The Beneficiaries of the Dividend Tax Rate Reduction:

A Profile of Qualified Dividend Shareholders

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Ernst & Young
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Prepared by the Quantitative Economics and Statistics Practice
Ernst & Young LLP

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Overview

Federal tax rates on qualified corporate dividends were temporarily reduced in 2003 when Congress passed the Jobs and Growth Tax Reconciliation Act. The maximum tax rate on qualified dividend income was cut from almost 40 percent to 15 percent. (Taxpayers in the 10-percent and 15-percent tax brackets currently pay no taxes on qualified dividend income.) The 2003 law also cut the maximum tax rate on long-term capital gains from 20 percent to 15 percent.

Congress extended the 2003 tax cuts in 2006 and again in 2010. The dividend tax rate reduction now is scheduled to expire on December 31, 2012. If current rates expire, dividend income will be taxed as ordinary income, with rates rising to as high as 39.6 percent. The top tax rate on capital gains, meanwhile, will rise from 15 percent to 20 percent.[1]

Ernst & Young LLP's (EY's) Quantitative Economics and Statistics Practice has analyzed the age and income characteristics of shareholders who qualify for the lower tax rates on qualified corporate dividends.[2]

Based on information from the Internal Revenue Service's (IRS's) Statistics of Income (SOI) on tax returns with qualified dividends, EY has made estimates of the age and income distribution of tax returns with qualified dividends at the national level in 2009, the latest year for which detailed information from federal individual tax returns is available.

In past years, EY used a special tabulation from the IRS SOI, showing the distribution of tax returns with qualified dividends by age and income. EY requested a special tabulation for 2009, but this information was not available at the time of publication of this report. In this report, EY uses data from three sources to make its estimates: 1) IRS SOI 2009 All returns by age and income; 2) IRS SOI 2009 Returns with qualified dividends by income; and 3) IRS SOI 2007 Special tabulation of returns with qualified dividends by age and income.

The update of the 2007 age and income distribution to 2009 reflects the change in the age and income distribution of all tax returns plus the change in the income distribution of returns with qualified dividends.

The IRS SOI reports that 25.4 million tax returns included qualified dividends in 2009, representing $123.6 billion of qualified dividends. The tax returns with qualified dividends have the following profile:

- 63 percent are from taxpayers age 50 and older,
- 32 percent are from taxpayers age 65 and older,
- 68 percent are from returns with incomes less than $100,000, and
- 40 percent are from returns with incomes less than $50,000.

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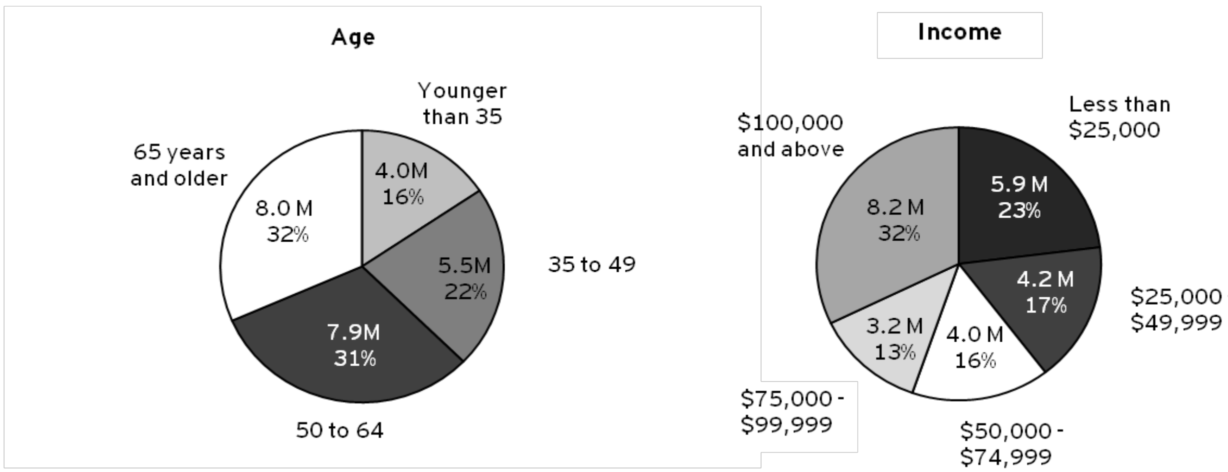
[1] The health care legislation enacted in 2010 imposes an additional 3.8-percent Medicare tax on all investment income beginning in 2013 for households earning more than $250,000 ($200,000 single). Therefore, dividend tax rates will be as high as 43.4 percent and long-term capital gains tax rates will be as high as 23.8 percent.

