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A surefire way to cut taxes for shareholders

By paying dividends in December instead of January, companies can save stockholders a bundle

By Robert N. Gordon
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Recently, an old friend called to commiserate about the possible spike in taxes on dividends. He made a good suggestion: Companies that usually pay dividends in January should pay them in December, saving shareholders millions, possibly billions, in taxes.

Dividends will be taxed at a higher rate next year, even if President Barack Obama and Congress agree on a plan to avert the so-called fiscal cliff. That is because, at the very least, dividends on upper-income taxpayers will be subject to an extra 3.8% Medicare tax.

Here are the scenarios that could come into play, depending on what the president and Congress do about the Bush-era tax cuts.

If the cuts are extended, taxes on dividends will rise by 25%.

If they aren't extended but dividends continue to be taxed at the rates of long-term gains, taxes on dividends will rise by 58%.

If the Bush-era tax cuts aren't extended and dividends revert to being taxed as ordinary income, taxes on dividends will almost triple — an increase of 189%.

A lot of money could be left in shareholders' hands if companies are accommodating.

I take some comfort in the fact that the first three budgets that the president offered had all the Bush tax cuts expiring except the dividend tax.

This was in recognition of two things: Dividends are paid from earnings that have already been taxed, and almost all our trading partners have an integrated system in which dividends are taxed just once.

TAX DRAG

Under current law, $1 of corporate profit is taxed at 35% on the federal level. If the remaining 65 cents is paid to shareholders, it is taxed again.

This year, the combined tax drag is 44.75%. If dividends are taxed again as ordinary income, the combined taxes paid by the corporation and its owners will increase to 63.21%.

That's right: The government gets 63 cents of every dollar of profit; the owners get 37 cents.

That is how it was before the Bush tax cuts in 2003 and why Mr. Obama separated out dividends when proposing to reverse them. I think that the president will be willing to compromise and continue to tax dividends at the same rate as long-term gains.

Let's take Wal-Mart Stores Inc. (WMT) as an example of what could happen with companies' moving up their dividends, as it is widely held and has already declared its dividend.

In normal times, I would commend Wal-Mart on paying its dividend Jan. 2 instead of in late December. By paying in the new year, it allows shareholders to keep their tax dollars from one April 15 to the next.

But this isn't a normal year.

Wal-Mart has declared a dividend to be paid Jan. 2 for shares held as of Dec. 7. We estimate that dividends will be issued to shareholders on that date totaling $922 million.

At the 2012 rate of 15%, shareholders will pay $138.3 million in taxes on those dividends if received this year.

BILLIONS IN SAVINGS

If received in 2013, the same dividends will cost shareholders a minimum of $173.3 million at 18.8%, or as much as $400.1 million at 43.4%, absent an extension of the lower rate. The 43.4% assumes a 39.6% tax on dividends as ordinary income, plus the 3.8% Medicare surcharge.

By rolling its dividend pay date back by just 48 hours, Wal-Mart alone could save shareholders almost $262 million.

As a point of reference, between Jan. 1 and Jan. 15 of this year, 256 companies paid $16.1 billion in dividends. If those companies move them up, the tax savings could be in the billions.

At least one company already has. Leggett & Platt Inc. (LEG) has moved its upcoming divided of 29 cents a share from January to Dec. 27.

As taxes on dividends will rise by at least 25%, other companies owe it to their stockholders to adjust their dividend schedule.

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