economy?

- If rising dividends = lower share buybacks, it will likely slow the growth of EPS, which could keep a lid on the market over the next few years
  - Could put a further damper on issuing stock options or restricted stock as comp.
- If the tax rate on dividends < cap. gains, risk appetite may decrease, further curbing economic growth.

Impact to States

- If dividend paying stocks become more attractive, the demand for state and local bonds may decrease, forcing issuers to raise interest payouts to compete.
- Many state tax laws are directly or indirectly linked to federal laws
  - The stimulus plan would cause states to lose more than $4B per year, increasing already large state budget deficits.

End of the Revolution?

- REIT dividends will not qualify for exemption
- Investors may shift money from REITs to other dividend-paying stocks
  - The after-tax yield of non-REIT stocks will increase, decreasing the spread between REITs and non-REITs.
- Many REITs are dealing with the issue of cutting dividends, which might contrast sharply with non-REIT corporations that increase dividends.

Are REITs Doomed?

- Nope. Not even close.
  - About 2/3 of all REIT securities are held by tax-exempt institutions, which receive no benefit from the proposed legislation.
  - Foreign investors also may not benefit from the proposal.
  - REITs maintain other advantages over regular corporations.

REIT Advantages

- REITs will still be more tax-efficient
  - REIT earnings are subject to tax at the shareholders' tax rates, which will generally be lower than the 35% corporate rate.
    - Earnings distributed to a tax-exempt entity actually escapes tax entirely
    - REITs can pass through capital gains, which for individuals are subject to a lower tax rate

REIT Advantages (cont.)

- All non-REIT corporate earnings will be subject to a 35% rate, regardless of whether the shareholder is tax-exempt
- REIT earnings that are subject to tax, such as dividends from a TRS, net income from foreclosure property, or built-in gains recognized on the sale of former C-Corp. assets can be passed through to shareholders as exempt dividends.

Focus on Dividends

- More attention will be focused on the importance of dividends
  - REITs offer a balance between income production and appreciation of capital.
- Depreciation, a non-cash deduction, reduces a REITs taxable earnings without reducing its cash flow, allowing a REIT to pay out more than 100% of earnings = tax-free return of capital.

“Deemed” Dividends

- Instead of paying an actual cash dividend, companies can pass through to shareholders a basis adjustment
  - Management tells shareholders how much the company could have paid out tax-free
  - Reduces gain on the sale of the stock
  - Allows company to retain as much cash as possible in the business

Where do we go from here?

- It appears that there will be some sort of dividend exclusion, though 100% seems unlikely
- REIT yields will continue to dominate
  - REITs are *required* to pay out dividends
  - REITs average about 7.4%, while S&P 500 averages 1.7% yield. S&P would need to move to a 5.2% yield to be on par with REITs

How do we get there?

- REITs offer two important attributes: Dividends and Diversification
- REITs need to emphasize their safety, security and stability.
  - REITs may not be getting proper credit from investors due to the real estate crunch of the early 90’s.
  - REITs total returns have run 700 to 800 basis points above risk-free rates, with about 2/3 coming from dividends, 1/3 from appreciation

Some Final Thoughts...

- From 1972-2001, adding REITs to various portfolios increased annual total returns by .8%.
- From 1992-2001, adding REITs increased returns by 1.3% per year.

Thank you!

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