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Dividend Policy and Taxation—A Review

Dr. Pradip Kumar Das

Associate Professor
Commerce Unit (Morning), J.K. College, Purulia
Affiliation under S.K.B. University, Purulia
Mailing Address: Cooks' Compound,
Post.& Dist. Purulia(W.B.), India; Pin Code: 723102
Email Id: pradip57.prl@rediffmail.com

ABSTRACT

Indeed, corporate dividend policy and taxation is a subject of intense research. Mostly, statutory amendments in the dividend tax practice fabricate the dividend payout policy of corporate sector. At times, corporate composing substantial promoters' securities are identified to keep a major objective to curtail their dividend payout. The study aims at analyzing the interaction between dividend policy and taxation. This paper provides a brief contribution of the diverse thoughts on the clientele effect for analyzing the impact of taxation on corporate dividend policy and finds that the temporal pattern of corporate dividend payout and dynamic dividend behavior have significant impact on taxation in variety of modalities. The findings have significant implication for companies, investors and the Government.

Keywords: Dividend; taxation; clientele effect; Corporate dividend policy; shareholders.

1. INTRODUCTION

Tax burden on dividend depends on corporate and personal income-tax systems. In classical system, total tax is the sum of corporation tax, capital gains tax and tax on dividend. In imputation system, total tax is corporation tax plus effective gains tax plus reduced dividend tax. Impact of taxation on dividend policy plays significant role to both academicians and practitioners. From academic perspective, pertinence of taxation highlights the scope to which corporate contemplate after tax return of their shareholders and how any tax amendments affect dividend payout. On the other hand, practitioners intend to cognize how taxation influences dividends. Further, impact of dividend taxation is important to fund managers and users as changes in tax codes impress net return and corresponding pricing of shares. Most countries over the world accept different systems of taxing dividends. Countries following classical system dissociate shareholders' income from their corporate income. This system tolerates double taxation: first at the corporate level and then at the personal level. Conversely, countries supporting integrated system normally have full or partial relief from dividend tax in contemplation of the fact that the same unit of earning is taxed at the corporate level.

2. BACKGROUND

In theory, taxation prevents corporate from paying dividends; but Brav et al., (2005) in his empirical study remarked that taxation plays minor role in dividend decision. Therefore, the question remains why corporate still pay dividend despite their heavy tax burden? Michealy, Thaley and Womack (1995) in their studies indicated that although dividend has tax disadvantage, shareholders react positively with increase in dividend and negatively with decrease in dividend. Tax disadvantage of dividend and yet their popularity argues the conventional approach of dividend payout policy. Black. F (1976) highlighted the shortcomings of the finance theory in reacting the question, why corporate subject to classical tax system pay dividend? Models based on information asymmetry recommend that dividend changes provide information about the corporate future cash flows or about their cost of capital and/or maturity phase. Agency theory suggests that dividend provides constructive device to curtail agency cost. Behavioral finance theory propounds that dividend partly accommodates certain inclination in individuals like market sentiment, etc. The paper is a modest attempt to analyze the dividend tax systems of different studies but finds that no methodical and consistent policy is pursued, rather, mixed result is reflected.

3. GOAL OF THE STUDY

Goal of the study is to make a synthesized study on the influence of the taxation of investors on the behavior of distribution. This paper briefly reviews some aspects of taxation of dividends of corporate. Despite few theoretical and empirical results found in various articles and books, this document is not a comprehensive study; the purpose is rather to highlight certain issues glimpsed climacteric about taxation and dividend.

