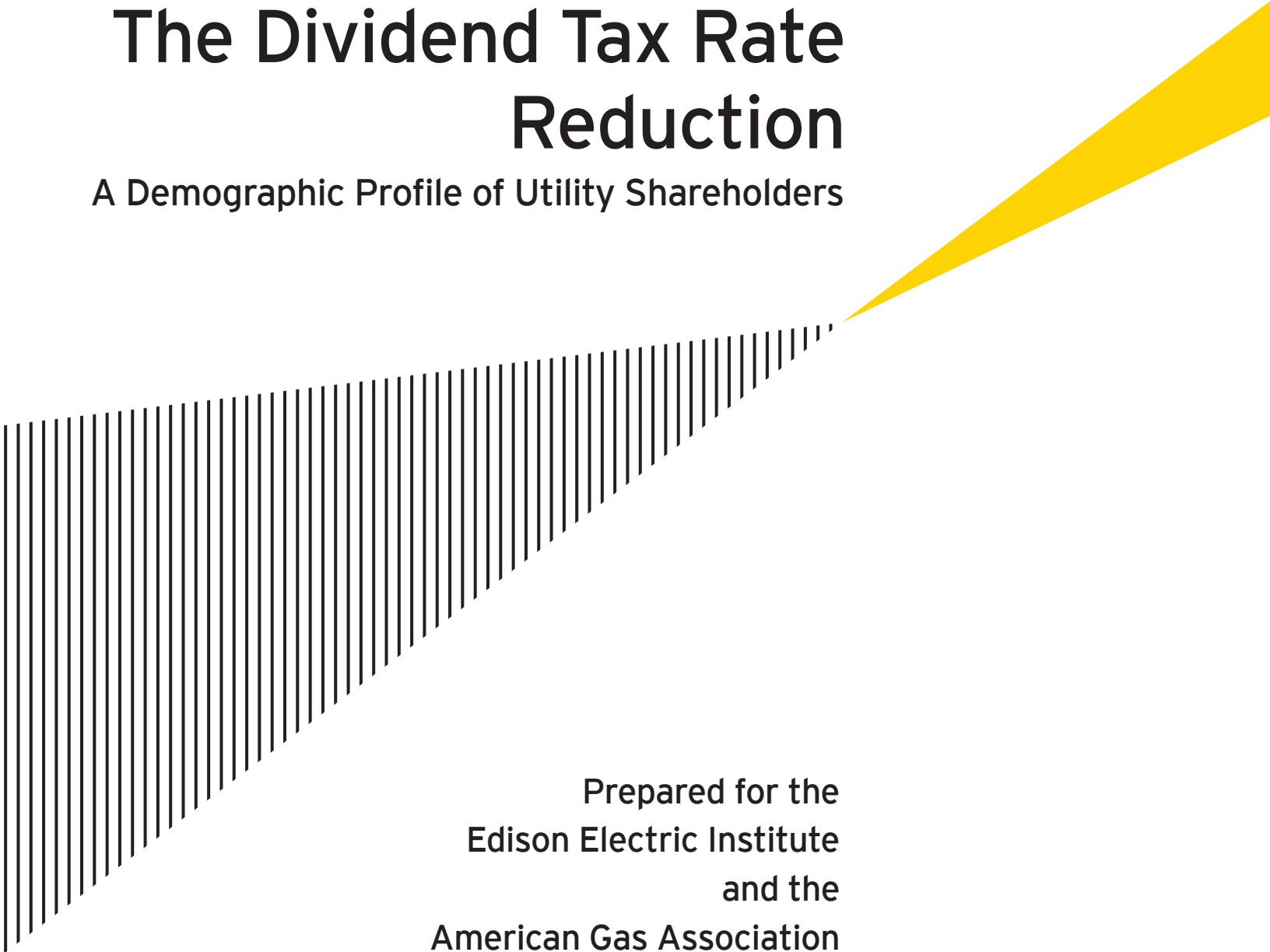


The Dividend Tax Rate Reduction

A Demographic Profile of Utility Shareholders



Prepared for the
Edison Electric Institute
and the
American Gas Association

The Dividend Tax Rate Reduction: A Demographic Profile of Utility Shareholders

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

Prepared for the
Edison Electric Institute
and the
American Gas Association

April 2008

© 2008 by the Edison Electric Institute (EEI).

All rights reserved. Published 2008.

Printed in the United States of America.

No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or any information storage or retrieval system or method, now known or hereinafter invented or adopted, without the express prior written permission of the Edison Electric Institute.

Attribution Notice and Disclaimer

This work was prepared by Ernst & Young LLP for the Edison Electric Institute (EEI) and the American Gas Association (AGA). When used as a reference, attribution to EEI is requested. EEI, AGA and any member of either, and any person acting on their behalf (a) do not make any warranty, express or implied, with respect to the accuracy, completeness or usefulness of the information, advice or recommendations contained in this work, and (b) do not assume and expressly disclaim any liability with respect to the use of, or for damages resulting from the use of any information, advice or recommendations contained in this work.

The views and opinions expressed in this work do not necessarily reflect those of EEI, AGA or their members. This material and its production, reproduction and distribution by EEI or AGA do not imply endorsement of this material.