[2] Qualified dividends eligible for the lower tax rates are dividends received by individual shareholders from domestic corporations or foreign corporations' stocks that are readily tradable on U.S. securities markets or corporations incorporated in a U.S. possession or eligible for benefits under a comprehensive income tax treaty with the United States.

Tax Returns with Qualified Dividends by Age & Income, 2009
(Millions of Returns)



Note: Totals may not add to 100% due to rounding.

Investor Characteristics and Portfolio Considerations

Holdings of Corporate Equities. According to the Federal Reserve Board's Flow of Funds, households held $17.3 trillion of corporate equities at market value at the end of 2011.[3] Households held $8.1 trillion of corporate equities directly. Another $9.2 trillion of corporate equities was held indirectly through life insurance companies, private pension plans, government retirement funds, and mutual funds. Equities held in pension and retirement plans and by life insurance companies generally are not subject to current taxation and would not qualify for the lower dividend tax rates. Corporate equities held through mutual funds (outside of defined contribution plans) potentially would qualify for the lower dividend tax rates and totalled $2.5 trillion.

Households held roughly $10.6 trillion of corporate equities directly or through taxable mutual funds. Approximately 17 percent of the total corporate equity holdings by U.S. residents are foreign issued,[4] including American Depositary Receipts, which would not be eligible for the lower tax rates on dividends. Thus, at the end of 2011, approximately $9 trillion of corporate equity of U.S. corporations was held in taxable form by U.S. households. Approximately 76 percent was held directly by households and 24 percent was held indirectly through mutual funds.

Investors' Risk Tolerance and Financial Goals. Academic and government studies of households' financial portfolios do not identify different types of assets beyond the general level of equities, bonds, mutual funds, and retirement assets. However, studies on investors' preferences and attributes of stocks are available, and can serve as a basis for an estimate of utility stock holdings by age and income.

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[3] Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Flows and Outstanding Fourth Quarter 2012, Z1, March 8, 2012, Table B.100.e. Includes households and non-profit organizations.

[4] Federal Reserve, Flow of Funds, Table L.213.

The Investment Company Institute (ICI) publishes results on investors' views of mutual funds from a periodic survey of nearly 2,000 mutual fund investors.[5]

Table 1 *(see page 4)* presents the results of a 2011 ICI survey by age and shows:

- Mutual fund investors age 65 and older are less likely than younger investors to take above-average or substantial risks, even for above-average or substantial gains.
- Of older mutual fund investors, 82 percent are willing to take only average or below-average risks, or no risk at all, in their financial investing compared to 65 percent for investors younger than age 40.
- More than half of older investors cite current income as a principal objective of their mutual fund investment, compared to 13 percent to 16 percent for younger investors.

The data do not suggest that investors age 65 and older shun equities in favor of bonds or fixed-income investments. Almost three-quarters of mutual fund investors age 65 and older invest in equity mutual funds, and 47 percent invest in individual stocks directly.

Older investors have different objectives and risk tolerances. They are likely to favor individual stocks and mutual funds with higher dividend yields and lower market volatility. Similarly, older investors are more likely to favor income mutual funds and value funds.

The Demographics of Shareholders with Qualified Dividends by Age and Income

Empirical information about ownership of specific types of equities is limited, compared to the significant literature on portfolio ownership across major types of investments. However, using the data from the IRS SOI, EY estimates qualified dividends by age and income for 2009, the latest year for which detailed information from federal individual tax returns is available.