4. LITERATURE REVIEW

Dividend policy issue is a controversial subject. Modigliani and Miller (1961) observed that in a perfect market and particularly in the absence of differences in taxation of dividends and capital gains, shareholders' wealth is independent from dividend policy. Black (1976) noted that dividend policy continues to be confusing in the task of development of corporate. Miller and Modigliani (1961) demonstrated that contrasting taxation of dividends and capital gains forms one of the main imperfections of capital markets. Moreover, in most countries dividends are taxed more extremely than capital gains. Many researchers have advanced studies on both the effects of taxation on payout policy and the clientele effect. Farrar and Selwyn (1967) and Brennan (1970) concluded that if the tax rate on dividend is higher than capital gains, optimum distribution policy presents no dividend. Repurchasing share implicitly suggests to pay the excess flow of the company. Several studies like Litzenberger and Ramaswamy (1979), Booth and Johnston (1984), Michaely and Vila (1996) and Sander (2007) supported the argument of tax effect. Others like Black and Scholes (1974), Miller and Scholes (1982) objected and proposed different explanations. Elton and Gruber (1970) tested the hypothesis of Miller and Modigliani to the existence of clientele effect on the American market. They compared the value of the corporate before and after payment of dividend. They substantiated an arbitrary model of investors around the payment date and found statistically significant positive relationship between the dividend yield and lower stock prices on ex-dividend. Their results are consistent with clientele hypothesis. Pettit (1977) showed that clientele is worth and there is no reason to remodel dividend policy for each corporate. Any remodeling of the policy, has, rather, unacceptable transaction cost for investors. Prevalent distinct empirical literatures on the subject of taxation and its impression on dividend policy brings forth mixed results. Hence, further studies govern to pursue other areas of divided policy.

5. METHODOLOGY & LIMITATION

The study is descriptive in nature. Descriptive research has been preferred for developing a better profundity of knowledge. Data required for the study has been collected from secondary sources viz. literature reviews, empirical studies, website, books, journals, reports, etc. The inherent limitation of the study is that as the study is based on published data and information, and this secondary source may be lacking in authenticity, the result inferred there from may not be completely dependable. The corpus of this paper is, therefore, limited to establish, in the first place, a global sketch on the reciprocity between dividend policy and taxation. On the other hand, it unveils the main strategy espoused during the analysis of this reciprocity. In the second place, an assessment on the foremost mission maneuvering the concept of the clientele effect has been represented.

6. RESULTS & DISCUSSION

6.1. Key factors influencing dividend policy

There are several key factors influencing corporate's dividend policy. The common factors are:

- **Income stability:** Popular companies having stable, ineludible income streams are more likely to pay dividend than companies having growing or volatile income. New and rapidly growing companies rarely pay dividends as they prefer to invest their profits back into the company to feed more future growth. Companies with irresolute revenue streams often prefer not to pay dividend, or pay small dividend to make sure the sustainability payout.

- **Better return:** Another influencing factor on management's dividend policy is the possibility for better return through capital reinvestment. A company even though its revenues are stable and predictable prefers not to pay if it feels in the interest of its shareholders to use their profits for other business activities than paying dividend.
- **Tax consideration:** Dividends are effectively taxed twice-once at the corporate level, and again when they are paid out to shareholders. Many corporate and their investors feel that repurchasing of shares are better for returning capital. However, this permits investors to reinvest their dividend without worrying about dividend taxes.
- **Legal requirements:** It is note worthy that few corporate having no alternative choice pay dividend. On the other hand, few require approval before paying dividend. Since the financial crisis, many banks need to submit capital plans for statutory confirmation for any plan to foster their payouts.
- **Economic condition:** Market environment influences dividend policy. If certain sectors having trouble anticipate downward profits, it is natural for them to protect their dividend.

6.2. Theories: dividend and taxation

6.2.1. Irrelevance of dividend policy without taxes

Modigliani and Miller (1961) demonstrated no impact of dividend policy on share value and, thus, shareholders' wealth in a perfect financial market and particularly in the absence of differences in taxation of dividends and capital gains. Shareholders should be passable between receiving dividend or capital gain. Modigliani and Miller (1961) devised a model in a perfect capital market environment under particular assumptions:

• No tax or tax deformation between the taxation of dividends and capital gains;
• Free information and equally approachable to all;
• Absence of transaction costs and issue costs;
• Rational investors.

