DIVIDENDS AND TAX POLICY IN THE LONG RUN

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There is a longstanding debate as to whether changes in shareholder-level taxes have an effect on firm dividend policy. The traditional view is that tax changes influence dividends, while the new view is that there generally is no such effect. In support of the traditional view, recent observers point to the rise in dividends following the reduction in the tax rate on dividends in 2003. In fact, the resurgence in dividends has been so strong that President Bush has made it one of his top legislative priorities to permanently extend the tax cut, which is currently set to expire at the end of 2010. The popular assumption is that the rise in dividends—and any associated economic and corporate governance benefits—will continue only if the lower rate is made permanent. This article challenges that assumption. Using finance theory and empirical evidence from the United States and other countries, this article shows that the relationship between dividends and taxes over the long run is more complex than dividend tax cut proponents suggest. Because the 2003 tax cut was only a temporary cut, making it permanent may actually have an effect that is opposite of what is intended. The implication is not that a temporary tax cut is preferable to a permanent one, but rather that the attempt to influence corporate behavior through tax laws should be resisted as either futile or potentially counterproductive.

Ever since the tax rate on dividends was lowered as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003,[1] dividends have

* Professor, UCLA School of Law. This paper benefited from the comments and suggestions of David Aboody, Alan Auerbach, Antonio Bernardo, David Cameron, Brian Cheffins, Dhammika Dharmapala, John de Figueiredo, Marc Goergen, Austan Goolsbee, Jeff Kwall, Yoram Margalioth, Robert McDonald, Jacob Nussim, Peter Oh, Troy Paredes, Katie Pratt, Kirk Stark, Jeff Strnad, Lynn Stout, and participants at the annual meeting of the American Law and Economics Association, a Northwestern University Tax Policy Colloquium, and a UCLA Program in Business Law and Policy faculty workshop. Thanks to David Martin for his research assistance.

1. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified at 26 U.S.C. § 1); I.R.C. § 1(h)(11) (taxing "qualified dividend income" as if it were "net capital gains" for tax rate purposes).

surged.[2] In 2005, S&P 500 companies paid out a record $202 billion in dividends.[3] This followed a similar year for dividends in 2004,[4] which broke previous records even without counting Microsoft's mammoth $32 billion special, or nonrecurring, dividend declared in July of 2004.[5] Notwithstanding General Motors' recent decision to cut its regular dividend in half, 2006 is expected to continue the streak of record years, with S&P 500 firms predicted to pay out as much as $225 billion in dividends.[6] Moreover, not only have aggregate dividends risen among large public companies, but so have the number of firms increasing or initiating a regular dividend.[7] In addition to Microsoft,[8] many major corporations such as Best Buy, Clear Channel, Costco, Qualcomm, Viacom, and others have begun to pay regular dividends for the first time.[9]

Supporters of the dividend tax cut have suggested that the rise in dividends has had substantial benefits—such as stimulating the economy and constraining managers from inflating profits or pursuing speculative projects—that are attributable in large part to the reduction in the tax rate on dividends.[10] With the dividend tax cut scheduled to expire in 2010,[11] President Bush has made one of his top priorities to enact legisla-

2. Joseph Lisanti, *The Dividend Rediscovered*, BUS. WK. ONLINE, Dec. 3, 2004, http://www.businessweek.com/investor/content/dec2004/pidooy123_6750_pi046.htm?chan=search; Editorial, *Many Happy Returns*, WALL ST. J., Nov. 3, 2004, at A14. This stands in stark contrast to just a few years ago when observers lamented the "dividend deficit" of the 1990s. *See* Jeremy J. Siegel, *The Dividend Deficit*, WALL ST. J., Feb. 13, 2002, at A20.

3. Ian McDonald, *New Cash Cows: Biggest Stocks*, WALL ST. J., Jan. 6, 2006, at C3.

4. Jeff D. Opdyke, *Tax Cut, Shareholder Pressure Stoke Surge in Stock Dividends*, WALL ST. J., Jan. 18, 2005, at A1.

5. Floyd Norris, *The $32 Billion With a Bonus in Tax Breaks*, N.Y. TIMES, July 22, 2004, at C1 [hereinafter Norris, *Bonus*]; Floyd Norris, *Cash Flow in '04 Found its Way into Dividends*, N.Y. TIMES, Jan. 4, 2005, at C1 [hereinafter Norris, *Cash Flow*].

6. Jeff D. Opdyke, *GM's Dividend Cut Likely Doesn't Mean The Start of a Trend*, WALL ST. J., Feb. 8, 2006, at D2.

7. McDonald, *supra* note 3; *Number of Companies Lifting Dividends is Up*, L.A. TIMES, Jan. 4, 2006, at C4; *see* Opdyke, *supra* note 6 (noting that, since the end of 2002, S&P 500 firms "have announced 878 dividend increases, and 43 companies have initiated dividend payments").

8. Steve Lohr, *In a Surprise, Microsoft Says It Will Pay Dividends*, N.Y. TIMES, Jan. 17, 2003, at C1.

9. Robert J. Barro, *How Tax Reform Drives Growth and Investment*, BUS. WK., Jan. 24, 2005, at 26.

10. Stephen Moore & Phil Kerpen, *Show Me the Money! Dividend Payouts After the Bush Tax Cut*, CATO INST. BRIEFING PAPERS NO. 88, at 1 (2004), *available at* http://www.cato.org/pubs/briefs/bp88.pdf; Pete DuPont, *Rising Tide*, OPINION J., July 25, 2006, http://www.opinionjournal.com/forms/printThis.html?id=110008699; Don Evans, *Lock in These Rates*, WALL ST. J., Nov. 9, 2005, at A16; Editorial, *Tax-Cut Deadline*, WALL ST. J., Dec. 8, 2005, at A16; *see also* Barro, *supra* note 9, at 26 ("Because the sharp cut in dividend taxation was a centerpiece of the 2003 law, it is particularly interesting to see how companies' dividend policies changed. The anecdotal evidence suggests a strong positive response . . . ."); Jonathan Weisman, *At the Top, Pennies Per Share Add Up: Companies Boost Dividends After Tax Cut*, WASH. POST, Apr. 8, 2005, at E01 ("Two tax seasons after the dividend tax cut went into effect, its impact on corporate behavior and investors' taxes is beginning to come into focus."). The economic benefits may be much smaller than claimed, though. *See* Katherine Pratt, *Deficits and the Dividend Tax Cut: Tax Policy as the Handmaiden of Budget Policy* 40–42 (Loyola Legal Studies, Paper No. 2006-31, 2006), *available at* http://ssrn.com/abstract=935389.

11. As part of the original legislation, the tax cut provision was enacted only for a limited term because supporters could not muster sufficient votes to overcome the "Byrd Rule," which allows sena-

tion that would permanently reduce the tax rate on dividends.[12] The popular assumption is that making the dividend tax cut permanent will perpetuate the increase in dividends and any associated economic and corporate governance effects.[13]

This article challenges the assumption that the rise in dividends will continue if the dividend tax cut is made permanent. In fact, just the opposite may occur. Using finance theory and empirical evidence from the United States and other countries, this article shows that the relationship between dividends and taxes over the long run is more complex than dividend tax cut proponents suggest. Although several studies support the claims that the dividend tax cut is responsible for the rise in dividends,[14] and the 2005 Economic Report to the President calls the response to the dividend tax cut "unprecedented in the recent history of tax changes,"[15] the connection is not as simple as it might seem. First, there are a variety of other possible explanations for the rise in divi-

tors to object to measures that increase deficits beyond the ten-year budget window. *See* Elizabeth Garrett, *Accounting for the Federal Budget and its Reform*, 41 HARV. J. ON LEGIS. 187, 194 (2004). Thus, the dividend tax cut was initially set to expire on December 31, 2008. *See* Congressional Budget Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (codified as amended at 2 U.S.C. § 644). In 2006, the date was extended to 2010. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (enacted May 17, 2006). If it is not extended beyond that date, dividends will once again be taxed at ordinary income rates.

12. Nancy Ognanovich, *Bush Economic Team Pushes to Make Tax Cuts Permanent*, BNA DAILY TAX REP., Jan. 4, 2006, at G-11; Nancy Ognanovich, *Card Says Making Tax Cuts Permanent Bush's Top Priority for Domestic Agenda*, BNA DAILY TAX REP., Jan. 12, 2006, at G-1; Nancy Ognanovich, *Snow Says Making Tax Cuts Permanent Top Priority for President in Coming Year*, BNA DAILY TAX REP., Dec. 8, 2005, at G-10; *President Says He Will Push for Making Tax Cuts Permanent Social Security Reform*, BNA DAILY TAX REP., Oct. 24, 2006, at G-13; Meg Shreve, *Bush Credits Tax Policy for Drop in Deficit*, 113 TAX NOTES 199 (2006). The President's tax reform panel also recently proposed making the dividend tax cut permanent. PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 159 (2005). Bush has assumed that the dividend tax cuts will be made permanent by including it in his baseline for the budget he submitted to Congress this year. David S. Broder, *Trillion-Dollar Gimmick*, WASH. POST, Feb. 19, 2006, at B07. In spite of this, the prospects for a permanent extension remain uncertain. *See* Daniel Altman, *Taxes and Consequences: The Second Term Begins*, N.Y. TIMES, Nov. 7, 2004, at 4; Janet Novack, *Your Next Tax Hike*, FORBES, Nov. 29, 2004, at 51; Kurt Ritterpusch, *Grassley Unsure Capital Gains, Dividend Rate Extension Can Pass in Reconciliation*, BNA DAILY TAX REP., Jan. 11, 2006, at G-1; Holly Rosenkrantz, *Deficit, Social Security Fight Delaying Bush's Tax-Cut Goals*, BLOOMBERG NEWS, May 4, 2005, *available at* http://www.concordcoalition.org/news/article-storage/2005/bloomberg-050502.htm; Jim VandeHei, *Tax Cuts Lose Spot on GOP Agenda*, WASH. POST, Mar. 7, 2005, at A01.

13. Moore & Kerpen, *supra* note 10, at 9 ("Congress should make this successful change in tax policy permanent so that Americans can continue to benefit from rising stock market values, more ethical and efficient corporate behavior, and greater investment and growth."); Stephen Moore, *Real Tax Cuts Have Curves*, WALL ST. J., June 13, 2005, at A13 ("All of this brings us to the crucial policy issue of whether Congress will observe these new economic and revenue data and have the common sense to keep a good thing going by making the Bush tax cuts permanent.").

14. Moore & Kerpen, *supra* note 10; Raj Chetty & Emmanuel Saez, *Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut*, 120 Q. J. ECON. 791 (2005); Jennifer L. Blouin et al., *Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?* (Nat'l Bureau of Econ. Research, Working Paper No. 10301, 2004). *But see* Shawn Howton & Shelly Howton, *The Corporate Response to the 2003 Dividend Tax Cut*, 16 J. APP. FIN. 62, 70 (2006) (finding results mixed).

15. 2005 ECONOMIC REPORT OF THE PRESIDENT 76 box 3-2.

dends, including the improving economy, the rise in firms' cash holdings as alternate investments have declined, and the increased demand for better measures of earnings quality. Second, and perhaps more importantly, even if the increased dividends over the last several years are a direct result of the temporary tax cut, it does not necessarily mean that making the dividend tax cut permanent will continue to yield the same results.

In fact, the effect of a permanent dividend tax cut may be very different from that of a temporary dividend tax cut. In the short run, under a temporary tax cut, there is a general consensus that dividends should rise.[16] This is because of the understanding that dividends will be subject to higher rates when the tax cut expires. In the long run, however, under a permanent dividend tax cut, there is substantial disagreement as to whether taxes influence dividend policy.[17] Under the traditional or "old" view, taxes affect dividend policy, with the cost of the tax balanced against the nontax benefits of the dividend in signaling profitability and in constraining managerial discretion to misuse free cash flow.[18] Consequently, any reduction in taxes should increase the flow of dividends. This is the view that appears to have motivated dividend tax cut proponents.[19] By contrast, under the "new" view, firms set dividend policy independently of shareholder tax considerations, on the assumption that all profits will eventually be distributed to shareholders in transactions taxed at the same rate, regardless of when paid.[20] This suggests that under normal circumstances a change in dividend policy that is understood to be permanent should have no effect on dividend policy. It is only under a temporary dividend tax cut, where the assumption of constant rates no longer holds, that dividend policy would take taxes into account. Thus, the new view is that dividends would increase until the cut is made permanent, at which point tax would no longer be relevant and dividends would either stop rising or even fall as firms seek to replenish cash holdings.

16. Alan J. Auerbach & Kevin A. Hassett, *On the Marginal Source of Investment Funds*, 87 J. PUB. ECON. 205, 216 (2002); Chetty & Saez, *supra* note 14, at 828.

17. *See* Chetty & Saez, *supra* note 14, at 792 (stating that "despite extensive research, the effects of taxation on dividend policies and corporate behavior more generally remain disputed").

18. John A. Brittain, *The Tax Structure and Corporate Dividend Policy*, 54 AM. ECON. REV. 272 (1964); Martin Feldstein, *Corporate Taxation and Dividend Behaviour*, 37 REV. ECON. STUD. 57 (1970); James Poterba & Lawrence Summers, *The Economic Effect of Dividend Taxation, in* RECENT ADVANCES IN CORPORATE FINANCE 227 (Edward Altman & Marti Subrahmanyam eds., 1985).

19. *See* Blouin et al., *supra* note 14, at 3 ("This 'old view' logic underlies President Bush's assertion at the signing that '[t]he bill also allows for dividend income to be taxed at a lower rate. This will encourage more companies to pay dividends . . . .'").

20. The origin of this view is typically traced to the following three sources: David Bradford, *The Incidence and Allocation Effects of a Tax on Corporate Distributions*, 15 J. PUB. ECON. 1 (1981); Alan J. Auerbach, *Wealth Maximization and the Cost of Capital*, 93 Q.J. ECON. 433 (1979); Mervyn A. King, *Taxation and the Cost of Capital*, 41 REV. ECON. STUD. 21 (1974). It is still called the "new" view despite being more than thirty years old. JANE G. GRAVELLE, DIVIDEND TAX RELIEF: EFFECTS ON ECONOMIC RECOVERY, LONG-TERM GROWTH, AND THE STOCK MARKET, CONGRESSIONAL RESEARCH SERVICE REP. NO. RL31824, at 16 (2003).

