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Stuart J. Sweet, President

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ON DIVIDEND TAX CUTS, DOES BUSH HAVE A SHORT GAME?

Competitive golfers sometime say, “Drive for show, putt for dough,” the point being that you cannot win at golf with flashy 300 yard-drives if you miff the close-in shots. The same principle applies to legislation. After months of campaigning in favor of eliminating taxation of dividend distributions to individuals, we’re about to learn if George Bush has a “short game.” We are only two steps away from knowing the exact shape of the tax cut. If Bush performs well now, he will score a birdie rather than a bogie.

This week, the full Senate will debate the tax bill approved by the Senate Finance Committee last Thursday. After 20 hours of debate, it is expected to pass the bill, probably on Wednesday or Thursday. It’s no secret that the Finance Committee bill reflects the demands of Senator Olympia Snowe (R-ME). In Committee her views were pivotal. If Snowe had joined Committee Democrats in opposition, the bill would have failed in Committee by a 11-10 vote. To get Snowe’s vote, the White House agreed to overall limits on the size of the total tax cut, as well as its composition. On dividends, Snowe said she would support exempting the first \$500 of individual dividend income from taxation, plus 10 percent above \$500 during 2004 to 2007, and 20 percent above \$500 from 2008 to 2012. Those provisions are in the Senate bill right now. However, Senate floor proceedings will add another chapter to this convoluted saga. “If it’s another day, apparently they have another plan,” quipped House Ways and Means Chairman Thomas last week on CNBC’s “Capital Report,” responding to a question about proposed Senate tax cuts. Negotiations are far from over.

A Successful Long Drive in the House

Carrying a 10-year price tag of just under \$550 billion, the House passed a White House supported tax cut bill that has provisions for individuals, businesses, and investors. The bill:

- , Accelerates marginal tax reductions and marriage penalty relief included in the 2001 tax bill moving up provisions planned for 2006 and enacting them retroactive to Jan. 1, 2003
- , Increases the child care credit and individual alternative minimum tax deductions in 2003
- , Provides for “bonus depreciation allowances” from 2003 to 2005, and increases small business expensing limits from \$25,000 to \$75,000
- , Extends the 5-year Net Operating Loss carryback rule from 2003 to 2005
- , Reduces the capital gains tax rate to 5 percent for individual taxpayers in the ten percent and fifteen percent brackets and to 15 percent for all other taxpayers, and applies these much lower rates also to dividend income

Getting to Fifty in the Senate

With a skillful short game, the White House can reshape the tax bill. It only needs to win support from two more Senators; Vice President Dick Cheney will break any 50-50 tie. The Bush Administration starts with the support of 48 Senators – 47 Republicans and Zell Miller (D-GA). Its Senate lobbyists are working hard now to find those two decisive votes by negotiating with Democrats Blanche Lincoln (D-AR), Ben Nelson (D-NE), Bill Nelson (D-FL), Jeff Bingaman (D-NM), and John Breaux (D-LA) along with two Republicans, Senator Snowe and George Voinovich (R-OH). They view John McCain (R-AZ) and Lincoln Chafee (R-RI) as lost causes.

The key maneuver is to tell each Senator that the bill is going to pass anyway, and the only question is which two Senators will be part of the winning coalition. Then, the White House will ask each Senator what changes are necessary to secure a “yes” in favor of a bill that provides more favorable treatment of dividend taxation. For example, Lincoln and Ben Nelson might be swayed by offers to help chicken and hog farmers. If Bush putts with a steady hand, he can pit many of these seven Senators against each other, driving up the size of dividend relief while driving down the size of the concessions he has to make to find fifty votes.

The Senate Vote Does Not End This Game

After the bill passes the Senate this week, differences between the House and Senate bills will have to be resolved. This probably happens in a traditional conference where both bodies send representatives to iron out their differences. Bush’s second chance to play for a birdie comes during this House-Senate negotiation. He again will try to drive the Senate closer to the House bill, tempting moderate Democrats with deals if only they will go along. With perfect play, the final product will look very similar to the House result – to the surprise of nearly everyone! Played poorly, the final result will look much like what Senate Snowe forced on the Senate Finance Committee.

Most observers expect the conference to produce a bill that is closer to Snowe’s wishes, not those of the House. As a contrarian strategy, investors may elect to purchase securities that would be helped by the liberalization of dividend taxation. Typically, these are viewed as equities with above average dividend yields. If the expected happens, “the news is in the stocks.” If the White House scores a surprise win, then the contrarians could take the club trophy.