It is useful to start with the age and income distribution for total households from the U.S. Census Bureau, shown in Table 2 *(see page 5)*. Households in which the head of household is age 65 or older account for 21 percent of all households, and those in which the head of household is between ages 50 and 64 account for 28 percent of all households. Hence, households in which the head of household is age 50 or older account for 49 percent of all households; and those in which the head of household is younger than 50 account for slightly more than half of all households.

[5] Investment Company Institute, Annual Mutual Fund Shareholder Tracking Survey, 2011. The most recent survey was conducted in May 2011 and was based on a sample of 4,216 U.S. households randomly selected, of which 1,859 households, or 44 percent, owned mutual funds.

Table 1. Mutual Fund Views and Characteristics, 2011
(Percent of mutual fund-owning households by age)

	Younger than 40	40 to 64	65 Years or Older
Level of risk willing to take with financial investments:			
Substantial risk for substantial gain	9%	3%	2%
Above-average risk for above-average gain	26	27	16
Average risk for average gain	43	51	45
Below-average risk for below-average gain	8	9	16
No risk at all	14	10	21
Financial goals for mutual fund investments:[1]			
Retirement	97%	97%	84%
Emergency	47	43	63
Current income	13	16	52
Reduce taxable income	44	53	45
Education	41	23	9
House or other large purchase	22	8	7
Percent of Mutual Fund-Owning Households Own:[1]			
Equity Mutual Funds	83%	83%	73%
Bond Mutual Funds	51	53	48
Hybrid Funds	41	46	41
Money Market Funds	61	63	66
Individual stocks	38	45	47
Individual bonds (excluding U.S. savings bonds)	8	8	15
Fixed or variable annuities	23	34	45

[1]Multiple responses are included.
Source: Schrass, Daniel, and Michael Bogdan. 2012. "Profile of Mutual Fund Shareholders, 2011." ICI Research Report (February).

Table 2. Households, by Age & Income, 2009

Number of Households (in millions)					
Income	Younger than 35 years	35 to 49 years	50 to 64 years	65 years and over	Total
Less than $25,000	6.8	5.9	6.7	10.0	29.4
$25,000 - $49,999	7.2	7.5	7.1	7.7	29.6
$50,000 - $74,999	5.1	6.7	6.0	3.6	21.3
$75,000 - $99,999	2.8	4.9	4.2	1.6	13.5
$100,000 and above	3.6	9.0	8.8	2.4	23.7
Total	25.5	34.0	32.8	25.3	117.5
Percent of All Households					
Income	Younger than 35 years	35 to 49 years	50 to 64 years	65 years and over	Total
Less than $25,000	6%	5%	6%	8%	25%
$25,000 - $49,999	6%	6%	6%	7%	25%
$50,000 - $74,999	4%	6%	5%	3%	18%
$75,000 - $99,999	2%	4%	4%	1%	12%
$100,000 and above	3%	8%	8%	2%	20%
Total	22%	29%	28%	21%	100%

Source: US Census Bureau, Table HINC-02, Current Population Survey 2009
Note: Age reported is that of head of household. Totals may not add due to rounding.

Table 3 *(see page 6)* shows that tax returns are more heavily weighted to taxpayers who are younger than 35 years of age because there are more single taxpayers and child tax returns. There has also been an increasing share of returns from taxpayers older than age 50 due to the aging population. Returns filed by taxpayers age 65 and older accounted for 14 percent of all tax returns in 2009. Of those returns, 66 percent had adjusted gross incomes (AGI) of less than $50,000 and 88 percent had AGI less than $100,000.