While there is evidence to support both views, recent empirical studies, including comparative studies of the effect of taxes on dividend policy over extended periods in other countries, indicate that the new view might have the upper hand. This is particularly true with respect to the large public companies that often make up the bulk of dividend payers. This suggests that the tax cut may no longer have a significant effect on dividends if it is made permanent. At the very least, the notion that a permanent dividend tax cut would have the same effect on dividends over the long run is much more controversial than the consensus about the short-term effects of the 2003 dividend tax cut would suggest.

The implication is not that the impermanence of the dividend tax cut should be maintained as long as possible so as to continue to reap any benefits from a rise in dividends. Nor is it that we should necessarily raise the dividend tax rates to maintain two layers of tax as part of our classical system of corporate taxation. Rather, it is that the impulse to influence corporate behavior via tax laws should be resisted as either futile or potentially counterproductive. Part I discusses the circumstances that led to President Bush's proposal for dividend tax reform and outlines the legislation that was adopted. Part II critically examines the evidence suggesting dividends have risen in the two years following the enactment of the cut, noting that a variety of factors may mitigate the size of the increase and its connection to the dividend tax cut. In Part III, the article reviews recent corporate finance scholarship on the relationship between taxes and dividend payout rates, and notes that the temporary nature of the 2003 cut, combined with comparative empirical evidence on the short- and long-term relationship between dividends and taxes, should call into question any push to make the cut permanent based on the recent rise in dividends. While there is other evidence in favor of the traditional view, the question is far from settled. The article briefly concludes in Part IV by suggesting some possible policy implications.

I. THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003

In January of 2003, President Bush announced a proposal to eliminate the double taxation of corporate income.[21] At the time, corporate income was subject to two levels of tax. First, it was taxed at the corporate level through the corporate income tax, which had a maximum rate of 35% for income in excess of $10 million.[22] Second, upon distribution as a dividend, corporate income was subject to another tax imposed at the shareholder level at the shareholder's marginal rate of as much as

21. Press Release, The White House, Fact Sheet: President Bush Taking Action to Strengthen America's Economy (Jan. 7, 2003), *available at* http://www.whitehouse.gov/news/releases/2003/01/20030107.html.

22. I.R.C. § 11(b)(d).

38.6%.[23] This system of double taxation for dividends has long been derided as unfair and inefficient.[24] Corporations could resort to repurchasing stock from its own shareholders as an alternative to distributing corporate income as a dividend. Share repurchases are generally treated as sales or exchanges under the current system.[25] Thus, they are taxed at the preferential capital gains rates, and shareholders are not taxed on the amount that represents their "basis," or original investment, in the stock.

Under Bush's proposal, income would have been subject to the corporate income tax as under the current regime, but dividends on that income would have been exempt from the shareholder income tax. The goal of the proposal was to tax income "once and only once," which had been the mantra of the 1992 Treasury Integration plan upon which the Bush proposal was patterned.[26]

One significant factor prompting the Bush proposal was the desire to increase dividends and thereby improve corporate governance. In the year preceding the release of Bush's proposal, many commentators had clamored for tax reform designed to reverse the downward trend in dividend payouts that was blamed on the double taxation of dividends.[27] Bush's proposal sought to address this concern. According to the Joint Committee on Taxation's Blue Book on Integration, which was released in connection with the Bush announcement, the tendency to retain earn-

23. *Id.* §§ 1, 301, 316.

24. It is considered unfair because it makes no distinction between shareholders at different marginal rates, and it is considered inefficient because it distinguishes between corporate and noncorporate investments and thereby distorts investment decisions. *See* CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 2–3 (1979); Michael J. Graetz & Alvin C. Warren, *Integration of the Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1768 (1999). *But see* Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889 (2006) (suggesting that the separate corporate tax evolved as a response to fundamental differences between the corporation and noncorporate vehicles).

25. Assuming compliance with the requirements of I.R.C. § 302(b).

26. U.S. DEP'T OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992); Martin A. Sullivan, *Dividend Déjà Vu: Will Double Tax Relief Get Canned—Again?*, 98 TAX NOTES 645, 647 (2003).

27. *See, e.g.*, Editorial, *Bring Back Dividends*, WALL ST. J., Aug. 6, 2002, at A20 ("There is, however, one big problem with dividends: The government taxes them twice . . . . Little wonder then that over the past decade or so, as investors become more sensitive to taxes, they start rewarding companies for retaining earnings instead of paying out dividends."); James Glassman, *Liberate the Dividend*, AM. ENTERPRISE, Sept. 2002, at 13; James K. Glassman, *Numbers You Can Trust*, WASH. POST, Feb. 10, 2002, at H1 ("Unfortunately, dividends are getting more scarce . . . . Double taxation encourages companies to hold on to most of what they earn, whether the companies really need the money or not."); Paul Gompers et al., *This Tax Cut Will Pay Dividends*, WALL ST. J., Aug. 13, 2002, at A20 ("At the top of his agenda should be the elimination of one of the most detrimental taxes in our economy—the corporate dividend tax. The sharp decline in cash dividends on common stocks over the past decade has been the major cause of the woes bedeviling the stock market."); Edward J. McCaffery, *Remove a Major Incentive to Cheat*, WALL ST. J., July 9, 2002, at B2 ("If we repealed the corporate income tax . . . . [C]orporations would no longer have an excuse for growing large, or an incentive for hiding their gains from everyone to avoid taxation. They could instead pay dividends."); Siegel, *supra* note 2 ("What contributed to the sharp fall in the dividend yield? . . . [O]ur tax system has played a crucial role."); Steve Stein, *Taxes, Dividends, and Distortions*, POL'Y REV., June–July 2002, at 59; Amit Ghate, *Eliminate Double Taxation of Dividends*, CAPITALISM MAG., Apr. 14, 2002, http://www.capmag.com/article.asp?id=1535.

ings "lessens the pressure on corporate managers to undertake only the most productive investments because corporate investments funded by retained earnings may receive less scrutiny than investments funded by outside equity or debt financing."[28]

The theory was that by cutting dividend taxes, firms would increase dividend payments and this would result in improved corporate governance. Commenting on the Bush proposal, the Joint Economic Committee predicted that reducing dividend tax rates "would change managerial behavior."[29] According to the Committee, "paying dividends rather than retaining earnings would become a more attractive proposition for companies; this change would promote a more efficient allocation of capital and give shareholders, rather than executives, a greater degree of control over how a company's resources are used."[30] Many economists believed that this predicted change in the locus of control over retained earnings would lessen the temptation for managers to engage in "empire-building" with retained earnings.[31] The Council of Economic Advisers concluded that the President's proposal might resolve this issue by increasing the dividend payout rate by as much as four percentage points.[32]

Ultimately, the President's proposal was scaled back. It still constituted, however, the most significant reduction of the double tax burden in the post–World War II era. Under the Jobs and Growth Tax Reconciliation Act of 2003, "qualified dividend income" is taxed at the same rate as capital gains.[33] Dividend income is considered qualified if it comes from a taxable domestic corporation, and if the recipient has held the corporation's shares upon which the dividend was paid for at least sixty days during the one hundred and twenty day period starting sixty days prior to the ex-dividend date.[34] When coupled with the reduction of the maximum capital gains rate from 20% to 15%,[35] the tax rate on dividends thus was cut by more than half for taxpayers subject to the top individual rates.[36] The new law also closed the gap in tax treatment between dividends and share repurchases. Both are now subject to the

28. *See* Press Release, Joint Committee on Taxation, Eliminate the Double Taxation of Corporate Earnings 1 (Jan. 2003) [hereinafter Bluebook on Integration], *available at* http://www.ustreas.gov/press/releases/docs/bluebook.pdf.

29. JOINT ECONOMIC COMMITTEE, DIVIDEND TAX RELIEF AND CAPPED EXCLUSION 1 (2003), *available at* http://jec.senate.gov/_files/DividendTaxRelief.pdf.

30. *Id*.

31. Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19 J. ECON. PERSP. 163, 163 (2005).

32. *See* Press Release, Council of Economic Advisers, Eliminating the Double Tax on Corporate Income (Jan. 7, 2003), *available at* http://www.ustreas.gov/press/releases/docs/exclusion.pdf (citing a 1992 Treasury study on integration).

33. I.R.C. § 1(h)(11).

34. *Id.* § 1(h)(11)(B)(iii).

35. *Id.* § 1(h)(1)(C).

36. The ordinary income rate was 39.6% in 2000 and was lowered to 38.6% in 2002 as part of a phased-in tax cut passed during Bush's first term in 2001. Under the Act, the rate cut was accelerated so that the top ordinary income rate in 2003 was 35%. Jobs and Growth Tax Relief Reconciliation Act of 2003, § 102, 26 U.S.C. § 1(f)(8)(B) (2000 & Supp. III 2003).

same 15% rate, although share repurchases are taxed only to the extent the distribution exceeds the shareholder's basis in his stock, while dividends are taxed as to the entire distribution.

Although the change in the tax treatment of dividends was substantial, it was only temporary. Under the terms of the legislation, the dividend tax cut expires on December 31, 2010.[37] Therefore, unless Congress acts to extend it before then, the rate of tax on dividends once again will jump up to the ordinary income rate starting in 2011. This kind of a sunset provision in tax legislation is a fairly recent innovation (or gimmick, depending upon your perspective), but it is one that has been used in each of the last three major tax reductions enacted during President Bush's first and second terms in office.[38]

Sunset provisions were developed to get around the so-called Byrd Rule.[39] During the early 1990s, there was a heightened concern for the growing federal deficits. Tax legislation was scored for its revenue effects to ensure that any revenue losses would be offset with sufficient revenue gains to be considered deficit-neutral. To minimize the apparent revenue losses associated with tax cuts, legislators would push the losses to future years even as Congress progressively increased the budget windows against which these tax provisions were evaluated. The Byrd Rule was adopted to inhibit the ability of Congress to play games with deficit projections.[40] Under the Byrd Rule, senators may object to consideration of reconciliation bills (which include most tax bills) that would increase the deficit in the years outside the budget window.[41] It takes a vote of at least sixty senators to waive the objection and continue with the reconciliation process.[42] Thus, while a bare majority is necessary to pass the tax legislation in the first instance, a supermajority is required to make it permanent. President Bush and his allies have already expressed their intention to make the dividend tax cut permanent. The prevailing view, however, appears to be that permanently extending the dividend tax cut is far from certain.[43]

Despite the temporary nature of the dividend tax cut, it was still considered an effective response to the retained earnings issue. The House Ways & Means Committee, in its Report commenting on the final bill, highlighted the concern over retained earnings:

> [P]resent law, by taxing dividend income at a higher rate than income from capital gains, encourages corporations to retain earnings

37. Originally, the legislation was set to expire on December 31, 2008. In May 2006, the date was extended to 2010 under the Tax Increase Prevention and Reconciliation Act of 2005. *See supra* note 11.

38. Garrett, *supra* note 11, at 195.

39. Named after its author, Senator Robert Byrd (D-W. Va.).

40. Garrett, *supra* note 11, at 194.

41. *Id*.

42. *Id*.

43. *See supra* note 12.

> rather than to distribute them as taxable dividends. If dividends are discouraged, the shareholder may prefer that corporate management retain and reinvest earnings rather than pay out dividends, even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings.[44]

By placing dividends on virtually the same footing as capital gains,[45] the hope was that corporations would not be subject to the pressure to reflect all gains in the stock price, but would instead be encouraged to distribute more dividends.

II. Dividends Since the Dividend Tax Cut

Proponents of the dividend tax cut point to the rise in dividends in the last two years as evidence of the legislation's success. Not only have aggregate dividends increased, but many prominent companies have initiated regular dividend payments for the first time. Moreover, several empirical studies conducted in the immediate aftermath of the cut have found a statistical connection between the legislation and the rise in dividends. It may be too soon, however, to accept this evidence uncritically. While these studies have garnered significant attention in both academic circles and the popular press, they are not wholly accepted. A variety of factors may also have influenced the rise in dividends, and the rise itself may be an illusion caused by the decline in previous years.

A. The Rise in Dividends

Dividends have risen substantially in the last two years. This is true both in terms of the aggregate amount paid as well as in the number of increases in regular dividend payout rates. Among S&P 500 companies, dividends rose from a then-record $160.8 billion in 2003 to a new record of over $200 billion in 2005.[46] One study found that regular dividends had increased by as much as 20% since early in 2003.[47] While one-time payouts such as Microsoft's $32 billion special dividend can inflate such numbers, many other firms are also raising the ante. Between 2003 and mid-2006, almost 390 of the S&P 500 firms increased their dividend payout rate and only 25 reduced it.[48] Overall, 1745 firms reported increases in their dividend payouts in 2004, which was an increase of 7.2% from

44. H.R. REP. NO. 108-94, at 31 (2003).

45. Qualified dividend income is not treated identically to capital gain income because the former is taxed only as if it is "net capital gain" and therefore may not be offset by capital losses. I.R.C. §§ 1(h)(11), 1222(11).

