DIVIDEND TAX RELIEF CAN HAVE NEGATIVE CONSEQUENCES FOR SHAREHOLDERS

FAYETTEVILLE, Ark. – Eliminating income taxes on shareholder dividends, the centerpiece of tax legislation currently being considered by congress, may have an unexpected negative impact on research and development, according to University of Arkansas researcher Deborah Thomas.

“We found that dividend tax relief reduces the effectiveness of other corporate tax incentives,” explained Thomas. “As companies focus on paying higher dividends, tax credits for beneficial corporate activities such as research and development (R&D) stop working.”

Thomas, associate professor of accounting, investigated the relationship between dividend taxation and research and development expenditures along with Tracy Manly, assistant professor of accounting and MIS at the University of Tulsa, and Craig Schulman, associate professor of economics at Texas A&M University. Their results will appear in the April issue of the Journal of the American Taxation Association.

Currently the United States has a classical tax system, where corporate profits are taxed twice – first when the corporation earns the income and again when the corporation pays dividends to
shareholders. The tax reform proposal currently before congress will eliminate this double taxation. A common mechanism in use in other industrialized countries for handling this is through imputation credits.

In this system, company shareholders receive imputation credits, which are tax credits equal to the corporate tax paid by the company on the dividends. Shareholders that have received dividends and use the credits to offset against their income tax liability, effectively eliminating the tax on dividends for the shareholder.

“All firms, no matter what the regime, must allocate funds between dividends and investment,” Thomas explained. “To benefit from an R&D tax credit, a corporation must use available funds to increase R&D spending rather than pay dividends. But firms in countries with dividend tax relief are encouraged to pay higher dividends to take advantage of the lower cost of equity capital provided by the imputation tax credit.”

The researchers used an international sample to look at three different tax regimes. The United Kingdom and Germany represented countries that have an imputation credit, but no tax credit for R&D, while the United States and Japan represented countries with a tax credit for R&D, but no imputation credit. Canada and France have both an imputation credit and an R&D tax credit.

“Since we were looking at the firm response to R&D credits when imputation credits are in place, our focus was on the countries that had both, Canada and France,” said Thomas. “The other countries serve as control groups in the study.”

The researchers have been looking at the economic effects of dividend tax relief since 1992. Their sample of predominantly manufacturing businesses from the years 1993 to 1997 contained 7,138 firm-year observations. They have previously reported evidence from these data indicating that corporations will increase dividend payments to shareholders with the implementation of dividend tax relief, although this increase is sensitive to changes in capital gains taxes.

According to Thomas, a firm’s financial characteristics determine its dividend policy. Managers typically consider the effects on share price and the maintenance of dividend stability when determining the amount to be paid out in dividends. However, firms that omit dividend payments experience unfavorable long-term share price performance.
The researchers found that dividend pay out and R&D expenditure were inversely related – as one went up, the other went down. They also found that this relationship is significantly stronger for firms operating in a tax regime that has both R&D and imputation tax credits.

“Dividend tax relief reduces the effectiveness of other corporate tax incentives,” Thomas explained. “Corporations may reduce their investment in beneficial activities, such as research and development, in order to maintain high dividend payments.”