

The cost of misaligned tax incentives: Evidence from tax-motivated special dividends

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Abstract

Prior research finds that firms pay special dividends before a dividend tax increase. We examine the real effects of this decision, finding that firms incur costs to pay these tax-motivated special dividends. Specifically, firms reduce investment and repurchases to pay these dividends. Further, the source of funding varies with the tax incentives of shareholders.

When (tax-insensitive) institutional investors likely influence the dividend, for the benefit of shareholders other than insiders, firms reduce repurchases and capital expenditures. Conversely, misaligned tax incentives between insiders and other shareholders are associated with a reduction in R&D, consistent with these misaligned payouts signaling managerial myopia which erodes shareholder value.

Tests using both market responses to tax-motivated special dividend announcements and total factor productivity changes around the dividends support these conclusions. These findings add to our understanding of tax-based agency issues influencing real corporate decisions.