Published by:

Edison Electric Institute

701 Pennsylvania Avenue, N.W.

Washington, D.C. 20004-2696

Phone: 202-508-5000

Web site: www.eei.org

Table of Contents

Executive Summary	v
Introduction	1
Investor Characteristics, Utility Stock Attributes and Portfolio Considerations	1
The Demographics of Utility Shareholders with Qualified Dividends by Age and Income	7
Estimates of Demographics of Utility Shareholders Qualifying for the Lower Federal Tax Rate on Qualified Dividends by Age and Income, by State	12

List of Tables

Table 1: Family Holdings of Selected Financial Assets, by Age & Income, 2004.....	2
Table 2: Mutual Fund Views and Characteristics, by Age, 2004	3
Table 3: Portfolio Objective Guidance Table by Investor Life Stages and Risk Tolerance	4
Table 4: Dividend Payout Ratio and Yield for Selected Sectors, 12-month period through June 2007.....	5
Table 5: Industry Stock Market Beta for Selected Industries, January 2007.....	6
Table 6: Households, by Age & Income, 2004.....	8
Table 7: All Tax Returns, by Age & Income, 2004.....	8
Table 8: Tax Returns with Qualified Dividends, by Age & Income, 2004	9
Table 9: Estimate of Tax Returns with Qualified Dividends from Utility Stocks, by Age & Income, 2004	11
Table 10: Returns with Qualified Dividends and Utility Holdings in 2004, by State.....	13
Table 11: Share of Returns with Qualified Dividends from Utility Stocks for Selected Age & Income Groups in 2004, by State	14

The Dividend Tax Rate Reduction: A Demographic Profile of Utility Shareholders

Executive Summary

Ernst & Young's Quantitative Economics and Statistics Practice was engaged by the Edison Electric Institute, in cooperation with the American Gas Association, to analyze the age and income characteristics of utility company shareholders who qualify for the lower tax rates on qualified corporate dividends.

Utility stocks, particularly electric and 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 for investors seeking current income and/or reduced market volatility, which include many investors near or in retirement.

Investor surveys about the views on the risk tolerance, investment horizons, and financial goals for mutual fund investments find that investors age 65 and older are more likely to invest to earn current income, have shorter investment horizons, and less risk tolerance than younger investors. Older investors are more likely to own stocks directly and also more likely to own investments outside of tax-qualified defined contribution plans compared to younger investors.

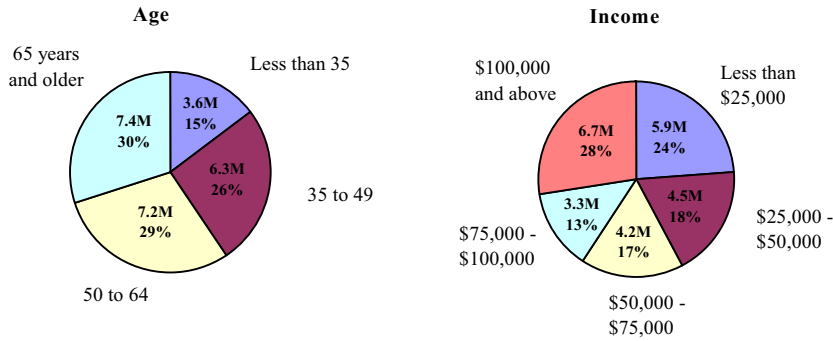
Based on information from the Internal Revenue Service's (IRS's) Statistics of Income on tax returns with qualified dividends and information from a variety of sources on investors' portfolio holdings, we have made estimates of the age and income distribution of tax returns with qualified dividends from utility stocks at the national and state levels.

The findings of the study include the following:

- In 2004, 24.5 million tax returns had dividends qualifying for the lower tax rates from equity investments.¹
- The percentages of tax returns with qualified dividends have the following profile:
 - 59 percent are from taxpayers age 50 and older,
 - 30 percent are from taxpayers age 65 and older,
 - 59 percent are from returns with incomes less than \$75,000, and
 - 24 percent are from returns with incomes less than \$25,000.
- According to the Investment Company Institute, more than half of the older investors cite current income as a principal objective of their investment, compared to 11 to 14 percent for younger investors.

¹ IRS/SOI Individual Income Tax Returns Publication 1304 reports 25.9 million returns with qualified dividends totaling \$119 billion in 2005.

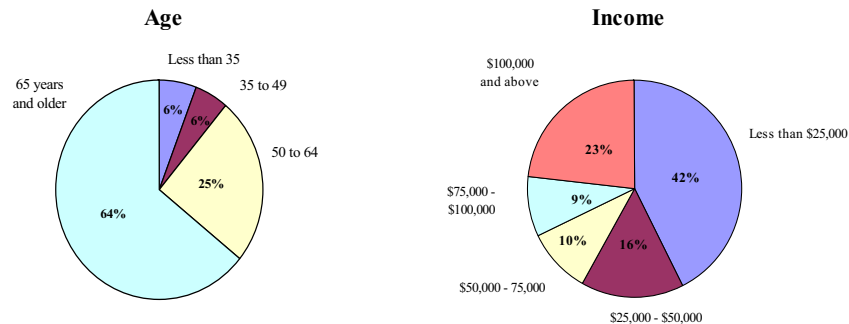
Tax Returns with Qualified Dividends by Age & Income, 2004
(Millions of Returns)



The findings of the study for utility shareholders include the following:

- In 2004, 16.7 million tax returns had dividends qualifying for the lower tax rates from equity investments in utility companies.
- Taxpayers with investments directly and indirectly (through taxable mutual funds) in utility company stocks account for 68 percent of tax returns with qualified dividends.
- More than half of the returns with qualified dividends from direct and indirect utility stock holdings are from taxpayers age 50 and older and from taxpayers with incomes less than \$75,000.
- The percentages of tax returns with qualified dividends from direct utility investments are:
 - 89 percent are from taxpayers age 50 and older,
 - 64 percent are from taxpayers age 65 and older,
 - 68 percent are from returns with incomes less than \$75,000, and
 - 42 percent are from returns with incomes less than \$25,000.

