Research Journal of Finance and Accounting www.iiste.org
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.4, No.5, 2013

The Effect of Corporate Taxes on Dividend Policy of Banks in Nigeria

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Abstract

The study considers the effect of taxes on the dividend policy of banks in Nigeria. The study was set out to examine the relationship among profit, dividend and taxes and to find out whether profitability and taxes affect the dividends of the nineteen banks quoted in the Nigerian Stock Exchange between 2000 and 2008. The ordinary least square regression analysis was used to test the hypotheses. The analyses of the results show that profitability is a major determinant of the dividend policy as there is significant association between dividend and profitability . Also, taxes have negative and non- significant impact on the dividend policy of the banks. The paper concludes that there are other factors that determine the dividends of Nigerian banks other than profitability and taxes.

Keywords: Dividend, taxes, banks, dividend policy

1. Introduction

A dividend is money a company pays to its shareholders from the profit made over a period of time. The dividend could be cash or script dividend which is paid as interim or final dividend. Theoretically, there are different types of dividend policies of firms such as: constant payout, progressive policy, residual policy, zero policy and non-cash policy (Kolb & Rodriguez 1996., Beasley, Myers & Marcus, 1999).Basically various factors affects the dividend policy of firms which ranges from capital availability, the industry norms, expected earning of the firm, capital project execution, profitability and liquidity of the firm, clientele or investors group (Hutchinson, 1995).

The dividend policy of a firm is purposefully planned because of the market reactions or dividend signaling. The market reacts positively to the announcements of dividend increases but negatively to announcements of dividend decreases. Hence corporations follow extremely deliberate dividend payout strategies to meet the diverse needs of the different shareholders (Lintner,1956). This evidence raises a puzzle: how actually do firms choose their dividend policies? It has argued that dividends are not just outcome of a firm's payout policy but reflect a complicated combination of investment strategy, financial decision and private information (Miller & Rock, 1985). From managerial perspective, dividends serve as a tool to mitigate agency problem by digesting extra free cash flows from manager's expropriation(Jensen,1986), or to give signal to the market that only good quality firms can afford to pay dividend (Bhattacharya,1979). From the investor's perspective, dividends are beneficial since they represent a regular stream of income which will enhance self-control by avoiding irrational behaviour (Shefrin & Statman 1984). Dividends reflect the characteristics of the firm especially profitability, investment opportunity and size (Fama & French, 2001). Allen & Michaely (2002) reveal that the payout policy is important not only because of the substantial amount of money involved and the repeated nature of the decision but it is closely related to and interacts with most of the financial and investment decisions of firms.

A lot of controversies surround the relationship between taxes and dividend policies. Starting from Miller & Modigliani (1961), hereafter M&M (1961), dividend irrelevance proposition which argues that in perfect and complete capital market, a firm's dividend policy does not affect its value and only the investment policy matters, a lot of researches have tried to resolved the puzzle. Similarly, the impact of taxes on dividend has been debated by scholars for decades (Dharmapala,2008). Several postulations and assumptions have been made regarding whether taxes paid by the organization affect their pattern of dividend policy. In fact, scholars have long argued for corporate tax integration as a means of reducing the distortions to organizational form, payout policy and financing decisions (Hubbard, 1993 & 2005). Brennan (1970), Masulis & Trueman (1988) argue that taxes affect the dividend policies of organizations. In fact, changes in corporate dividend payout would be expected whenever the government changes her tax policy (Wu, 1996). Lintner (1956) asserts that the major determinants of dividend policy are the anticipated level of future earnings and the pattern of past dividend

The purpose of this paper is to examine the effect of corporate taxes on dividend policy of banks in Nigeria and also to find out whether there is a significant relation between profitability and the dividend payout of banks in Nigeria. The paper is structured as follows. The next section dwells on the literature review. The methodology adopted is shown in section three while section four dwells on the data analysis. Section five is the conclusion.