Table 3. All Tax Returns, by Age & Income, 2009

	Number of Returns (in millions)				
Size of adjusted gross income (AGI)	Younger than 35 years	35 to 49 years	50 to 64 years	65 years and over	Total
Less than $25,000	29.7	11.5	8.9	9.0	59.1
$25,000 - $49,999	11.1	10.1	8.3	4.4	33.8
$50,000 - $74,999	3.8	6.2	5.8	2.9	18.7
$75,000 - $99,999	1.7	4.2	3.8	1.7	11.5
$100,000 and above	1.6	6.7	6.8	2.3	17.4
Total	47.9	38.7	33.5	20.3	140.5
	Percent of All Returns				
AGI	Younger than 35 years	35 to 49 years	50 to 64 years	65 years and over	Total
Less than $25,000	21%	8%	6%	6%	42%
$25,000 - $49,999	8%	7%	6%	3%	24%
$50,000 - $74,999	3%	4%	4%	2%	13%
$75,000 - $99,999	1%	3%	3%	1%	8%
$100,000 and above	1%	5%	5%	2%	12%
Total	34%	28%	24%	14%	100%

Source: IRS Statistics of Income 2009, Table 1.6.
Note: Age reported is that of head of household. Totals may not add due to rounding.

Table 4 *(see page 7)* shows the estimated distribution of returns with qualified dividends by age and income for 2009. Among the results:

- While 38 percent of all Form 1040 returns were filed by taxpayers age 50 or older *(as shown in Table 3)*, 63 percent of returns with qualified dividends were filed by the same age group.
- Taxpayers with AGI of less than $100,000 accounted for 68 percent of the tax returns with qualified dividends.
- Taxpayers with AGI of less than $50,000 accounted for 40 percent of the tax returns with qualified dividends.

Table 4. Tax Returns with Qualified Dividends, by Age & Income, 2009

	Number of Returns (in millions)				
Size of adjusted gross income (AGI)	Younger than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than $25,000	2.1	0.5	0.9	2.4	5.9
$25,000 - $49,999	0.7	0.7	1.2	1.7	4.2
$50,000 - $74,999	0.4	0.8	1.3	1.4	4.0
$75,000 - $99,999	0.3	0.8	1.1	0.9	3.2
$100,000 and above	0.5	2.7	3.3	1.6	8.2
Total	4.0	5.5	7.9	8.0	25.4
	Percent of All Returns with Qualified Dividends				
AGI	Younger than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than $25,000	8%	2%	4%	10%	23%
$25,000 - $49,999	3%	3%	5%	7%	17%
$50,000 - $74,999	2%	3%	5%	6%	16%
$75,000 - $99,999	1%	3%	4%	4%	13%
$100,000 and above	2%	11%	13%	6%	32%
Total	16%	22%	31%	32%	100%

Source: IRS Statistics of Income, EY Calculation.
Note: Age reported is that of head of household. Totals may not add due to rounding.

Sector in Focus: A Profile of Electric and Natural Gas Utility Shareholders Benefiting from the Dividend Tax Rate Reduction

Electric and natural gas utility stocks have above-average dividend yields and below-average volatility compared to the overall stock market. These two key characteristics make utility equity investments attractive to many investors near or in retirement, as well as to investors seeking current income with reduced market volatility.

U.S. electric and natural gas utilities paid $18.3 billion in dividends in 2009, $19.3 billion in 2010, and $20.8 billion in 2011.[6] Lower tax rates on dividends have contributed to the above-average share appreciation of utility stocks during the past eight-and-a-half years, which reduces the cost of capital for the major transmission and distribution upgrades, environmental and energy-efficiency improvements, and new capacity needs the industry is facing.

Utilities have an above-average dividend payout ratio and a high dividend yield. For the twelve months ended December 31, 2011, U.S. shareholder-owned electric utilities paid out 58 percent of their net income as dividends, with a dividend yield of 4.1 percent at year-end 2011—both measures significantly higher than other industry sectors.[7] Thus, utility stocks are attractive for investors seeking current income.

6 Edison Electric Institute, Q4 2011 Financial Update.

7 Edison Electric Institute, Q4 2011 Financial Update, Dividends.

Electric and natural gas utility stocks also have, on average, a low volatility compared to the overall stock market, and other industries. A common measure of relative market volatility is the Beta, which is set at 1.0 for companies or industries that have the same volatility as the overall stock market. Companies and industries that have a Beta of less than 1.0 are less volatile than the overall market, while companies and industries with Betas greater than 1.0 are more volatile than the overall market. For electric utility companies, the Beta was 0.73 as of January 2012; for natural gas utility companies, the Beta was 0.66.[8] In both cases, their stock volatility is significantly lower than the overall market.

