What if dividends were tax-exempt?
Evidence from a natural experiment

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Abstract:

We study the effect of dividend taxes on the payout and investment policy of publicly listed firms. To do so, we exploit a unique setting in Switzerland where some, but not all, firms were suddenly able to pay tax-exempt dividends to their shareholders following the corporate tax reform of 2011. Using a difference-in-differences specification, we show that treated firms permanently increase their payout by around 30% compared to control firms after the tax cut. The rise in dividends is not compensated by an equally-sized reduction in share repurchases. In the cross-section, the impact on payout is much less pronounced in firms where the controlling shareholders have more voting rights than cash-flow rights. However, reducing dividend taxes does not boost investment. The tax-inelasticity of investment is due to a significant drop in retained earnings and to the fact that equity issuances do not surge after the tax cut. Overall, we interpret our findings as evidence for the distortive effect of dividend taxes on the allocation of capital across firms.

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