2. Literature Review

For managers, dividend policy is a way of maintaining and increasing the share price and thus attracting investors. The shareholders read different meaning to it as it signals a lot depending on the clientele. It could show an indication of future strength and build confidence in investors. It could also be a nightmare because of the attendant tax liability and various other factors as amplified in the literature. Managers avoid reduction in dividend because of the sticky signal it sends to the investors and shareholders. It may be a hallmark of incompetent management or a tip of an iceberg of future failure. It is difficult to divorce dividend policy formulation of firms from the tax effect it attracts. Many literatures existing in the sphere of the impact of tax on dividend policy are superfluous as their diverse opinions are. The M&M theory posits the irrelevance in a tax-less society in remarkable fictitious on its assumption of taxes. Tax is a recurrent factor in most economics. Taxes undeniably affect investors and the firm especially in the dividend policies. Tax plays an important point in dividend decisions particularly for the shareholders in attempt to make tax saving. The firm may structure their dividend policy to suit shareholders' clienteles thus weighing a substantial influence in dictating how the dividend policy should be. However, there are other issues that are crucial in the dividend policy of any business organization such as: the clientele effect, signaling hypothesis, dividend stability dividend extras, residual dividend model, share price, etc. Some investors prefer large dividends; these investors will therefore invest in companies that have suitable policy for them. Changes in the amount of dividend send a signal to the investors. When dividend increases, it is a signal of growth and a reduction signals otherwise.Thus companies that have stabled or predictable dividend enjoys the goodwill of investors. The bank dividend policy is found different from other industries as it does not react to the Rozeff model elements such as past growth rate, data and other acute factors (Casey & Dicken, 2000). In a similar study, Baker, Powell & Veil (2001) segment the factors affecting the dividend policy of financial and non financial firms to include: pattern of past dividends concern about maintaining a target capital structure, current degree of financial leverage, shareholder's need for dividend income, legal rules and constraints such as impairment of capital, the desire to send favourable signals to investors, the desire to conform to the industry's dividend payout ratio, investment considerations such as the availability of profitable investment, expected rate of return on firms asset, etc. Baker at al. (2001) find that the pattern of past dividends, strength of earnings and the level of existing and projected future earnings are the most significant factors for the managers when they made the dividend decisions

When dividends are taxed at much higher rates than capital gains, taxable shareholders would prefer capital gains to dividends. One reason could be the "bird-in-hand" approach. Another reason could be the tax implications. Brennan (1970) predicts a higher pre-tax stock return to compensate shareholders for the tax disadvantage of dividends. But Miller & Scholes (1978) argue that taxable shareholders are eventually indifferent between dividends and capital gains; and changes in tax rates will neither affect dividend policy nor the market value of the firm. The key to this "tax irrelevancy" hypothesis is the assumption that all the dividend-receiving shareholders possess the ability to transform their dividend income into capital gain by correctly adjusting their portfolios. This is consistent with the famous irrelevance of dividends in the value of the firm by M & M (1961) ignoring taxes in their assumptions. At the empirical level, many studies tested the tax-effect hypothesis; but the results are inconclusive. Blume (1980) and Gordon & Bradford (1980) find that investors dislike dividends and require compensation for receiving them. Kalay & Michaely (2000) find no significant difference between the risk-adjusted rates of return of high and low dividend-yield stocks. This evidence leads to the rejection of the tax-effect hypothesis. Naranjo et al (1998) find that the magnitude of the "yield effect" is too large to be explained by the tax penalty on dividend.
Jabbour & Yikang Liu (2003) find that profitability is the only factor related to dividends when tax rates are included. In other words, the more profitable the firms are, the more likely they pay higher dividends as applicable tax rates decline. They find a significant negative relationship between averaged dividend forecast error and dividend tax rate for the most profitable firms. This evidence suggests that the more profitable the firms are, the more likely they pay higher dividends as applicable tax rates decline. Black & Scholes (1974) find no correlation between profitability and the dividend policy. This contrasts with the findings of Ramaswamy (1979). Miller & Scholes (1982) attributed any significant relationship between profit and dividend to the dividend information effort rather than the tax effect (Watson & Head, 2004). Dividend payment is believed to decrease or increase as the tax liability increases or decrease (Frankfurter & Wood, 1997). La Porta et al (1999) find no conclusive evidence on the effect of taxes on dividend