Demographics of Utility Shareholders with Qualified Dividends

Investors in individual utility stocks are more likely to be seeking above-average dividend yields and lower risk tolerance. Thus, utility stocks are more likely to be held by investors near or in retirement and are attractive to investors with low- or middle-class incomes.

To estimate the number of tax returns with qualified dividends from utility stocks, EY used information from several sources. Taxpayers could directly hold shares of stock in individual utility companies or indirectly through taxable mutual funds.

ICI estimates that, on average, between 2007 and 2011, approximately 13.1 million households had stock or hybrid mutual funds in taxable accounts.[9] These mutual funds are held outside of 401(k) and Individual Retirement Accounts (IRAs). Hybrid mutual funds comprise balanced funds that include equities, bonds and other investments. Based on ICI data on the age and income distribution of households with taxable equity and hybrid mutual funds, the estimate assumes most households with taxable equity mutual funds indirectly hold some stocks given the diversification of mutual fund holdings.

The IRS SOI reports that 25.4 million tax returns included qualified dividends in 2009. EY estimates that approximately 12.9 million of these tax returns with qualifying dividends had some utility holdings through taxable mutual funds. For taxpayers with qualifying dividends from taxable mutual funds with utility holdings, EY estimates:

- 58 percent were from taxpayers age 50 and older,
- 23 percent were from taxpayers age 65 and older, and
- 56 percent were from taxpayers with AGI less than $100,000.

EY estimates that the remaining 12.5 million tax returns with qualifying dividends received dividends from direct holdings of equity shares in individual companies. To determine the percentage of those returns that have some direct utility stock investments, the estimate used information on direct utility stock investments and general stock and mutual fund investments from a major brokerage firm. From this information, the percentage of investors in a given age and income group that owned individual utility stocks was calculated.

On average, 23 percent of investors who owned direct equity shares owned some utility company shares. This translates to approximately 2.7 million tax returns with qualified dividends from direct holdings of individual utility stocks. The propensity of investors to own utility stocks directly, conditional on their owning some direct equities, ranged from 16 percent for investors age 35 or younger with incomes of $50,000 or less, up to 36 percent for

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8 Damodaran, Aswath. NYU Stern School of Business, January 2012: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html

9 Special tabulation from the Investment Company Institute from its Annual Mutual Fund Shareholder Tracking Surveys, 2007 to 2011.

investors age 65 and older with incomes of $100,000 or more. This relationship is consistent with the other information on investor risk tolerance and investment objectives.

Table 5 shows the estimated 15.6 million tax returns with qualified dividends through ownership in utility stocks either directly through investments in shares of individual utility company stocks (2.7 million) or indirectly through taxable mutual funds (12.9 million). Many other households own utility stocks through their insurance and retirement accounts, which are not taxed currently.

Table 5. Estimate of Tax Returns with Qualified Dividends from Utility Stocks, by Age & Income, 2009

	Number of Returns with Qualified Dividends from Direct and Indirect Utility Stock Holdings (in millions)				
Size of adjusted gross income (AGI)	Younger than 35 years	35 to 49 years	50 to 64 years	65 years and over	Total
Less than $25,000	0.24	0.18	0.29	0.91	1.62
$25,000 - $49,999	0.25	0.47	0.59	1.14	2.45
$50,000 - $74,999	0.39	0.64	0.80	0.87	2.70
$75,000 - $99,999	0.28	0.67	0.84	0.64	2.43
$100,000 and above	0.52	2.28	2.52	1.03	6.35
Total	1.69	4.24	5.03	4.59	15.55

