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Rethinking Double Taxation's Role in Dividend Policy: A Historical Approach

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*[Tax Law Review, Vol. 56, 2003](#)***Abstract:**

Corporate dividend policy has long been a source of concern in both tax and corporate law. From a tax law perspective, retained earnings potentially escape the high marginal rates imposed on shareholders. From a corporate law perspective, retained earnings increase agency costs for shareholders. With the steady drop in dividends in the last decade, concern over dividend policy has arisen once again. Many commentators attribute the disappearance of the dividend to our corporate income tax system, which "traps" retained earnings in the corporation by subjecting dividends to two layers of tax. The assumption is that integrating the corporate and shareholders income taxes - either through a dividend exemption or some other technique - will lead corporations to pay out more money as dividends.

Missing from this analysis is any historical perspective on the relationship between taxation and corporate dividend policies. The double taxation of corporate income actually emerged between World War I and II in response to a shift in corporate dividend policies, rather than vice versa. Over that period, managers agreed to a higher rate of tax at the corporate level, and, eventually, to the repeal of the dividend exemption at the shareholder level in exchange for Congress' tacit agreement not to interfere with managerial discretion over undistributed profits. This history not only belies the claim that double taxation is responsible for the disappearance of the dividend, but also suggests that integration of the corporate and shareholder income taxes may not have the effect on corporate dividend policies that its proponents claim.

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