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The relationship between corporate dividend policy and taxation: an overview of listed firms in China

In Partial Fulfillment of the Requirements

for the Bachelor of Science in Finance

by

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May, 2020

ABSTRACT

Several studies have been demonstrated on the determinants of dividend policy. However, none of them has provided a perspicuous answer on the effect of taxation on corporate dividend policy. This research sought to fathom the relationship between firm dividend policy and taxation among all listed firms in China. Especially, it analyzed the impact of corporate income tax on dividend per share of all industries quoted firms in China. Regression analysis was adopted to formulate both univariate analysis and multivariate analysis. Data used were derived from CSMAR Database during the periods from 2005-2010. The results show that dividend payout may be correlated with tax under a long-term period. It can be concluded that tax may affect the dividend policy more efficiently in the long run.

Keywords: *Dividends, Dividends policy, Regression analysis, Taxation*

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Introduction

To maximize the shareholder's values, managers are employed to manage the company. During the achievement of this goal, there are two significant decisions to make. One is company capital budgeting that how much assets should maintain; the other one is about managing the capital structure that from which source firm should finance their assets, either by issuing the equity or by increasing the debt ratio (Kouser, Luqman, Yaseen, & Azeem, 2015). The term ‘dividend' refers to "the cash received from the company as the portion of the profit towards their share in the company. Company pay dividends quarterly, semiannually and annually" (Okafor & Mgbame, 2011). According to (Kouser, Luqman, Yaseen, & Azeem, 2015), dividend policy is making dividend payout decisions, more detailed, distributing the size and pattern of cash over time to shareholders as the practice of management.

Most shareholders purchase the shares in exchange for the dividends that they could receive from the company. Once the firm decides not to issue dividends, the shareholders may probably think worse on the firm condition. In other words, non-dividend payment offers a bad future expectation to its shareholders, leading to a sharp fall in the share price. In fact, firm performance is viewed as how well a firm enrich its shareholders wealth and enhance the competence of firm to generate earning from the capital investment in the market, it holds therefore that dividend policy affects the value of the firm and in turn, the wealth of shareholders (Odesa & Ekezie, 2015).

According to (Gangil & Nathani, 2018), dividend is a benefit of a shareholder in return of risk and investment and dividend policy results from changes in growth rate,

cash flows, and project investments in hand. Considered the stage of life cycle, generally high growth firms with large cash flows are capable to pay more dividends out of their earnings. Because of higher transaction costs in external finance, the firm retained the earnings for the internal financing rather than paying dividends.

Whether you choose to retain earnings (i.e. reinvest in the company) or to distribute the earnings (i.e. pay cash to the shareholders), it's a crucial decision. Above all, managers should concentrate on maximizing the wealth of shareholders, while balancing the dividend payout ratio and retention ratio (Kouser, Luqman, Yaseen, & Azeem, 2015). That also explained why making dividend decisions is important for the company, for managers to consider. Thus, dividend policy is the most crucial financial decisions that corporate managers encounter.

Nowadays, dividend policy has been developed and gradually beyond its scope concluded as the conflict between reinvesting and cash distribution. The manager recognized that other issues need to be considered while making the dividend decisions. For example, how to balance people whose inclinations are different (prefer highly taxed and relatively "untaxed" investors), how to elevate the share value in the stock market, etc (Okafor & Mgbame, 2011).

Furthermore, the determinants of the dividend policy are also be examined in various studies. It is recommended that in formulating dividend policy, companies should consider more on the profit, debt and shareholder composition; the last dividend paid more than investment opportunity (Odesa & Ekezie, 2015).

Therefore, this research endeavors to explore what extant connection between taxation and corporate dividend policy. Based on extant studies, some empirical models prove that taxation does have an impact on firm dividend policy; however, all of these studies have their limitations and most of them are not in China. Whether the corporate dividend policy is correlated with the taxation for listed firms in China? The paper aims to answer this question later. To do so, we take advantage of a vital event influencing the corporate income taxation in China.

Before 2008, China had constructed two Corporate Income Tax (CIT) systems. One prescribes the foreignn investment over 25% or more for both foreign and chinese enterprises; another applied to all other enterprises. Within these two various tax systems, different tax incentives will also be provided. Until the year 2008, the Corporate Income Tax Law came into effect in China, which reduced the CIT rate from 33 percent to 25 percent. The present paper founded the model on this event to fathom the interaction between corporate dividend policy and taxation. Moreover, we try to manage the effect of control concentration which has an inevitable influence on corporate finance and investment decisions.

