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Fundamentals of shareholder tax capitalization ☆

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Abstract

We investigate how shareholder-level taxes are capitalized into stock prices using a model that incorporates the investment and payout decisions of a firm and the investment alternatives available to investors. Shareholder taxes affect stock prices both indirectly, via the effect of taxes on corporate investment decisions, and directly, by reducing both the mean and variance of after-tax returns. In our model, tax capitalization is not eliminated by the presence of tax-exempt investors, does not depend on whether equity is composed of contributed capital or retained earnings, and does not depend on the tax rate faced by a hypothetical marginal investor.
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1. Introduction

We examine a question that has long been of interest to researchers in accounting, finance, and economics: Are shareholder-level taxes capitalized into the prices of common

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stocks? We extend prior research by explicitly modeling both the firm's investment and dividend payout decisions, and the investment alternatives available to both tax-exempt and taxable investors. We also investigate how tax capitalization is affected by the presence of tax-exempt investors.

Recent papers by Hanlon et al. (2003, hereafter HMS) and Dhaliwal et al. (2003, hereafter DEFB) argue that the existence of tax clienteles and/or the presence of tax-exempt shareholders will reduce or eliminate dividend tax capitalization. For example, HMS state (p. 123) "if taxpayers know dividends will be paid, trading will likely take place so that low tax rate or tax-exempt entities hold the securities at the time tax is assessed," and that the conclusions of prior research "seem to be at odds with the theory of tax clienteles."[1] DEFB state (p. 180) the "conclusion that shareholder dividend taxes are fully capitalized in equity values is inconsistent with the existence of tax clienteles."

Because neither HMS nor DEFB offer a model of shareholder tax capitalization, it is difficult to evaluate their assertions about the effects of clienteles and tax-exempt shareholders. In this paper, we first develop a simple model showing the circumstances under which tax capitalization can arise, and then formally investigate how (or whether) the existence of clienteles and/or exempt shareholders affect tax capitalization.

Our paper is motivated by recent suggestions that more research into tax capitalization is needed. Maydew (2001, p. 397) argues for more theoretical research, stating "without a foundation of underlying theory, tax capitalization research has been unable to address key questions. Under what conditions do we expect tax capitalization to take place? What factors determine the extent of tax capitalization?" HMS (p. 121) argue that "future research might fruitfully consider developing a valuation model that explicitly incorporates dividend-tax clienteles, alternative means of distributing corporate earnings (such as share repurchases, mergers), arbitrage activities by tax-free investors, and the dividend-tax free treatment of complete liquidations. Such a model would endogenize why firms pay dividends in the presence of costly dividend taxes." Making a similar argument, Graham (2003, p. 1120) states "Several articles assume that companies have clienteles of investors that have similar tax characteristics, and then link these companies' policies to the assumed investor tax rates; however, it would be helpful to make these linkages more direct."

We examine three alternative settings for an economy with only two investment assets: a taxable bond and a risky dividend-paying stock. The first setting contains only tax-exempt investors; the second setting contains only taxable investors facing identical tax rates; and the third setting contains both types of investors. Using the first two settings as benchmark cases, we investigate how investment decisions, stock prices, and tax capitalization are affected by the presence of both taxable and tax-exempt investors. In the third setting, we allow both types of investors to own stock.

We address three questions in our analysis. First, how will shareholder-level taxes affect the corporation's optimal investment and dividend policies? Second, what is the tax clientele for the stock (i.e., will the stock be held by taxable investors, tax-exempt investors, or both)? Third, in the presence of tax clienteles and optimal investment and dividend policies, to what extent will shareholder taxes be capitalized into stock prices?

[1] The prior research referred to in this quote is Harris and Kemsley (1999), Harris et al. (2000), and Collins and Kemsley (2000).

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