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Political affiliation and dividend tax avoidance: Evidence from the 2013 fiscal cliff☆

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ABSTRACT

This paper uses the 2013 fiscal cliff as a natural experiment to examine how the political affiliation of the CEO affects a firm's response to an expected increase in personal taxes on dividends. Firms could avoid such additional taxes by paying extra dividends and accelerating dividends in the last 2 months of 2012. These tax avoiders are compared with a sample of firms that did not accelerate the payment of their first quarterly dividend from the first 3 months of 2013 to November or December 2012 (the deliberate taxpayers). Ceteris paribus, Republican CEOs are more likely to help their investors to save money on personal income taxes. However, the political affiliation has explanatory power in addition to previously documented effects (Hanlon and Hoopes, 2014), such as the consequences for the CEO's personal wealth as well as the percentage of insider holdings. Reputational concerns about "avoiding taxes for the rich" as well as corporate governance quality are also significant determinants of corporate behavior.

1. Introduction

During the last 2 months of 2012, more than 400 U.S. firms announced special dividends or accelerated the payment date of some of their 2013 planned dividends to December 2012. While most of the time the acceleration only involved the payment of a single quarterly dividend, in some cases several planned dividend payments were accelerated. For example, on December 3, 2012, Oracle announced that it would pay a dividend of 18 cents per share in December, which replaced the three quarterly 6 cents per share dividends that were planned to be paid in 2013. The obvious motivation for this decision was tax avoidance: the re-election of Barack Obama in November 2012 significantly increased the probability that, starting January 1, 2013, the dividend tax cuts, introduced by George W. Bush in 2003, would expire. If tax cuts were allowed to expire, the marginal tax rate on dividends would increase from 15% to 39.6%, at least for the "rich," defined as anyone who makes more than $250,000 per annum.[1] Moreover, an additional tax of 3.8% on unearned net investment income mandated by the Patient Protection and Affordable Care Act of 2010 would also go into effect on January 1, 2013, raising the marginal tax rate on dividends further to 43.4% for investors in the highest marginal tax brackets. The threat of this tax increase was commonly referred to as the tax side of the "fiscal cliff": because of a prior agreement to cut the government deficit, these increases in tax rates as well as reductions in government spending were supposed to take effect on January 1, 2013.

The fiscal cliff was a heavily debated issue in the fall of 2012, so it is reasonable to assume that every CEO in the country was aware of the high probability that taxes on dividends would increase after January 1, 2013, at least for the wealthy investors.

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[1] See, e.g., "The economic and fiscal effects of the Obama tax plan," heritage.org, December 14, 2012.

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Although a large number of firms announced special or accelerated dividends, the overwhelming majority did not. The fact that many firms did not pay a special dividend is not surprising, as in general, very few firms pay special dividends. For example, Hanlon and Hoopes (2014) show that since 2000 in normal times (i.e., ignoring the anticipation of tax changes in 2010, 2011, and 2012) fewer than 10 firms per month pay special dividends. We find 234 firms that paid a special dividend in December 2012, almost 24 times larger than "normal."

What is surprising is the behavior of 198 firms that could have moved up the payment date of their 2012 fourth quarter dividend from January, February, or March 2013 to December 2012, but did not, despite the fact that such a move could have saved wealthy investors a lot of taxes. For example, CBS announced its fourth quarter 2012 dividend on November 30th and paid it on January 1, 2013. It could have saved investors taxes by simply accelerating the payment date 1 day but chose not to. Note that dividend payment days are almost as stable as birthdays: every quarter firms pay dividends on (approximately) the same calendar date. For example, since 2007, every year, CBS has announced its fourth quarter dividend in November and paid it on January 1 of the following year. Thus, identifying firms that kept their dividend policy constant despite a substantial increase in tax rates is straightforward. Explaining why these firms (which we define as "deliberate taxpayers") behaved so differently from the firms that either decided to pay a special dividend or accelerate dividends (i.e., the tax avoiders) is the core question of this paper. Comparing two samples with dramatically opposite policies should potentially provide more insights than comparing tax avoiders with all other firms, many of which do not pay dividends or generally announce and pay their final quarterly dividend during the last 3 months of the year. Especially considering that, unlike paying extra dividends, moving a dividend payment date from January 1 2013 to December 31 2012 has no impact on firm value or cash flows.