With these assumptions, price of a share at the beginning of a period is defined as equal to the current value of the dividend paid at the end of the period increasing the price on the market at the end. This can be expressed as follows:
$P_0=1\div1+r\ (D_1+P_1)$ …………………..(1)
Where:
P_0 : Price of a share;
r : Rate of return;
D_1 : Dividend expected;
P_1 : Price of share at the end of the period.
Assuming 'n' is the number of shares at the beginning of the period studied and 'm' is the number of new shares sold at the end.
Equation (1) can be rewritten thus:
$nP_0=1\div1+r\{nD_1+(n+m)P_1-mP_1\}$ … (2)
Equation (2) denotes that the total value of the old shares is equal to the value of the dividend which is paid to them plus value of the old and new shares minus the value of the new shares. So for a program of investment and a financing strategy, amount of capital increase is equal in:
$mP_1=I_{-}\ (B-nD_1)$………………………. (3)
Where:
I: Investment;
B: Benefits created during the period;
By replacing the amount of capital increase (mP_1) by its expression, the following is obtained:
$nP_0=1\div1+r\ \{(n+m)P_1-I+B\}$…………… (4)
Since D does not materialize directly in the expression and other parameters are assumed to be independent of the value of dividend, current share value is independent of dividend policy. Analysis of Modigliani and Miller is valid in a perfect world. It ignores tax and transaction costs surrounding financial transactions. Indeed, in a world without taxes, or at least where taxation is rigorously neutral in the world of realization of the income, it will be indifferent to each individual shareholder.

6.2.2. Dividend policy in a world with taxes

The study of Modigliani and Miller functioned in a corporate world without taxes or at least neutral with the realization of income. Usually, dividends are taxed as capital gains especially for people belonging to maximum tax rate. Investors take tax considerations in their choice. Farrar and Selwyn (1967) proved that corporate ignore paying dividends if dividends are more heavily taxed than capital gains. Albouy & Dumontier(1992)observed that corporate fulfill the needs for liquidity of the shareholders by using other alternates for dividend like issue of bonus shares, share repurchase, etc. Brennan (1970) also espoused the similar explanation of Farrar and Selwyn. Subject to a particular degree of risk, a moderate dividend distribution yields much higher expected return than the tax difference between dividends and capital gains. Thus, Brennan instituted that favorable tax treatment of capital gains over dividends normally governs less assessment. Litzenberger and Ramasway (1979) outline linear relationship between the increase in the rate of return to equity and dividend yield if tax on capital gain becomes less than dividend. They established that shareholders necessitate increase in pre-tax return to compensate the outcome of taxation. However, Black and Scholes (1974)exercised a different methodology and discerned no association between the rate of return on equity and dividend yield. This result is in accord with the result of Miller and Scholes (1982). Miller and Scholes justified the findings of Litzenberger and Ramaswamy. They watched that investors can avoid taxes on dividends by borrowing and investing at the same rate on assets exempted from tax. Few studies like Poterba(2004) reviewed the responses of corporate for amendments in taxation and eyed no association between proposition and dividend taxation. However, empirical studies of Lee, Liu, Richard, & Subrahmanyam(2006) suggested a relationship between taxes and dividend policy. Brav, Graham, Harvey & Michealy (2005) propounded that taxation of dividend is not a prime consideration in the decisions of payment of dividends and the selection between dividends and repurchases. Elton and Gruber (1970) demonstrated that investors have no preference for dividends, on the contrary, taxation steers at preferring capital gains. Michaely and Vila (1996), McDonald (2001) and Sander (2007) further strengthened this idea.

6.3. Dividend clientele effect

Investors' behavior are not always same in the face of financial investments due to fiscal and personal considerations. Few prefer the securities contributing periodic income while others prefer capital gains. Usually, investors having low tax support high dividend shares while investors belonging to high tax category eulogize low dividend shares and high capital gains. Thus, clientele effect alludes the shareholders to search for a corporate that suits their financial budget. Consequently, corporate accepts a dividend policy that can meet their shareholders' requirements. In general, dividends are taxed more than capital gains. In the opinion of Modigliani and Miller (1961), clientele effect of dividend is one of the important drawbacks of capital market. Different taxations enable a corporate to fascinate clientele of investors. There is no consensus of opinion about clientele effect of dividend and taxation. Few studies provide theoretical and empirical evidences to clientele effect while others provide contradictory evidences. Kent Baker (2009) surmised that researchers pertain two models to examine the clientele effect - Capital Asset Pricing Model (CAPM) and the model preferring transactions on the day of dividend payment. For understanding delineation of the results of these models, a distinction between the two models may be prospered: static clientele model and dynamic clientele model.

