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New dividend plan threatens tax shelters

By Julie Earle

Tax sheltered investments, such as annuities, will be less attractive under the White House proposal to scrap tax on personal dividends, say financial planners and fund industry experts.

Investors in annuities, municipal bonds or other tax friendly investments could find themselves preferring stocks that pay dividends, to reap tax benefits. Financial planners said tax deferred annuities, offered by insurance companies, had high operating expenses for investors, which was justified as they had tax advantages.

"Some have felt that annuities were the only way to earn income but, if they can buy stocks and not pay tax on the dividends, they may now opt to keep it out of annuities," said Gary Schatsky, former chairman of the National Association of Personal Financial Advisers.

Michael Hirsch, a principal at The Lynnvest Group, at Advest, a financial services firm, said: "I think it would now be far more attractive to have dividend paying stocks. If you don't pay taxes on guaranteed return, my choice would be to opt for a dividend paying stock with a nice, high paying yield on it. Tax shelters are clearly less attractive," he said.

However, he said investors should speak to tax accountants before deciding.

The White House proposal does little for investors in 401(k) or IRA accounts, which are tax-protected. Investors in equity mutual funds would benefit under the proposal, because the corporate dividend part of the portfolio would be reported separately and excluded from income tax. Mutual fund shareholders pay taxes at rates as high as 30 per cent, which comprise income from dividends and capital gains.

Mr Schatsky warned that investors needed to understand fully the issues before changing their portfolios. A decision not to contribute to a 401(k) pension plan and buy stocks with high dividend yields instead would be "a disaster" because individuals would lose benefits such as matching company contributions and tax advantages. David Stein, chief investment officer of Parametric Portfolio Associates, a firm specialising in tax-sensitive investing, said the dividend tax proposal would change investors' demands and the investing landscape.

Dividends, which have traditionally been less important to US investors than UK ones, would suddenly be more in favour because many US companies do not pay dividends. Mr Stein also warned that eliminating the dividend tax could encourage insurance companies and mutual funds to market new "tax-free" products.

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