In this paper, we consider a number of hypotheses to explain why a firm is a tax avoider rather than a deliberate taxpayer.

According to the *Political Preference Hypothesis*, CEOs are influenced by their political opinions when making corporate decisions. Why should political affiliation matter? While political opinions are based on a variety of criteria, one major difference between Democrats and Republicans is the attitude toward "taxes on the rich." Mitt Romney, Mr. Obama's Republican opponent, made it clear that, if elected, he would not let the Bush tax cuts expire while Mr. Obama clearly promised to do the opposite.[2] Thus, if Democrats are more driven by social motives such as reducing income inequality, one would expect that fewer of them would engage in dividend policies designed to avoid income taxes for wealthy shareholders. Hence, the *Political Preference Hypothesis* predicts that the CEO of a tax avoider is more likely to be a Republican. Using personal characteristics such as political affiliation to predict corporate decision making is complementary to the approach of Perez-Cavazos and Silva (2014). They identify tax-minded executives as executives who strategically realize capital gains prior to major anticipated tax increases. They find that these executives were also more likely to save their shareholder taxes by paying special dividends and accelerating dividends prior to the 2013 tax hikes.

Evidence that politics influences business decisions is reported by Di Giuli and Kostovetsky (2014), who find that firms with Republican CEOs and founders have lower corporate social responsibility (CSR) rankings than firms run by Democrats. Hong and Kostovetsky (2012) find similar results on the investor side: Democrat mutual fund managers are less likely to hold socially irresponsible companies in their portfolios than Republican mutual fund managers. Using a unique database from Finland, Kaustia and Torstilla (2011) find that left-wing Fins invest less in the stock market than right-wing Fins. Hutton et al. (2014) find that firms run by Republicans are more profitable and pay higher dividends but invest less in R&D and have lower leverage. They describe these as conservative financial policies and argue that conservative management teams follow conservative policies.[3] Christensen et al. (2015) show that companies run by Republicans engage less in *corporate* tax avoidance than Democrats. They explain this result by the same logic as Hutton et al. (2014): although Republicans do not like taxes, they have lower risk tolerance than Democrats, and thus engage in less tax avoidance. This interpretation is challenged by Hanlon and Heitzman (2010) and Kim and Zhang (2014) who define corporate tax avoidance as tax aggressiveness. Kim and Zhang (2014) find that firms with political connections are more tax aggressive. Note that avoiding corporate taxes and avoiding personal taxes could be driven by different motivations as corporate tax avoidance should affect shareholder value, while this is less obvious for personal taxes. As Hanlon and Heitzman (2010) point out, the evidence of dividend taxation on stock prices is mixed, while everyone agrees that higher corporate taxes lower shareholder value.

It should be noted that eventually, as part of a compromise between President Obama and the Republican Party, the tax increase implemented in 2013 was smaller than anticipated. The tax rate on dividends and capital gains was increased from 15% to 20%. Because of the 3.8% tax increase due to the Healthcare Act, the marginal tax rate on dividends increased from 15% to 23.8%, a 58.7% increase in the tax burden, much smaller than the 189% increase if the tax rate had gone up to 43.4%. Hence, one explanation for the behavior of the "deliberate taxpayers" is that they were more confident that the tax increases would not be as drastic as expected. Thus, if we find that Democrat CEOs are more likely to be "deliberate taxpayers," it may simply mean that they were more informed about the true intentions of President Obama. One way to test this *Superior Information Hypothesis* is to use the approach of Kim et al. (2012), who develop a political alignment index (PAI). The PAI measures the proximity of a local firm to the party in power. They find that firms whose headquarters are located in high PAI states outperform those located in low PAI states. The interpretation is that because these firms are better informed about the intentions of politicians, they are better informed about the political intensions of the party in power. A CEO in a predominantly Democrat state will have more contacts with Democrat politicians and may be better able to judge whether the threat to increase massively taxes on

[2] See, e.g., "Surprise! Romney tax plan favors the rich," Bloombergview.com, August 1, 2012.

[3] Note that paying a special dividend or accelerating dividends is consistent with conservatism: although the tax increase is not certain, the safe thing to do is to take initiatives that will lower expected taxes. Not doing anything is more or less "gambling" that the tax increase will not happen.