policies when we attempted to identify some of the basic elements of the agency approach to dividends and to evaluate them on a cross-section of over 4,000 firms from 33 countries around the world.

Economists are divided on the effects of taxes on the valuation of dividends (Poterba & Summers, 1985). M & M theory assumes that taxes do not affect the dividend policy of the firm in a perfect market. Thus, investors' decisions are independent of dividend consideration. However, when the tax on dividend is higher than tax on the capital gain of the investor, the issue of the dividend policy of the firm becomes a provocative factor for the investors.
Bolster & Jamjigian (1991) research on the 1986 tax law in US find no concrete evidence of correlation of any increase in dividend following the reforms. However, Papaioannou & Savarese (1994) find an increase in the dividend payout for the average firms after such reforms attributed to the reduction in income tax, which the reform injected in the tax system. This aligns with the preposition that tax has a tremendous effect. One identification problem of inferring the tax effect on dividend is the variation in tax rates faced by different investors. While some investors whose personal tax liabilities are less than their capital gain liability, this underscores their interests in dividend rather than capital gains (Hutchinson, 1995). As such, the tax effect does not apply and different tax situations would ignite diverse effects on the share price of the firm. The rise in dividend can inversely be attributed to the tax provisions on such dividends. Ross, Westerfield & Jordan (2001) highlight that effective tax rates on dividend income are higher than the tax rates on capital gains. The dividends are taxed as ordinary income while the capital gains are taxed at a relatively lower rate and are taxed when the shares are sold.
One outstanding contribution at correlating dividend and taxes was made by Rozeff (1982) in his dividend payout model. He attempted to correlate the dividend payout with the effect of changes in tax policies. This model was later-replicated in a study by Casey & Dicken (2000) in which banks were used in the research. The result indicated a series of sequence of effect following changes in capital gain tax, which consequently increased the likelihood of no change in dividend payout. But Dharmapala (2008) strongly suggest that taxes have a significant impact on dividend payments. Using 50 banks quoted in the Nigerian Stock Exchange before the consolidation of the Nigerian banking industry in December 2005, Nnadi & Akpomi (2008) find that there was a significant correlation between taxes and dividend structure of the banks and that profit is a major variable in the formation of dividend policy of the banks since there was a significant effect of profit on dividend and a positive correlation between profit, tax and dividend. Samuel & Inyada (2010) examine effect of company income tax on dividend policy of financial institutions in Nigeria using survey research method. They find a significant relationship between corporate income tax and dividend policy of financial institutions in Nigeria and conclude that a change in corporate income tax rate will significantly affect the dividend policy of financial institutions in Nigeria. Hamid et al (2012) investigated the effect of taxes on the dividend policy in the Pakistan banking sector from 2006 to 2010.They find a significant correlation between taxes and the dividend income of banks and conclude that the tax rates is an important determinant of the dividend policies of the banking sector. Sajid, Muhammad , Bilal, Shafiq and Mehran (2012) investigate the association between taxes and dividend policy as well as the association between dividends, profits and taxes using of 120 listed companies in the Karachi Stock Exchange from 2000 to 2011.They find a statistically insignificant but positive link between profit and tax. On the other hand they find that dividend has direct positive correlation with profit.