Tax Returns with Qualified Dividends from Direct Utility Stocks, 2004



The numbers of tax returns with qualified dividends from utility investments are estimated by income and age for each of the 50 states.

U.S. electric and gas utilities paid \$16.3 billion in dividends in 2005, and increased those dividends to \$17.7 billion in 2006. Lower tax rates on dividends have helped to increase the above-average share appreciation of utility stocks during the past three years, which reduces the cost of capital for the major transmission and distribution system upgrades, environmental and energy-efficiency improvements, and new capacity needs the industry is facing.

The Dividend Tax Rate Reduction: A Demographic Profile of Utility Shareholders

Introduction

Ernst & Young's Quantitative Economics and Statistics Practice was engaged by the Edison Electric Institute, in cooperation with the American Gas Association, to analyze the age and income characteristics of utility company shareholders who qualify for the lower tax rates on qualified corporate dividends.²

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

Investor surveys about the views on the risk tolerance, investment horizons, and financial goals for mutual fund investments find that investors over age 65 invest in corporate equities but with shorter time horizons, an appetite for average or below-average risk (with commensurately lower expected returns), and with many seeking current income from their investments. Older investors are more likely to own stocks directly and also more likely to own investments outside of tax-qualified defined contribution plans compared to younger investors.

Based on information from the Internal Revenue Service's (IRS's) Statistics of Income on tax returns with qualified dividends and information from a variety of sources on investors' portfolio holdings, we have made estimates of the age and income distribution of tax returns with qualified dividends from utility stocks at the national and state levels.

Investor Characteristics, Utility Stock Attributes and Portfolio Considerations

Holdings of Corporate Equities. According to the Federal Reserve Board's Flow of Funds, households held \$16.3 trillion of corporate equities at market value at the end of 2006.³ Households held \$5.5 trillion of corporate equities directly. Another \$10.8 trillion of corporate equities were indirectly held 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 are generally not subject to current taxation and would not qualify for the lower dividend tax rate. Corporate equities

² Qualified dividends eligible for the lower tax rate are dividends received by individual shareholders from domestic corporations or foreign corporation 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.

³ Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Flows and Outstandings Fourth Quarter 2006, Z1, March 8, 2007, Table B.100.e.

held through mutual funds (outside of defined contribution plans) would potentially qualify for the lower dividend tax rate, and totaled \$3.5 trillion.

Households held roughly \$9.0 trillion of corporate equities directly or through taxable mutual funds. Approximately 20 percent of the total corporate equity holdings by U.S. residents are foreign issues,⁴ including American Depositary Receipts, which would not be eligible for the lower tax rate on dividends. Thus, approximately \$7.2 trillion of corporate equity of U.S. corporations at the end of 2006 were held in taxable form by U.S. households. Approximately 60 percent is held directly by households and 40 percent is held indirectly through mutual funds.

The Federal Reserve Board's Survey of Consumer Finances shows the percent of families that holds bonds, stocks, pooled investment funds (mutual and money market funds), and retirement accounts by age and income, as shown in Table 1. Households age 55-74 are more likely to hold corporate equities directly than younger families, who are somewhat more likely to hold financial investments through mutual funds.

Table 1. Family Holdings of Selected Financial Assets by Age and Income, 2004 (percent of families)

	Bonds	Stocks	Pooled investment funds	Retirement accounts
All families	1.8	20.7	15.0	49.7
<i>Percentile of income</i>				
Less than 20	*	5.1	3.6	10.1
20-39.9	*	8.2	7.6	30.0
40-59.9	*	16.3	12.7	53.4
60-79.9	2.2	28.2	18.6	69.7
80-89.9	2.8	35.8	26.2	81.9
90-100	8.8	55.0	39.1	88.5
<i>Age of head (years)</i>				
Younger than 35	*	13.3	8.3	40.2
35-44	0.6	18.5	12.3	55.9
45-54	1.8	23.2	18.2	57.7
55-64	3.3	29.1	20.6	62.9
65-74	4.3	25.4	18.6	43.2
75 or older	3.0	18.4	16.6	29.2

Source: Bucks, Brian K. *Recent Changes in the US Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*. p. A13.

Investors' Risk Tolerance, Investment Horizons 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. We were unable to find any prior studies that present or estimate the percent of

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

households investing in utility equities. However, studies on investors' preferences and attributes of utility stocks are available, and can serve as a basis for an estimate of utility stock holdings by age and income.

The Investment Company Institute publishes results on investors' views of mutual funds from a periodic survey of several thousand mutual fund investors.⁵ Table 2 presents the results of a 2004 survey by age.

- 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 elderly investors, 69 percent are willing to take only average or below average risks through mutual fund investing compared to 48 percent for investors under 40.
- Older investors have significantly shorter investment horizons, with more than two-thirds of investors age 65 and older citing investment horizons of five years or less.
- More than half of the older investors cite current income as a principal objective of their investment, compared to 11 to 14 percent for younger investors.