46. McDonald, *supra* note 3; Norris, *Cash Flow*, *supra* note 5.

47. Chetty & Saez, *supra* note 14, at 793.

48. Ian McDonald, *Capital Pains: Big Cash Hoards*, WALL ST. J., July 21, 2006, at C3.

2003 and was the highest number of firms reporting increases since 1998.[49]

Not only have dividends increased, but the number of firms initiating a dividend for the first time has risen sharply in the last several years. Thirty-seven S&P 500 firms have initiated a regular dividend payment since 2003,[50] the largest number of new dividend payers since 1980.[51] This figure includes many high-profile former dividend holdouts, by far the most prominent of which is Microsoft. In the fall of 2002, there had been intense pressure for the firm to start paying out some of its $40 billion cash surplus.[52] At its annual stockholders' meeting, several investors stood up to demand that the company start paying a dividend, "elicit[ing] applause from some of the other 300 shareholders at the meeting."[53] Despite such pressure, Microsoft indicated it had no intention to begin paying a dividend, citing ongoing antitrust litigation and its use of stock buybacks as support.[54] Even the day after President Bush announced his proposal for dividend tax reform, Microsoft stated it had no plans to initiate a dividend.[55] Within a few weeks, however, Microsoft reversed course and announced that it would be declaring a small, but regular, quarterly dividend.[56] Although the amount was paltry considering the size of its war chest,[57] Microsoft doubled the size of its regular dividend the following summer at the same time that it announced its record special dividend.[58]

B. *Connecting the Dividend Tax Cut with the Rise in Dividends*

There is anecdotal evidence that the dividend tax cut helped spur the rise in dividends in some firms. One chief executive explained that "[b]efore, it was inefficient to pay large dividends. They were taxed too high. Now, we're paying out about 50 percent of our earnings," (compared with 17% before the change in the law).[59] Another company's director of investor relations conceded that when her company was decid-

49. Norris, *Cash Flow*, *supra* note 5.
50. Weisman, *supra* note 10.
51. Tim Gray, *Here Come the Dividends. But Don't Cheer Yet.*, N.Y. TIMES, Sept. 14, 2003, at BU6.
52. Dan Richman, *No Dividends from Microsoft*, SEATTLE POST-INTELLIGENCER, Nov. 6, 2002, at E1.
53. *Id*.
54. *Id*.
55. David Leonhardt & Claudia H. Deutsch, *Few Officials at Companies Expect Surge in Dividends*, N.Y. TIMES, Jan. 8, 2003, at C1.
56. Lohr, *supra* note 8.
57. After a stock-split announced at the same time, the total dividend was eight cents per share. Rebecca Buckman, *Microsoft, Awash in Cash, Declares Its First Dividend*, WALL ST. J., Jan. 17, 2003, at 1.
58. Gary Rivlin, *Microsoft to Pay Special Dividend to Stockholders*, N.Y. TIMES, July 21, 2004, at A1.
59. Gray, *supra* note 51 (quoting Robert J. Glickman, CEO of Corus Bankshares, Inc.).

ing whether to initiate a dividend, "what helped was the Bush reduction in dividend taxes."[60]

Empirical studies appear to back up this anecdotal evidence. Several studies of the period after the 2003 dividend tax cut have suggested a meaningful relationship between the dividend tax cut and the rise in dividend payouts.[61] Jennifer Blouin, Jana Smith Raedy, and Douglas Shackelford compared dividend payouts in the first two quarters following the passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 with a similar period the preceding year and found a "statistically significant increase in both regular and special dividends."[62] Similarly, in a time series analysis of dividend payouts between 1980 and the first quarter of 2004, Raj Chetty and Emmanuel Saez found that "dividend initiations surged in the quarters following enactment of the reform."[63] According to Chetty and Saez, "these results suggest that the dividend response was caused by the tax cut."[64]

C. Critiquing the Connection

While the evidence connecting the rise in the dividends to the dividend tax cut is strong, it is not conclusive. Some companies, for instance, have denied that their dividend was based on the tax cut. Microsoft explained that "[t]he resolution of a significant portion of the U.S. and state antitrust matters reduced some of the uncertainty" that had prompted them to refrain from depleting their surplus with dividends.[65] According to one report, "Microsoft said its dividend decision wasn't influenced by President Bush's tax plan, though the company said in a statement that it welcomes 'the general effort by the administration and Congress to stimulate the economy.'"[66] Similarly, Costco's chief financial officer dismissed claims that its decision to start paying a dividend in 2003 was because of the tax cut. "I don't think it had much to do with changes in tax law," he said. "That was more an afterthought."[67]

Survey data suggests that this dismissive attitude toward shareholder-level tax consequences is widely held by managers.[68] One survey of 384 financial executives found that "taxes are a second-order payout

60. Weisman, *supra* note 10 (quoting Maria Quillard, senior director of investor relations at Xilinx, Inc.).

61. *See supra* note 14; *see also* C. Bryan Cloyd et al., Does Ownership Structure Affect Corporations' Responses to Lower Dividend Tax Rates? An Analysis of Public and Private Banks 4–5 (May 25, 2005) (unpublished paper, on file with author) (concluding that privately held bank-holding corporations and the largest public bank-holding corporations increased their dividends in response to the dividend tax cut).

62. Blouin et al., *supra* note 14, at 6.

63. Chetty & Saez, *supra* note 14, at 793.

64. *Id*.

65. Joseph Menn, *Many Factors Behind Microsoft's Dividend*, L.A. TIMES, Jan. 24, 2003, at C1.

66. Buckman, *supra* note 57.

67. Weisman, *supra* note 10.

68. Alon Brav et al., *Payout Policy in the 21st Century*, 77 J. FIN. ECON. 483, 484 (2005).

policy concern. Most say that tax considerations are not a dominant factor in their decision about whether to pay dividends, to increase dividends, or in their choice between payout in the form of repurchases or dividends."[69] According to the study's authors, the same result was found in a survey conducted after the dividend tax cut: "A follow-up survey conducted in June 2003, after tax legislation passed that reduced dividend taxation, reinforces the second-order importance of taxation. More than two-thirds of the executives in that survey say that the dividend tax reduction would definitely not or probably not affect their decisions."[70]

Further evidence of the disconnect between the tax cut and the rise in dividends is that dividends began to rise as long as two to three years prior to enactment of the cut. Brandon Julio and David Ikenberry systematically analyzed dividend trends in the years before and after the dividend tax cut was enacted.[71] They concluded that the shift in dividend payout policies preceded the dividend tax cut, with dividend-paying firms generally beginning to increase their payout rates at least two years earlier, and, in the case of large-cap firms, at least three years prior to the tax cut.[72] Even when firms started paying dividends in 2003, it is not clear that their prime motivation was the tax cut. Microsoft, the poster child for new dividend payers, declared its first regular quarterly dividend in January of 2003, which was soon after President Bush announced his proposal to eliminate the dividend tax, but long before its eventual passage in watered-down form four months later. Given the reluctance of companies to stop paying or to reduce a regular dividend once it has started,[73] as well as the uncertainty that President Bush's proposal would be adopted in any form,[74] it is unlikely that Microsoft or any other firm making a dividend announcement in early 2003 was substantially influenced by the actual prospect of a dividend tax cut as opposed to the public relations benefit from the timing of its announcement.[75]

Even though dividends may have been reemerging prior to 2003, they were still low in relative terms. This may have caused studies to

69. *Id*.

70. *Id*.

71. Brandon Julio & David L. Ikenberry, *Reappearing Dividends*, 16 J. APP. CORP. FIN. 89, 96 (2004).

72. *Id*. at 94.

73. The foundation for this near-truism is a study of financial executives done a half century ago. John Lintner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97, 99 (1956).

74. *See* Alan J. Auerbach & Kevin A. Hassett, *The 2003 Dividend Tax Cuts and the Value of the Firm: An Event Study* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 11449, 2005), *available at* http://www.nber.org/papers/n11449 ("The political debate over the dividend tax reductions of 2003 took a number of surprising twists and turns. The original proposal put forward by President Bush was eventually dropped, and replaced with a simpler version. There were times when the dividend tax reduction seemed almost dead, only to be revived by clever legislative gamesmanship.").

75. *See, e.g.*, Buckman, *supra* note 57 ("A spokesman for Oracle Corp . . . said the biggest factor affecting any dividend decision would be whether President Bush's tax proposal is actually approved.").

overstate the extent of the rise in dividends after the tax cut. Put differently, the percent increases in dividends in the last two years are exaggerated by comparison to the low dividends in the previous two years. James Poterba illustrates this point by referencing the net dividend increase percentage, or the number of firms increasing dividends less the number decreasing dividends.[76] In 2003, the net dividend increase percentage was 38.7%, compared with 29.8% in 2002 and 30.2% in 2001.[77] This appears to be a significant increase, except that as Poterba explains, the net dividend increase percentage was 39.4% in 2000 and 43% in 1999.[78] Given that the latter two years were years in which the dividend tax treatment was unchanged, it may be that some other factors were at work.

It is also not clear that the increase in dividends represents an increase in overall payouts, as opposed to a mere reshuffling of money between share repurchases and dividends. In a study conducted by Gene Amromin, Paul Harrison, Nellie Liang, and Steve Sharpe, the authors found that among S&P 1500 firms that initiated a dividend in 2003, 68% had repurchased shares the previous year and 78% of those firms reduced their repurchases in 2003 after initiating a dividend.[79] While two-thirds of the firms who initiated a dividend actually increased total payout in 2003, this was relatively weak compared to the 89% of firms that both initiated and increased total payout during the years between 1993 and 2002.[80] For firms that increased their dividends in 2003, less than half actually increased their total payout as a result of the increase in dividends.[81] The implication is that the dividends crowded out share repurchases.

Finally, the empirical studies connecting the tax cut and the rise in dividends are themselves not unequivocal. In one of the studies, Blouin, Raedy, and Shackelford noted that

> we are hesitant to conclude that tax rates caused dividends to increase. We are particularly cautious because the economy improved during the same period that the legislation took effect and the business press was regularly reporting that the market was looking to dividends, rather than earnings, to assess firm quality.[82]

In another study, Chetty and Saez conceded that their study might not prove the causal link between the tax cut and the rise in dividends, noting that "major accounting fraud scandals in 2000–2002 might have created

76. James Poterba, *Taxation and Corporate Payout Policy*, 94 AM. ECON. REV. 171, 174 (2004).
77. *Id*.
78. *Id*.
79. Gene Amromin et al., *How Did the 2003 Dividend Tax Cut Affect Stock Prices and Corporate Payout Policy?* 12 (Fed. Reserve Bd., Working Paper No. 2005-57, 2005), *available at* http://ssrn.com/abstract=873879.
80. *Id*.
81. *Id*.
82. Blouin et al., *supra* note 14, at 4–5.

distrust among shareholders and increased the demand for dividends."[83] Both papers also acknowledge other studies' concessions, suggesting that the matter is far from settled.[84]

D. Non–Tax Cut Explanations

The equivocal nature of the empirical studies done to date may reveal a fundamental weakness in the connection between the dividend tax cut and any change in dividend activity during the post-cut period. There are a variety of factors that appear to suggest alternative explanations for the rise in dividends. While none of these other possible explanations by itself eliminates the link between the tax cut and the rise in dividends, in the aggregate they should give pause to those who have concluded that the recent increase in dividend payouts is prima facie evidence in support of making the dividend tax cut permanent.

1. Maturity Hypothesis

One possible explanation for the rise in dividends is that many of the previous nonpayers—heavily dominated by the technology sector—started entering a more mature period of growth. This "maturity hypothesis," as it has been dubbed, posits that the survivors in a competitive market like the high-technology industry will mature and develop a combination of stabilized cash flows and declining investment opportunities, both of which are conducive to dividend initiations.[85] Brandon Julio and David Ikenberry found that while the tax cut did seem to be associated with a rise in dividend initiations, other factors such as the maturity hypothesis appear to be at work as well.[86]

Anecdotally, the profiles of new dividend payers seem to support this maturity hypothesis. Microsoft, the poster child for new dividend payers, was entering a new phase of its lifecycle as it transitioned from a growth company to a growth and investment company. A similar story could be told about some of the other new dividend payers and dividend

83. Chetty & Saez, *supra* note 14, at 793–94.

84. *See* Blouin et al., *supra* note 14, at 3; Chetty & Saez, *supra* note 14, at 794–95.

85. *See* Gustavo Grullon et al., *Are Dividend Changes a Sign of Firm Maturity?*, 75 J. BUS. 387, 389–90 (2002) ("As firms become more mature, their investment opportunity set becomes smaller. . . . The declining reinvestment rate, in turn, gives rise to excess cash, which should be ultimately paid out."); Julio & Ikenberry, *supra* note 71, at 91. This is certainly consistent with the anecdotal evidence. *See, e.g.*, Jonathan Fuerbringer, *Companies With Cash Hoards Don't Necessarily Pay It Out*, N.Y. TIMES, July 22, 2004, at 7 ("William E. Rhodes, chief investment strategist at Rhodes Analytics in Boston, said: 'Dividends are going up in general because dividends are historically very low. You have a lot of companies that have grown up and are ready to pay dividends.'").

86. Julio & Ikenberry, *supra* note 71, at 96; *see* Laarni T. Bulan et al., *On the Timing of Dividend Initiations* 3 (Harvard Bus. Sch. Negotiation, Orgs. & Mkts. Unit, Research Paper, forthcoming) (finding that "life cycle factors are fundamental to the initiation decisions, i.e., firms that initiate dividends are mature firms," but that "market sentiment plays a significant role in the initiation decision" as well).

raisers, such as Qualcomm, Clear Channel, and Intel. In fact, one of the criticisms of the Julio and Ikenberry study's conclusions about when dividends began to rise—that the reversal in dividend trends in 2000 reflects the de-listing of some of the immature technology companies[87]—further supports this notion that the remaining S&P 500 companies are more in the traditional income mold than the upstart growth-only mold of the previous decade.

2. *Rise in Cash Holdings*

A second possible explanation for the rise in dividends may be the explosion in cash holdings following a period of renewed economic growth and perhaps a declining appetite for debt or excessive risk. According to Commerce Department data, pretax profit among U.S. companies more than doubled between 2001 and 2005.[88] As a result, cash and short-term investments skyrocketed in recent years.[89] Excluding financial services business,[90] at the end of 1999, S&P 500 firms retained $260 billion.[91] By the same time in 2003, that number had almost doubled to just under $500 billion and it increased again to $594 billion by year-end 2004.[92] Through the first nine months of 2005, the cash holdings jumped even further to over $650 billion,[93] more than a 50% increase in the last several years.[94] Companies such as Exxon and Microsoft were each holding more than $34–36 billion in cash.[95] When you expand the base to include the top 1500 S&P firms, the amount accumulated in cash and cash equivalents is approximately $900 billion.[96] In percentage terms, cash on hand rose to close to 10% for nonfinancial companies, which is far above the historical average of 6%.[97] Approximately one-

87. *See* Chetty & Saez, *supra* note 14, at 795 (contending that the reversal in dividend trends in 2000 is due to the change in the composition of the firms in the sample because of the de-listing of immature technology firms after the stock market crash). This is consistent with the notion that the maturation process is long and gradual and therefore unlikely to be hastened on a firm-level by a single event or change in economic environment. Grullon et al., *supra* note 85, at 390.

