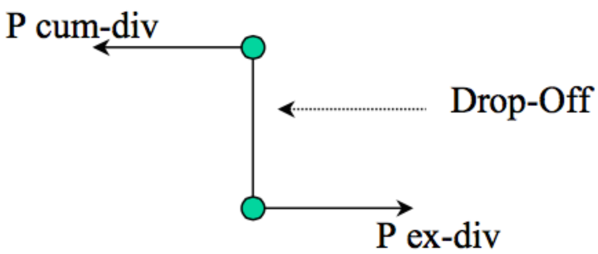
# Corporate Finance
# Topic 4:
# Payout Policy: Forms and Influences

- **Setting the Scene**
  - Dividend policy is concerned with the distribution of cash to shareholders via dividends.
  - We will concentrate on two methods by which firms distribute earnings to shareholders
    - Dividends
    - Share Repurchases
  - In the absence of taxes and transaction costs the two methods of distributing cash are virtually identical.
  - Dividends are typically paid semi-annually (interim & final)
    - They coincide with profit announcements
  - Subject to satisfaction of the Corporations Act and ASX Listing Rules, dividend decisions are discretionary although a solvency test must be passed.
    - Its assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend.
    - The payment of the dividend is fair and reasonable to its shareholders as a whole
    - The payment of the dividend does not materially prejudice its ability to pay its creditors.
  - Key dates
    - Announcement Date (declaration date)
    - Ex-Dividend Date
    - Books Close Date (record date)
    - Payments Date
- **Dividend Drop-Off**
  - Cum-Dividend Share Price Vs Ex-Dividend Share Price




  - Drop-Off Ratio= $\frac{(P_{CUM} - P_{EX})}{Dividend}$
    - In a perfect capital market, the drop-off ratio is equal to one.
    - This ratio forms the basis for many empirical tests.
    - How much are franking credits actually worth?
- **M&M Dividend Irrelevance Theory**
  - Miller and Modigliani demonstrated that dividend policy should not affect company value.
  - They had to make assumptions:
    - Company has a set investment plan that unaffected by the dividend decision.
    - Perfectly competitive capital market with no taxes, transaction costs, floatation costs or information costs.
    - Rational investors who are indifferent between receiving dividends or capital gains (since no taxes)
- **Factors Affecting the Payment of Dividends**
  - *Resolution of Uncertainty*
    - “Bird in the hand” argument
    - dividends are less uncertain than capital gains BUT can resolve uncertainty associated with capital gain by selling shares immediately.
    - Percentage ownership in the firm is reduced and there are transaction costs incurred.

- *Shareholders Preference for Current Income*
    - Shareholders need cash to fund consumption, however they can always sell their shares to do so.
- *Issue and Transaction Costs*
    - High dividends may imply a need for more frequent capital raising in order to fund investment plan.
    - There are transaction costs in raising capital
        - Direct Costs
            - Prospectus preparation, legal advice, brokerage fees, underwriting etc.
        - Indirect Costs
            - Dilution in ownership/value of existing shareholders if new shares issued, restrictive covenants enforced by new debt holders.
    - Therefore, the higher the costs associated with raising capital, the lower the expected level of dividends.
    - Is there a link between firm-size, transaction costs and dividend policy?
- *Information Content of Dividends and Information Asymmetry*
    - Information asymmetry between management and shareholders.
    - The market is constantly seeking signals from management.
    - There is evidence of a strong price reaction to dividend announcements.
    - Implies that the market perceives dividend announcement as a signal by management about firm prospects.
    - Therefore, management is reluctant to decrease dividends as it conveys a negative signal to the market about future prospects.
    - Management will tend to only increase dividends when the increase is sustainable.
- *Agency Costs*
    - Separation of ownership and control in firms create potential conflict of interest between managers and shareholders.
    - Agency costs include:
        - Wealth lost when management do not act in shareholder's best interests
            - Consumption of perquisites, inappropriate investment decisions etc.
        - Monitoring costs incurred by shareholders to ensure that management acts in their best interest.
    - Higher Dividend payout implies that:
        - There is less money available for managerial perk consumption and overinvestment.
        - More funds need to be raised externally.
    - Effects:
        - Higher payout disciplines management to use remaining funds efficiently.
        - External fund-raising provides shareholders with the opportunity to observe management behaviour cheaply.
- *Taxation*
    - When a firm pays a dividend the share price falls to reflect the fact that the funds have been distributed.
    - So from a shareholder perspective-payout policy is really just a question of whether receive returns via increases in share price or via dividends (or share repurchases).
    - In many countries- capital gains are taxed at a different rate to dividends.
    - ***Until June 1987: Classical Tax System in Australia***
        - As it operates in the U.S.
        - Company profits and dividends paid from those profits are taxed separately (i.e. effectively taxed twice)
    - ***Since July 1987: Imputation Tax System in Australia***
        - Investors get tax credits that undo the corporate tax already paid on the dividends.
        - Australia also has in place capital gains tax (CGT) system whereby increases in the value of an asset are taxed.