Research Objective

The main focus of the study was to empirically figure out the possible impact taxation may have on corporate dividend policy of listed firms in China. The secondary objective of the study is to ascertain if the dividend payout can be examined as an index of the company's financial performance. Eventually, to determine if there is any crucial relationship between the earning per share and dividend payout ratio of the firms.

Literature Review

The introduction part is concentrated on the studies done by many different authors before, who are concerned about the dividend policy and taxation. The first segment makes a clear definition of dividends and dividend policy. Next segment talks about the valuable ponderation refining from precedent researches for general and developing objectives in this field, which is the interaction between corporate dividend payout and taxation, also the extension of relationship or the factors affecting the dividend policy, as well as various kinds of dividend policies used by listed companies in China. The last section provides a concise description of research methodologies to support these objectives.

Dividend Policy and Corporate Finance

Dividends commonly refer to the return of the investment risk taken by those shareholders, it is the distribution of earnings (past or present) in real property of the firm in proportion to their owners and can be determined by various factors in the environment (Yegon, Cheruiyot, & Sang, 2014). At the end of the year, normally the company will decide whether to return cash or reserve as returned earnings, which means no dividend payments at all. And this process is what we called dividend decisions and is the central idea of dividend policy in firms. More specific, dividend policy determines the distribution of profit as payments to shareholders or reinvestment in the firm, which is a significant part of the firm's long-term financial strategy (Chijoke-Mgbame, Okafor, & Mgbame, 2011).

While talking about corporate finance, multiple aspects can be bound up with dividends. First, we discuss the interaction between dividend policy and firm

performance. Earnings generated by the company can be estimated as an index of profitability, as well as a substantial representation of the effect of dividend policy on the company performance. Therefore, for those existed shareholders and potential investors, it might be a good way to estimate the generated earnings of a company based on the dividends it paid. Another study emphasizes that a high current payout ratio may also follow with the fast growth of the company's future earnings. In other words, there is a positive relationship between the future earnings growth rate and the current payout ratio (Asness & Arnott, 2003). Their findings offer a strong suggestion to the market investors who are seeking for firms with a high dividend payout ratio so that they have more opportunities to earn profit in the long-term company performance.

Second, we also mention about dividends and maximization of stock value. It is said that dividend policy can affect multiple elements, such as information imbalance or agency problems, or the tax and trade costs, all of them may increase the firm value and elevates the expectation of shareholders (Murekefu & Ouma, 2012). To explain dividend policy in detail, we discuss the term of dividend. The dividend is the amount payable to existed shareholders, separating from profit or distributable reserves of the company, it explicates what role dividends played in maximizing the return of shareholders when the value of the investment goes up (Oloyede, Olaoye, & Oluwaleye, 2018). Dividend policy revolves around deciding between the distribution of present return and reinvestment of the same for future return (Kouser, Luqman, Yaseen, & Azeem, 2015).

Third, there are many studies try to explain how those determinants affect the dividends payout. It has articulated in his survey that determinants of dividend policy are industry-specific and connect without mincing words to the anticipated level of future earnings, also it observed that a collective of factors between firms' financial performance, size of firms and board independence can have a positive relationship on the dividend payouts decisions of listed firms (Ranti, 2013).

But it only considers a specific industry of the firms, might not be sufficient or effective enough to explain the impact of determinants on the dividend policy. Another study suggests that dividends are measured by debt-equity ratio, earnings, corporate tax, earnings per share and firms' size (Gangil & Nathani, 2018). It expressed that after the multiple regression examination of multivariable such as profitability indicator, firm size, liquidity, growth opportunity, and market value, the growth opportunity is the most obvious determinant, having a significantly affects the dividend payout; profitability is another positive factor on dividend policy. Different approaches to evaluate the relationship between dividend payout and different elements sometimes get a similar result.

Dividend Policy and Taxes

Under the assumption of rational investors, while the taxation altered, most of the market researchers, who take a different risk trending in the stock market, will also change their positions. And it refers to the theory of tax preference, which states that arbitragers prefer retained capital value to dividends payments. That also explained why the firms have a low dividend payment rate while maximizing the stock price. Several studies have measured the interaction between dividend policy and taxation.

One of the studies discusses the taxation and dividend payout comparing with the capital gain. The fundamental problem in the paper is why those companies continue to pay off dividends even when the capital gain tax rate is usually higher than the cash dividends, which is recognized as a ‘dividend puzzle'. For those investors, they prefer to maintain their capital rather than paying more tax on the reception of dividend (Chkir & Samir, 2008).