88. Art Pine & Simon Kennedy, *Exxon, Dell, Pfizer, Under Pressure to Spend, May Spur Economy*, BLOOMBERG.COM NEWS, Aug. 22, 2005, http://www.bloomberg.com/apps/news?pid=10000087&sid=a.KGVvOnbnTA&refer=t.

89. Fuerbringer, *supra* note 85 (quoting Howard Silverblatt, equity market analyst at Standard & Poor's); Justin Lahart, *Cash-Rich Firms Urged to Spend*, WALL ST. J., Nov. 21, 2005, at C1 (citing Howard Silverblatt, equity market analyst at Standard & Poor's).

90. Financial companies are excluded because they are required to maintain sizable reserves already.

91. Fuerbringer, *supra* note 85.

92. *Id*.; Opdyke, *supra* note 4.

93. Gregory Zuckerman, *Big Shareholders are Shouting Ever Louder*, WALL ST. J., Nov. 23, 2005, at C3.

94. Gregory Zuckerman, *Cash-Rich Firms Feel Pressure to Spend*, WALL ST. J., July 11, 2005, at C1.

95. McDonald, *supra* note 48.

96. Justin Lahart, *Crammed Coffers*, WALL ST. J., Aug. 19, 2005, at C1.

97. Fuerbringer, *supra* note 85 (citing Vadim Zlotnikov, chief investment strategist at Sanford C. Bernstein & Company). One caveat to these numbers is that many firms classify as "cash" invest-

third of all S&P nonfinancial companies have more cash on hand than debt, up from 17% in 2000.[98]

From an economist's perspective, this accumulation of free cash flow, combined with a lack of a clear plan on how firms plan to spend it, should prompt firms to distribute the residual cash as dividends.[99] To the extent that it does not, there may be an agency problem, prompting shareholder activists to pressure corporate managers to spend the cash on, among other things, higher dividends.[100] Thus, some hedge funds have teamed with traditional money managers to demand that cash-rich firms return some of that cash to shareholders.[101] Even in the absence of such pressure, though, the mere absence of suitable alternative investments may prompt firms to increase their dividend payments. While this could send the negative signal that firms have "nothing to do with their money," it may also reflect that they are taking a pause after the bursting of the dot-com bubble and the subsequent revelations of corporate scandals.[102]

There is some empirical data to support the intuition that the rise in cash holdings may be at least partially responsible for the rise in dividend payments. Gustavo Grullon, Roni Michaely, and Bhaskaran Swaminathan examined the capital expenditures and cash holdings of firms that changed their dividend rate between 1967 and 1993.[103] They found that firms that increase their dividend payments experience a significant drop in capital expenditures and levels of cash holdings over the succeeding three years.[104] Conversely, firms that decreased their dividend payments started to increase their capital expenditures and enjoyed a significant rise in cash holdings.[105] The authors concluded that "these results are consistent with the idea that dividend-increasing firms have less investment needs and hence more free cash flows. Consequently, dividend-increasing firms pay out dividends to reduce their excess cash and to reduce overinvestment."[106]

ments that are not property considered cash-equivalents because they are neither "short-term" nor highly liquid. *See* Steven D. Jones, *Firms Ponder What Constitutes Cash*, WALL ST. J., July 27, 2006, at C3.

98. Zuckerman, *supra* note 93; Zuckerman, *supra* note 94.

99. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. PAPERS & PROC. 323, 323 (1986); Morck & Yeung, *supra* note 31, at 170.

100. *See* Morck & Young, *supra* note 31, at 171–72.

101. Zuckerman, *supra* note 94; Lahart, *supra* note 89.

102. Lahart, *supra* note 89.

103. Grullon et al., *supra* note 85, at 414.

104. *Id*.

105. *Id*.

106. *Id*. at 414, 417.

3. *Change in the Composition of Investors*

As nearly every commentator mentions, the dividend tax cut reduced the shareholder-level tax on dividends to 15%,[107] but this does not mean that the tax cut benefited all shareholders equally. The effect of the dividend tax cut depends on each shareholder's relative after-tax preference for dividends versus capital gains, which can be expressed as the shareholder's tax preference ratio.[108] In calculating a shareholder's tax preference, a ratio of 1.00 would indicate that the taxpayer was indifferent between receiving a dollar in dividends or a dollar in capital gains. A ratio greater than 1.00 would indicate a preference for receiving a dollar in dividends, and a ratio less than 1.00 would indicate a preference for receiving a dollar of capital gains.

The dividend tax cut had the greatest effect on the tax preference ratio for individual shareholders. According to James Poterba, the weighted average individual or household investor tax preference ratio increased from 0.711 in 2002 to 0.845 in 2003 upon the enactment of the dividend tax cut.[109] This increase meant that although individuals still preferred a dollar of capital gains over a dollar of dividends, that preference was substantially reduced. In fact, the only time the individual tax preference ratio for dividends was higher was in 1929 and 1930, when the ratio was 0.902 and 0.912, respectively, due in large part to the significantly reduced average marginal tax rate resulting from the Depression.[110]

While the tax preference ratio suggested that the dividend tax cut resulted in an increased preference for dividends among the average individual taxpayer, or at least a reduced aversion to them, this only tells part of the story. Individual stock ownership has been declining for years, from the late 1960s when it accounted for over 80% of all corporate equity, to today when it accounts for at most only 57% of all equity.[111] Even this figure may be inflated, however, because it includes stock owned by individuals through mutual funds.[112] While individuals

107. *See, e.g.*, Norris, *Cash Flow, supra* note 5; Karen Talley, *S&P 500 Companies are Poised to Pay Record-Level Dividends*, WALL ST. J., May 19, 2004, at C3; Weisman, *supra* note 10.

108. Under the United States' classical corporate tax system, the preference for a dollar of dividends versus a dollar of capital gains is expressed using the following parameter: $(1-m)/(1-z)$, where m is the marginal tax rate on dividends and z is the capital gains rate. *See* Steven A. Bank, Brian R. Cheffins, & Marc Goergen, *Dividends and Politics* 55 (European Corp. Governance Inst., Working Paper No. 24/2004, 2004), *available at* http://www.utexas.edu/law/news/colloquium/papers/cheffinspaper.pdf.

109. James Poterba, *Data Appendix for "Taxation and Corporate Payout Policy"* tbl.A.4 (May 2004), http://econ-www.mit.edu/faculty/download_pdf.php?id=930 [hereinafter Poterba, *Data Appendix*]. This measures both the marginal federal tax rate and an estimate of the state marginal tax rate. Poterba, *supra* note 76, at 172. It also assumes that the effective capital gains rate is 0.25 times the statutory rate due to the ability to defer capital gains or eliminate them altogether by holding until death and allowing heirs to take a stepped-up basis. *Id.* at 173.

110. Poterba, *Data Appendix*, *supra* note 109, tbl.A.4.

111. Poterba, *supra* note 76, at 171.

112. *See id*.

are still subject to tax as a result of stock held in mutual funds, it is not clear that mutual fund managers are influenced by investor tax preferences in developing the composition of their funds.[113] If stock owned indirectly by individuals via mutual funds is excluded, then individual ownership drops from 57% to 44%.[114]

The remainder of corporate stock is owned by a combination of corporations and institutional investors, including pension funds and nonprofit organizations such as universities and hospitals. These groups generally receive more dividends than all other investors combined.[115] For corporations, the tax preference ratio remained largely unchanged between 2002 and 2003.[116] This is because the dividend tax cut applied only to individuals, and it did not affect the fact that corporations are entitled to exclude from income some or all of the dividend income received, and they are not eligible for a capital gains preference. For tax-exempt organizations, the tax preference ratio is 1.00 because both pension funds and nonprofits are tax-exempt and therefore subject to zero rate taxes on both dividends and capital gains.[117] As one bank investment officer observed, part of the reason dividend paying stocks have not suddenly become popular is that "the Bush tax cut applied to individuals, but not to pension funds or foundations, which represent a huge part of the investment community and tend to be more active investors than individuals. Such institutional investors never paid dividend taxes and are no more interested in dividends than they were before."[118]

Even for individuals, though, the average rate for all taxpayers may not adequately measure the true effect of the dividend tax cut on individuals who actually own stock. Poterba, for example, calculates his tax preference parameter using a 27.3% average household federal marginal income tax rate and a 5% average capital gains rate for 2002, and a 15% average household federal marginal income tax rate and a 4% capital

113. *Compare* Meg Richards, *Dividend-Paying Stocks Come Back into Fashion*, WASH. POST, Feb. 6, 2005, at F04 (describing the growth of mutual funds limited to dividend paying firms), *and* Michael Maiello, *Payout Payoff*, FORBES, Apr. 25, 2005, at 67 (noting that, according to one estimate, the 35% increase in equity income funds, which presumably emphasize dividend-paying firms although they are not restricted to them, can be attributed at least in part to the dividend tax cut), *with* E. S. Browning, *Dividend Stocks Haven't Caught Investors' Fancy*, WALL ST. J., Jan. 31, 2005, at C1 (suggesting that there has been little rush to purchase dividend-paying stocks: "Since the current bull market began in October 2002, investor treatment of dividend stocks has been about the same as it was in past bull markets.").

114. Poterba, *Data Appendix*, *supra* note 109, tbl.A.3, col. 3.

115. *See* Morck & Yeung, *supra* note 31, at 173 fig.2.

116. Poterba, *Data Appendix*, *supra* note 109, tbl.A.5.

117. Because pensions and other tax-exempt organizations are not taxed any differently on dividends than capital gains (both are not taxed), the tax rate on dividends divided by the tax rate on capital gains is one.

118. Browning, *supra* note 113 (citing Jack Ablin, chief investment officer at Harris Private Bank in Chicago); *see also* Robert D. Hershey, *They're Getting a Kick Out of Dividends' Growth*, N.Y. TIMES, July 10, 2005, at 28 ("[D]ividend-paying stocks generally seem not to have become noticeably more popular since income tax rates on them were cut just over two years ago. One reason may be that the cut applied only to individuals and not to pension funds or other institutional investors.").

gains rate for 2003.[119] This calculation assumes that the average tax rate for all taxpayers is the same as the average tax rate for all individual shareholders. However, some shareholders may be zero bracket taxpayers,[120] either because they have sufficient losses from other activities or because they are foreign residents not taxable in the United States.[121] For these shareholders, the dividend tax cut should have had no effect.

Notwithstanding the decline in the ownership and influence of individual stockholders, at least one group of individuals may have been significantly influenced by the dividend tax cut and were capable of doing something about it. This group consists of managers, who often hold large amounts of their own firm's stock and therefore stand to benefit significantly from the dividend tax cut. Some studies have concluded that firm dividend policies are driven in large part by the tax preferences of insiders, which in the past has meant a preference for stock repurchases over dividends.[122] In light of the 2003 Act's reduction of the gap between the tax treatment of dividends and repurchases, though, observers have suggested that managers may be swayed by their personal tax consequences rather than shareholder interest in setting dividend policy.[123] To avoid this connection, Bill Gates announced that he was giving his $3 billion share of Microsoft's record special dividend to his charitable foundation.[124]

On the other hand, the desire to distribute dividends among managers who own stock is counterbalanced by the disincentive to distribute dividends among managers who hold non-price-protected stock options instead of stock.[125] Jeffrey Brown, Nellie Liang, and Scott Weisbenner

119. Poterba, *Data Appendix*, *supra* note 109, tbl.A.4, cols. 1 & 6.

120. David Cay Johnston, *In 2002, More Wealthy People Paid No Tax*, N.Y. TIMES, July 3, 2005, *available at* http://www.nytimes.com/2005/07/03/business/03tax.html (reporting that the number of affluent individuals and couples who paid no tax increased in 2002 by 15%).

121. The value of U.S. corporate stock held by foreign investors has been rising. *See* U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2006, at 772 tbl.1187 (Equities, Corporate Bonds, and Municipal Securities—Holdings and Net Purchases by Type of Investor: 1990 to 2004), *available at* http://www.census.gov/compendia/statab/2006/banking_finance_insurance/banking.pdf; *id*. at 774 tbl.1192 (Foreign Holdings of U.S. Securities by Country: 2002 to 2004).

122. *See, e.g.*, Jim Hsieh & Qinghai Wang, Insiders' Tax Motivation and Corporate Payout Policy 2–3 (Oct. 1, 2004) (unpublished paper, on file with Financial Management Association International).

123. *See, e.g.*, Ken Brown, *As Taxes Fall, Dividends Rise—and Executives Reap Big Gains*, WALL ST. J., Aug. 11, 2003, at 1 ("The federal tax cut, which slashed the tax rate on dividends and prompted many companies to increase their payouts, is proving to be a boon for some corporate executives who are reaping millions in after-tax gains."); Joseph Weber, *A Dividend Windfall in the Corner Office*, BUS. WK., Apr. 5, 2004, at 53 ("Where execs and directors have big holdings, that means the same folks who voted in the hefty payouts will be among the largest beneficiaries.").

