

## Dividends, double taxation of

Joseph J. Cordes

George Washington University

*Taxation that comes about in the U.S. tax system because corporate profits are taxed once by the corporate income tax and then again when these profits are distributed to shareholders.*

---

Income that is earned by corporations in the United States is currently subject to two levels of tax. Corporate profits are subject to the corporate income tax. When these profits are distributed to the shareholders who own the corporations, these distributions are also included in the shareholders' taxable income.

The consequence of this system is that the return on equity investments in corporate activities is taxed twice. For example, if the statutory corporate tax rate is 34 percent and the personal tax rate is 33 percent, one dollar of corporate earnings is first reduced by 34 cents in corporate profits taxes, which leaves the corporation with 66 cents that can either be kept as retained earnings or paid out in dividends. If the 66 cents is paid out in dividends, this amount would be included in a shareholders' taxable income and would be subject to the personal tax of 33 percent, leaving the shareholder with 44 cents. This situation may be contrasted with a dollar that is earned by, for example, a business that is not incorporated. In that case one dollar of earnings would be subject only to the personal income tax, and the owners of the unincorporated business would get to keep 66 cents.

Double taxation of corporate earnings has long been considered a nettlesome problem of the U.S. tax system, and it is believed to affect business behavior in several ways. One that has received particular attention is the corporation's decision as to how much of its after-tax earnings to retain and how much to pay out to shareholders in dividends. Another is the corporation's decision about how to finance its investments.

### Retained earnings versus dividend payout

One way corporations can reduce the sting of the double tax is to retain earnings rather than pay them out in dividends. If the retained earnings are invested wisely by the corporation, each dollar of retained earnings should increase the value of the firm, which raises its share price. Such price appreciation translates into a capital gain for shareholders; and although capital gains are ultimately subject to tax, they are taxed more lightly than dividends, mainly because of tax deferral. Although retained earnings are neither good nor bad in and of themselves, economists believe that the decision to retain earnings or pay them out should be based on nontax considerations.

### Equity versus debt finance

Double taxation also makes equity finance "more costly" to the corporation than debt finance. This is because corporations are allowed to deduct interest payments on corporate taxes as a business expense but are not allowed to take a tax deduction for the costs of equity finance. As a consequence, the returns from corporate investments that are ultimately paid out to bondholders are subject to only one level of tax. In effect, this means that one dollar of investment that is financed by debt needs to earn a lower overall rate of return in order to pay bondholders their required return after tax, because this dollar is subject only to the personal income tax, than does one dollar of investment that is financed by equity, which is subject to both the corporate and personal income taxes.

### Policy implications

Double taxation of corporate equity has given rise to calls for integrating the corporate and personal income taxes. This is discussed in more detail in the entry *Integration, corporate tax*. The tax system also has features that are designed to attenuate the effects of double taxation, including the tax treatment given to Subchapter S corporations.

*Cross references:* [dividends-received deduction; income tax, corporate, federal; income tax, federal; integration, corporate tax; Subchapter S corporation.](#)