Another theory called the clientele effect may work, which explained why the majority of investors would be allured by some less-risky security and heavily influenced by the price of the bonds, especially when the environment changes. However, later in the study done by (Chkir & Samir, 2008), they have concluded that taxation can make a large influence on the dividends payout ratio in Canada. Also, it is proved that under the transform of taxation or dividend payout policy, there still exists a clientele effect.

Research Methodology

Until the year 2008, the Corporate Income Tax (CIT) rate of China has reduced from 33 percent to 25 percent. And the theoretical and empirical model has proved that there is a connection between the corporate dividend payout and taxation in previous studies. The present paper tries to build up the model based on this important event and take advantage of empirical theories and models, to delve the interaction between corporate dividend policy and taxation of listed firms in China.

Univariate Analysis

This study adopt regression analysis in both univariate and multivariate anlaysis process, in order to examine the effect of tax changes on corporate dividend payout. To compare the significant difference of average dividend payout within same interval before or after the change of Corporate Income Tax rate. Then we apply a two-tailed t-test to investigate the null hypothesis that means of the pair-wise difference over the before and after the change of corporate income tax rate is equal to 0 against the alternative hypothesis that this mean is not equal to zero.

Test of Hypotheses

H_0: the mean of pair-wise differences of before and after the event is equal to 0

H_1: the mean is not equal to zero.

Multivariate Analysis

In the multivariate analysis, the study used a total of 3 variables of study: one dependent variable and 3 independent variables. The dependent variable is the dividend payout ratio which takes the average payout of selected firms on year t. The independent

variables are earnings per share, the lagged dividend payout ratio and an added dummy variable of the year 2008. The model for the regression analysis is stated below:

$$DPY_{i,t} = f\left(EPS_{i,t}, DPY_{i,t-1}, D_{2008}\right) \qquad (1)$$

We reconstruct the regression model (1) then get the following equation (2) :

$$DPY_{i,t} = C_0 + C_1 EPS_{i,t} + C_2 DPY_{i,t-1} + C_3 D_{2008} + \epsilon_t \qquad (2)$$

Where:

$DPY_{i,t}$ is the average payout ratio of the firm i on year t,

$EPS_{i,t}$ is the average earning per share of firm i in year t,

$DPY_{i,t-1}$ is the lag value of the average payout ratio,

D_{2008} is a dummy variable that equals 1 after 2008 and 0 otherwise,

C_0 is a constant term,

C_1, C_2, C_3 are the coefficients of each pattern,

ϵ_t is a random error term.

Multivariate Analysis with Control Variable

To control the effect of ownership on the dividend payout ratio, we import a control variable on behalf of control concentration level in Equation(2). This control variable is defined as ‘control-block’, measuring the members of the directors and other individuals or companies who own more than 10% of the shares of the company, who are capable of excercising over 10% control of the company (Stock-Guide).

Considering the insufficience of the database, this study would use the total shares owned by the top ten holders of the company instead.

After combing the control variable into the regression model (1), we formulate the equation (3):

$$DPY_{i,t} = C_0 + C_1 EPS_{i,t} + C_2 DPY_{i,t-1} + C_3 D_{2008} + C_4 control + C_5(control * D_{2008}) + \epsilon_t \qquad (3)$$

Apriori Expectation

For the univariate analysis, we also apply the t-test to measure the statistical significance of the discrepancy within the average dividend payout ratio before and after altering the corporate income tax rate. Then the study takes the dividend payout in 2007 and 2009 as Group 1. The experiment Group 2 will be the paired-wise average dividend payout during year 2006-2007 and year 2009-2010. The reason why we set up two comparable groups is to examine whether the period may affect the interaction of dividend payout and taxation. The trend of dividend payout may be more conspicuously to be observed in a longer interval period (Chkir & Samir, 2008).

For the multivariate analysis, we combine the control variable into the regression model. The control variable refers to the level of control concentration, especially represents the percentage of voting power owned by the directors of the firm.

Supposed C_2 (i.e. the coefficient of $DPY_{i,t}$) is positive and is statistically significant at 1%, which telling us that the reduction of corporate income tax ratio from 33% to

25% was barely enough to accelerate the dividend payouts. If C_1(i.e. the coefficient of earnings per share) is positive and statistically significant at 1%, then the interaction between earnings per share and dividend payouts is also positively correlated. However, if C_4(i.e. the coefficient of control variable) is significantly positive, which means the level of control concentration may boost the impact of taxation on dividend payouts. In other words, a company whose directors have heavy voting power may promote the effect of taxation. Furthermore, if there is a significantly negative sign of C_5 (i.e. the coefficient of the "$control * D_{2008}$" pattern) that means the influence will be maintained after the year 2008.