6.3.1. Static Clientele Model

Pettit (1977) demonstrated positive relationship between age of investors and dividend yield of their portfolios. From other perspective, it reveals negative relationship between investors' income and dividend yield. Pettit also substantiated that investors having high systematic risk portfolios choose high dividend shares. Investors are not taxed in the same way Albouy & Dumontier(1992) ascertained that it is from the rate of return that the companies fascinate a particular tax. Elton and Gruber (1970) deliberated that the investors having high tax rate on high dividend selects companies with low dividend, while the investors having low tax rate prefer liberal corporate about payment of dividend. Allen and Michaely (2003) noted propensity of investors to retain shares with low dividend. Seida (2001) marked the appearance of clients on dividend taxation. Hence, it can be reckoned that many studies have instituted substantiation confirming the hypothesis of clientele effect; while other studies have proven irregularity in the hypothesis.

6.3.2. Dynamic Clientele Model

Kalay,A.(1982) stipulated that based on the dynamic version of clientele effect, investors, in non-appearance of transaction costs, utilize the liberty to interact the actions during detachment of dividend to enable the least taxed investors to presume dividend. Berk & DeMarzo (2014) opined that shareholders benefitted from additional tax on low dividend retain the shares in the time of detachment instead of retaining all the time. Consequently, investors who are taxed heavily can sell their shares to insignificant tax inflicted investors. Lakonishok and Vermaelen (1986) noticed significant growth in transaction volume on the day of detachment of the coupon. Studies of Liljeblom et al. (2001), Seida, (2001), McDonald 2001 and Sander (2007)analyzed the market reactions around dividend events and confirmed the existence of the clientele effect. However, the studies made by Bali and Hite(1998),Lewellen et al.(1978),Lakonishok and Vermaelen (1986) do not support the hypothesis of clientele effect. Jain (2007) showed that institutional investors prefer corporate paying low dividend or no dividend at all. Brav et al. (2005) showed that institutional investors have dispassionate object about dividend decisions. Desai and Jin (2011) revealed inclination of the maximum institutional investors towards dividend taxation. Grinstein and Michaely (2005) watched that institutional investors guard funding in corporate that do not allot dividend but still favor corporate paying higher dividends. Michaely, Thaler and Womack (1995) found that portfolios of institutional investors remain unimpressed due to dividend changes. Thus, various empirical studies substantiate clientele effect or otherwise of dividend policy and taxation**(Table-1)**.

Table- 1: Empirical results of few studies on the clientele effect

AUTHOR(S)	SAMPLE/ COUNTRY	PERIODICITY	EMPIRICAL RESULTS
Miller and Modigliani(1961)	(USA)	1961	Clientele effect
Elton and Gruber (1970)	4148 observations (USA)	1966-1967	Clientele effect
Black and Scholes (1974)	25 common shares listed on NYSE(USA)	1931-1966	Clientele effect
Petit (1977)	Portfoliopositions914Individualinvestors(USA)	1957-1967	Clientele effect
Lewellen and et al (1978)	2500 individual investors (USA)	1964-1970	No clientele effect
Litzenberger and Ramaswany (1979)	(USA)	1936-1977	Clientele effect
Kalay (1982)	2540 observations (USA)	1966-1967	No clientele effect
Booth and Johnston (1984)	Companies listed in Toronto Stock Exchange (Canada)	1970-1980	Clientele effect
Poterba &Summers (1984)	British companies (UK)	1955-1981	Clientele effect
Lakonishok and Vermaelen (1986)	(Canada)	1970-1981	No clientele effect
Desbrières (1988)	(France)	1977-1990	Clientele effect
Scholz (1992)	(USA)	1983	Clientele effect
Hamon & Jacquillat, (1992)	(France)	1977-1990	Clientele effect