124. Norris, *Bonus*, *supra* note 5.

125. Price-protected stock options are those that have a mechanism for adjusting the strike or exercise price for the option downward when dividends are distributed. The intent is to reflect the fact that the option is now worth less because the company's stock value per share has declined by the amount of the dividend distributed. Employee stock options, however, are rarely price-protected in this fashion. Kevin Murphy, *Executive Compensation*, *in* 3B HANDBOOK OF LABOR ECONOMICS 2485 (Orly Ashenfelter & David Card eds., 1999). One possible explanation for this failure to offer price-protected options is the presence of the $1 million cap on the deductibility of executive compensation under section 162(m). I.R.C. § 162(m). The exception for performance-based compensation, which

studied 1350 of the largest publicly traded firms to determine whether managerial stock and option ownership had an effect on whether dividend payout decisions were influenced by the tax cut.[126] The authors found a significant difference between firms whose managers held only stock versus those whose managers held only options, concluding that a company whose managers held only stock were twenty percentage points more likely to raise dividends after the tax cut than a company with managers who held only stock options.[127] This was a striking result given that they found no difference between such firms in the pre–dividend tax cut years.[128]

Others have reached similar conclusions about the concentrated effect of the dividend tax cut. In their study of dividend policy after the 2003 dividend tax cut, Chetty and Saez found that dividend increases were concentrated in corporations with at least one of the following three elements present: (1) taxable executives with stock rather than unexercised stock options; (2) taxable institutional owners with large blocks of stock; or (3) taxable individuals with large blocks of stock and seats on the board of directors.[129] By contrast, Chetty and Saez found that in firms controlled by a "non-affected entity," which was defined to include institutional investors like pension funds, insurance companies, nonprofit organizations, and nonfinancial corporations, the dividend policy remained constant pre– and post–dividend tax cut.[130] Perhaps most importantly, they found that taxable individual stockholders who were not executives or directors had no effect on dividend policy.[131] Blouin, Raedy, and Shackelford confirm this result, concluding that "the mere presence of large number[s] of individual investors in the shareholder group was insufficient to alter dividend policy."[132]

In addition to the possible effects on dividend policy because of a company's preexisting executive compensation program, some have sug-

includes options, does not apply if there is protection against downside risk, such as in the case of a provision for the repricing of stock options. Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 306–07 (1995).

126. Jeffrey R. Brown et al., *Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut* 1–2 (Fed. Reserve Bd., Fin. and Econ. Discussion Series Working Paper No. 2006-14, 2006), *available at* http://www.federalreserve.gov/PUBS/FEDS/2006/200614pap.pdf. A more limited study of firms with ongoing dividend programs arrived at a similar conclusion. Jouahn Nam et al., The Impact of the Dividend Tax Cut and Managerial Stock Holdings on Firm Dividend Policy 4 (Jan. 15, 2004) (unpublished paper), *available at* http://ssrn.com/abstract=492802.

127. Brown et al., *supra* note 126, at 5.

128. *Id.* at 29.

129. Chetty & Saez, *supra* note 14, at 794. At least the first point was also confirmed in Nam et al., *supra* note 126, at 4.

130. Chetty & Saez, *supra* note 14, at 814–15.

131. *Id*. at 824. One study of the effect of the Tax Reform Act of 1986 found more broadly that large individual shareholders did have an effect on dividend policy, although this study did not explore whether this effect was based on actual board membership or other official insider status. Francisco Pérez-Gonzaléz, Large Shareholders and Dividends: Evidence from U.S. Tax Reforms 3 (Jan. 2003) (unpublished paper), *available at* http://www.columbia.edu/~fp2010/lgsh.pdf.

132. Blouin et al., *supra* note 14, at 4.

gested that the dividend tax cut may have actually induced changes in the design of executive compensation programs. David Aboody and Ron Kasznik analyzed the compensation of chief executive officers for 645 companies in the S&P 500, S&P 400 MidCap, and S&P 600 SmallCap indices over 2002 and 2003.[133] They found that an increase in the tax preference for dividends among individual shareholders, as occurred with the 2003 dividend tax cut, was associated with an increase in the use of restricted stock and a decrease in the use of stock options in executive compensation packages.[134] The authors attribute this association to the fact that restricted stock, which is stock that is limited by, for example, a vesting period or a restriction on sale, is dividend-protected in the sense that its value is not limited by dividends, whereas stock options lose their value to the extent that the strike price is not adjusted downward to reflect the reduction of profits in firm coffers.[135]

This conclusion, however, may not adequately take into account a corporate governance-motivated explanation for the rise of restricted stock in executive compensation. For example, Aboody and Kasznik acknowledge that the switch to restricted stock may have reflected the decision of many firms to expense stock options in the wake of the Enron and WorldCom scandals.[136] This decision was part of an overall campaign to discourage the use of options on corporate governance grounds. The knock against options was that they encouraged a short-term focus.[137] Restricted stock, once criticized as "pay for breathing" because it rewarded job retention and not performance,[138] does not incentivize executives to engage in short-term manipulation of the stock price.[139] It therefore does not encourage executives to engage in overly risky investments in an attempt to resuscitate options that are under water.[140] Consequently, even before the dividend tax cut was enacted, shareholder activists started pushing companies to shift from stock options to restricted stock.[141] Moreover, since 2003, the rise in the use of restricted

133. David Aboody & Ron Kasznik, Executive Stock-Based Compensation and Firms' Cash Payout: The Role of Shareholders' Tax-Related Payout Preferences 9–11 (Oct. 2005) (unpublished paper), *available at* http://www.hbs.edu/unit/um/pdf/Aboody_KASZNIK_October.2005.pdf.

134. *Id*. at 20.

135. *Id*. at 25.

136. *Id*. at 4.

137. *See, e.g.*, Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, J. ECON. PERSP., Summer 2003, at 49, 49 (noting that "employee stock options have become increasingly controversial"); Robert A. G. Monks, *Equity Culture at Risk: The Threat to Anglo-American Prosperity*, 11 CORP. GOVERNANCE 164, 165 (2003) (characterizing the "option machine" as "the clearest possible indicator of governance failure").

138. David Milstead, *Bonanza Continues Despite Changes*, ROCKY MOUNTAIN NEWS, May 7, 2005, *available at* http://www.rockymountainnews.com/drmn/business/article/0,1299,DRMN_4_3754394,00.html.

139. Hall & Murphy, *supra* note 137, at 60.

140. *Id*.

141. Kris Frieswick, *Better Options*, CFO MAG., May 1, 2003, at 44.

stock may have been spurred in part by the Financial Accounting Standards Board's decision to require the expensing of options.[142]

III. DIVIDEND TAX CUTS AND DIVIDEND POLICY IN THE LONG RUN

Even if the short-term rise in dividends was partly or primarily a product of the dividend tax cut, it is not entirely clear that making the dividend tax permanent will have the same consequences over the long run. It essentially depends upon the resolution of a thirty-year-old debate in finance theory over the effect of taxes on corporate payout decisions. The "puzzle" is why corporations pay dividends at all when they are taxed twice under the classical system employed in the United States.[143] Two views have attained prominence: (1) the traditional view, which is that taxes influence dividend policy, but do not eliminate dividends because of the nontax benefits; and (2) the new view, also sometimes more descriptively called the "tax capitalization" or "trapped equity" view,[144] which is that there is generally no such effect from a permanent change in tax rate.

A. Traditional View

The traditional view is that because the marginal source of funds for corporations is from the public market rather than from retained earnings, firms need to pay dividends despite the tax costs in order to continue to attract investment.[145] This is explained by the fact that dividends have unique benefits to investors. One such benefit is the dividend's ability to signal profitability to both current and potential shareholders.[146] This is considered particularly valuable post-Enron when the quality of reported earnings has been under attack,[147] but it has long been considered one of the primary functions of the dividend.[148] By definition, dis-

142. *See* Michael S. Knoll, *Restricted Stock and the Section 83(b) Election: A Joint Tax Perspective* 2 & n.2 (Univ. of Pa. Law Sch. Inst. for Law and Econ., Research Paper No. 05-26, 2005).

143. *See generally* Fischer Black, *The Dividend Puzzle*, 2 J. PORTFOLIO MGMT. 5 (1976); Terry A. Marsh & Robert C. Merton, *Dividend Behavior for the Aggregate Stock Market*, 60 J. BUS. 1, 1–2 (1987).

144. There is a third view, the "tax irrelevance" view, based on the ability to offset any negative tax consequences through arbitrage. This view appears to have fallen out of favor. *See* Auerbach & Hassett, *supra* note 16, at 216; Merton Miller & Myron Scholes, *Dividends and Taxes*, 6 J. FIN. ECON. 333, 344 (1978).

145. AM. LAW INST., FEDERAL INCOME TAX PROJECT—INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION 36–37 (1993) [hereinafter ALI REPORT]. As a result of the need to increase dividends when taxes rise in order to continue to attract investors, a corporation's cost of capital increases under the traditional view. This potentially impacts a firm's investment. *Id*.

146. B. Douglas Bernheim & Adam Wantz, *A Tax-Based Test of the Dividend Signaling Hypothesis*, 85 AM. ECON. REV. 532, 532–33 (1995).

147. Siegel, *supra* note 2.

148. Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 471–72 (2003).

tributing a dividend indicates the presence of current or accumulated earnings and profits.[149] Beyond that, however, a special dividend can also be used to inform shareholders about some significant event that differentiates the firm from its competitors, and an increase in a firm's regular dividend can signal some permanent increase in profitability.

A second benefit of paying dividends is the ability to constrain managerial discretion. Corporations are often thought to be plagued by agency costs as a result of the separation of ownership and control. Managers are self-interested agents, and therefore do not always act in the best interests of their principal, the shareholders.[150] In this agency relationship, shareholders must monitor managerial behavior to guard against self-serving behavior.[151] The argument in favor of dividends is that manager-shareholder interests will become better aligned by reducing the cash managers could use to engage in self-serving projects.[152] Instead, managers will be forced to seek funding for such projects in the capital markets where they will be subject to the discipline of outside monitoring.[153]

Under the traditional view, the assumption is that firms pay dividends until the tax cost on the last dollar of dividends paid exactly equals the nontax benefit from that last dollar of dividends.[154] Lowering dividends by one dollar has tax benefits, but they must be offset by the reduction in informational content to investors or the increase in potential agency costs from the one dollar of retained earnings. Of course, the tax benefits or costs from reducing dividends are not solely a function of the tax on dividends. Retained earnings increase the value of the firm's stock and thus increase the capital gains tax on a potential sale. Therefore, the traditional view would predict that when the tax burden on dividends relative to capital gains decreases, dividends should increase.[155]

The dividend tax cut was enacted in 2003 under the assumption that the traditional view is correct. By lowering the tax cost of dividends to equal the tax cost of sales of stock, firms could once again turn to dividends in order to signal quality earnings and restrain managerial discretion. Making the dividend tax cut permanent therefore would permit this free flow of dividends to continue.

149. DEL. CODE ANN. tit. 8, § 170 (2001); I.R.C. § 316.

150. *See generally* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

151. *See, e.g.*, Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11, 21–22 (1985).

152. Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (1984).

153. Jensen, *supra* note 99, at 323.

154. R. Glenn Hubbard, *Corporate Tax Integration: A View From the Treasury Department*, 7 J. ECON. PERSP. 115, 120 (1993).

155. *Id*.

There are a variety of objections to the traditional view. One criticism is that it assumes firms pay a fairly high cost—in the form of dividend payments—to achieve the signaling of corporate governance benefits.[156] For example, managers could signal profitability and optimism, without incurring the tax cost of dividends, by engaging in share repurchases.[157] Up until the 2003 dividend tax cut, share repurchases were taxed much more favorably than dividends because they were treated as exchanges giving rise to capital gain treatment. A possible explanation is that dividends provide a better signal precisely because they are more costly from a tax perspective. In this sense, the dividend has more "bang for the buck" than a share repurchase.[158]

Similarly, boards could better monitor managers rather than forcing them to disgorge free cash flow in order to limit their ability to operate inefficiently.[159] Even if this was implausible, either because boards are ineffective or because they are essentially controlled by management, share repurchases could accomplish the same ends by removing cash from managerial control. One possible advantage to regular dividends is that they precommit managers,[160] whereas share repurchases are not necessarily recurring events. With the advent of standing share repurchase programs, though, it is not clear that this is an inherent dividing line between dividends and share repurchases. In any event, debt might provide an even better check on corporate management than dividends because of the various operating covenants in the debt instruments and because of the presence of active creditor oversight.[161]

A more fundamental criticism of the old view is that it presumes firms rely on new share issuances as the marginal source of obtaining funds.[162] This is the key assumption underlying the need to satisfy shareholder demand for dividends. In reality, however, much if not most capital investment by corporations is funded by retained earnings or debt rather than by going back to the public market for new equity.[163] Thus, it is perhaps reasonable to question whether new share issuances would constitute the marginal source of finance.

156. George R. Zodrow, *On the "Traditional" and "New" Views of Dividend Taxation*, 44 NAT'L TAX J. 497, 503 (1991).

157. Franklin Allen & Roni Michaely, *Payout Policy*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 339, 378 (George M. Constantinides, Milton Harris, & René M. Stulz eds., 2003).

158. B. Douglas Bernheim, *Tax Policy and the Dividend Puzzle*, 22 RAND J. ECON. 455, 468 (1991); *see* ALI REPORT, *supra* note 145, at 40; *cf.* Bernheim & Wantz, *supra* note 146, at 533 (noting that dividends have more bang for the buck as a signal when dividend taxes increase).

159. Allen & Michaely, *supra* note 157, at 384.

160. *Id.* at 384–85.

161. *See* Jensen, *supra* note 99, at 324 (discussing why debt may be an effective substitute for dividends for the purpose of decreasing corporate managerial discretion).

162. Hans-Werner Sinn, *Taxation and the Cost of Capital: The "Old" View, the "New" View, and Another View* 5 (Nat'l Bureau of Econ. Research, Working Paper No. 3501, 1990).

163. *Id.* at 5–6.

B. New View

Under the new view, retained earnings rather than new equity issues constitute the marginal source of funds.[164] Dividends are residual payments from this perspective, used as the principal method of distributing cash after exhausting all other productive investment opportunities, and therefore are paid independently of any shareholder-level tax consequences.[165] The assumption is that all profits of the firm eventually will be distributed to the shareholders and be subject to a second layer of tax, even if that distribution does not take place until liquidation.[166] In this sense, equity is "trapped" in the firm because of the dividend tax, which causes the firm's share price to drop when first instituted. After this lump-sum tax on equity is imposed, however, share prices become competitive with investments in noncorporate entities. In effect, the cost of dividend taxation has already been capitalized in the share price.[167]

The implication of the new view is that a dividend tax cut would be a one-time windfall to existing investors because of the rise in share prices,[168] but it would not affect dividend policy.[169] Currently, the tax benefit from deferring a present dividend exactly offsets the tax burden from receiving a future dividend consisting of the original dividend amount plus any earnings on that amount while retained by the corporation.[170] Conversely, the cost of a current dividend distribution is exactly offset by the benefit from avoiding future liability if the current dividend amount were retained and distributed along with the earnings on that amount at a later time.[171] Thus, if the dividend tax rate is permanently changed, it will be changed in both periods. Because of this assumption of symmetry under the new view, there should be no effect on dividend payouts from a change in investor-level tax rates.