Table 2. Mutual Fund Views and Characteristics, by Age, 2004

	Under 40	40 to 64	65 Years or Older
Level of risk willing to take with mutual fund investments:			
Substantial risk for substantial gain	9%	5%	6%
Above-average risk for above-average gain	38	29	12
Average risk for average gain	40	52	55
Below-average risk for below-average gain	8	9	14
No risk at all	5	5	13
Time frame for considering the investment risks of equity or bond mutual funds:			
Less than one year	4%	4%	47%
One to five years	22	25	19
Six to ten years	21	31	19
More than ten years	54	40	29
Financial goals for mutual fund investments:¹			
Retirement	95%	95%	77%
Emergency	44	41	54
Current income	11	14	53
Reduce taxable income	53	54	40
Education	47	28	10
House or other large item	28	9	7
Percent of Mutual Fund-Owning Households Own:¹			
Equity Mutual Funds	79%	83%	74%
Bond Mutual Funds	41	46	39
Hybrid Funds	34	36	28
Money Market Funds	45	51	47
Individual stocks	48	57	55
Individual bonds (excluding U.S. savings bonds)	8	14	24
Fixed or variable annuities	12	23	27

¹ Multiple responses included

Source: The Investment Company Institute. *Profile of Mutual Fund Shareholders, Fall 2004*. Washington, DC. Figures 58,60, p. 116-118.

⁵ Investment Company Institute, *Profile of Mutual Fund Shareholders, Fall 2004*, p. 116-118.

This does not suggest that investors age 65 and older shun equities in favor of bonds or fixed income investments. Three-quarters of mutual fund investors age 65 or older invest in equity mutual funds, and 55 percent invest in individual stocks directly. It does suggest that older investors have different objectives and risk tolerances, and thus are likely to favor individual stocks with higher dividend yields and lower market volatility. Similarly, older investors are more likely to favor income mutual funds and value funds, which have higher percentages of underlying utility investments.

This tendency of investors nearing or at retirement (and investors with low and medium risk tolerance) to favor investments focused on income or investments balanced toward growth and income, is reflected in an Edward Jones portfolio guidance,⁶ shown in Table 3. Investors in retirement years and with lower risk tolerances will favor investments focused more on balanced growth and income, and thus favor equity investments that pay higher dividend yields and with lower market volatility.

Table 3. Portfolio Objective Guidance Table by Investor Life Stages and Risk Tolerance

		Investor Life Stages				
		Early Investing Years	Good Earnings Years	Higher Income & Savings Years	Early Retirement Years	Late Retirement Years
Investor Risk Tolerance	High	Growth Focus	Growth Focus	Growth Focus	Growth Focus	Balanced toward Growth
	Medium to High	Growth Focus	Growth Focus	Growth Focus	Balanced toward Growth	Balanced toward Growth
	Medium	Growth Focus	Growth Focus	Balanced toward Growth	Balanced toward Growth	Balanced Growth & Income
	Medium to Low	Balanced toward Growth	Balanced toward Growth	Balanced toward Growth	Balanced Growth & Income	Balanced toward Income
	Low	Balanced toward Growth	Balanced Growth & Income	Balanced Growth & Income	Balanced toward Income	Income Focus

Numerous factors can cause you to adjust your portfolio objective from those suggested in the table, including your:

- Current and future income needs
- Amount in existing savings
- Investing time horizon
- Estate-planning considerations

Please note that if you adjust your Portfolio Objective, it does not mean that your risk tolerance has changed.

Source: Edward Jones; The Portfolio Objective Guidance Table as determined by the Edward Jones Investment Policy Advisory Committee.

Utility Stock Attributes. Utility stocks, consisting of shares of electric, water and gas companies, tend to pay relatively high dividend rates and have lower volatility than the overall corporate equity market. Thus, utility stocks are generally perceived as being less risky and more for income-oriented investors. In terms of mutual fund selection, utility stocks are less likely to be included in growth portfolios and more likely to be included in value portfolios and income portfolios.

U.S. electric and gas utilities paid \$16.3 billion of dividends in 2005, and increased those dividends to \$17.7 billion in 2006. Lower tax rates on dividends have helped increase the above-average share appreciation of utility stocks during the past three years, which

⁶ Edward Jones, Portfolio Objective Guidance Table as determined by the Edward Jones Investment Policy Advisory Committee, posted on firm Web site as of June 2007.

reduces the cost of capital for the major transmission and distribution system 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. Between July 2006 and June 2007, U.S. shareholder-owned utilities paid out 49 percent of their net income as dividends, with a dividend yield of 3.3 percent, both measures significantly higher than other sectors.⁷ Thus, utility stocks are attractive for investors seeking current income. Table 4 compares the dividend payout ratio and yield of the utility sector to a number of other sectors.

Table 4. Dividend Payout Ratio and Yield for Selected Sectors, 12-month period through June 2007

Sector	Payout Ratio	Sector	Yield (%)
Utilities	49.1	Utilities	3.3
Consumer Non-Cyclical	46.7	Financial	2.8
Conglomerates	43.4	Consumer Non-Cyclical	2.5
Healthcare	30.9	Healthcare	2.5
Basic Materials	28.8	Conglomerates	2.3
Financial	25.9	Services	2.2
Consumer Cyclical	22.9	Basic Materials	2.1
Services	20.7	Consumer Cyclical	2.0
Transportation	20.3	Energy	1.6
Capital Goods	18.7	Transportation	1.6
Energy	15.2	Capital Goods	1.4
Technology	10.6	Technology	1.3

Sources: EEI Q3 2007 Financial Update and Reuters

Electric and gas utility stocks also have, on average, a low volatility compared to the overall market, and lower than most other industries. A common measure of relative market volatility is the Beta, which is set at one for companies or industries that have the same volatility as the overall stock market. Companies and industries that have a Beta less than one are less volatile than the overall market, while companies and industries with Betas greater than one are more volatile than the overall market. For electric companies, the Beta was 0.88 as of January 2007. For natural gas distribution companies, the Beta was 0.83. Table 5 shows Betas for a number of industries.

