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What do firms do when dividend tax rates change? An examination of alternative payout responses☆

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ABSTRACT

This paper investigates whether investor-level taxes affect corporate payout policy decisions. We predict and find a surge of special dividends in the final months of 2010 and 2012, immediately before individual-level dividend tax rates were expected to increase. We also find evidence that immediately before the expected tax increases, firms altered the timing of their regular dividend payments by shifting what would normally be January regular dividend payments into the preceding December. To our knowledge this is the first evidence in the literature about changes in the timing of regular dividend payments in response to tax law changes. For both actions (specials and shifting), we find that it was more likely for a firm to respond to individual-level tax rates if insiders owned a relatively large amount of the firm. Overall, our paper provides evidence that managers consider individual-level taxes in making corporate payout decisions.

1. Introduction

The goal of the firm is to maximize shareholder wealth but unambiguous evidence consistent with managers taking actions consistent with this goal is limited. This paper examines whether corporate payout policy decisions appear to account for investor tax preferences in a manner that would increase shareholder wealth. In particular, we examine corporate payout behavior around two expected increases in individual-level dividend tax rates. We find that corporations responded by paying special dividends in advance of the tax rate increase and by shifting regular dividends into the expected lower-taxed-period. This evidence is consistent with corporations making decisions in response to investor-level taxes in order to maximize shareholder wealth.

The two tax rate events that we study are the expected individual-level dividend tax rate increases set to take effect on January 1, 2011 and January 1, 2013. As background, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, also known as the Bush Tax Cuts) lowered individual tax rates on ordinary, capital gain, and dividend incomes. Specifically, the tax rate on qualified dividends was lowered to a maximum of 15%.

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Previously, the dividend tax rate was set equal to the ordinary income tax rate for the taxpayer receiving the dividends (e.g., the highest ordinary rate prior to JGTRRA was 39.6%). The lower tax rates (ordinary, capital, and dividend) established by JGTRRA were scheduled to expire (sunset) on December 31, 2010, after which the tax rates would increase back to pre-JGTRRA rates.

Through late 2010, there was considerable uncertainty regarding extension of the low tax rate; deadlock in Congress made some deem it likely that no congressional action would be taken, the provisions would sunset, and the dividend rate would revert back to pre-JGTRRA levels (e.g., Bases, 2010).[1] Others believed that a compromise was likely, with the dividend tax rate to rise to 20% (Briginshaw, 2010; Norris, 2010). Finally, on December 17, 2010, uncertainty around the investor-level dividend tax rate was completely resolved, and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Jobs Act) was signed into law, extending the favorable 15% maximum dividend tax rate for the next two years.[2]

In 2012, the JGTRRA rates were again set to expire, with the dividend tax rate potentially increasing to a rate as high as 39.6%. In addition, another tax on dividend income was set to go into effect on January 1, 2013 (the 3.8% tax on unearned net investment income mandated by the Patient Protection and Affordable Care Act of 2010). This meant that even if JGTRRA did not expire, the dividend tax rate would still increase by 3.8 percentage points for some taxpayers. In addition, the economy was perceived to be stronger and, thus, the sunset of JGTRRA considered more likely. Eventually, Congress reached a compromise, and President Obama signed into law a top dividend tax rate (and long-term capital gains rate) of 20% (with the additional 3.8% tax also applicable for certain 'high income' taxpayers).

Changing regular dividend policy in response to investor-level taxes has been examined in prior literature with some mixed results (e.g., Gordon and MacKie-Mason, 1990; Bolster and Janjigian, 1991). Recently, the enactment of JGTRRA provided a potentially fruitful setting to test the effect of investor-level tax rates on payout policy. For example, Chetty and Saez (2005) find an increase in dividend payments (including special dividends) following the enactment of JGTRRA and attribute it to the tax rate reduction. Blouin, Raedy, and Shackelford (2011) also study the time period around JGTRRA and find that the percentage of total payout represented by regular dividends increased after JGTRRA, consistent with individual-level taxes affecting payout.