	Percent of Returns with Qualified Dividends from Direct and Indirect Utility Stock Holdings				
Size of adjusted gross income (AGI)	Younger than 35 years	35 to 49 years	50 to 64 years	65 years and over	Total
Less than $25,000	2%	1%	2%	6%	10%
$25,000 - $49,999	2%	3%	4%	7%	16%
$50,000 - $74,999	3%	4%	5%	6%	17%
$75,000 - $99,999	2%	4%	5%	4%	16%
$100,000 and above	3%	15%	16%	7%	41%
Total	11%	27%	32%	30%	100%

	Percent of Returns with Qualified Dividends from Direct Utility Stock Investments				
Size of adjusted gross income (AGI)	Younger than 35 years	35 to 49 years	50 to 64 years	65 years and over	Total
Less than $25,000	5%	2%	4%	23%	34%
$25,000 - $49,999	2%	2%	4%	10%	17%
$50,000 - $74,999	0%	2%	3%	11%	16%
$75,000 - $99,999	0%	1%	2%	6%	10%
$100,000 and above	0%	4%	8%	12%	24%
Total	7%	11%	20%	61%	100%

Source: EY Calculation.
Note: Age reported is that of head of household. Totals may not add due to rounding.

Of tax returns with qualified dividends, EY estimates that 61 percent have some utility holdings. This is likely a conservative number since some investors may hold shares in utility companies outside of brokerage firms or have stock holdings in multiple brokerage firms.

Age and Income Profile of Returns with Direct Utility Stock Holdings.

The income and age composition of direct utility company stock holdings is more concentrated among lower-income and elderly taxpayers. Of tax returns with qualified dividends from direct utility stock investments:

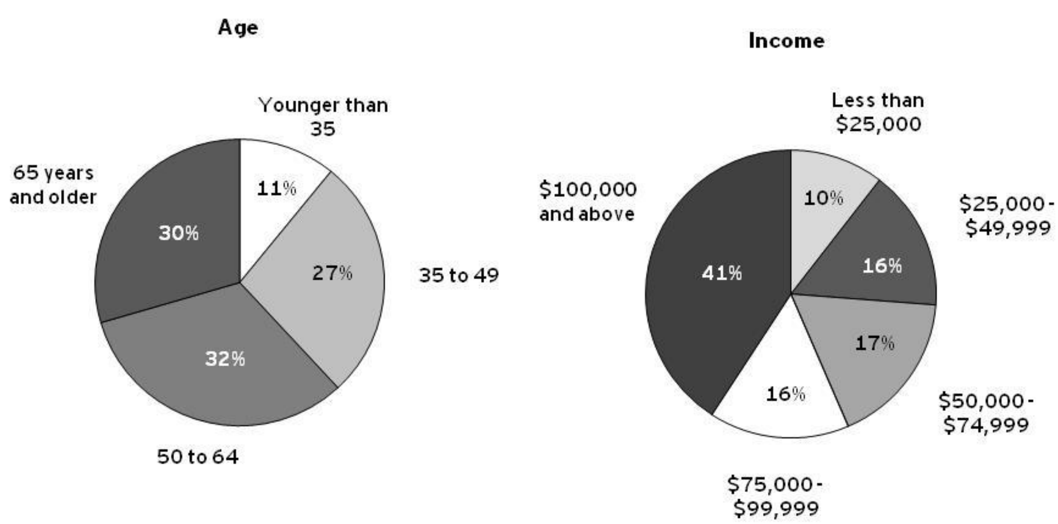
- 81 percent are from taxpayers age 50 and older,
- 61 percent are from taxpayers age 65 and older,
- 76 percent have incomes less than $100,000, and
- 51 percent have incomes less than $50,000.

Age and Income Profile of Returns with Direct and Indirect Utility Stock Holdings

Of tax returns with qualified dividends from direct and indirect utility stock holdings:

- 62 percent are taxpayers age 50 and older,
- 30 percent are taxpayers age 65 and older,
- 59 percent have incomes less than $100,000, and
- 26 percent have incomes less than $50,000.

Tax Returns with Qualified Dividends from Direct and Indirect Utility Stocks, 2009



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