Dividends and taxes: why income can cost taxable investors

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The idea

For an investor holding stocks in a taxable account, a dollar of return received as a dividend is usually worth less after tax than a dollar received as a rise in the share price.

When a company pays a dividend, its share price falls by roughly the amount paid out. The investor is no richer: value has simply moved from the share to the cash account. But that move is a taxable event. A rise in the price of a share that is held is not taxed until the investor chooses to sell, and in some cases is never taxed at all.

Many investors favor dividend-paying stocks because the income feels reliable and the dividend seems to come on top of the return. Research on investor behavior calls this the "free dividends fallacy": a dividend is part of the total return, not an addition to it.[1]

Why dividends cost more in tax

The tax rate on qualified dividends and on long-term gains is the same: at the federal level, up to 20% plus the 3.8% net investment income tax in 2026, with state taxes on top.[2] The difference lies in when, and whether, the tax is paid.

- **Timing is not the investor's choice.** A dividend is taxed in the year it is paid, whether or not the investor needs the cash. A gain is taxed only when the investor sells.
- **Deferral compounds.** Tax not paid this year stays invested and keeps earning. Over decades, putting tax off is worth a great deal.
- **Some gains are never taxed.** Shares given to charity avoid tax on their gains. Shares held until death generally receive a step-up in basis, so heirs can sell without tax on the gains built up during the holder's lifetime. A dividend, once paid and taxed, gets neither benefit.
- **Some dividends are taxed at higher rates.** Dividends that do not meet the holding-period and other rules for qualified treatment, and most REIT distributions, are taxed largely as ordinary income, at up to 37% federal plus the 3.8% surtax, with state income tax on top.
- **Gains can be managed; dividends cannot.** An investor who wants cash can choose which shares to sell, selling those with the highest cost first or pairing gains with losses. A dividend offers no such choice.

Companies can return cash to shareholders in two main ways: dividends and share buybacks. For a taxable shareholder who does not sell, a buyback returns value through a higher share price, with no tax until the shares are sold.

A worked example

Two portfolios of $1 million each earn the same 8% a year before tax for 20 years. Portfolio A gets 4% of that from dividends; Portfolio B gets 1%. Both reinvest their dividends after paying tax at 23.8%, the top federal rate on qualified dividends including the surtax.

After 20 years	A: 4% dividend	B: 1% dividend	Difference
Value if still held	$3.90 million	$4.46 million	$0.56 million more for B
Value if sold, after tax on the gains	$3.51 million	$3.72 million	$0.21 million more for B

The same pre-tax return leaves Portfolio B about 14% richer if the shares are still held, and about 6% richer even if both are sold and all tax is paid. The gap comes entirely from paying tax earlier on Portfolio A's dividends. If Portfolio B's shares are later given to charity or passed to heirs with a step-up in basis, its advantage stays close to the larger figure.

The figures assume both portfolios earn the same return, which will not hold exactly in practice. They are meant to isolate the effect of taxes, not to predict how any group of stocks will perform.

Where dividend stocks still make sense

The tax cost of dividends applies only in taxable accounts, and taxes are only one consideration.

- **Inside tax-advantaged accounts.** In an IRA, 401(k) or Roth account, dividends are not taxed when paid, so the difference disappears. Higher-dividend holdings are natural candidates for those accounts.
- **Investors in low tax brackets.** Qualified dividends are taxed at 0% below certain income levels, which removes most of the cost.
- **Foundations and other tax-exempt holders.** They pay no tax on dividends either way.
- **As part of a diversified portfolio.** Dividend-paying companies are a large part of the market. Excluding them would concentrate a portfolio in other kinds of companies, a risk that can outweigh the tax saving. The aim is to hold them where they are taxed least, not to avoid them.

An investor who needs regular income can create it by selling a small portion of a portfolio, choosing which shares to sell. That is often more tax-efficient than relying on dividends.

Practical takeaways

For a taxable investor, the question is not whether a stock pays a dividend but how much of its return arrives as taxable income each year, and in which account it is held.

1. **Judge investments on total return after tax,** not on yield.
2. **Hold higher-dividend investments in tax-advantaged accounts** where possible, and lower-dividend, growth-oriented holdings in taxable accounts.
3. **Meet spending needs from the portfolio as a whole,** selling shares with the highest cost first and pairing gains with losses where available.

4. **Watch for non-qualified dividends and REIT income,** which are taxed at higher rates.
5. **Keep the portfolio diversified.** Tax efficiency should shape where and how a holding is owned, not override the overall allocation.

A dividend is not a free addition to return. In a taxable account it is a portion of the return on which tax is paid early.

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The example is a simplified illustration using an assumed return and tax rate; it is not a forecast and does not represent any actual portfolio. Tax treatment depends on each investor's circumstances and on tax law, which can change; investors should consult their own tax adviser.

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Notes: [1] Hartzmark and Solomon, "The Dividend Disconnect," Journal of Finance (2019), as summarized by CFA Institute. [2] Federal rates for 2026 from the TIAA 2026 quick tax reference guide.