JOINT HEARING BEFORE THE SENATE COMMITTEE ON
FINANCE AND THE HOUSE COMMITTEE ON WAYS AND MEANS

United States Congress

"Tax Reform and the Tax Treatment of Capital Gains"

September 20, 2012

Statement for the Record by
The Edison Electric Institute
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Introduction

The Edison Electric Institute (EEI) is pleased to submit these comments for the record with respect to the joint hearing regarding tax reform and the tax treatment of capital gains, which was held by the Senate Committee on Finance and the House Committee on Ways and Means on September 20, 2012.

EEI is the association of U.S. shareholder-owned electric utilities, international affiliates, and industry associates worldwide. Our U.S. members serve 95 percent of the ultimate customers in the shareholder-owned segment of the industry and represent approximately 70 percent of the U.S. electric power industry.

The electric power industry is a $790-billion[1] industry that powers our nation's economy and enhances our everyday lives. The electric power industry's 2011 revenues of $373 billion represent 2 percent of real GDP.[2] As of December 31, 2011, U.S. shareholder-owned electric utilities employed more than 500,000 full-time employees.

EEI commends the Chairmen, Ranking Members, and Members of the Committees for holding this hearing, and similar hearings, on the critical issue of tax reform. Retaining low tax rates on dividends is one of the most important issues for EEI and its member companies. As outlined herein, EEI strongly urges Congress to maintain parity between the tax rates for dividends and the tax rates for capital gains and to extend the current dividend tax rates until Congress addresses comprehensive tax reform.

EEI also believes that it is absolutely critical to our nation's recovering economy and to the stability of financial markets that Members of Congress act this year to stop a dividend tax hike. We look forward to working with the Members and staff of the Committees as legislation develops.

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[1] Edison Electric Institute, *2011 Financial Review*, May 2012. Industry size as measured by net property, plant and equipment as of December 31, 2011.
[2] Edison Electric Institute, *2011 Financial Review*, and U.S. Department of Commerce, Bureau of Economic Analysis.

Background

In 2003, Congress passed the Jobs and Growth Tax Reconciliation Act, which *temporarily* reduced the maximum tax rate on qualified dividends from almost 40 percent to 15 percent. The law also cut the maximum tax rate on capital gains from 20 percent to 15 percent. Extended twice on a bipartisan basis, in 2006 and 2010, the current tax rates on both dividends and capital gains are set to expire on December 31, 2012.

The current tax rates for both dividends and capital gains are either 0 percent or 15 percent, depending on a taxpayer's income level. If the current tax rates expire, dividends would be taxed as ordinary income, at a maximum rate of 39.6 percent, while the maximum tax rate for capital gains would increase to 20 percent.

The 2010 health care law imposes an additional 3.8-percent Medicare tax on all investment income beginning in 2013 for households earning more than $250,000 ($200,000 single). This effectively raises the maximum tax rate on capital gains from 15 percent to 23.8 percent; on dividends, from 15 percent to 43.4 percent—a 189-percent increase.

Electric Utilities and Dividends

Dividends are a key component for companies to provide a return on capital to investors and to attract new shareholders. Electric utilities and other businesses that pay dividends do so because it makes their stocks more attractive to investors. And through their stock sales, these companies can achieve the appropriate balance of debt and equity in their capital raising efforts.

Electric utilities paid out 57.9 percent of their earnings in the form of dividends last year—the most of any business sector. The next highest payout ratios were the S&P's Consumer Staples sector at 44.6 percent, and Industrials at 31.3 percent. And since the 2003 law lowering dividend tax rates took effect, electric utility capital expenditures have increased 84 percent—from $43.0 billion in 2003 to $79.3 billion in 2011.

The electric power sector is one of the most capital-intensive industries, and the annual capital expenditures for U.S. shareholder-owned electric utilities are projected to remain at historically high levels of approximately $85 billion for the next several years. The tax treatment of dividends and the cost of capital are important considerations for electric utilities making significant investment decisions.

Today's low dividend tax rates help utilities lower their cost of equity capital and maintain a stronger financial condition. A financially strong company is more likely to receive favorable terms when issuing debt, which is critical for electric utilities, especially at this time of elevated capital expenditures.

By attracting new investment in their shares, electric utilities are able to raise the capital they need to finance major infrastructure and other investment projects. This capital is needed to build new generation, transmission, and distribution systems and to upgrade existing facilities; to meet environment requirements; to modernize the grid; and to improve the ability of the electric system to respond to cyber threats. And it should be noted that these infrastructure investment projects and upgrades offer an important source of much-needed, high quality job creation in states across the country.