This logic is supported by the following example illustrated in table A.[172] Assume a corporation has $100 in posttax earnings in Year 1 when the corporate and shareholder tax rates for both dividends and ordinary

164. Auerbach & Hassett, *supra* note 16, at 206; Hubbard, *supra* note 154, at 120.

165. Kenneth J. McKenzie & Aileen J. Thompson, *The Economic Effects of Dividend Taxation* 8 (Technical Comm. on Bus. Taxation, Can. Dep't of Fin., Working Paper No. 96-7, 1996).

166. *See id.* at 9–10.

167. Geraldine Gerardi et al., *Corporate Integration Puzzles*, 43 NAT'L TAX J. 307, 311 (1990); Trevor S. Harris et al., *The Share Price Effects of Dividend Taxes and Tax Imputation Credits*, 79 J. PUB. ECON. 569 *passim* (2001).

168. This was one argument raised during the corporate tax reform discussions of the early 1990s in favor of limiting the integration of the corporate and shareholder income taxes to new equity. Daniel Halperin, *Will Integration Increase Efficiency? The Old and New View of Dividend Policy*, 47 TAX L. REV. 645, 648 (1992).

169. McKenzie & Thompson, *supra* note 165, at 10. *Bee see* Sinn, *supra* note 162, at 12.

170. Alvin C. Warren, Jr., *The Timing of Taxes*, 39 NAT'L TAX J. 499, 501 (1986).

171. *Id.* Expressed algebraically, a current dividend of amount A would yield $(1 - t) * A$, at tax rate t. This amount would compound to $(1 - t) * A * (1 + r)^y$ in y years. Similarly, if the corporation retains amount A, it would compound after y years to $A * (1 + r)^y$, which when distributed would leave shareholders with $(1 - t) * A * (1 + r)^y$. *See id*.

172. This example is derived from ALI REPORT, *supra* note 145, at 29 (example 2).

income are 30% and the pretax rate of return inside and outside of the corporation is 10%. Assume also that these rates will remain stable throughout the period. The corporation can either retain the earnings for investment, the principal and earnings of which would be distributed as a dividend sometime in the future, or it can distribute them currently. If it chooses the former option and invests the $100 for ten years, it will have $197 to distribute to shareholders in Year 10.[173] After paying the second layer of tax on the dividend, shareholders would end up with a net amount of $138.[174] Alternatively, if the corporation chooses the later option and distributes an immediate dividend of the $100 in Year 1, the shareholder would receive only $70 after the shareholder-level tax. Invested at the 10% rate of return for ten years, though, the shareholder will once again end up with an after-tax net amount of $138 in Year 10.[175]

TABLE A
RETAIN/DISTRIBUTE CALCULUS WITH A PERMANENT DIVIDEND TAX CUT

Action	Distribute (Year 1)	Amount Invested at 10% Rate of Return (Year 1)	Distribute (Year 10)	After-Tax Receipt (Year 10)
Distribute $100 in Year 1 (30% tax rate)	$100	$70	N/A	$138
Retain $100 and Distribute in Year 10 (30% tax rate)	N/A	$100	$197	$138

This result is different, however, if the dividend tax is cut only temporarily, as was true with the 2003 reform. Under the previous example, assume the dividend tax rate was expected to rise from 30% to 50% in Year 10, and all participants knew about this scheduled rise prior to making their decisions about what to do with the earnings in Year 1. If the $100 were distributed currently, the shareholder would receive $70, which it could invest for ten years and net $138. If, however, the corporation retained the $100, the result would be very different. The corporation's after-tax investment of $100 would still rise to $197 over the ten-

173. $\$100 * (1.07)^{10} = \$197$. The return of 1.07 is net of the 30% corporate tax.
174. $197 * .7 = $138.
175. $\$70 * (1.07)^{10} = \$138$.

year period, but the shareholder tax rate on the dividend would have risen to 50% in Year 10. Thus, as illustrated in table B, instead of ending up with the same net after-tax dividend of $138 as when a dividend was paid up front and the proceeds invested individually, a shareholder who received a dividend after the corporation invested the earnings for the ten-year period would receive only $98.50.[176]

TABLE B
RETAIN/DISTRIBUTE CALCULUS WITH A TEMPORARY DIVIDEND TAX CUT

Action	Distribute (Year 1)	Amount Invested (Year 1)	Distribute (Year 10)	After-Tax Receipt (Year 10)
Distribute $100 in Year 1 (30% rate)	$100	$70	N/A	$138
Retain $100 and Distribute in Year 10 (30% rate in Years 1–9 and 50% rate in Year 10)	N/A	$100	$197	$98.50

The deferral of shareholder tax liability therefore would no longer offset the future tax liability on the investment of the earnings in the case of a dividend tax cut with an expiration date.[177] This removal of the assumption of rate parity would suddenly make taxes relevant to the dividend decision under the new view. In this circumstance, it becomes beneficial to pay dividends now rather than wait and have them subject to the higher tax later. This is particularly true because corporate managers and their shareholders know at the time the dividend tax cut is announced that the current reduction in the dividend tax rates may not be matched by the same rate in any future period, absent future legislation to make the cut permanent.

Under the new view, therefore, the temporary nature of the dividend tax cut may account for the rise in dividends in the last two years.[178]

176. .5 * $197 = $98.50.

177. *Cf.* Auerbach & Hassett, *supra* note 16, at 216 ("[A] *temporary* increase in the dividend tax rate does raise the cost of paying dividends in this case, for it reduces the opportunity cost of funds more than the ultimate burden on the returns to investment."); Harris et al., *supra* note 167, at 569 n.1 (noting that while it is true that dividend policy would be unaffected by dividend taxes "for a constant dividend tax; unanticipated temporary changes in the dividend tax would affect payout decisions").

178. Mihir Desai & Austan Goolsbee, *Investment, Overhang, and Tax Policy* 308 & n.27 (Brookings Papers on Econ. Activity, 2:2004, 2004). On the other hand, Chetty and Saez suggest that the fact that the rise in dividends has been characterized more by increases in regular rather than special dividends—Microsoft's huge special dividend notwithstanding—may suggest that companies believe the

Making the dividend tax cut permanent, though, would only restore the equivalence between the tax benefit of current deferral and the tax cost of future distribution. Thus, any bump in dividend payouts as a result of the temporary dividend tax cut would also be temporary under the new view.

One of the principal criticisms of the new view is its assumption that corporate earnings eventually will be distributed to shareholders as a dividend. Specifically, the rise in share repurchases over the last two decades implies that there is an alternate, lower-tax route to paying dividends.[179] Share repurchases are taxed as exchanges giving rise to capital gains treatment on the amount in excess of the shareholder's basis or original cost, while up until 2003 dividends were taxed as ordinary income transactions for the full amount of the distribution.[180] Many commentators have suggested that the presence of share repurchases may call into question the basic principles of the new view.[181] The notion is that if earnings can be distributed to shareholders in a tax-advantaged, nondividend payment, then, contrary to the new view, dividends are not paid simply because firms have no other method of getting cash to shareholders.

While the share repurchase objection to the new view has intuitive appeal, it recently has been found to be lacking in several respects.[182] The primary flaw in the argument is that share repurchases are not an adequate substitute for dividends. First, unlike dividends, share repurchases cannot be done pro rata without being characterized by the Internal Revenue Service as "essentially equivalent to a dividend" and subjected to dividend treatment for tax purposes.[183] Second, share repurchases are used differently than dividends for nontax reasons. Several studies recently confirmed this, noting that share repurchases are not being used as substitutes for dividends, but rather as a supplement to dividends by firms wishing to pay special one-time amounts.[184] If divi-

cut will be permanent. Chetty & Saez, *supra* note 14, at 828. Of course, it also may indicate that the rise in dividends was unrelated to the tax cut.

179. Murali Jagannathan et al., *Financial Flexibility and the Choice Between Dividends and Stock Repurchases*, 57 J. FIN. ECON. 355, 356 (2000) ("One of the most significant trends in corporate finance during the 1990s is the increasing popularity of open market stock repurchase programs. Between 1985 and 1996, the number of open market repurchase program announcements by U.S. industrial firms has increased 650% from 115 to 755, and their announced value has increased 750% from $15.4 billion to $113 billion.").

180. *Compare* I.R.C. § 301, *with id.* § 302.

181. *See, e.g.*, Gerardi et al., *supra* note 167, at 311; Zodrow, *supra* note 156, at 501.

182. *See, e.g.*, Robert Carroll et al., *The Effect of Dividend Tax Relief on Investment Incentives*, 61 NAT'L TAX J. 629, 633 (2003) ("It is not clear, however, that the ability of firms to distribute via share repurchases invalidates the new view's implication that the dividend tax does not affect the cost of capital.").

183. Auerbach & Hassett, *supra* note 16, at 210. Under § 302(b)(1) of the Internal Revenue Code, a distribution that is "essentially equivalent to a dividend" will not be given exchange treatment as a redemption.

184. Eugene F. Fama & Kenneth R. French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3, 35–37 (2001); Wayne Guay & Jarrad Harford,

dends and share repurchases are not in practice being used interchangeably, and cannot be from a tax perspective, then this objection to the new view has less merit.

C. Which View Is More Accurate?

The traditional view suggests that making the dividend tax cuts permanent should keep dividends flowing, while the new view suggests that a permanent cut might not have the same effect as a temporary cut. In fact, under the new view the rise in dividends that occurred with a temporary dividend tax cut may cease if the tax cut is made permanent. Dividend payouts might even drop, as firms attempt to retain more earnings to rebuild cash holdings depleted by greater than normal dividend payments. The question, then, is which view more accurately describes actual firm dividend policy.

1. Changing Consensus

A decade or so ago, the consensus was that the traditional view had the upper hand,[185] based primarily on a study by James Poterba and Lawrence Summers that connected tax changes to dividend payout rates in the United Kingdom over a thirty-year period.[186] In fact, during President George Bush's administration in the early 1990s, the Treasury relied on the traditional view in recommending integration of the corporate and individual income taxes as a method of removing the bias against dividends.[187]

In recent years, the traditional view's hold on public finance theory appears to be weakening.[188] Alan Auerbach and Kevin Hassett reviewed

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The Cash-Flow Permanence and Information Content of Dividend Increases Versus Repurchases, 57 J. FIN. ECON. 385, 412–13 (2000); Jagannathan et al., *supra* note 179, at 382–83; *cf.* Harry DeAngelo et al., *Special Dividends and the Evolution of Dividend Signaling*, 57 J. FIN. ECON. 309, 344–45 (2000) (noting that repurchases did not replace special dividends and their surge is probably not attributable to changes in tax laws).

185. *See* ALI REPORT, *supra* note 145, at 37 ("A number of attempts have been made to identify the effects of changes in dividend taxes on corporate dividend policy, with the most common conclusion being that the data are more consistent with the traditional view than with the tax capitalization view."); Gerardi et al., *supra* note 167, at 312 ("[T]he current state of empirical knowledge gives the edge to the traditional—as opposed to the new—view of dividends . . . ."); Zodrow, *supra* note 156, at 507 ("Although the empirical evidence on this issue is somewhat mixed, most studies support the traditional view over the new view . . . .").

186. Poterba & Summers, *supra* note 18, at 227.

187. U.S. TREASURY DEP'T, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS—TAXING BUSINESS INCOME ONCE 109 (1992), *available at* http://www.ustreas.gov/offices/tax-policy/library/integration-paper/integration.pdf.

188. Indeed, George Zodrow recently announced at a conference on corporate taxation that the empirical evidence now appears to support the new view. George R. Zodrow, discussant, Session II, "The 2003 Dividend Tax Cuts and the Value of the Firm: An Event Study," at Taxing Corporate Income in the 21st Century, Stephen M. Ross School of Business, University of Michigan (May 5, 2005). Poterba and Summers' study of the United Kingdom has also been criticized, in part because their model is subject to measurement error and in part because the nature of the United Kingdom's tax

the arguments against the new view and found them "inconclusive, based either on unnecessarily restrictive representations of the new view or on questionable collateral assumptions."[189] In their own study of the effect of dividend tax policy on marginal incentives, they concluded that many firms "do vary their dividends in response to cash flow, investment, and debt," rather than in response to dividend taxation.[190] In another recent study, Mihir Desai and Austan Goolsbee examined the effect of dividend tax policy on marginal investment incentives.[191] This work addressed one of the key assumptions of the new view that dividends are residual payments made after all other investment alternatives are exhausted. If a change in dividend taxes affects investments, this would appear to dispute the residual payment argument. According to Desai and Goolsbee, however, "[o]ur results show that the dividend tax cut, despite its high revenue cost, had minimal, if any, impact on marginal investment incentives. The results strongly favor the 'new' view of dividend taxation in which such taxes are capitalized into share prices and do not affect marginal incentives."[192]

2. *Recent Empirical Evidence*

In addition to the studies cited above, a number of recent papers have attempted to test directly whether dividend taxes influence payout policy, based on U.S. and comparative data. The results have been mixed, although the weight of authority tends to support the new view.

a. United States

In a recent study based on U.S. data, Poterba found empirical support for the traditional view. Poterba examined the historical relationship between a shareholder's dividend tax preference and dividend payout rates in the United States between 1929 and 2003.[193] In his study, which was based on annual aggregate dividend payments from the National Income and Product Accounts for all entities required to file federal corporate tax returns,[194] Poterba found that "the relative tax burden on dividends and on capital gains affects the share of earnings that is dis-

system during the period under study undercuts its ability to serve as a test of the traditional view. *See* Harris et al., *supra* note 167, at 573 n.6; *see also* William M. Gentry & R. Glenn Hubbard, *Fundamental Tax Reform and Corporate Financial Policy*, *in* 12 TAX POLICY AND THE ECONOMY 191 (James M. Poterba ed., 1998).

189. Auerbach & Hassett, *supra* note 16, at 206.

190. *Id*. at 228.

191. Desai & Goolsbee, *supra* note 178, at 287.

192. *Id*. at 327.

