Dividend policy

1. Tax disadvantages of high-dividend stocks

- Capital gains are tax-favored. Since low-dividend paying securities have higher capital gains components, they are more tax-favored.

- Why might stocks not bear implicit taxes?

  Answer: The deferral opportunity afforded by capital gains may compensate for the unfavorable tax treatment afforded to dividends.

- Why might high-dividend paying stocks not earn more pretax than low-dividend paying stocks?

  Answer: Dividends may be a costly signal that a firm is of high quality, where quality means a firm offers higher expected future pre-tax returns. These higher returns may compensate for the tax disadvantage of paying dividends.

2. Strategies for investor tax-clientele

   Taxation of capital gains and dividends differs across the classes of investors listed below. How do the trading strategies of these investors differ?

   - pension funds
   - corporations
   - broker-dealers
2.1 Pension funds

- All gains and losses, and all dividend and interest income earned by pensions is exempt from tax. Pension funds are indifferent among income types, so they should invest in assets that bear high explicit taxes for other classes of investors, like individuals.

- Pensions should invest in
  - bonds, and
  - high dividend stocks.

- As an empirical matter, they do.

2.2 Corporations

- Corporations prefer dividends to capital gains and interest because of the dividends received deduction

- Many corporations without NOLs buy adjustable rate preferred stocks.

- Corporations with a high marginal explicit tax rate benefit from paying implicit tax on dividend income rather than explicit tax on capital gains or interest income.

2.3 Broker-dealers

- All gains and losses, and all dividend and interest income earned by these traders is taxed as ordinary income.

- Broker-dealers should:
  - short stock and buy bonds,
  - short low-dividend paying stock and buy high dividend paying stock, and
  - buy preferred stock and short common stock.
3. Empirical Evidence

- Let $P_b$ be the stock price on the date of record. Let $P_a$ be the stock price on the ex-date. If the marginal investor in stocks paying dividends are individuals facing top personal rates of tax who can engage in dividend stripping if they choose, then the appropriate stock price drop should be

$$\frac{P_b - P_a}{d} = \frac{(1 - t)}{(1 - g)} = \frac{(1 - 39.6\%)}{(1 - 20\%)} = 75.5\%$$

of the dividend paid.

- Consistent with dividends being tax-disfavored, stocks drop by only 80 to 90% of the dividend amount, on average, on ex-dividend days. This implies the market values the $1.00 of dividends at only 80 to 90 cents.

- Some evidence suggests high dividend paying stocks experience higher pretax returns than low dividend paying securities. This is consistent with the stock being priced low to compensate for the tax disadvantage of the dividend. The issue is unresolved in the literature.

4. Puzzle: Stock repurchases exploded following 1984

- The timing is a mystery.

- Repurchases did not come at the expense of dividend payments.
  - Dividends tended to grow about the same 10% rate.

- Share repurchases and cash acquisitions appear to coincide with periods of dramatic debt issuance by corporations
  - consistent with a desire on the part of firms to increase leverage when equity capital is particularly costly.

5. Why pay (tax disadvantageous) dividends?

- Some arguments suggest that firms paying dividends are signalling good future prospects.
• Management may not believe there is a tax disadvantage
  – empirical evidence suggests that both high dividend yielding securities and zero dividend yielding securities earn higher rates of return!
  – relation between return and dividend yield is nonlinear
  – both high dividend paying and non–dividend paying stock tends to be issued by smaller firms

6. The U.S. dividends-received deduction

Many countries, including the U.S., offer relief from the multiple rounds of taxation on dividends paid by one corporation to another (and possibly a third and fourth corporation) before the dividends arrive in the hands of an individual taxpayer. The U.S. rules (under §243 and §246) are representative:

• Corporations owning less than 20% of the distributing corporation’s stock may deduct 70% of the dividends-received.

• Corporations owning 20% or more of the distributing corporation’s stock may deduct 80% of the dividends-received.

• Members of an affiliated group of corporations may deduct 100% of the dividends-received from other members of the affiliated group. A group of corporations is affiliated if the parent owns at least 80% of the stock of at least one subsidiary and at least 80% of the stock of each other corporation is owned by other group members.

• Limitations:
  – Dividends-received from foreign corporations are ineligible for the dividends-received deduction.
  – A dividends-received deduction is not allowed for stock held by a corporation for 45 days or less.
  – Roughly speaking, the dividends-received deduction cannot exceed 70% (or 80% in cases where the corporation owns 20% or more of the distributing corporation’s stock) of taxable income before NOLs, capital loss carrybacks, and the dividends-received deduction itself.

• Limitations on the limitations:
  – This last limitation does not apply to dividends-received under the affiliated group provision.
Also, the last limitation above does not apply if, after taking account of the full dividends-received deduction, the corporation has an NOL for the year.