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Four facts about dividend payouts and the 2003 tax cut

Published: 08 June 2012

Volume 20, pages 769–784 (2013) Cite this article



International Tax and Public Finance

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Abstract

Recent literature has claimed that the 2003 U.S. dividend tax cut caused a large increase in aggregate dividend payouts. I document four simple facts that call this claim into question. First, the post-tax cut increase in dividend payouts coincided with a surge in corporate profits, such that the dividend payout ratio did not rise. Second, share repurchases increased even more rapidly than dividend payouts. Third, dividend payouts by Real Estate Investment Trusts also rose sharply, even though they did not qualify for reduced taxation. Finally, the stock market was forecasting an increase in dividend initiations by mid-2002, before the tax cut had been proposed.

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Notes

1. Chetty and Saez (2005, p. 793), write, “Aggregating the changes in amounts along the extensive and intensive margins, we estimate that the tax cut raised total regular dividend payments by about $5 billion per quarter (20 percent), a change that is statistically significant at the 1 percent level. This implies an

elasticity of regular dividend payments with respect to the marginal tax rate on dividend income of −0.5. All of these results are robust to controlling for a variety of potential confounding factors such as levels and lags of profits, assets, cash holdings, industry, and firm age." A survey of related papers is provided in Dharmapala (2009), and the discussion of this survey by Shackelford is also useful in that it provides some reasons to be skeptical of the cited papers. Some other related papers include Julio and Ikenberry (2004), Nam et al. (2004), Aboody and Kasznik (2008), and Hsieh and Wang (2008). All of these claim to find some impact of the tax cut on payouts, though Julio and Ikenberry (2004) note that payouts were also already increasing prior to the tax cut.

2. The working paper version of this paper (available online at http://www.federalreserve.gov/pubs/feds/2010/201034/201034abs.html) reviews relevant prior literature on the "old," "new," and "agency" views of dividend taxation.

3. An exception to this exception applies to dividends paid by so-called "taxable REIT subsidiaries," which are regular C corporations that REITs have been allowed to own since January 2001, when the REIT Modernization Act took effect. REITs are limited to holding 20 % of their assets in taxable REIT subsidiaries. Data from NAREIT indicate that qualified dividends paid by TRSs constitute a negligible portion of total REIT dividend payouts.

4. REITs can be identified in CRSP either by a Share Code that ends in 8 or by an SIC code equal to 6798. However, these two variables sometimes disagree on a firm's status in a given month. By comparing observations with disagreement to firm 10-Ks and other documents, I concluded that the Share Code variable correctly indicates REIT status, while the SIC code variable often contains errors. Thus, I identify REITs in this paper using the Share Code variable only.

5. I focus this section of the paper on regular (as opposed to special) dividend

payouts for comparability to the prior literature, particularly Chetty and Saez (2005). Special dividends normally have negligible effects on aggregate payout amounts. An important exception occurred in the second half of 2004, when Microsoft announced and payed a $32 billion special dividend. I do include special dividends in the comparison to repurchases discussed in the next section.

6. The appendix to the working paper version contains a detailed discussion of the construction and behavior of different measures of corporate income.

7. If one constructs a ratio of aggregate regular dividend payouts to aggregate net income, it displays an even more pronounced spike during the recession and an even larger *decline* around the time of the tax cut. It is also worth noting that all figures in this paper refer to the publicly traded firms in the Compustat/CRSP sample. However, if one constructs a payout ratio using aggregate dividends and profits from the National Income and Product Accounts (which include private firms), it shows a very similar pattern to the data in Fig. 1. See also Yagan (2012) for more on private firm reactions to the dividend tax cut.

8. To argue that the tax cut caused an increase in dividend payouts, one would need to argue that the payout ratio would have fallen further in absence of the tax cut. It is true that this ratio typically fell during periods of growth in corporate earnings in the 1980s and early 1990s. It was quite stable, however, during the expansion of the late 1990s. I judge that this more recent experience is the better one from which to form a counterfactual. Note also that the ratio spiked back up as earnings fell during the financial crisis and recession of 2008 and 2009, but these movements clearly have little to do with the 2003 tax cut.

9. Poterba (2004) calculates implications for the aggregate "dividend tax preference parameter," $(1-\tau_{div})/(1-\tau_{cg})$, where τ_{div} is the tax rate on dividends, and τ_{cg} is the effective tax rate on capital gains. Although JGTRRA

also lowered the top rate on capital gains from 20 to 15 percent, the decrease in dividend tax rates was much larger, so the dividend tax preference parameter still rose.