Bali & Hite (1998)	207,499observations (USA)	1962-1994	No clientele effect
Morgan & Thomas (1998)	British companies (UK)	1975-1993	No clientele effect
Liljeblom and et al(2001)	(Finland)	1994-1996	Clientele effect
McDonald (2001)	Companies listed in Frankfurt Stock Exchange(Germany)	1989-1998	Clientele effect
Barclay and al (2003)	336 companies (USA)	1995	No clientele effect
Anand(2004)	500 companies (India)	1999-2000	Clientele effect
Grinstein & Michaely (2005)	79,010 observations (USA)	1980-1996	No clientele effect
Graham and Kumar(2006)	(USA)	1991-1996	Clientele effect
Lee, Liu and Roll (2006)	Companies listed on the Taiwan Stock Exchange(Taiwan)	1995-1999	Clientele effect
Jain (2007)	Companies of NYSE, AMEX and NASDAQ (USA)	1989-1996	No clientele effect
Sander (2007)	Companies listed in Tallinn Stock Exchange(Estonia)	2000-2006	Clientele effect
Procianoy&Verdi (2009)	394 observations (Brazil)	1996 - 2000	No clientele effect
Desai & Li Jin (2010)	(USA)	1980-1997	Clientele effect

Oubal(2013)	(Morocco)	2013	No clientele effect
Dahlquist and et al (2014)	Companies listed in Stockholm Stock Exchange(Sweden)	2001-2005	Clientele effect
Muñoz & Rodriguez (2016)	Companies listed on the Stock Exchange of Santiago (Chile)	1999-2012	Clientele effect

N.B.: Author's own elaboration

Table-1 exhibits that maximum studies have clientele effects(shown in yellow color)

7. DIVIDEND POLICY—INDIAN CONTEXT

Corporate in India declaring dividend pay dividend tax in addition to tax levied on their income. Dividend received by the shareholders from Indian corporate enjoys exemption from tax as the corporate declaring such dividend already deducts dividend distribution tax (DDT) before making payment. However as introduced by the Finance Act, 2016, a resident individual/HUF/Firm is chargeable to tax @ 10%, if the aggregate amount of dividend received from an Indian corporate during the financial year exceeds Rs 10,00,000 (Section 115BBDA). Dividend received from foreign corporate is subsumed in the total income of taxpayer and is imposed tax at the prescribed rate. Such dividend features taxed in India as well as in the country in which the foreign corporate belongs. However, a taxpayer can assert double taxation relief, if the tax on dividend from foreign corporate is paid twice. Relief claimed can be either as per the provisions of the Double Taxation Avoidance Agreement, if any launched into by the Government of India with the country to which the foreign corporate belongs, or a taxpayer can assert relief as per Section 91 (in case, no such agreement acknowledges). Principally, a taxpayer does not pay tax on the identical income twice.

8. CONCLUSION

Despite several studies on the concept of dividend policy, issue remains debatable touching the essence of association between taxation and dividend policy. Indeed, introduction of taxation does not resolve hypothetical discourse on dividend policy as the prevailing hypothetical and empirical evidence presents conflicting results. Dividend's taxation and capital gains vary intra-country and inter-country, and also, from period to period. Shareholders' preferences being heterogeneous reflect clientele effect. Dividend policy is never optimal for all shareholders. Investors take into account the performance and distribution policies adopted by the corporate. Nevertheless, clientele effect is limited since shareholders taxed heavily still receive dividends indicating that there are more determinants other than taxation that influence the composition of shareholders' portfolios.

9. RESEARCH COMMENT

Taxation is an important doctrine in determining dividend policy. It cannot meet all the problems concerning dividend. Dividend policy is still a matter of concern and involves a large number of factors that make it more complicated. Researchers need to focus more on these factors like market imperfections having big impact in the development of dividend policy.

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