193. Poterba, *supra* note 76, at 171–72. A shareholder's tax dividend tax preference is a function of the relative difference between the tax treatment of dividends and capital gains.

194. *Id*. at 173; Kenneth A. Petrick, *Comparing NIPA Profits with S&P 500 Profits*, SURV. CURRENT BUS., Apr. 2001, at 16, 17.

tributed as dividends."[195] Poterba also concluded, however, that "short-run changes" in the dividend tax preference should "have a small and statistically insignificantly [sic] effect on aggregate dividends."[196] The recent empirical evidence of a sharp increase in dividends following the dividend tax cut would appear to contradict this finding,[197] although Poterba suggests that "[i]t is difficult to draw strong conclusions from this time-series evidence."[198] Furthermore, Poterba's study relies on average marginal rates. As discussed above, many taxpayers are not affected at all by the 2003 dividend tax cut and they may be the most influential group of taxpayers.[199]

b. United Kingdom

One of the limitations of the empirical data regarding the effect of taxes on dividend policy in the United States has been the paucity of changes to the tax treatment of dividends over the last half-century.[200] The 2003 dividend tax cut is perhaps the only relevant change over that period. Other developments involved marginal rate changes that affected not only the taxation of dividends, but also the value of the interest deduction and other related factors.[201] Even under Poterba's estimation of the dividend tax parameter for individuals, the investor tax preference has never gone above 1.00, indicating that capital gains have always been preferable to dividends in America.[202]

By contrast to the United States, the United Kingdom has significantly changed its tax treatment of dividends many times since World War II through a variety of modifications of its taxation of companies. The individual investor tax preference ratio has ranged from a low of 0.04 in 1949 to a high of 1.33 between 1988 and 1993, before settling in at its current 1.11 in 1997.[203] Moreover, pension funds have had a tax preference ratio that has been at 1.00 for two periods in the last fifty years, with a preference for dividends in the other years.[204] Thus, the United Kingdom provides a valuable laboratory to test the question of whether tax has an effect on dividend policy over the long run.

The U.K. experience of late is even more revealing in discussing the current question of dividend tax permanence in the United States. As

195. Poterba, *supra* note 76, at 174.
196. *Id*.
197. *See* Chetty & Saez, *supra* note 14, at 828.
198. Poterba, *supra* note 76, at 174; *see supra* Part II.
199. *See supra* Part II.D.3.
200. *See* Chetty & Saez, *supra* note 14, at 792 ("[D]espite extensive research, the effects of dividend taxation on dividend policies and corporate behavior more generally remain disputed, largely because of the lack of compelling tax variations . . . .").
201. *See* Auerbach & Hassett, *supra* note 16, at 216.
202. Poterba, *supra* note 76, at 172.
203. Bank et al., *supra* note 108, at 55 tbl.3.
204. *Id*. at 58 tbl.4.

with the United States, the United Kingdom has experienced a burst of dividend payments recently.[205] In absolute terms, the aggregate amount of U.K. dividend payments has increased 30% in the last five years, from £35 billion in 1999 to £46 billion in 2004.[206] Moreover, the annual rate of increase in dividend payments has risen from 10% in 1999 to 12% in 2004, after a low of 4% in 2003.[207]

What is most striking about this rise in dividends is that it follows on the heels of a major corporate tax reform in the United Kingdom that moved in the opposite direction of the U.S. reform.[208] Since 1973, the United Kingdom has operated an imputation-style corporate tax system that provides shareholders with a credit for a portion of the taxes paid at the corporate level.[209] The credit could then be used to offset part of the tax due on the dividend received.[210] For shareholders who owed no tax, the credit was refundable up until recently.[211] This proved particularly attractive to pension funds, which constituted some of the most powerful shareholders in the United Kingdom.[212] In 1997, however, the credit was reduced from 20% to 10% and, as of 1997 for pension funds and 1999 for all other shareholders, the credit was made nonrefundable.[213] All of these changes appeared to push the United Kingdom closer to the classical corporate tax system that President Bush sought to eliminate with his proposal for making dividends tax-exempt. This would appear to refute any connection between dividend tax cuts and dividend increases, although perhaps it is too recent of a change to make a definitive assessment.

In a separate paper with two coauthors in the United Kingdom,[214] we studied dividend policy in the United Kingdom over the last fifty years to determine whether taxes had any influence over a more extended period. Using two sources—Cambridge/DTI Databank of Company Accounts and Thomson Financial Datastream—we developed a da-

205. Some suggest that the rise in dividends in the United States contributed to the U.K. trend. *See* Charles Batchelor, *Return of the Dividend Offers Prospect of a Bounce-Back*, FIN. TIMES, June 25, 2005, at 2 ("'The whole dividend culture took a step forward, kick-started by the changes in the U.S.,' says Mr. [John] Kennedy [manager of the Scottish Investment Trust]. 'It was notable that Microsoft paid its first dividend, but the change took place across all sectors.'").

206. Robert Cole, *Shareholders' Friend Could Turn into a Foe*, TIMES ONLINE, June 11, 2005, http://business.timesonline.co.uk/article/0,,8214-1648300,00.html.

207. *Id*.

208. *See generally* Steven A. Bank, *The Dividend Divide in Anglo-American Corporate Taxation*, 30 J. CORP. L. 1 (2004) (discussing the divergence in U.S. and U.K. corporate taxation, both current and historical).

209. Bank et al., *supra* note 108, at 50–51.

210. *See id*. at 51.

211. *Id*. at 52.

212. *See id*. at 20.

213. *Id*. at 52.

214. Bank et al., *supra* note 108.

tabank of year-by-year changes to dividends and annual earnings between 1949 and 2002.[215]

Previous dividend studies have relied upon net, after-tax figures for dividends and earnings.[216] This is based on the classical double tax system in place in the United States throughout the last fifty years and in the United Kingdom between 1965 and 1973. Under this regime, both retained and distributed earnings are treated the same for tax purposes, so a dividend does not alter a firm's total tax burden or its posttax income.[217] Other than during its brief foray with the classical system, the U.K.'s tax regime does not support the use of net dividends and profits figures. Between 1947 and 1958, for example, the United Kingdom taxed distributed corporate profits at a higher rate than retained profits.[218] Similarly, between 1973 and 1997, U.K. companies operated under the Advance Corporation Tax (ACT) system.[219] The ACT had to be paid when dividends were distributed, but it could be credited against the firm's regular tax liability, if any, or carried over to subsequent years.[220] In the latter case, it meant that the firm's aggregate tax liability was higher if it paid dividends than if it retained those funds.[221] To address this potential distortion caused by dividend payouts, we recalculated profits on a "zero distribution profits" basis, as if no dividends were distributed.[222] We also used gross dividends to reflect the fact that dividends in an imputation system are grossed up by the amount of tax due, which is a more accurate measure of corporate dividend policy than measuring what shareholders actually received.[223]

To determine whether tax law-induced changes in individual investor tax preferences affected dividend policy, we created a dividend tax preference variable (DTP). DTP represents the preference a top marginal rate taxpayer will have for receiving dividends rather than capital gains.[224] This methodology is identical to that used in the Poterba and Summers study,[225] which in turn is based on Mervyn King's 1977 study of dividends, tax, and other aspects of U.K. corporate behavior.[226] We deviated from their approach, however, in two noteworthy respects. First,

215. The Cambridge/DTI Databank covered 1116 companies with shares publicly traded on the London Stock Exchange between 1948 and 1977. Datastream provides firm-level data from 1973 onward for 1217 public companies, which we tailored to match the industrial sectors included in the Cambridge/DTI Databank. *See id.* at 10 n.30.

216. *See* Lintner, *supra* note 73, at 107.

217. Bank et al., *supra* note 108, at 11.

218. *Id*. at 12.

219. *Id.*

220. *Id.*

221. *Id*.

222. *Id.* For further discussion of this approach, see LUIS CORREIA DA SILVA, MARC GOERGEN & LUC RENNEBOOG, DIVIDEND POLICY AND CORPORATE GOVERNANCE 70 (2003).

223. Bank et al., *supra* note 108, at 12–13.

224. *Id.* at 18–19.

225. Poterba & Summers, *supra* note 18, at 252–54.

226. MERVYN A. KING, PUBLIC POLICY AND THE CORPORATION (1977).

rather than using weighted average marginal rates, which rely on interpolated estimates of shareholder composition that may understate the influence of certain groups of taxpayers, we followed other studies in calculating DTP by focusing on the position of a taxpayer falling into the top income tax bracket.[227]

In a second deviation from previous studies, we created an additional variable, pension dividend tax preference (PTP), which represents the preference a tax-exempt pension fund taxpayer will have for receiving dividends rather than capital gains.[228] This step was important because, at least in the United Kingdom if not in the United States as well, the institutional investor is an increasingly powerful force as a shareholder. Individuals used to dominate the U.K. share market, owning nearly 66% of all equities as of 1957.[229] This figure has dropped steadily since then, however, from 54% in 1963 to 38% in 1975 and 18% in 1993.[230] Over the same period, pension fund ownership of U.K. corporate equities, which was only 3% in 1957, has grown from 6% in 1963 to 17% in 1975 and 30% in 1993.[231]

Pensions also may have more power and interest than their share ownership figures suggest. While tax-exempt institutional investors are nonaffected entities in the United States, that was not the case for most of the period under study in the United Kingdom. Pensions were not only tax-exempt; they also had the right to claim a refund for any tax credit generated as a result of dividends paid.[232] This meant that the indirect tax burden on pension fund investment in companies was less for dividends than for retained earnings. This refundable credit was worth approximately £2.5 billion per year in the mid-1990s,[233] before it was abolished in 1997.[234] Thus, pensions had a tax-based interest in having firms maintain and increase dividend payments. Given that companies may determine dividend policy with the tax position of key investors such as pension funds in mind,[235] it is useful to independently determine the pension dividend-tax preference.

To test whether firm dividend policy was affected by changes in the tax laws, we augmented a modified version of John Lintner's partial adjustment model to include the DTP and PTP tax variables. The partial

227. For another study using this approach, see Rafael La Porta et al., *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1 app. at 27 (2000).

228. Bank et al., *supra* note 108, at 21.

229. JOHN SCOTT, CORPORATE BUSINESS AND CAPITALIST CLASSES 86 tbl.18 (1997).

230. *Id.*

231. *See id.* These are the only years for which estimates are available (firms were not required to report this data until quite recently), which is why year-by-year data in prior studies using weighted average marginal rates must rely upon interpolations.

232. *See* Bank, *supra* note 208, at 48.

233. Barry Riley, *Second Thoughts on the Dividend Tax Dangers*, FIN. TIMES, June 18, 1997, at 29.

234. For further detail on the refundable tax credit, see Bank, *supra* note 208, at 46–48.

235. *See, e.g.*, Helen Short et al., *The Link Between Dividend Policy and Institutional Ownership*, 8 J. CORP. FIN. 105, 108–09 (2002).

adjustment model was developed in the 1950s based upon a series of interviews with managers of U.S. corporations.[236] Lintner found that managers set dividend policy using dividend smoothing to ensure that dividend adjustments are based on substantial and persistent changes in earnings rather than transitory fluctuations, and are based on long-range target payout ratios.[237] Adding the tax variables allowed us to test whether the tax law changes affected the normal adjustments managers make to dividend policy.

During the period under study, we found a weak statistically significant correlation between the annual real change in dividends and the lag of the DTP variable, effectively measuring the long-term tax burden of dividends to individual investors.[238] There was no such association, however, between current tax changes and current dividends.[239] This suggests that companies adjusted dividend policies in response to long-term trends rather than sudden shifts in policy. Even with the tax lag correlation, however, the chronology calls into question any inference that U.K. firms were setting their dividend policies in response to the tax treatment of individual shareholders. Given the declining percentage of individual ownership discussed earlier,[240] the association between dividends and DTP should have declined over time if it had been based on the status of influential investors. No such trend, however, was evident in the data.

Moreover, the tax treatment of pension funds as measured by the PTP variable, whether measured by current law changes or the long-term tax burden, was not significantly correlated with dividend policy.[241] This is particularly striking given the growing importance of pension funds during the period under study. One possible explanation is that pension funds owned so little corporate equity during the first decade of the study that the results were skewed. Thus, we also tested the correlation between pension fund dividend tax preference and dividends after omitting the earlier years and still found no statistically meaningful connection.[242]

These results, while mixed, generally contradict those studies that have concluded that tax is a determinant of dividend policy in the United Kingdom.[243] By separating out the relevant shareholder groups, it is easier to see the presence of potentially spurious connections. Where there

236. Lintner, *supra* note 73, at 98–99, 107.

237. *Id*. at 107. For further description of the Lintner partial adjustment model, see RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 437 (7th ed. 2003); Marsh & Merton, *supra* note 143, at 5–6.

238. Bank et al., *supra* note 108, at 34–35.

239. *Id*. at 35.

240. *See supra* text accompanying note 230.

241. Bank et al., *supra* note 108, at 35.

242. *Id*.