10. Note that this line of reasoning rests on the assumption that dividends and repurchases are gross substitutes. A review of the large literature on firms' choices between dividends and repurchases is beyond this paper's scope, but see DeAngelo et al. (2009) for an overview. In particular, note that dividends and repurchases are often thought to be imperfect substitutes, with regular dividends serving to distribute "permanent" income increases, while repurchases and special dividends are used to distribute "transitory" income. Over the last several decades, repurchases have steadily grown to replace special dividends after it became clear that repurchases met the approval of tax and regulatory authorities. The decline in the relevance of special dividends after repurchases became "cheaper" suggests that the two forms of payout are indeed gross substitutes.

    In fact, both Brown et al. (2007) and Blouin et al. (2011) present evidence that some firms substituted dividends for share repurchases following the tax cut. Figure 2 clearly demonstrates that these effects do not drive the aggregate data on dividend and repurchase amounts. Thus their results must be driven by smaller firms. It should also be noted evidence from other countries has sometimes produced clearer signs of tax-induced substitution between dividends and repurchases. For example, in Jacob and Jacob (2010) it appears that Japanese firms raised dividends and cut repurchases after a 2004 tax reform.

    Blouin and Krull (2009) and others have argued that some U.S. repurchases were driven by the American Jobs Creation Act of 2004, which allowed firms to repatriate cash from foreign subsidiaries at a lower tax rate than usual. There is no apparent reason, however, that these funds could not have been distributed to shareholders as dividends rather than repurchases, as, in fact, IRS guidance indicated that both dividends and repurchases were *dis*allowed as uses of repatriated funds.

11. The visible seasonality in REIT payouts arises due to a somewhat interesting phenomenon. Particularly around the 2000 to 2002 period, there were a handful of large REITs that essentially paid a regular quarterly dividend, but always paid out their fourth quarter dividend just before the end of the calendar year. In other quarters, they paid their dividends a few weeks after the end of the quarter. They thus appear as paying a double dividend in the fourth quarter and zero in the first quarter. This phenomenon is not strictly limited to REITs—the Coca-Cola Company has been paying dividends on a similar schedule for decades.

12. Results are very similar if Post is equal to one in 2003Q3 and later, or if observations from 2003Q1 and 2003Q2 are excluded from the sample.

13. Unfortunately, the data required to measure EBITDA for REITs were not collected by Compustat until 2001Q1, so REIT observations are missing EBITDA prior to that quarter.

14. Several alternative specifications and robustness checks are presented in the working paper version.

15. Unfortunately, REITs must pay a dividend in every year that they are profitable, so there are very few REITs that initiate dividends by this definition. Thus, I cannot perform the same falsification exercises using REITs that I have performed for other measures of dividend behavior.

16. Figure II of Chetty and Saez (2005) presents data on firms *paying* a dividend for the first time in more than a year, while here I present data on firms *announcing* a dividend initiation. As many firms announce dividend payments in the quarter before they are paid, the series presented by Chetty and Saez (2005) displays a more pronounced increase in 2003Q3.

17. These data were downloaded from http://pages.stern.nyu.edu/~jwurgler/.

18. It is interesting to note that the firm announcing the largest initiation by dollar amount in 2003Q3 was Harrah's Entertainment, whose CEO, Gary Loveman, holds a Ph.D. in economics and may be less prone to behavioral biases towards inertia than others. The biggest spike in the figure, however, is in 2003Q1, when Microsoft announced a $900 million dividend. This payment was announced on January 16, 2003, nine days after President Bush announced his intention to push for a dividend tax cut, 42 days *before* legislation including a dividend tax cut was introduced in the House of Representatives, and 132 days before it became law. It seems unlikely that the tax cut played a significant role in Microsoft's decision to begin paying regular dividends.

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Acknowledgements

I thank Malcolm Baker, Jeff Brown, Raj Chetty, Amy Finkelstein, Alex Gelber, Jerry Hausman, James Hines, David Lebow, Jillian Popadak, James Poterba, Steve Sharpe, Johannes Spinnewijn, and Danny Yagan for helpful comments or conversations.

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Previous versions of this paper circulated under the title, “Effects of the 2003 Dividend Tax Cut: Evidence from Real Estate Investment Trusts.”

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About this article

Cite this article

Edgerton, J. Four facts about dividend payouts and the 2003 tax cut. *Int Tax Public Finance* **20**, 769–784 (2013). https://doi.org/10.1007/s10797-012-9242-z

Published Issue date

08 June 2012 October 2013

DOI

https://doi.org/10.1007/s10797-012-9242-z

Keywords

Taxes Payout policy Dividends Share repurchases

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H20 G35

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