- Differential tax treatment of dividends and capital gains may have effect on the dividend policy preferred by shareholders.
- Under the imputation system, shareholders pay tax on the grossed-up dividend amount, but receive a credit for corporate tax already paid
- Corporate tax is effectively an interest-free loan to the government that is only repaid when shareholders claim the imputation tax credit.
    - Therefore, there is a very clear incentive for firms to distribute franking credits to shareholders as quickly as possible.

- ***Capital Gains Tax***
    - If companies retain profits, their share price is likely to rise relative to companies that distribute profits, giving rise to capital gains tax liabilities for shareholders if and when the shares are sold.
    - Capital gains receive preferential tax treatment compared to 'ordinary' (dividend) income.
    - Capital gains tax applies only to short-term gains and to long-term real capital gains on assets acquired on or after 20th September 1985, payable only when gains have been realised.
    - As of 21st September 1999, capital gains earned over 12 months or longer are subject to CGT discounting.
    - For individuals, only 50% of the gain is taxed at their personal marginal tax rate.
    - For superannuation funds, the discount is 33.33%, so 66.66% of the capital gain is subject to CGT.
        - Consequently, effective rates of CGT are likely to be relatively low for many investors.
    - However, where a capital gain arises from retention of profits which have been taxed, any CGT that is payable will be in addition to the tax already paid by the company.
        - In other words, retention of profits can involve double taxation as imputation credits cannot be transferred to shareholders through capital gains.
- ***Does imputation affect payout policy preferences?***
    - Assume Capital Gains Tax=0 then,
        - $If\ t_p < t_c$, they prefer dividends
            - **Effectively paying tax at the personal rate.
        - $If\ t_p > t_c$, they prefer capital gains
            - **Effectively paying tax at the company rate.
- ***Non-residents***
    - Assume Capital Gains Tax > 0 then;
        - $If\ t_p < t_c$, they prefer dividends
            - **Effectively paying tax at the personal rate.
        - $If\ t_p > t_c$, they may prefer dividends
            - **As capital gains are subject to double taxation.
        - $If\ t_p > t_c$, they may prefer capital gains
            - **if able to defer realisation of capital gains until personal tax rate falls and/or take advantage of discounted treatment.
    - Often unable to take advantage of franking credits
        - Although mutual tax treaties often allow for some recognition of Australian tax paid when dividends are taken home.
    - Often still subject to double taxation
    - Preference for capital gains or unfranked dividends
        - Unfranked dividends are those paid from profits on which corporate tax has not been paid.
        - Remember that the tax system gives rise to taxable income upon which tax is levied, whilst the accounting system determines profits from which dividends may be paid.
        - Differences between the system do arise.

    - ***Special Dividends***
        - Imputation promotes the payment of dividends.
        - This can increase dividend volatility
        - Information asymmetry implies that this may increase perceived risk of shares
        - Avoid this by signalling to the market that a portion of the dividend is of a non-recurring or "special" nature.
    - ***Dividend reinvestment Plan (DRPs)***
        - DRPs allow high dividend without loss of cash
        - Legally, investors receive the cash and the tax credits, and reinvest cash in company.
            - Subject to the 45-day trading rule which requires shareholders to hold the shares "at risk" for 45 days in order to claim the franking credits.
        - DRPs are essentially small rights issues.