Tax Policy Considerations

If current dividend tax rates expire and the parity between dividends and capital gains tax rates is lost, federal tax policy will distort investment decisions by favoring growth stocks and debt investments over dividend-paying investments. Such a decoupling of the dividend tax rate from the capital gains tax rate would be harmful not only to dividend-paying companies and their shareholders, but also to the economy as a whole.

As of December 31, 2011, the capital structure of shareholder-owned electric utilities was roughly 57 percent long-term debt and almost 43 percent common equity. Should the current dividend tax rates expire, tax policy would revert to favoring debt over equity in order to raise capital—an outcome that could make investors hesitant to provide financing for major new projects and disrupt companies' ability to implement long-term strategic plans. Increasing the tax rates on dividends and making equity capital more expensive would further exacerbate the perverse economic incentives for corporations to utilize excessive debt financing.

In addition, it is important to remember that if a company decides to pay dividends, the earnings are taxed twice—first at the corporate level when the company pays taxes on these earnings (at a statutory rate of up to 35 percent), then later at the individual level when shareholders receive the dividends. According to a February 2012 study prepared by Ernst & Young for the Alliance for Savings and Investment, the top U.S. integrated dividend tax rate is currently 50.8 percent (when both corporate and individual tax levels, as well as state taxes, are factored in). If the current rates expire, the top U.S. integrated dividend tax rate will rise to 68.6 percent—the highest level among developed nations. In other words, if a company has $100 of available earnings to pay in dividends, the investor would receive only $31 after all taxes are paid.

Dividends suffer from double taxation to a much greater extent than capital gains. The tax on capital gains is deferred until realization (e.g., the investor sells the stock). Dividends, in contrast, are taxed annually as they accrue, not just when the stock is sold.

Raising Dividend Tax Rates For Anyone Would Hurt Everyone

Millions of Americans—from all income levels and age groups—directly own stocks that pay dividends. Dividend-paying stocks are also held by the tens of millions of Americans who own stocks indirectly through mutual funds, and they support the value of stocks held in employer and union pension plans, life insurance policies, 401(k) plans, or individual retirement accounts.

Raising dividend tax rates will hurt all investors, regardless of their income level. That's because higher-income investors, when faced with such a staggering tax hike, likely would sell their dividend-paying stocks, turning instead to investments with a lower tax burden that offer more attractive rates of return. A retreat from dividend-paying stocks would depress stock prices for dividend-paying companies, which ultimately will hurt all shareholders.

Raising Dividend Tax Rates Would Disproportionately Hurt Seniors and Retirees

Older investors who are at or nearing retirement age are likely to be hurt the most by a dividend tax hike. Unfortunately, with interest rates now so low, and expected to remain low for several more years, interest-bearing investments (e.g., certificates of deposit) have failed to keep pace with inflation. As a result, older investors increasingly are turning to dividend-paying investments that produce supplemental income. For those living on fixed incomes and counting on dividends to help pay their bills, a reduction in these dividend payments could be devastating.

According to a 2012 study by Ernst & Young, taxpayers age 50 or older represent a majority of tax filers claiming dividends. In fact, in 2009, the latest year for which complete IRS data are available, Ernst & Young found:

- 63 percent of tax returns with qualified dividends were filed by taxpayers age 50 and older;
- 32 percent were from taxpayers age 65 and older;
- 68 percent were from returns with incomes less than $100,000; and
- 40 percent were from returns with incomes less than $50,000.

Raising Dividend Tax Rates Would Hinder Economic Growth and Job Creation

Discouraging investment in dividend-paying companies will hurt huge sectors of the economy—including manufacturing, utilities, telecommunications firms, retailers, drug companies, and food producers—that are all critical to economic growth and job creation. Reducing the capital these sectors can raise in equity markets will force them to increase their debt financing, thereby creating more leveraged balance sheets and injecting unnecessary risk into already nervous financial markets.

Conclusion

EEI strongly urges Congress to maintain parity between the tax rates for dividends and the tax rates for capital gains and to extend the current dividend tax rates until comprehensive tax reform is addressed. We also urge Congress to act before the end of this year to help prevent the potentially dire impact on economic growth, job creation, and financial markets that could happen if the 2001/03 tax provisions expire and the nation goes over the so-called “fiscal cliff.”

Taxing dividends at the higher marginal rates applicable to ordinary income would have significant negative consequences at a time when the U.S. economy is still struggling to recover. The current dividend tax rates benefit investors, consumers, American businesses, and the U.S. economy. And they have helped the electric power industry to attract the capital necessary for crucial infrastructure investments and job creation. A lower cost of capital allows utilities to maintain a stronger financial condition and helps to decrease the costs of utility services to consumers and businesses.

Thank you for the opportunity to provide this testimony. If any of the Members of the Committees or their staffs have any questions or comments, please contact:

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