243. In addition to Poterba & Summers, *supra* note 18, see, for example, M. Ameziane Lasfer, *Taxes and Dividends: The UK Evidence*, 20 J. BANKING & FIN. 455, 470 (1996); Jeremy Edwards et al., *The Effects of Taxation on Corporate Dividend Policy in the UK* (Inst. For Fisc. Stud., Working Paper No. 96, 1985); Feldstein, *supra* note 18, at 69; Brittain, *supra* note 18, at 286–87.

is, at best, a (weak) correlation with taxpayers in the top marginal rate, it is a connection that flies in the face of the underlying evidence of a declining trend of ownership by individuals. Where there is no correlation with pension funds, it suggests that their growing influence and tax-motivated interest in dividends had no real effect on firm dividend policy.

c. Global Comparisons

One possible qualm about the U.K. data is that it is unique by virtue of the sheer number of corporate tax changes in the last fifty years. It may be that other countries with similar experiences to the United States would be more relevant in addressing the connection between tax and dividend policy. Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer, and Robert W. Vishny (LLSV) recently looked at this question on a multicountry basis.[244] Unlike the U.K. study, which evaluated one country over an extended period of time, LLSV examined the tax laws and dividend payout ratios of firms in many countries during a single year, 1994.[245]

In the study, LLSV examined over four thousand firms in thirty-three countries to ascertain the determinants of dividend policy.[246] Among the factors it investigated was the "dividends tax advantage," defined much like the tax preference ratio as "[t]he ratio of the value, to an outside investor, of US$1 distributed as dividend income to the value of US$1 received in the form of capital gains when kept inside the firm as retained earnings."[247] This derives from the tax parameters developed by King and modified by Poterba and Summers.[248] One of the objectives was to help assess whether the new view or the traditional view better described the effect of taxes on dividends.[249]

Much like the U.K. study, the LLSV study fails to establish any tax effect on dividend policy. According to the authors, "we find no conclusive evidence on the effect of taxes on dividend policies."[250] Although there was a positive relationship between tax and all other variables, it was only statistically significant in one of the regressions assessing the ratio of dividends to sales.[251] The authors found the interpretation of this result "highly ambiguous."[252] While the LLSV results are necessarily lim-

244. La Porta et al., *supra* note 227.
245. *Id*. at 9.
246. *Id*. at 2.
247. *Id*. at 13.
248. *Id*. at 27 app. A.
249. *Id*. at 9.
250. *Id*. at 27.
251. *Id*. at 19. The authors used the dividend-to-sales ratio as a check on the dividends-to-profits ratio because the latter was more susceptible to intercountry differences in accounting for profits. *Id*. at 11.
252. *Id*. at 19.

ited because of the study's ambitious scope, they help to confirm that the rise in dividends that followed the U.S. dividend tax cut may not be sufficient evidence upon which to base further policy decisions.

D. Reconciling the Old and New Views

Proponents of the old and new views are beginning to find common ground in reconciling these competing results. Rather than searching for the view that explains the relationship between tax and dividend policy for all firms, they have begun to think about the distinction in terms of "new view firms" and "old view firms."[253] The idea is that firms are different depending upon their stage of development. For example, new view firms tend to be either very early in their development, with little or no access to capital markets, or they tend to be large, established firms with high bond ratings and a ready supply of retained earnings.[254] In both cases, these types of firms are at a point in their development when they are likely to finance investments with retained earnings or debt rather than with the proceeds from stock offerings. Because the dividend tax is already reflected in the price of the outstanding shares, the dividend payout rates of these firms will not fluctuate with tax policy. Thus, they can be characterized as firms for which the new view is more descriptively accurate. This does not mean that such new view firms—particularly large, mature firms—pay fewer dividends. Rather, dividend payments for such firms are comprised of residual funds and will be paid to shareholders regardless of the tax consequences at the shareholder level.

By contrast, the firms that are most likely to issue new shares tend to fall between the two extremes of the infant firm and the longstanding firm.[255] These firms are established enough to have access to the capital markets, but not so much as to have a steady supply of retained earnings available to fund investments. Thus, they are likely to rely on new share issuances where sensitivity to tax rate changes is the greatest.[256] Because of such reliance, these firms are best described as traditional view firms.

This distinction between new and old view firms may help explain the disparity in results among the empirical studies. For example, it may

253. Auerbach & Hassett, *supra* note 16, at 228–29; *see* Poterba, *supra* note 76, at 175 (conceding that "[t]he aggregate evidence does not address potential differences across firms" and citing with approval the argument that "there is likely to be substantial heterogeneity across firms, with only some firms responding to dividend taxes as the traditional view suggests").

254. Auerbach & Hassett, *supra* note 16, at 228–29; *see also* ALI REPORT, *supra* note 145, at 38. The proxies used to evidence capital access were the presence of a bond rating and reported analyst forecasts. Auerbach & Hassett, *supra* note 16, at 222.

255. Auerbach & Hassett, *supra* note 16, at 229.

256. *Cf.* Colin P. Mayer & Ian Alexander, *Stock Markets and Corporate Performance: A Comparison of Quoted and Unquoted Companies*, CENTRE FOR ECONOMIC POLICY AND RESEARCH DISCUSSION PAPER NO. 571 (1991) (finding that quoted companies paid higher dividends than unquoted companies and were less likely to cut dividends in the face of deteriorating financial conditions).

be that large, well-established firms, which are generally classified as new view firms because of their resort to retained earnings rather than public offerings to finance investment, may not be heavily influenced by tax considerations. To the extent that the dividends of such firms constitute a large percentage of all dividends paid,[257] it would not be surprising to find that a permanent dividend tax cut could be ineffective in changing dividend policy. Similarly, the recent initiation and expansion of dividend programs by high-tech companies is consistent with the new view perspective that a mature company with dwindling productive investment opportunities may pay or increase its dividend as a residual payment. On the other hand, for "middle-aged" firms looking to the public market to raise capital, the dividend tax cut could affect incentives. For all types of firms, however, the rise in dividends over the last several years would be consistent with what both the new and old views would predict would happen in the case of a temporary dividend tax cut.

IV. Policy Implications

The distinction between temporary and permanent dividend tax cuts and between old view and new view firms may have important implications for current tax policy debates over the use of taxation to influence dividend payout rates. Unless we can create a "permanently impermanent" dividend tax cut, where all types of firms would be affected similarly, it may be time to recognize that this kind of across-the-board attempt to influence corporate dividend behavior through the Code is often futile or even counterproductive.

A. Permanent Impermanence?

One possible conclusion to draw from this distinction between permanent and temporary tax cuts is that we should strive to establish some level of "permanent impermanence." The rationale is that if a temporary dividend tax cut will encourage the payment of dividends regardless of whether the new or old view is more accurate, then the task is to create an environment in which businesses believe that the cut is always temporary. This would be consistent with Congress' recent extension of the dividend tax cut for two years,[258] rather than to extend it permanently. By enacting dividend tax cuts with built-in expiration dates, Congress can theoretically remove the continuous tax rate assumption under the new view and thereby preference current dividends over future dividends.

The difficulty in this permanent impermanence approach is in achieving the proper level of uncertainty for the dividend tax rates. One

257. *Cf.* Chetty & Saez, *supra* note 14, at 801 n.9 (finding that "the dividends from the top twenty payers account for half of all dividends paid by all firms in our core sample [of 3807 firms]").
258. *See supra* note 11.

extension may be deemed uncertain, but multiple extensions would reassure business that additional extensions are likely. As the probability of an extension grows, the importance of dividend timing will lessen and new view firms may revert to the traditional pattern of using dividends for residual funds.[259] This would effectively replicate our current system. Changes in tax rates are always possible because an existing Congress or President could alter policy or a new Congress or President could take office.[260] Predicting the fate of proposed changes is difficult, however, as evidenced by the market's ups and downs in the months following President Bush's original proposal in January 2003 to exempt dividends from tax.[261] Thus, in the absence of evidence that a specific proposal is likely, businesses can do nothing other than plan under the assumption that the current tax rules will continue.

B. Corporate Governance Through the Tax Code

Because Congress may not be able to continue to rely on temporary tax cuts as a stimulus to dividends, the question emerges whether tax policy has any role as a tool for influencing corporate behavior and corporate governance in the context of dividend policy. Several recent academic papers have asserted that tax can play a role in positively influencing corporate governance and behavior generally,[262] as well as dividend policy more specifically.[263] Moreover, proponents of the integration of corporate and shareholder income taxes assert that double taxation improperly influences corporate behavior by creating a bias against dividends.[264] This is where the distinction between old and new view firms may offer some insight that has so far been missing from the public debate.

259. Alan J. Auerbach & Kevin A. Hassett, Dividend Taxes and Firm Valuation: New Evidence 3 (Jan. 2006) (unpublished paper, on file with University of California, Berkeley Department of Economics), *available at* http://www.econ.berkeley.edu/~auerbach/divtax.pdf.

260. *See* Kirk J. Stark, Time Consistency and the Choice of Tax Base 23 (Feb. 2006) (unpublished manuscript, on file with University of California, Los Angeles School of Law).

261. Auerbach & Hassett, *supra* note 74, at 17–18.

262. *See, e.g.*, Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1196 (2004) (arguing that the corporate tax is a regulatory tool); Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 227–33 (1991) (arguing that the tax reduces the potential for managerial abuse in the face of diverse shareholder profiles); Mihir A. Desai et al., *Theft and Taxes* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 10978, 2004) (concluding that a strongly enforced corporate tax reduces opportunities for managerial diversion of corporate assets); Kose John et al., Law, Organizational Form and Taxes: A Stakeholder Perspective 3 (Nov. 2005) (unpublished manuscript), *available at* http://ssrn.com/abstract=676987 (suggesting that corporate taxation helps align shareholders and stakeholders by reducing profit available for speculative projects).

263. *See* Morck & Yeung, *supra* note 31, at 164 (suggesting that dividend taxes should remain to encourage ownership and monitoring by institutional investors and to attack pyramidal business groups); Randall Morck, *How to Eliminate Pyramidal Business Groups—The Double Taxation of Inter-Corporate Dividends and Other Incisive Uses of Tax Policy* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 10944, 2004).

264. *See, e.g.*, MCLURE, *supra* note 24, at 7; Graetz & Warren, *supra* note 24, at 1768.

Large, well-established corporations are often the target of corporate governance reformers. This targeting is in part due to the money at stake and in part due to the greater risks coming from the large cash holdings under their control. Under the firm-specific view, however, the dividend policies of such large corporations are likely to be least affected by changes in tax policy because they rely principally on retained earnings as their marginal source of additional funds. Dividends are residual payments according to this view. This negates the prevailing assumption that double taxation hinders dividend payments from such firms. To the extent that large, mature firms have increased their dividend payments in recent years, it has been the result of declining investment opportunities or increasing risk aversion, both of which may have contributed to the large rise in cash holdings. Tax policy changes would be relatively ineffective in influencing corporate behavior and governance for this type of firm.

On the other hand, the firms most likely to change their behavior in response to the dividend tax cut are "middle-aged" firms with access to capital markets but without significant retained earnings to draw down. These firms are more likely to be best characterized by the old view because they tend to rely on public markets as their marginal source of finance. Ironically, however, it is not clear that investors are better off if such firms increase dividends. It is possible that they would prefer if such firms reinvested the earnings at this stage in their development so as to encourage growth through acquisitions and new investments. Perhaps as one indication of this point, recent studies have found that non-dividend-paying firms received higher increases in their share prices as a result of the dividend tax cut than dividend-paying firms, although this is also evidence of the new view more generally.[265]

The implication is that attempting to resolve corporate governance concerns through tax changes may be futile or even counterproductive. An across-the-board change such as the 2003 dividend tax cut may be counterproductive by covering midsize firms that might benefit from greater focus on retained earnings and at the very least may suffer from fewer of the corporate governance concerns that appear to plague large companies. By contrast, a narrowly tailored solution would need to focus on larger corporations, but such a change might be futile because these are precisely the types of firms least likely to be affected by tax changes. Finally, the one way to reach potentially all types of firms—via a temporary tax cut—is, by definition, difficult to sustain. Enacting a permanent cut could have the exact opposite effect for large firms by leading them to stop increasing or even to decrease their dividend payments as they rebuild reserves depleted in the last several years through unusually large dividend distributions.

265. Auerbach & Hassett, *supra* note 74, at 3.

V. CONCLUSION

Proponents of increased dividends contend that the recent rise demonstrates that the temporary dividend tax cut merits permanent status. Under closer scrutiny, however, this evidence is far from conclusive. It is true that the rise in dividends seems dramatic compared with the preceding years. Several prominent, nonpaying companies such as Microsoft have initiated a dividend and others have increased their dividends significantly. In comparison with historic norms, however, dividend payout rates are still far below average.[266]

Furthermore, the connection with the dividend tax cut is not as clear as the recent empirical studies would suggest. Some of the increase in dividends started prior to the dividend tax cut and much of it has been fueled by an improvement in earnings generally. Perhaps more significantly, the tax cut had no effect at all on a significant number of holders of corporate equity. Only individuals were affected by the cut and their ownership percentage has been declining steadily. By contrast, institutional investors were not affected at all and they may be the most influential group of investors on questions of dividend policy. A number of alternative explanations, including the maturation of technology companies and the dramatic increase in cash holdings, may be more responsible for the rise in dividends than the tax cut.

What has been overlooked in at least the public debate over making the dividend tax cuts permanent is the unique effect of the temporary nature of the cut. Although all tax cuts are temporary to some extent because of the ability of a future legislature to reverse them, the 2003 dividend tax cut is distinguishable because it was enacted with an expiration date. Proponents have concluded that the rise in dividends established the supremacy of the traditional view that taxes dampen dividends, given that the new view typically holds that a dividend tax cut should have no effect on dividend policy. The temporary nature of the dividend tax cut, however, negates this conclusion. This aspect of the legislation eliminated the parity between current and future distributions and therefore offered firms an incentive to distribute dividends currently. Recent empirical studies support the new view and imply that a permanent dividend tax cut will not have the same effect as a temporary one. The traditional view itself has had support from empirical data, but the most important insight may be that both views may have currency depending on the nature of the firm involved. This only underscores the need for further study before the current rise in dividends could be viewed as support for making the dividend tax cuts permanent.

266. *See* Ian McDonald, *Dividends, Buybacks Set New Benchmark for Largess*, WALL ST. J., Nov. 28, 2005, at A1 ("[E]ven though billions are going out the door, dividends only comprise about 32% of payers' profits. Historically, companies have paid out about 54% of their profits as dividends.").

This conclusion does not preclude the possibility that the temporary dividend tax cut served as an adequate stimulus measure,[267] which was one of the stated goals for the legislation. It does, however, call into question whether the expected corporate governance benefits will be achieved. If dividends are the goal, it might be beneficial to consider a more narrowly tailored strategy aimed at firms likely to be affected by tax changes, rather than the broad approach employed in the dividend tax cut. Even better, it might make more sense to rethink whether increased dividends specifically, and corporate governance benefits more broadly, should be the goal at all when it comes to the Tax Code.

267. It is not self-evident that this is the case though. *See, e.g.*, JOEL FRIEDMAN & AVIVA ARON-DINE, CTR. ON BUDGET AND POLICY PRIORITIES, ECONOMIC EVIDENCE FOR EXTENDING CAPITAL GAINS AND DIVIDEND TAX CUTS IS WEAK 1 (2005); Pratt, *supra* note 10.