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## Insider ownership and dividend policy in an imputation tax environment

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### ABSTRACT

Firms are more likely to pay dividends with higher payout ratios in an imputation environment. The effects of profitability and earned/contributed capital mix on the decision to pay dividends and dividend payout are weaker for firms following imputation tax system than traditional tax system. Insider ownership is positively related to the decision to pay dividends and dividend payout and this effect does not vary between traditional and imputation tax systems. Firms with higher foreign institutional ownership are less likely to pay dividends and have lower payout ratios. The study demonstrates the significance of the imputation tax system upon dividend policy.

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### 1. Introduction

The impact of taxation on dividend policy has received much attention in the finance literature (see for example, [Poterba and Summers \(1984\)](#), [Fung and Theobald \(1984\)](#), [Masulis and Trueman \(1988\)](#), [Poterba \(2004\)](#), [Barclay et al. \(2009\)](#) and [Desai and Jin \(2011\)](#)). However, there is a scarcity of research on how dividend policy differs across imputation and traditional tax environments. In this paper, we address this important and interesting issue by utilizing the unique Australian tax setting. Under the Australian imputation tax system, Australian companies pay dividends on profits that are earned and taxed in Australia (known as franked dividends) and provide shareholders resident in Australia with a credit for the corporate tax paid that can be subsequently offset against their own personal tax liabilities. Any dividends paid arising from the profits that are earned outside Australia, referred to as unfranked dividends, do not carry any tax credits and are taxed as ordinary income in the hands of investors in a similar fashion to the treatment in a traditional tax environment. As such, then, we use this novel Australian setting that has these two tax systems operating contemporaneously to provide insights regarding the effect of insider share ownership and institutional ownership on the dividend decision and how these effects vary as between imputation (paying franked dividends) and classical (paying unfranked dividends) tax environments.

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Brav et al. (2008) survey executives to determine the effects of the 2003 dividend tax cut in the US on dividend policy and find that the tax rate reduction is less important for executives than the stability of future cash flows, cash holdings, and the historic level of dividends.<sup>1</sup> However, Brown et al. (2007) find that the share ownership of the top five executives in a company is significantly and positively related to an increase in dividends after the tax cut in 2003. A significantly negative relation between insiders' effective tax rates and dividend payouts is found by Holmen et al. (2008) in Sweden. Furthermore, Korkeamaki et al. (2010) find that payouts increased immediately prior to the tax reform in 2004, when Finland abolished its full imputation tax system and introduced a traditional tax system with double taxation of dividends. The findings in Brown et al. (2007), Holmen et al. (2008) and Korkeamaki et al. (2010) demonstrate the significance of taxation on dividend policy in both traditional and imputation tax environments and the potentiality of tax induced clientele effects.

Balachandran et al. (2012) find a negative relation between the market reaction to dividend reductions and reductions in franking credits after controlling for the magnitude of the dividend reduction. They assert that this evidence provides empirical support for the view that the market incorporates the impact of the reduction in the franking credit in prices at the announcement date of the dividend reduction. Therefore, we argue that companies will pay dividends when imputation credits are available, irrespective of the size of profits and earned/contributed mix. We further predict that the effect of profitability and earned to contributed capital mix on the decision to pay a dividend will be lower for firms subject to the imputation tax system than for firms subject to the traditional tax system. As companies tend to distribute imputation credits as early as possible, we argue that dividend payout ratios will be larger for firms with franking credits available than for others, *ceteris paribus*.

Dividend payments can be considered to be a part of a firm's optimum monitoring/bonding package, thereby serving to reduce agency costs, and thus firms establish higher dividend payouts when managers hold a lower fraction of equity (Rozeff, 1982). We argue that if managers, themselves, have larger shareholdings they will, *ceteris paribus*, have a greater incentive to pay dividends in order that they may enjoy the imputation tax benefits. Since institutions are likely to be better informed than individual investors and have more incentives to devote resources to monitoring activities, a positive relation between firms' payout and institutional holdings would be anticipated. However, Grinstein and Michaely (2005) find little evidence that the presence of institutional investors does lead to increases in payout in the US. Similarly, Brav et al. (2005) find that most executives do not use payout policy as a tool to alter the proportion of institutions among their investors. In a partial adjustment framework, Short et al. (2002) find that dividend payout ratios are significantly higher for firms with 5% or more institutional ownerships in the UK when the partial imputation tax system prevailed.<sup>2</sup> This result indicates that the presence of institutional ownership does have a positive impact upon dividend payout ratios. Since non-resident shareholders are ineligible for tax credits in Australia, we examine whether domestic and foreign institutional investors have differential impacts upon dividend policy. We argue that firms with larger foreign institutional ownership are less likely to pay dividends and have lower payout ratios.

Jensen et al. (1992) argue that insider ownership is itself determined by many of the same firm-specific variables that affect dividend and debt policy and suggest that estimation within a simultaneous equation system framework will reduce the possibility of drawing false causal inferences as a consequence of these interdependencies. Using a simultaneous equation system, Jensen et al. (1992) find that insider ownership and debt levels determine dividend payout ratios while insider ownership and dividend payout ratios determine debt levels in the US.

Following Jensen et al. (1992), we use a simultaneous equation system estimator approach and find that earned/contributed capital mix, insider ownership and the prior year franking dummy variable are significantly and positively related to the likelihood of paying a dividend and the payout ratio. The profitability is positively related to the decision to pay, while it is negatively related to the payout ratio. Further, we find that the effect of profitability and the earned/contributed capital mix on the decision to pay dividends and the payout ratio are weaker for firms following the imputation tax system (that is, firms paying franked dividends) than for those following the traditional tax system (i.e. firms paying unfranked dividends). In addition, we find that firms with higher foreign institutional ownership are less likely to pay dividends and have lower payout ratios, as foreign institutional investors will not be eligible to receive the imputation credit under the Australian tax legislation as described in Section 2. Franking status does not affect the positive impact of insider ownership on the decision to pay dividends and the level of payout. Overall, our findings demonstrate that the tax treatment of dividends does have a significant impact on the role of both profitability and earned/contributed capital mix on the dividend decision. We also find that dividends, leverage and insider ownership are simultaneously determined within the Australian context.

Our study extends the literature on tax clientele effects in dividend policy (Brown et al., 2007; Holmen et al., 2008; Pattenden and Twite, 2008; Korkeamaki et al., 2010; Henry, 2011; Alzahrani and Lasfer, 2012; Hanlon and Hoopes, 2014) and contributes to the debate on shareholders' tax preferred corporate dividend policies using a unique institutional setting – the imputation and traditional tax systems operating contemporaneously. First, we find that the likelihood of paying a dividend is stronger and the magnitude of the payout ratio is higher in an imputation tax environment than under a traditional tax system. Second, we extend the previous research findings that profitability and earned/contributed capital mix are important determinants of the decision to pay dividends (DeAngelo et al., 2006; Denis and Osobov, 2008) and show that the effects of profitability and earned/contributed capital mix on the decision to pay dividends and dividend payout are weaker for firms following an imputation tax system than for the traditional tax system.

<sup>1</sup> Brav et al. (2005) document that tax considerations are not a dominant factor in executives' decisions about whether to pay dividends or to increase dividends.

<sup>2</sup> During the period from 1973 to 1999 the UK had a partial imputation tax system where shareholders are able to claim a tax credit reflecting the *advance corporation tax* (ACT) paid by a company.

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