A famous theory argues that dividend policy is far from the cost of capital and the value of the firm within a no tax and no transaction fees' world (Modigliani & Miller, 1961). That can be demonstrated like investors determine whether to buy or sell the shares only if there is profit. At the moment, the investment has nothing to do with shareholders' future expectations on the firm, and the firm can decide whether to pay a cash dividend or reinvest or issue new stocks.

To be a conclusion, once there are no tax requirements and transaction payments, investors can easily get profit only by selling and buying the shares, then the firm has not to take shareholder's expectations into account, which gives firm managers free right to make financial decisions for the firm. Thus, dividend policy is irrelevant to the expected net cash flows and cost of capital, and the firm can choose any payout pattern without influencing its value. This is also be defined as "MM theory", an abbreviation of Miller and Modigliani. Moreover, under the MM theory, you can treat

the fluctuation of dividend payout as by-products source from investment and financing decisions (Wu, 1996).

Miller and Scholes (1982) have also shown that dividend income was independent of taxation to a large extent. In other words, it is the level in which individuals can avoid taxes determines how taxes react on corporate dividend policy. By the way, empirical studies separate the block traders from individuals or corporations: individuals are those who should be taxed on dividend income, but corporations are not required to pay tax on dividend income. According to (Barclay, Holderness, & Sheehan, 2009), they find no evidence to prove that those corporations may pay more dividends for the exemption of tax payment, as a conclusion, taxes are not significant while the corporation making decisions to distribute cash dividend.

Empirial financial theory has proved that taxes may influence corporate dividend policy, and no matter when corporate income tax changes, we observe changes in the firm's dividend policy (Wu, 1996). Later, Wu (1996) provides conflicting results. Similar to this present study, to measure the sequel of changes in taxes, both of us analyze the payout pattern over a same interval with major reforms. The study offers support to the hypothesis that the change of taxation has a positive effect on the aggregate dividend payout focusing on the tax reform in the year 1986. On the other hand, the aggregate dividend payout ratio fluctuates over time and is affected by the business cycle.

Another study is related to the impact of huge block traders on dividends. But this provides evidence that large shareholders are adjusting dividends for the tax situations

(Holmen, Knopf, & Peterson, 2008). Generally, most of the empirical studies take control of concentration into account, while examining the determinants of the dividend payouts. The study compared how controlling (or large) shareholders with high or low marginal tax rates make dividend decisions for the change of taxes. As a result, for large shareholders or controlling shareholders with the high effective tax rate, the change of taxes may induce them to decrease the dividend distribution, so that they can avoid paying more taxes; however, for those controlling shareholders following in low effective tax rate, since they have not to pay taxes on their dividends, they have low likelihood to increase the dividend payments. By the way, large shareholders are investors who owning relatively high percent of the voting power, which is verisimilar to the present study.

Our empirical results suggest that normally C_1 would be positive and the deduction of corporate income tax does have an impact on the corporate dividend payouts, the company may pay more cash dividends to the shareholders due to the change of taxation. It is perspicuously to understand because lower income tax leads to higher extra profit remained. Most of the time, a company with good company performance decides to pay dividends using the extra profits, in return for good future expectations of its shareholders.

Also, we find that firms with a high level of control concentration tend to pay fewer dividends (Chkir & Samir, 2008). Remember we talked about the term "control concentration" in the previous context, and it is said, "to control the effect of ownership on the research, we introduce this variable”.

Data

The data of the study is made up quoted firms in all industries distributing dividends over the period 2000 - 2016. Companies, who are in the China Securities Regulatory Commission 2001 Edition Industry Classification, will be selected into the database. Those firms who never paid dividends are not included, neither who hold negative dividend payout ratio. The data of dividends periodically paid, earnings per share of the stocks and control concentration of the company are available from CSMAR Database. This study will use STATA to do regression analysis.

Result

Univariate Analysis

In the univariate analysis, we examine the effect of tax deduction on the dividend payout ratios of quoted firms by comparing the differences pre- and post- event. Table 1 show as the descriptive summary of the data. The study filters out 85 valid firms with the positive dividend payout ratio during the period 2000 and 2016.

