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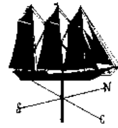

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Dividend Taxes Slated to Rise

"Do you know the only thing that gives me pleasure? It's to see my dividends coming in."
John D. Rockefeller to a neighbor, 1908

Last month we discussed how high-quality, growth-oriented, dividend-paying equities could be an effective means of maintaining income in the current environment of extended low interest rates. This month, we review the implications of the looming increase in taxes on dividend income.

If Congress does nothing before the end of December, the tax rate on dividend income, along with 65 other taxes, will increase next year. For individuals and couples making at least $200,000 or $250,000 a year, dividends will be taxed at the federal level as ordinary income at a rate of 39.6%. This is more than two and a half times the present tax rate of 15%. Health care reform includes an investment tax surcharge of 3.8%, which would push the dividend tax rate past 43%. Add in state taxes on dividend income and some individuals and families could see their dividend income taxed at rates close to 50%.

On Wall Street, there are concerns about the impact of these changes on dividend-paying companies. Dividends are taxed twice: first at the corporate level as earnings (which is where dividends come from) and then at the individual level as dividend income. The concern is that because of this double-taxation, companies may decide to slow the annual rate of their dividend increases and focus instead on other uses for their cash. For many, cash balances are at all-time highs.

Companies could use their cash to repurchase their common stock. By buying back stock, companies effectively reduce the number of shares outstanding and thus increase their earnings per share. Theoretically, shareholders benefit from this reduction but studies have not shown conclusively that there is a corresponding increase in a company's share price due to stock buybacks.

Another use for cash is mergers and acquisitions, which are typically aimed at increasing the share price. Here the concerns are two-fold: in the past, a corporate focus on stock appreciation has tended to encourage executives to spend recklessly -- Tyco is one such example. Also, some analysts fear that money in search of a purpose flooding into the financial markets could lead to a stock market bubble, like the "dot.com" bubble of the late 1990s. This, too, ended badly for many investors.

So what should investors do?

The information provided herein represents the opinions of David Wendell Associates and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Long-term investors should do the same thing they should always do -- invest in high quality, financially strong and growing companies with top-notch management teams and shareholder-friendly Boards of Directors. Good management teams keep companies on track and Boards set the dividend policy. Many quality companies have continued to increase their dividends over long periods, through good times and bad.

Our top twenty-five equity holdings are shown below, as well as their retention, earnings and dividend per share growth rates for the last five years and the projected next five years. Even through the financial crisis, recession and uncertainty of 2007 through 2011, these companies maintained their rates significantly above those of the Standard & Poor's 500 -- a proxy for the average company. And even with the potential tax increase and associated ripple effects, these companies are likely to continue to turn in superior results over the years ahead:

	-------	***Last 5 years***	-------	-------	***Projected Next 5 years***	-------
Company	**Retention Rate**	**Earnings Growth Rate**	**Dividend Growth Rate**	**Retention Rate**	**Earnings Growth Rate**	**Dividend Growth Rate**
Abbott Labs	16%	10%	9%	18%	10%	9%
Apple	26	65	*Not Meaningful*	20	28	*Not Meaningful*
Automatic Data	11	7	17	10	9	6
Church & Dwight	13	19	16	11	11	21
Coca-Cola	14	9	10	15	9	8
Colgate-Palmolive	52	12	13	38	10	10
Ecolab	15	12	12	19	12	9
ExxonMobil	21	4	9	14	10	7
IBM	52	17	24	29	10	10
Johnson & Johnson	15	9	12	10	5	7
MasterCard	41	44	---	21	17	5
McCormick & Co.	15	10	10	12	9	10
McDonald's	17	18	30	21	9	10
Microsoft	32	12	22	23	12	17
Nike 'B'	16	12	18	16	10	8
PepsiCo	18	8	14	13	10	5
Praxair	17	14	23	16	13	12
Procter & Gamble	10	8	12	10	10	11
Qualcomm	12	12	19	13	14	7
Sigma-Aldrich	17	12	16	18	9	8
Stryker	16	16	38	11	7	10
Sysco Corp.	15	7	12	15	9	4
TJX Companies	35	16	22	37	14	13
United Tech.	16	9	15	15	10	10
Walgreen	13	9	23	11	9	16
Average	**21%**	**15%**	**17%**	**17%**	**11%**	**10%***
S&P 500	**9%**	**6%**	**2%**	**10%**	**6%**	**2%***

Sources: Value Line, Standard & Poor's, DWA estimates
** Assumes expiration of present tax cuts on dividend income. Long-term average annual dividend growth rate for the S&P 500 is 5%.*

This is an election year and Congress may decide to do nothing about the expiring tax cuts until after November. At that point, it will be a lame-duck session with a host of issues and some or all of the 65 expiring tax cuts may be extended for another year. Regardless, investors who focus on solid fundamental characteristics, such as quality and financial strength, are likely to be well-rewarded even in uncertain and challenging times.