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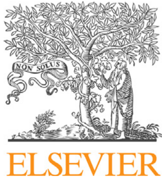

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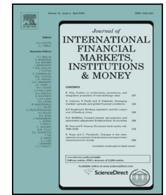

Taxes, earnings payout, and payout channel choice

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ABSTRACT

We study the tax regulations in relation to dividends and capital gains over the last two decades for the UK in order to determine whether changes in tax regimes affect corporate payout policy (dividends, share repurchases, or a combination). While we can identify investors' tax-driven preferences for a specific payout channel, we find no evidence of tax-induced clienteles. Firms do indeed not cater to the tax preferences of their shareholders (including individuals, pension funds, corporations). Other factors, such as equity-based compensation received by the CEO and investor sentiment in the form of optimism reduce the dividend payout and increase the use of share repurchases.

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'But in the real world there remains one overwhelming reason why dividend policy is not irrelevant: tax. The way dividends are taxed can have wide-ranging consequences for how a firm is run. In particular, it can influence whether a firm finances itself primarily through equity or debt, and how it chooses to return profits to its shareholders.' (The Economist, 9th January 2003)

'In Britain Gordon Brown staged an infamous pensions tax "grab" in 1997, which reduced private pension funds' income by around £5 billion (then $8.4 billion) a year by eliminating the tax credit on dividend payments.' (The Economist, 2nd December 2010)

'In America dividends seemed to go out of fashion in the 1990s. A yield of 2% or so appeared trivial when the market was rising by 20% a year. The disrespect for dividends also reflected the belief that, for tax reasons, share repurchases were a better way of returning cash to investors.' (The Economist, 2nd September 2010)

1. Introduction

Over the past 15 years, there has been a strong decrease of UK listed firms paying out dividends. This decline has only been modestly compensated by an increase in companies adopting share repurchases. Fama and French (2001) have shown that

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fewer US corporations have paid dividends over the last quarter of the last century, but DeAngelo et al. (2008) demonstrated that, while the number of dividend-paying firms did indeed go down, the total amount of dividends did actually increase.

When introducing readers to dividend policy, corporate finance textbooks typically refer to the dividend irrelevance theorem by Miller and Modigliani (1961): investors are indifferent as to whether a firm chooses dividends or share repurchases under the assumption of perfect capital markets. Allen and Michaely (2003b: 13) phrase it this way: 'any desired stream of payments can be replicated by appropriate purchases and sales of equity'. A number of reasons have been advanced that cause the above statement not to hold, including taxation and tax clienteles, the use of dividends as a signaling device, the dividend catering theory, and personal motives by management induced by the structure of their compensation packages. Share repurchases are used for occasional payout of excess cash and is hence a more flexible payout device than dividends, which are more 'sticky' – especially with regard to downward adjustments (Ofer and Thakor, 1987; Stephens and Weisbach, 1998; Jagannathan et al., 2000; Renneboog and Trojanowski, 2011). CEOs with option packages tend to prefer share repurchases and avoid dividends because of the associated negative effect on their personal wealth in case part of their remuneration package consists of non-dividend corrected stock options (and restricted stock) (Fenn and Liang, 2001; Liljeblom and Pasternack, 2006; Aboody and Kasznik, 2008; Geiler and Renneboog, 2014). Companies can adjust their dividends to signal their prospects to the market (Bhattacharya, 1979; Miller and Rock, 1985; Allen et al., 2000; Allen and Michaely, 2003b). According to Allen and Michaely (2003b), the accumulated evidence indicates that changes in payout policy are not motivated by firms' intentions to signal their true worth to the market, but rather suggests that dividends and share repurchases curb overinvestment by management. This is in line with Jensen's (1986) 'free cash flow theory', which says that a commitment to payout reduces management's discretion over cash flows. Hovakimian et al. (2001) and Jagannathan and Stephens (2003) report that more profitable firms have lower leverage ratios and tend to prefer share repurchases to repaying debt. The catering theory states that corporate payout decisions reflect investors' preferences for a specific payout channel (Baker and Wurgler, 2004). The idea being that a high dividend premium[1] proxies for the investors' taste for dividends and induces managers to opt for a higher dividend payout. In the case of a negative dividend premium, managers may react with earnings retentions or the use of share repurchases (Geiler and Renneboog, 2014).

In relation to taxation, Allen and Michaely (2003b) learn from the payout literature that there seems to be an effect of differential taxes (between dividends and capital gains) in the US on share prices, but that there is little evidence of a significant clientele shift triggered by tax-induced dividend changes. DeAngelo et al. (2008) argue that the introduction of a tax on payout should lead to a replacement of payout by retention, but report that such shifts do not occur. Even if dividends are taxed and capital gains are not, payouts will not cease to exist because the capital appreciation gained by foregone dividends is not one-to-one. It is problematic to attempt to transfer insights on taxation to another country as taxation systems often significantly differ across countries (and even within a single country, tax rules frequently change over time). Given the mixed empirical evidence of the impact of taxes on the payout decision and the lack of non-US research, we revisit the payout taxation for the UK while at the same time considering alternative explanations such as market sentiment, managerial incentives, top management's remuneration and their individual traits, ownership concentration, and company-specific characteristics.

Over the past two decades, the UK has seen many reforms on the tax treatment of dividends and share repurchases. For instance, the tax reform in 1997 withdrew the ability of tax-exempt investors (such as pension funds) to reclaim tax credits on dividends, which led to an immediate drop in the after-tax value of dividends to these investors of approximately 20% (Bell and Jenkinson, 2002; Bond et al., 2007). This supported the statement by Bond et al. (1996) that a more neutral tax treatment of the dividend payout would negatively affect dividend payout ratios, which were previously inflated precisely because of the favorable tax treatment of dividends.

Our approach consists of these steps; we examine: (i) the impact of different tax regimes on the payout level (over time); (ii) the relative attractiveness of the different payout channels (dividends, share repurchases, or a combination of both) by means of a multinomial logit setup; (iii) the impact of taxation on switching behavior from one payout method to another using a dynamic probit model; and (iv) the relation between taxation on the aggregated dividend payout by means of an extended partial-adjustment model.

We contribute to the literature in the following way: First, with exception of Bell and Jenkinson (2002) who focus on the impact of the 1997 reform on institutional shareholders, Bank et al. (2004) who investigate the relation between politics and dividend payout, and Bond et al. (2007) who study the effect of taxes on corporate valuation, there is hardly any research investigating the effect of taxation on payout decisions in the UK. This paper is to our knowledge the first to address the effect of taxation on the earnings distribution method. Second, this paper provides a thorough account of the many tax changes over the past decades related to the payout/retention decisions. Third, our data set is particularly rich: our analysis is based on a large panel comprising virtually all listed UK companies (including small caps and fledglings) starting in 1997 (at the onset of a period with major tax reforms) until 2007 (when the financial crises commence). Fourth, in contrast to many US studies, we dispose of information on the actual share repurchases (and not just on the announcement of share repurchase programs).

[1] The dividend premium is typically calculated as the logarithm of the average market-to-book ratio of dividend paying firms minus that of non-dividend paying firms (Baker and Wurgler, 2004).

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