⁷ Sources: Edison Electric Institute, Q3 2007 Financial Update, Dividends, p. 1, and Reuters.

Table 5. Industry Stock Market Beta for Selected Industries, January 2007

Industry Name	Beta
Natural Gas (Distribution)	0.83
Electric Utility	0.88
Banks	0.89
Financial Svcs. (Diversified)	0.98
Food Processing	1.51
Machinery	2.03
Petroleum Production	2.49
Retail Specialty Lines	2.51
Industrial Services	2.72
Medical Services	2.89
Telecom. Services	2.89
Medical Supplies	3.12
Electronics	4.37
Drug	4.64
Biotechnology	5.16
Computer Software/Svcs	6.04
Semiconductor	6.35
Telecom. Equipment	7.48
Internet	8.70

Source: Damodaran, Aswath. (January 2007). NYU Stern School of Business faculty website:
http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html

Modern portfolio theory recommends that investors balance the trade-off between risk and return with adjustments in the amount of their portfolio held in fixed income securities and equities. Modern portfolio theory generally treats equities in terms of general indices without making sector adjustments, thus the percentage of utility equities would be the same irrespective of age, income or risk tolerance, since adjustments would be made in the composition of bonds, equities and cash. Accordingly, when comparing life-cycle funds, which are designed for investors with a target retirement date, the composition of equities does not change greatly. In the case of Fidelity target retirement funds, utilities represent 1.8 percent of equities in the Fidelity Freedom 2005 Fund (for retired investors), while only 1.5 to 1.6 percent of equities in the Fidelity Freedom 2010-2040 Funds, and 1.45 percent in the Fidelity Freedom 2050 Fund. The higher utility share for current retirees reflects a smaller share of non-U.S. equities, which are not eligible for the qualified dividend tax rate reduction.

Survey responses from investor relation departments of several large electric utilities have found that a majority of their direct shareholders are age 65 and older, and are more likely to be middle-income investors. A proprietary age and income distribution of utility shareholders from one brokerage company's customer base shows utility stocks are much more likely to be held by investors age 50 and older and with a proportionately higher share among middle-income investors.

Based on these data sources, we have adjusted the national relationship of income and age for all tax returns reporting qualified dividend income in 2004 to estimate the income and age distribution of utility shareholdings. The distribution is of shareholders, rather than the value of the shares or the value of the dividends.

The Demographics of Utility 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. Information below general equities is generally limited to direct and indirect holdings through mutual funds, and whether the mutual funds are inside or outside of defined contribution plans.

Based on information from a limited number of electric utility investor relations departments that participated in an Edison Electric Institute survey, electric utility investors are heavily weighted toward older investors and middle-income investors. This is consistent with the recommendations for more income-focused stocks and funds suggested by many financial planners, given the risk tolerance of many investors at or near retirement.

One brokerage company's proprietary account information provided a comparison of the distribution by age and income of ownership of utility stocks with the distribution by age and income of overall stock ownership. This information was used to estimate the percentage of taxpayers with qualified dividends who were likely to own utility stocks.

It is useful to start with the age and income distribution for total households from the Census, shown in Table 6. Households with the head age 65 or older account for 21 percent of all households, and those age 50 to 64 account for 26 percent of all households. Hence, households with the head 50 or older account for 47 percent and under age 50 account for more than half of all households.

Table 6. Households, by Age & Income, 2004

Number of Households (in millions)					
Income	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	Total
Less than \$25,000	7.3	6.2	6.2	11.2	30.9
\$25,000 - \$50,000	7.9	8.3	7.1	6.7	30.0
\$50,000 - \$75,000	5.3	7.4	5.7	2.7	21.0
\$75,000 - \$100,000	2.7	5.2	3.7	1.2	12.7
\$100,000 and above	2.8	8.4	6.9	1.6	19.7
Total	25.9	35.5	29.5	23.5	114.4

Percent of All Households					
Income	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	Total
Less than \$25,000	6%	5%	5%	10%	27%
\$25,000 - \$50,000	7%	7%	6%	6%	26%
\$50,000 - \$75,000	5%	6%	5%	2%	18%
\$75,000 - \$100,000	2%	5%	3%	1%	11%
\$100,000 and above	2%	7%	6%	1%	17%
Total	23%	31%	26%	21%	100%

Source: US Census, Table HINC-02. E&Y calculation. Totals may not add due to rounding.

Based on the total number of tax returns, tax returns are more heavily weighted to younger taxpayers below 35 years of age, due to more single taxpayers and child tax returns. Returns filed by taxpayers age 65 and older accounted for 13 percent of all individual income tax returns in 2004, with almost half of those returns with adjusted gross income of less than \$25,000, as shown in Table 7.

