Ownership structure and tax-friendly dividends

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1. Introduction

The role of taxation in influencing corporate dividend policy and the existence of taxation-based dividend clienteles is a vexed issue in the corporate finance literature. In the presence of differential taxation of dividend income and capital gains, which is observed in many countries around the world, shareholders should, other things being equal, exhibit a preference for dividend policies which maximise their after-tax investment returns. This would be consistent with rational investors preferring payment of dividends (retention of earnings) if dividend income is less-highly (more-highly) taxed than capital gains. Similarly, the relevance of such taxation considerations would also be consistent with companies tailoring dividend policies to suit the preferences of major investor classes or their ‘marginal’ shareholder.

Substantial empirical evidence investigating this tax-preference hypothesis and the existence of taxation-based dividend clienteles, however, provides only limited evidence that taxation considerations influence either shareholder demands or firm dividend policy development. Much of this prior research focuses on the clientele demands of only one particular class of investor, such as institutional investors, corporate shareholders, company officers and directors, or individuals, in isolation, and is approached from an aggregate ownership or trading perspective (not considering different classes of the one shareholder category – such as domestic and foreign). This literature is also derived predominantly from countries operating taxation systems that have a tax-based bias against shareholder preference for dividend payment.

The novelty of this paper is the evaluation of the existence of ownership-based dividend clienteles in Australia, which operates a full dividend imputation taxation system. Under this system, the receipt of franked dividends (dividends providing full imputation or corporate tax credits) is highly tax-advantageous relative to capital gains for a number of shareholder categories, but less attractive for other investor types, providing an environment conducive to identifying a variety of dividend-policy clienteles. In this environment, it is possible to accurately define the underlying tax-based dividend preferences of five major shareholder classes – institutional shareholders and corporate shareholders, both domestic and foreign, and company directors. Using the franking percentages of dividend payments to represent their degree of tax ‘attractiveness’ to these shareholder classes, we can directly assess the presence of tax-based ownership clienteles and/or the influence of these shareholders on corporate dividend policy.

As such, this paper contributes to the literature by examining the tax-preference hypothesis in an environment favourable to dividend payment, jointly examining individual, institutional and corporate shareholder categories and distinguishing between domestic and foreign shareholder classes who are expected to have differing dividend preferences. This incorporates modelling of both dividend and total payment likelihood and considering three
measures of dividend payout magnitude to determine whether shareholder preferences differ depending on the nature of firm dividend decisions. This setting also provides for the utilisation of a direct measure of the tax benefit associated with dividends rather than relying on inferences based on shareholder marginal or effective tax rates or dividend tax preference measures.

The findings of the paper suggest that Australian companies maintain a high propensity to pay dividends, they distribute a high proportion of earnings in the form of dividends, and dividend payments continue to be the predominant form of earnings and cash flow distribution in preference to share repurchases. Excluding taxation considerations, none of the major shareholder categories show a preference for dividend payment or other earnings distribution generally. However, incorporating the dividend imputation effects, domestic shareholder categories, and particularly corporate shareholders and company directors, exhibit a significant preference for increased payment of dividends providing greater tax (franking) benefits. Foreign shareholders, on the other hand, and foreign institutional investors in particular, have a preference for capital retention or lower dividend payment, consistent with reduced benefit being associated with the receipt of franked dividends. These results are robust to various econometric specifications addressing the effects of unobserved firm heterogeneity and potential endogeneity between ownership and dividend policy, and persist after also incorporating share repurchase activity. They provide support for the tax-preference hypothesis, indicating the relevance of tax considerations in investment selection and corporate dividend policy setting, and the existence of tax-based dividend clientele formation. More importantly, they suggest that the degree of tax benefit associated with dividend payments is a critical factor in driving clientele effects.

The remainder of this paper is structured as follows. Section 2 outlines the theoretical motivation for the paper and presents a review of relevant prior literature. Section 3 presents the background of the dividend imputation system in Australia and the impact on corporate dividend policy and shareholder preferences, leading to the hypothesis development for the paper. Section 4 describes the research methodology, company sample and data employed for the empirical analysis, and provides some summary descriptive statistics. The following section presents the empirical testing and robustness results and associated discussion, and Section 6 summarises the conclusions and implications of the paper.

2. Theoretical background and literature review

Following the pioneering work of Lintner (1956) and Modigliani and Miller (1961) on the mechanics of dividend policy, a number of theoretical models have been developed relating to dividend payment and tax clientele behaviour. These explain dividend payment based on agency arguments (Eastbrook, 1984; Jensen, 1986; Miller and Rock, 1985), the interaction between tax and monitoring motives (Sheifer and Vishny, 1986; Brennan and Thakor, 1990), and signalling (Allen et al., 2000; Allen and Michaely, 2002).


There are two prior studies examining dividend clientele behaviour under a full dividend imputation tax system, both relating to Finland which operated a full dividend imputation system from 1993 to 2004. Rantapauska (2008) provides evidence of ex-dividend day and overnight arbitrage trading in the Finnish stockmarket that is consistent with dividend clientele preferences, and Korkemaki et al. (2010) find that firms with a higher proportion of large shareholders affected by the 2004 tax reform paid significantly higher dividends in the year prior. Dividend payout ratios are also found to decrease following the tax change, although the shareholder response to the reform was less significant.

The Finnish dividend imputation tax system operated relatively simply with all domestic investors, excluding non-taxed entities such as mutual funds and non-profit institutions, taxed at a flat rate equal to the corporate tax rate, resulting in tax-free dividends for domestic investors. The Australian taxation system, on the other hand, involves a progressive tax scale based on income level, resulting in varying taxation outcomes for shareholders of different type and income level and greater potential dividend clientele variability. The introduction of the 45-day holding period rule in 1997 also removed the possibility of trading around the ex-dividend date to obtain imputation credits.

In regards to evidence from partial dividend imputation systems, Short et al. (2002), Farinha (2003), Khan (2006) and Renneboog and Trojanowski (2011) provide mixed evidence regarding the influence of managerial and institutional ownership, as well as the overall level of ownership concentration, on dividend payout by UK firms. Eckbo and Verma (1994) conclude that Canadian firm dividend yields decreased (increased) in response to increases in managerial (corporate shareholder) voting power, and Gugler and Yurtoglu (2003) show that the concentration of large shareholder voting power is positively related to dividend payout in German firms.

Al-Yahyaee et al. (2011) provide evidence inconsistent with tax-based arguments for dividend policy in Oman, whereas Lee et al. (2006) examine the Taiwanese capital market, where there is no capital gains tax, and find support for the existence of tax-based clientele in relation to both dividend and total payouts (including share repurchases). Finally, Ferreira, Massa and Matos (2009) conduct a cross-county analysis of dividend clientele and find a negative relationship between foreign institutional ownership and dividend payout, ex-dividend drop-off ratios and the likelihood of dividend initiation, and no relationship for domestic institutional investors.

3. The dividend imputation tax system in Australia

3.1. Mechanics of the dividend imputation system

A classical taxation system operated in Australia until July 1st 1987. From this date, a full dividend imputation system became

1 Under partial dividend imputation systems, some proportion (such as 25% or 50%) of the corporate tax paid of dividend income is imputed for use as a personal tax credit by eligible shareholders. This can be contrasted with the full dividend imputation system in Australia where 100% of corporate tax paid is attached as a franking (tax) credit with dividends paid. Such tax systems have been in existence in the UK, Canada, and many European countries since the 1970s, although the UK reverted back to a classical taxation-like environment in 1999.
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