However, there are also several studies that attribute the increase in dividends following JGTRRA to other factors. For example, Edgerton (2013) documents that real estate investment trusts (REITs) increased dividends at the same rate as corporations. Dividends from REITs do not receive the preferential tax rate under JGTRRA, and therefore, Edgerton (2013) attributes the increase in dividend payouts at both REITs and non-REITs to factors other than taxes (e.g., profitability or investors' demand for cash).[3] Similarly, Julio and Ikenberry (2004) contend that the increase in dividends was merely a result of a change in firm composition over the studied time period. Finally, Floyd, Li, and Skinner (2012) conclude that dividends likely did not increase after 2003 due to individual-level taxes, but rather due to other factors (e.g., firm profitability). Chetty and Saez (2005) concede several limitations to their study: (1) their findings do not hold in a standard time-series regression as a result of firms entering and exiting over the sample period, and (2) other factors such as corporate profitability, investor demands for cash, and other economic events (e.g., corporate scandals) make causal inference in their study difficult.[4]

To the best of our knowledge, all studies examining JGTRRA find an increase in dividends, but diverge when interpreting the cause of the increase. Clean inference depends upon knowing exactly when to look for an increase in dividends, and being able to isolate taxes, rather than other factors, as the cause of changes in payout (Shevlin, 2008). These other factors include macroeconomic conditions, investor preferences for dividends, and fluctuations in corporate earnings (corporate earnings increased following the recession of the early 2000s). To this end, Chetty and Saez (2005, p. 816) state that "future tax changes might allow identification of tax effects in an environment where such [confounding factors] are less relevant."

Our research setting allows us to draw a much stronger causal link between dividend taxes and payout response than has been achieved in prior studies because we

[1] For example, Bases (2010) reported that "Companies and investors have been left in limbo as Congress and the White House wrangle over whether to extend the Bush-era tax cuts on dividends…." Others merely assumed the extension would not happen. For example, in a conference call for Scripps Networks Interactive Incorporated held on September 22, 2010, analyst Brian Karimzad asked, "As we get to January 1, we're probably going to see a hike up in the dividend tax rate….How is that kind of changing the tenor or the options you are considering, things like a special dividend that you may not normally think about?".

[2] While uncertainty was resolved with the passage of the Jobs Act on December 17, substantial uncertainty had previously been resolved. On December 6, President Obama announced that a compromise had been reached and that the dividend tax rate would be extended. However, as late as December 4, a bill that had already been passed in the House failed to pass in the Senate, receiving only 53 votes. As a result of this uncertainty that persevered up until shortly before the passage of the bill on December 17, we assume all December 2010 dividends were issued with the possibility that the tax rate would increase. In our sample, there are no firms that declared and paid a dividend by year-end that declared after December 17, 2010.

[3] Further, Edgerton also documents that the ratio of dividend payouts to corporate earnings changed very little after the tax cut, consistent with the dividend increases resulting from increased firm profitability.

[4] Survey evidence suggests that the relation between investor-level tax rates and payout policy is not strong. For example, Brav, Graham, Harvey, and Michaely (2008) reports that surveyed managers rank taxes as fifth in order of importance among factors that affect their dividend decisions (after factors such as the stability of cash flows and the historic level of dividends). Further, of managers at firms that initiated dividends in the three years surrounding JGTRRA, the average manager stated that the tax change had "a little" effect on the decision to increase/initiate dividends payments. Brav, Graham, Harvey, and Michaely (2008) thus support the sentiment in Brav, Graham, Harvey, and Michaely (2005), that investor-level tax rates are at best of second-order importance with respect to corporate payout policy. This is also consistent with previous survey work done after a prior tax rate reduction, which finds evidence that "cast[s] doubt on the notion that dividend policy is based on shareholders' tax rates" (Abrutyn and Turner, 1990, p. 493).