Table 7. All Tax Returns, by Age & Income, 2004

Number of Returns (in millions)					
Size of adjusted gross income (AGI)	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than \$25,000	30.4	11.9	7.5	8.4	58.3
\$25,000 - \$50,000	10.6	11.2	7.5	3.8	33.0
\$50,000 - \$75,000	3.6	6.9	5.3	2.1	18.0
\$75,000 - \$100,000	1.5	4.3	3.3	1.2	10.1
\$100,000 and above	1.2	5.4	4.6	1.6	12.8
Total	47.3	39.7	28.2	17.1	132.2

Percent of All Returns					
AGI	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than \$25,000	23%	9%	5%	6%	43%
\$25,000 - \$50,000	8%	9%	6%	3%	25%
\$50,000 - \$75,000	3%	5%	4%	2%	14%
\$75,000 - \$100,000	1%	3%	2%	1%	8%
\$100,000 and above	1%	4%	4%	1%	10%
Total	36%	30%	21%	13%	100%

Source: IRS Statistics of Income, special tabulation. Totals may not add due to rounding.

The Internal Revenue Service's (IRS's) Statistics of Income (SOI) reported that 24.5 million tax returns included qualified dividends in 2004, reporting \$110.5 billion of qualified dividends.⁸ Based on a special tabulation from the IRS Statistics of Income, Table 8 shows the distribution of returns with qualified dividends by age and income. While roughly one-third of all 1040 returns were filed by taxpayers age 50 or older, 60 percent of returns with qualified dividends were filed by the same age group. Taxpayers with AGI of \$75,000 or lower accounted for 59 percent of the tax returns with qualified dividends.

Table 8. Tax Returns with Qualified Dividends, by Age & Income, 2004

Number of Returns (in millions)					
Size of adjusted gross income (AGI)	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than \$25,000	1.8	0.5	0.9	2.6	5.9
\$25,000 - \$50,000	0.6	0.9	1.3	1.7	4.5
\$50,000 - \$75,000	0.4	1.2	1.4	1.2	4.2
\$75,000 - \$100,000	0.3	1.1	1.1	0.7	3.3
\$100,000 and above	0.4	2.6	2.5	1.2	6.7
Total	3.6	6.3	7.2	7.4	24.5

Percent of All Returns with Qualified Dividends					
AGI	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than \$25,000	7%	2%	4%	11%	24%
\$25,000 - \$50,000	3%	4%	5%	7%	18%
\$50,000 - \$75,000	2%	5%	6%	5%	17%
\$75,000 - \$100,000	1%	5%	5%	3%	13%
\$100,000 and above	2%	11%	10%	5%	27%
Total	15%	26%	30%	30%	100%

Source: IRS Statistics of Income, special tabulation. Totals may not add due to rounding.

To estimate the number of tax returns with qualified dividends from utility stocks, we used information from several sources. Taxpayers could directly hold shares of stock in individual utility corporations or indirectly through mutual funds or financial assets, including life insurance, annuities and pension funds. Since qualified dividends come from taxable sources, qualified dividends from utilities would come from direct holdings of utility stocks or indirect holdings of taxable mutual funds whose underlying investments include utility stocks.

Data from the Investment Company Institute (ICI) show that, on average, between 2002 and 2006 approximately 15.1 million households had taxable stock or hybrid mutual funds. These mutual funds are held outside of 401k and Individual Retirement Accounts. Hybrid mutual funds include balanced funds that include equities, bonds and other investments. Based on ICI data on the age and income distribution of households with

⁸ IRS/SOI Individual Income Tax Returns Publication 1304 reports 25.9 million returns with qualified dividends totaling \$119 billion in 2005.

taxable equity and hybrid mutual funds, our estimate assumes most households with taxable equity mutual funds indirectly hold some utility stocks given the diversification of mutual fund holdings.

EY estimates that approximately 14.5 million tax returns with qualifying dividends had some utility holdings through taxable mutual funds. The percentages of tax returns with qualifying dividends from taxable mutual funds with utility holdings were 49 percent for taxpayers with AGI of less than \$75,000, while 51 percent of those tax returns were from taxpayers age 50 and older, and 20 percent from taxpayers age 65 and older.

The remaining 10 million tax returns with qualifying dividends are estimated to be receiving dividends from direct holdings of equity shares in individual companies. To determine the percentage of those returns that have some direct utility stock investments, we used information on direct utility stock investments and general stock and mutual fund investments from a major brokerage firm. From this information, we calculated the percentage of investors in a given age and income group that owned stock directly and also owned individual utility stocks.

On average, 23 percent of investors who owned direct equity shares owned some utility company shares. The propensity to directly own utility stocks, conditional on their owning some direct equities, ranged from 7 percent for investors age 35 or younger with incomes of \$25,000 and under, up to 36 percent for investors age 65 and older with incomes of \$75,000 or more. This relationship was consistent with the other information on investor risk tolerance, investment horizon and investment objectives. Older investors were more likely to invest in utility stocks than younger investors, and utility stock ownership increased slightly with income level.

Table 9 shows the estimate of 16.75 million tax returns with qualified dividends own utility stocks either directly through investments in shares of individual companies or indirectly through taxable mutual funds. Many other households own utility stocks through their insurance and retirement accounts, which are not taxed currently. Of tax returns with qualified dividends, 68 percent are estimated to 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 and Indirect Utility Holdings. Of tax returns with qualified dividends from direct and indirect utility holdings:

- 52 percent have incomes less than \$75,000,
- 55 percent are taxpayers age 50 and older, and
- 25 percent are age 65 and older.

