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About Half of Dividend Payments Do Not Face Double Taxation

By William G. Gale

The United States is often said to maintain a classical tax system, under which corporate profits are subject to double taxation, once at the corporate level when they are earned, and again at the individual level when they are paid out as dividends. The Bush administration is reportedly considering corporate tax reform options in part because of concerns about double taxation.

Dividends are not taxed twice if they are paid to nonprofit institutions or foundations; federal, state or local governments; public or private pension funds; and 401(k) plans or Individual Retirement Accounts. (Pensions and tax-deferred saving plans face double taxation in a mechanical sense, since the funds are taxed when eventually withdrawn. But the effective tax rate at the individual level on the income earned in those plans is typically zero or negative because contributions are deductible and taxes on earnings are deferred.)

In 2000, the National Income and Product Accounts report personal dividend income — paid to individuals, pensions, nonprofits, and personal trusts — of \$376 billion. Since \$175 billion represents flows from S corporations, personal dividend income paid by corporations subject to the corporate tax was

\$201 billion. In the same year, taxpayers reported \$142 billion in dividend income, \$62 billion of which was interest payments from mutual funds that the IRS required be recorded as dividends, leaving \$80 billion in dividends on tax returns. Estimates using the SOI public use file imply that 5 percent of reported dividends typically accrue to households in the zero tax bracket, which leaves \$76 billion in taxable dividends. BEA data reports personal trust dividend income of \$17 billion, raising total taxed dividend income to \$93 billion. As a result, just under half — 46 percent (93/201) — of dividends paid out of the corporate sector were subject to double taxation in 2000. The figure shows that the taxed share has fluctuated over time.

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