What to Watch For

The seven targeted Senators can help the White House liberalize the tax treatment of dividends in two ways. First, they can agree to expand the size of the tax cut. The House has passed a plan that reduces revenue over ten years by \$550 billion. The Senate bill contains \$350 billion in reductions, consisting of \$413 in tax reductions, \$83 billion in tax increases, fee

extensions, and program reforms, and – at Snowe’s urging – \$20 billion in aid to state governments. To the degree two targeted Senators agree to boost the size of the tax cut above \$350 billion, that amount can be applied toward treating dividends more favorably.

Less obviously, the Senate Finance Committee has made subtle changes in the way it treats the Administration’s other tax requests. The Senate Finance Committee provides more generous tax reductions than in House in several ways:

- , It elects to index to inflation the income limits for the 10 percent and 15 percent brackets in the years after 2006, while the House did not
- , It adds similar inflation indices to provisions boosting the child tax credit and reducing the “marriage tax”
- , It provides for more generous changes in depreciation schedules

These differences are getting little attention now. As the attached chart shows, if the Senate conferees were to adopt the House position on these items, they would raise \$100 billion over ten years! This \$100 billion would go a long way toward narrowing the dividend tax gap between the House and Senate. Currently, the House dividend reduction plan reduces revenue by \$246 billion over ten years while the Senate dividend plan reduces revenue by \$80 billion. If the Senate agreed to drop these provisions and applied the \$100 billion toward dividend tax relief, Congress could pass a \$350 billion net tax cut which includes \$180 billion in dividend tax reductions. The Senate’s ability to move toward the House on dividend policy may turn on its own powers of persuasion, convincing the House that the tax increases the Senate applies toward Americans working abroad and the revenue it raises by boosting customs fees make sense. If the Senate loses the argument about including \$83 billion in tax and fee hikes, then it has \$83 billion less to apply toward dividend changes without boosting the size of the tax cut.

This is a tricky course to play. There are a lot of dog legs, sand traps, water hazards, and rolling greens – but an excellent golfer would get the birdie.

For further analysis or information, contact Capitol Analysts Network, Inc. at:

4405 Bradley Lane
Chevy Chase, Maryland 20815
website: www.capitolanalysts.com

Phone: 301-951-9161
Fax: 301-652-5831
Email: capnet@xecu.net

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Chart One: Cost Comparisons of House and Senate Tax Bills (in \$ millions)

	Ways & Means 5-year cost	Finance 5-year cost	House - Senate 5-year cost	Ways & Means 10-year cost	Finance 10-year cost	House - Senate 10-year cost
Accelerate expansion of 10% bracket	18,597	35,857	(17,260)	18,597	44,792	(26,195)
Accelerate 2006 rate schedule	74,015	74,015	0	74,015	74,015	0
Accelerate expansion of 15% bracket; increase standard deduction for joint married taxpayers	43,376	51,022	(7,646)	43,376	51,357	(7,981)
Increase child care credit to \$1,000	45,045	72,163	(27,118)	45,045	89,813	(44,768)
Increase small business expensing from \$25,000 to \$75,000/\$100,000	14,454	16,451	(1,997)	2,688	23,393	(20,705)
Increase bonus depreciation to 50%	78,512		78,512	21,471		21,471
Increase individual AMT exemption by \$7,500 single, \$15,000 joint/\$6,000 single, \$12,000 joint (W&M/Finance), '03 and '04	52,981	49,268	3,713	52,981	49,268	3,713
Extend 5-yr. NOL carryback and waive AMT 90% limitation for '02-'05	27,021		27,021	14,556		14,556
Dividend income: Tax at 15%/5% capital gains rate (W&M); Exclude 100% of first \$500/return for dividends, and for amounts above \$500, exclude 10% from '04-'07 and 20% from '08-'12 (Finance)	105,552	24,320	81,232	245,766	80,507	165,259
Tax Capital gains @15%/5%	14,481		14,481	31,048		31,048
Total Tax Cuts	474,034	323,096	150,938	549,543	413,145	136,398
SENATE FINANCE OFFSETS						
Various Foreign/Expatriated receipts		(1,307)			(3,441)	
Impose Tax Shelter limitations		(1,395)			(3,366)	
Repeal foreign housing credit		(10,343)			(32,097)	
Extend Customs user fees		(7,682)			(17,836)	
SSI/SCHIP reform and Other Offsets		(11,502)			(26,330)	
Total Tax Increases		(32,229)			(83,070)	
Increase State Aid Trust Fund		20,000			20,000	

Estimates prepared by the Joint Committee on Taxation