Table 9. Estimate of Tax Returns with Qualified Dividends from Utility Stocks, by Age & Income, 2004

Number of Returns with Qualified Dividends from Utility Stocks (in millions)					
Size of adjusted gross income (AGI)	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than \$25,000	0.34	0.23	0.31	0.94	1.82
\$25,000 - \$50,000	0.48	0.71	0.82	1.25	3.26
\$50,000 - \$75,000	0.45	1.17	1.07	0.91	3.61
\$75,000 - \$100,000	0.28	1.08	0.97	0.44	2.77
\$100,000 and above	0.44	2.26	1.87	0.72	5.30
Total	1.99	5.45	5.04	4.27	16.75

Percent of Returns With Qualified Dividends from Direct and Indirect Utility Holdings					
Size of adjusted gross income (AGI)	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than \$25,000	2%	1%	2%	6%	11%
\$25,000 - \$50,000	3%	4%	5%	7%	19%
\$50,000 - \$75,000	3%	7%	6%	5%	22%
\$75,000 - \$100,000	2%	6%	6%	3%	17%
\$100,000 and above	3%	13%	11%	4%	32%
Total	12%	33%	30%	25%	100%

Percent of Returns With Qualified Dividends from Direct Utility Investments					
Size of adjusted gross income (AGI)	Less than 35 years	35 to 49 years	50 to 64 years	65 years or older	All Returns
Less than \$25,000	5%	1%	6%	30%	42%
\$25,000 - \$50,000	1%	1%	5%	9%	16%
\$50,000 - \$75,000	0%	0%	4%	6%	10%
\$75,000 - \$100,000	0%	0%	2%	7%	9%
\$100,000 and above	0%	3%	9%	12%	23%
Total	6%	6%	25%	64%	100%

Source: E&Y calculations. Totals may not add due to rounding.

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 investments:

- 68 percent have incomes less than \$75,000,
- 42 percent have incomes less than \$25,000,
- 89 percent are from taxpayers age 50 and older, and
- 64 percent are from taxpayers age 65 and older.

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

Estimates of Demographics of Utility Shareholders Qualifying for the Lower Federal Tax Rate on Qualified Dividends by Age and Income, by State

Based on the national estimate of federal individual income tax returns with qualified dividends from utility stocks, we estimated the age and income distribution of returns with qualified dividends from utility stocks for each of the 50 states.

Information on the age and income distributions within each of the 50 states is available from the U.S. Census Bureau. Based on the estimated propensity of different age and income groups to have taxable mutual equity funds and direct individual stock holdings, we adjusted the national distribution to reflect the relative age and income composition of the households within each state.

Table 10 shows the state-by-state breakdown of federal individual income tax returns with qualified dividends and also the estimate of those returns with utility holdings. Of the 131.55 million federal tax returns, 24.55 million—or 19 percent—of those returns have qualified dividends benefiting from the lower federal tax rate. An estimated 16.75 million—or 68 percent—of those returns have qualifying dividends from utility holdings. The percentages vary by state.

Table 11 shows the state-by-state breakdown of federal income tax returns, by age and income, with qualifying dividends with utility holdings as well as with direct stock investments. As noted above, the majority of tax returns with qualifying dividends from utility holdings are from taxpayers age 50 and older with incomes below \$75,000. Almost two-thirds of tax returns with qualified dividends from direct utility stock holdings are from taxpayers age 65 and older with incomes below \$75,000. The percent of returns with qualifying dividends with direct utility stock among taxpayers 65 and older ranges from 47 percent in Alaska to 75 percent in Florida.

Table 10. Returns with Qualified Dividends and Utility Holdings in 2004, by State
(Numbers in Millions)

State	Number of Returns	Returns with Qualified Dividends		Number of Returns with Utility Holdings ¹	Percent of Returns with Qualifying Dividends with Utility Holdings ¹
		Number	Percent		
U.S. National	131.51	24.55	19%	16.75	68%
Alabama	1.91	0.25	13%	0.17	67%
Alaska	0.35	0.07	19%	0.05	68%
Arizona	2.37	0.41	17%	0.28	68%
Arkansas	1.14	0.16	14%	0.11	67%
California	15.33	2.67	17%	1.83	68%
Colorado	2.11	0.44	21%	0.30	68%
Connecticut	1.67	0.45	27%	0.31	69%
Delaware	0.40	0.08	21%	0.06	69%
District of Columbia	0.28	0.05	18%	0.03	67%
Florida	8.17	1.45	18%	0.99	69%
Georgia	3.78	0.58	15%	0.39	67%
Hawaii	0.61	0.12	19%	0.08	70%
Idaho	0.59	0.10	17%	0.07	67%
Illinois	5.76	1.22	21%	0.83	68%
Indiana	2.85	0.48	17%	0.33	68%
Iowa	1.33	0.30	22%	0.20	68%
Kansas	1.23	0.25	20%	0.17	68%
Kentucky	1.76	0.25	14%	0.17	67%
Louisiana	1.87	0.24	13%	0.16	66%
Maine	0.62	0.12	19%	0.08	68%
Maryland	2.64	0.52	20%	0.36	69%
Massachusetts	3.06	0.72	23%	0.49	69%
Michigan	4.56	0.90	20%	0.61	68%
Minnesota	2.41	0.54	22%	0.37	68%
Mississippi	1.17	0.12	10%	0.08	66%
Missouri	2.59	0.49	19%	0.33	68%
Montana	0.44	0.09	21%	0.06	67%
Nebraska	0.81	0.17	21%	0.11	68%
Nevada	1.09	0.15	14%	0.10	68%
New Hampshire	0.64	0.14	22%	0.10	69%
New Jersey	4.11	1.02	25%	0.71	69%
New Mexico	0.83	0.12	14%	0.08	67%
New York	8.63	1.84	21%	1.26	68%
North Carolina	3.77	0.63	17%	0.42	67%
North Dakota	0.31	0.06	20%	0.04	67%
Ohio	5.45	1.03	19%	0.70	68%
Oklahoma	1.48	0.20	14%	0.14	67%
Oregon	1.60	0.31	19%	0.21	68%
Pennsylvania	5.81	1.30	22%	0.89	68%
Rhode Island	0.50	0.10	20%	0.07	68%
South Carolina	1.84	0.27	15%	0.18	67%
South Dakota	0.36	0.07	19%	0.05	67%
Tennessee	2.61	0.35	13%	0.23	67%
Texas	9.43	1.30	14%	0.88	67%
Utah	1.00	0.14	14%	0.09	68%
Vermont	0.31	0.07	23%	0.05	68%
Virginia	3.49	0.70	20%	0.48	68%
Washington	2.86	0.61	21%	0.41	68%
West Virginia	0.75	0.10	14%	0.07	66%
Wisconsin	2.62	0.58	22%	0.40	68%
Wyoming	0.24	0.05	19%	0.03	67%

