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Payout policy, taxes, and the relation between returns and the bid–ask spread

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Abstract

Recent evidence demonstrates that corporate payout policy has shifted from the nearly exclusive use of dividend payout to the inclusion of stock repurchase, primarily through open markets. This trend has been attributed to the tax advantages associated with repurchase relative to dividends. In this paper, we introduce personal taxation and stock repurchase to reexamine the relation between returns and the bid–ask spread. Our model provides insight into the nature of this relation. Tests performed using NYSE, AMEX, and NASDAQ data provide empirical support of our theoretical conclusions. We conclude that the firm's choice of payout policy influences the relation between returns and spreads.

JEL classification: G12

Keywords: Asset pricing; Bid–ask spread; Liquidity; Payout policy; Tax

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1. Introduction

There is extensive evidence that, since the early 1980s, corporate payout policy has shifted from the nearly exclusive use of dividend payout to the inclusion of open-market stock repurchase (Allen and Michaely, 2001; Bagwell and Shoven, 1989; Fama and French, 2001; Jagannathan et al., 2000). This trend has been attributed to the personal tax advantages associated with repurchase relative to dividends (Allen and Michaely, 2001).[1] Support for this explanation comes from Green and Hollifield (2003), who argue that using stock repurchase instead of dividend payout leads to savings of 40–50% of the present value of the personal tax liability.

Allen and Michaely (2001) report that repurchasing firms almost exclusively use open market repurchases to distribute cash. These firms must act under SEC Rule 10b–18 that specifies the guidelines that govern open-market repurchases. This rule requires that firms engaging in an open market repurchase use only one broker or dealer on any single day. Thus, the use of stock repurchase has important implications for the study of liquidity, as investors in firms performing open market-repurchase bear a cost for the immediacy service provided by the broker or dealer. Investors in firms issuing dividends do not face such costs. Hence, while stock repurchase is the dominant strategy from a personal tax perspective, there is a tradeoff between the personal tax advantages of stock repurchase and liquidity costs.

In this paper, we derive a theoretical model based on Amihud and Mendelson (1986) that relates returns to the bid–ask spread but allows for stock repurchase and personal taxation. Our extended model demonstrates that stock repurchase can be superior to dividends as a payout methodology when personal taxation is included. This result differs from the one identified in Amihud and Mendelson's tax-free environment, in which dividends are always dominant. We identify a critical bid–ask spread level that determines the firm's optimal payout policy, and demonstrate that the personal tax advantage of stock repurchase dominates immediacy services costs of open-market repurchase for firms with spreads lower than the critical spread. On the other hand, firms with spreads exceeding the critical spread will choose to pay dividends, because repurchase immediacy costs exceed the related tax advantage.

In Amihud and Mendelson's (1986) tax-free model, dividends always dominate repurchase due to immediacy costs associated with open-market repurchase. This yields a concave gross relation between returns and the relative spread. In contrast, in our model repurchase can dominate dividends due to personal taxation. When

[1] Other factors may have contributed to the increased popularity of stock repurchase as well. Allen and Michaely (2001) note that dividends exhibit a general upward trend with decreases occurring only rarely, while stock repurchases are highly responsive to the firm's earnings and general economic conditions. Thus, stock repurchase provides the firm with a higher degree of flexibility. Brockman and Chung (2001) argue that the relaxed regulatory requirements associated with stock repurchases make them more attractive than dividend payouts. Grullon and Ikenberry (2000) provide empirical evidence indicating that stock repurchase programs are liquidity enhancing for the firm's stock.