- **Share Buybacks**
    - A share buy-back is when a company purchases its own shares on the stock market and then proceeds to either cancel them (Australia) or retain them as treasury stock (US).
    - There are legal requirements associated with buy-backs, but generally Australian companies can repurchase up to 10% of their ordinary shares in a 12-month period.
        - In some cases they can go beyond this limit- often with the approval of 75% of non-participating shareholders.
    - <u>Types of Share Buy-Back</u>
        - **Equal Access Buy-Back**
            - Pro-rata to all shareholders
        - **Selective Buy-Back**
            - Repurchase from specific, limited number of shareholders
            - **requires approval by > 75% of non-selling shareholders.
        - **On-Market Buy-Back**
            - Repurchase through normal stock exchange trading
        - **Employee Share Scheme Buy-Back**
        - **Minimum Holding**
            - Buy back small unmarketable parcels of shares.
    - <u>Share Buybacks and Taxes</u>
        - The tax treatment of a share buyback depends on whether the buyback takes place on or off-market.
            - On-Market buybacks are subject only to the capital gains tax provisions.
            - In the case of an off-market buyback, following a private tax ruling from the Australian Taxation Office, part of the proceeds can be labelled as a dividend
                - And have attached to it franking credits.
        - Might different tax treatment of buybacks and dividends create a tax-induced bias for one over the other?
    - <u>Tightening up the regulation of share buybacks…or not…</u>
        - **Tax Determination TD 2004/22**
            - TD 2004/22 had the effect of reducing the impact of the buyback discount on the capital loss claimed by the shareholder.
            - Operates by calculating tax liability with reference to the deemed consideration (whilst adjusting values to reflect the increase in the general level of share prices after the announcement date).
        - Board of taxation prepared a report in **May 2009** on the taxation of off-market share buybacks
            - There were 6 recommendations- the key one being
                - Recommendation Three
                    - Notional losses should be denied to all shareholders participating in buybacks in listed firms (unless total proceeds fall short of the initial cost)
        - **October 2011**: Australian Treasury releases new draft legislation
        - **December 2013:** The Treasurer announces that the government will not be going ahead with the recommendations (along with 91 other pending changes to the tax system).

- **Why Buyback Shares?**
    - Improved Performance Measures
        - $EPS = \frac{Earnings}{Number\ of\ Shares}$
        - If we decrease the number of shares then we increase the earnings per share.
        - Why do we not buyback all shares except 1? Where does the cash come from?
    - Signalling and Undervaluation
        - Managers buying back company stock indicates that they believe the stock is undervalued by the market.
        - Alternatively, a buy-back announcement could be accompanied by some new information.
            - E.g. sale of unprofitable asset/division.
    - Resource Allocation
        - Share repurchase returns capital to shareholders, who can reallocate funds into profitable activities through the capital market.
    - Financial Flexibility
        - Payment of Dividends is a long-term commitment and sudden major changes (especially decreases) in dividend policy are unappreciated by market.
        - Buy-backs offer an alternative way to make distributions that may not be permanent.
    - Employee Share Options
        - Unlike paying dividends, share repurchases do not lead to the ex-dividend price drop-off.
            - Often the share price will rise.
        - Call option holders (typically management) might prefer a share repurchase to a dividend payout as a means of distributing profits to shareholders
            - Dividend yields are small though (2-4% p.a.)
- **Empirical Evidence: Dividend Substitution in the US**
    - Dividends are paid by firms with higher permanent operating cash flows, while:
        - Repurchases are used by firms with higher temporary, non-operating cash flows.
        - Repurchasing firms also have much more volatile cash flows and distributions.
    - Firms repurchase stock following poor stock market performance and increase dividends following good performance.
    - Managers favour off-market buybacks to distribute franking credits when the buyback is larger and is generating more cash flows.
    - On-market buybacks are more likely to be use when the firm is undervalued.
    - Managers were asked what factors were important in deciding whether to undertake a share buyback
        - Surplus of funds that cannot be currently invested in wealth-producing projects.
        - Positive impact on the firm's earnings per share
        - Level of franking credits available to be paid out to shareholders
        - Markets response to the firm's announcement of the buyback.
        - Preferential tax treatment of buyback proceeds relative to dividends.
        - Ability to conduct the buyback without creating expectations of recurrence
        - Cost of replacing funds paid out via the buyback.
    - Interviews with managers were also conducted.