¹ Utility holdings include direct utility stock investments and indirect holdings through taxable mutual funds.
Source: IRS Statistics of Income; E&Y Calculations.

Table 11. Share of Returns with Qualified Dividends from Utility Stocks for Selected Age & Income Groups in 2004, By State

State	Percent of Returns with Qualifying Dividends					
	<u>With Utility Holdings¹</u>			<u>With Direct Utility Stock</u>		
	AGI under \$75k	Taxpayer 50 and older	Taxpayer 65 and older	AGI under \$75k	Taxpayer 50 and older	Taxpayer 65 and older
U.S. National	52%	56%	25%	68%	89%	64%
Alabama	68%	57%	29%	81%	88%	69%
Alaska	50%	45%	16%	56%	80%	47%
Arizona	62%	57%	31%	72%	88%	69%
Arkansas	73%	59%	31%	84%	88%	70%
California	51%	53%	26%	61%	87%	65%
Colorado	55%	49%	22%	66%	85%	59%
Connecticut	48%	55%	28%	59%	90%	68%
Delaware	56%	56%	29%	67%	89%	67%
District of Columbia	52%	56%	30%	62%	87%	68%
Florida	63%	62%	37%	72%	92%	75%
Georgia	58%	50%	22%	72%	85%	61%
Hawaii	50%	61%	33%	52%	91%	71%
Idaho	68%	55%	27%	80%	87%	65%
Illinois	56%	54%	27%	68%	88%	66%
Indiana	64%	54%	26%	78%	88%	66%
Iowa	69%	58%	31%	80%	90%	71%
Kansas	64%	55%	29%	76%	88%	69%
Kentucky	69%	55%	28%	83%	88%	67%
Louisiana	68%	55%	27%	82%	87%	67%
Maine	69%	57%	29%	82%	90%	69%
Maryland	49%	53%	25%	58%	88%	64%
Massachusetts	51%	54%	27%	65%	90%	68%
Michigan	58%	54%	27%	72%	88%	66%
Minnesota	58%	51%	25%	71%	88%	65%
Mississippi	71%	57%	29%	84%	87%	69%
Missouri	66%	56%	29%	79%	89%	69%
Montana	74%	59%	30%	85%	87%	67%
Nebraska	67%	56%	30%	79%	88%	69%
Nevada	60%	54%	26%	69%	87%	63%
New Hampshire	56%	52%	24%	68%	88%	64%
New Jersey	46%	55%	28%	58%	90%	68%
New Mexico	67%	57%	29%	78%	87%	66%
New York	54%	56%	29%	67%	89%	69%
North Carolina	64%	54%	27%	77%	88%	66%
North Dakota	74%	57%	31%	85%	88%	71%
Ohio	63%	56%	28%	76%	89%	68%
Oklahoma	70%	58%	30%	82%	87%	69%
Oregon	63%	56%	28%	75%	88%	66%
Pennsylvania	63%	58%	31%	77%	91%	72%
Rhode Island	59%	56%	30%	74%	90%	71%
South Carolina	66%	56%	28%	78%	88%	67%
South Dakota	73%	57%	31%	84%	89%	71%
Tennessee	66%	55%	27%	80%	88%	67%
Texas	60%	51%	24%	73%	85%	63%
Utah	60%	50%	24%	68%	85%	62%
Vermont	65%	56%	27%	75%	89%	66%
Virginia	54%	53%	25%	64%	88%	64%
Washington	58%	53%	25%	69%	87%	63%
West Virginia	75%	62%	33%	88%	89%	71%
Wisconsin	63%	54%	27%	76%	89%	68%
Wyoming	68%	55%	26%	80%	87%	64%

¹ Utility holdings include direct utility stock investments and indirect holdings through taxable mutual funds.

Source: E&Y Calculations.

Ernst & Young LLP

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 130,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve potential.

About Tax Quantitative Economics and Statistics

Our Quantitative Economics and Statistics (QUEST) practice can help you with data collection, quantitative analysis and implementation. Our economists, statisticians and government policy professionals work with companies, associations, coalitions and government agencies to build the quantitative data and analysis to solve business and policy problems. Our services include statistical sampling, surveys, data analytics, financial modeling, forecasting and economic analysis, which provide new insights.

