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Taxes and dividend clientele: Evidence from trading and ownership structure

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Abstract

Although dividend clientele have been studied over several decades, their existence remains controversial. We study the interaction of dividends and taxes by exploiting a unique dataset from Taiwan, where the capital gains tax is zero. We find strong evidence of a clientele effect. Agents subject to high rates of taxation on dividends tend to hold stocks with lower dividends and sell (buy) stocks that raise (lower) dividends. Agents in lower tax brackets behave in the opposite manner. After legalization of repurchases in 2000, firms with higher concentrations of more heavily taxed shareholders were more apt to begin repurchase programs.

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1. Introduction

Whenever dividends and capital gains are differentially taxed, it seems plausible that equity investors would arrange themselves into heterogeneous classes, or "clientele," by their effective tax brackets. In many countries, dividends are more heavily taxed than capital gains, so highly taxed investors should favor firms with lower dividend payout ratios, ceteris paribus. Investors subject to lower effective tax rates should behave in a complementary fashion and thus favor firms with higher payout ratios.

Differential taxation of dividends might impact equilibrium asset prices. Rational investors should be attracted only by *after*-tax returns, so it seems possible that firms with higher dividend payout ratios might have higher pre-tax expected returns, ceteris paribus (unless firms can arrange themselves in perfect correspondence with clientele). Brennan (1970) was probably the first to derive a formal asset pricing theory that accommodated the differential taxation of dividends and capital gains. Early empirical papers by Black and Scholes (1974) and Litzenberger and Ramaswamy (1979), which reached different conclusions, typify the controversy surrounding dividend taxation and asset pricing that continues to the present day; see, for example, Elton and Gruber (1970), Litzenberger and Ramaswamy (1980, 1982), Fung (1981), Asquith and Mullins (1983), Elton et al. (1983), Haugen et al. (1986), Blose and Martin (1992), Denis et al. (1994), Fama and French (2002), Harris and Kemsley (1999), Naranjo et al. (1998), Demsey (2001), Bell and Jenkinson (2002), Gentry et al. (2003), and Elton et al. (forthcoming).

Whether or not it has an impact on asset pricing, dividend taxation represents a conundrum with respect to the financial policy of corporations: if firms can distribute cash through lower-taxed methods such as share repurchase, why are dividends ever paid? Black (1976) referred to this as the "dividend puzzle."

Indirect evidence does suggest some sort of connection between dividend *policy* and taxes. Firms appear to change payout ratios in response to changes in relative dividend tax rates (see Briston and Tomkins, 1970; Bolster and Janjigian, 1991; Papaioannou and Savarese, 1994; Casey et al., 1999). Fama and French (2001) document a secular decline in dividend paying American firms accompanied by an increase in the rate of share repurchases. Although it is technically illegal for American firms to evade dividend taxes, the tax authorities appear to be winking at the actual evasion. More recently, the Bush administration succeeded in reducing the tax rate on dividends dramatically, avowedly to encourage an increase in dividend payouts and also to reduce any distortion caused by differential taxation.

Dividend clientele have been studied for several decades. They are part of the asset pricing debate because heterogeneous clientele are implied by a dependence of expected returns on dividend taxes.[1] The opposite is not true; clientele could still exist even with no asset pricing effect of taxation. Without relying on asset pricing, Elton and Gruber (1970) devised an ingenious test for the existence of clientele by compar-

[1] See Allen et al. (2000) and Allen and Michaely (2003) for theoretical models of dividend clientele.