Table 1. Summary statistics

	N	Mean	St.Dev	min	max	Median
id	1445	385000	293000	2	900948	600160
year	1445	2008	4.901	2000	2016	2008
DPY	1445	.208	1.152	.007	38.07	.116

First, let’s see the row1 is the difference of dividend payout ratio between 2007 and 2009. Although we report an increase of the average dividend payout from 2007 to

2009, the t-test shows that it is not significantly different from zero. Thus, it seems that dividend payout ratio is not correlated with the change of tax. However, later we have tested the paird-wise difference between same interval of years. And the results show that the larger the time period interval is, the smaller p-value is, which implies that time would be an implicit factor in the relationship between tax and dividend payout ratio. While considering for a long-term effect, the effect of tax on the dividend payout ratio will be more efficient and will be more obviously to see. By the way, the reduction of corporate income tax inclined to be a negative effect on the dividend payout ratio.

Tabel 2. Paired t test: DPY2007~DPY2009

	obs	dif	St.Err	t value	p value
DPY2007 - DPY2009	85	.001	.015	.05	.942
DPY0706 - DPY1009	85	-.003	.018	-.15	.877
DPY0705 - DPY1109	85	-.057	.044	-1.3	.201
DPY0704 - DPY1209	85	-.05	.021	-2.45	.016
DPY0703 - DPY1309	85	-.56	.46	-1.2	.226
DPY0702 - DPY1409	85	-.103	.056	-1.85	.065
DPY0701 - DPY1509	85	-.36	.149	-2.4	.018
DPY0700 - DPY1609	85	-.51	.194	-2.65	.01*

* p < 0.1, ** p < 0.05, *** p < 0.01

Multivariate Analysis

In the multivariate analysis, we try to control the concentration of votes owned by those big shareholders, and add variable “control” into the model (2). However, due to the dearth of database, we cannot get a complete list of the “Proportion of the top

ten shareholders", so we decide to use average filling the missing values. And we get the result show as Table 3.

Tabel 3. Multivariate analysis of the impact of taxation on dividend policy

	Model 1		Model 2	
Constant	0.118	0.000***	0.089	0.223
DPY_lag	0.046	0.072	0.045	0.080
EPS	-0.047	0.104	-0.049	0.093
D2008	0.025	0.270	0.029	0.714
control			0.002	0.681
control_D2008			-0.001	0.800
Observations	1500		1500	
Adjusted R^2	0.00		0.00	

p-values in second column

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

It seems that the control variable has no strong impact on the change of dividend payout ratio. But to be more precise, we suppose that maybe because of large propotion of missing value in control variable. Therefore, we would not refer too much on this result.

Conclusion

To conclude, plenty of theoretical and empirical studies have examined the relationship between taxation and firm dividend policy. Usually, there are controvertible and contentious arguments mentioned in the paper. Although most of them have strong evidence and data foundation to support, there are still limitations exists.

There are five parts that I concluded as the limitations showed up in the research. First, the database is limited due to the complex calculation. It will be more consummate if much additional information can be known, especially more data included in the model. Our study result must be more precise and close to the truth. However, there is a period limited between the years 1998 and 2008. It may take a lot of time to collect data for 10 years long. Then I decide to make the study easier by randomly choose 10 listed firms in China. And this may cause some bias.

Second, the fundamental location is various which causes the results may be different. Refers to theoretical and empirical studies, most of them have a special country or region as the basis. Like Holmen et al. (2008) set up a database in Sweden, Nathani et al. (2018) set up a database in India, Ranti (2013) set up a database in Nigeria, etc. This paper also set up a country which is China as our database. And we cannot eliminate the discrepancy of a similar result from different countries or regions.

Third, empirical theories are mostly focusing on the individual tax rate rather than a corporate income tax. Less information is related to corporate income tax and dividend policy. We take advantage of extant limited studies to measure the

relationship between taxation and corporate dividend policy, which may be fragile to support the objective.

Forth, there are still unobservable control variables that may affect the study. The only control variable taken into account in this paper is the control of concentration, however, the owner is only a small part included. Most of the time, it is inevitable to face the influence of other control variables, leading to bias results. Besides, the number of control variables also determines the complexity of the model, consumed time and presumed assumptions.

Fifth, one of the requirements of this study is including references within 5 years. Although we try our best to do so, there are still some old studies and empirical theories should be taken in. And the oldest maybe in 1960 that is out of date. However, since some important studies have demonstrated the idea from those antiquated papers, finally we still decide to remain those old references. To be easy for readers to read and make the resources clearer.

The most important contribution done in the research is to reconstruct the regression model. Based on the fundamental model, we try to fit the model into our situation. And this study has changed a little bit, which is more perspicuous for readers to understand.

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