2.1 Research Hypotheses

Based on the literature review, we formulate the hypotheses as follows:

(1) There is a significant relationship between the dividend payout and the profitability of banks in Nigeria
(2) There is a significant relationship between the dividend payout and taxation of banks in Nigeria.
(3) There is a significant relationship between the profitability and taxation of banks in Nigeria

3. Research Methodology

The sample population consisted of nineteen (19) banks in Nigeria quoted in the Nigeria Stock Exchange (NSE) out of the twenty-five banks which were able to meet the Central Bank of Nigeria policy of banks re-capitalization to twenty-five billion naira or about $200 million by the deadline of 31st December, 2005. Secondary data were obtained from the annual reports over a period of nine (9) years (2000 –2008). The data analysis techniques are the Pearson correlation and Ordinary least square (OLS) regression analyses.The

3.1. Model Specifications

First, the dividend policy is expressed as a function of profitability and taxation. That is:
DIVIDEND = f (PROFIT, TAXES).

The relationship expressed in the equation form is:

$$DIVIDEND_t = \propto_o + \propto_1 PROFIT_t + \propto_2 TAXES_t + U_t \quad (1)$$

where $\propto_1, \propto_2 > 0$

Moreover, the relationship between profitability and taxation is depicted as :

PROFIT = f (TAXES) is specified as:

$$PROFIT = \propto_o + \propto_1 TAXES_t + U_t \quad (2)$$

and $\propto_1 > 0$

Where: $PROFIT_t$ = Profit after Tax of banks for period t, $DIVIDEND_t$ = Dividend of banks for period t, $TAXES_t$ = Corporate taxes of banks for period t, $\propto_o$ = Intercept,
$\propto_1, \propto_2$ = Coefficients , U_t = error term,

4. Data Analysis

4.1 Descriptive statistics

Table 1 shows the mean and standard deviation of dividend, profitability and taxes of banking sector. The mean of dividend, profits and tax are N97385903.58, N36412867.68 and N13928327.79 respectively, while the standard deviations are 369891342.90, 32408016.134 and 16674146.060 respectively.

The Pearson correlation coefficient is used to find out whether relationship among taxes and dividend. Table 2 shows an insignificant and weak correlation between the dividend and profitability as well as between dividend and taxes.The result shows that both taxes and profitability are positive but insignificantly related to the dividend. But there is a positive and significant correlation between profitability and taxes.

4.2 Regression results

A critical evaluation of the model summary in table 3 shows that about 18.3 % of the systematic variation in DIVIDEND is explained by the two explanatory variables of profitability and taxes. The R^{-2} value is 8.1 % after adjusting for error in the degree of freedom. The F value of 1.793 is not significant at the 5% level and reveals there is no significant linear relationship between dividend, profit and taxation. The Durbin Watson value of 2.424 shows there is no problem of autocorrelation. The regression result in table 4 shows the linearity between the dependent and independent variables. Apriori signs indicate positive impact of profit and taxes on dividend. The t-value of 1.885 shows that profitability has significant association with dividend policy at the 10% .The t-value of -1.096 reveals that taxes has negative and no significant association with the dividend policy of Nigerian banks. In other, as the taxes increase, the dividend payout reduces. This result is not consistent with the findings of Nnandi et al (2008) and Samuel & Inyada (2010) of significant correlation between the dividend and taxes.

5. **Conclusion**

Usually, the profitability of a business is a major variable in the dividend formation of the organization. Where a business does not have good performance indicators, its dividend policy will be twisted and unstable; although profit does not always determine the structure of the dividend. Companies may maintain a constant dividend to impress investors. Thus, dividend is considered as a hallmark of good performance. Our study reveals that there is a positive and significant relationship between dividend and the profitability of banks. In other words, the dividend structure and payout by banks is very much influenced by the profitability of Nigerian banks.

Similarly, taxation has a negative and insignificant negative impact on the dividend policy of banks. The implication is that increase in taxes will have negative effect on the dividend. Alternatives to cash dividends are optimally sought for by managers in order to alleviate the impact of the taxes on the dividend. Hence, shareholders may want to opt for capital gain or script dividends and other tax avoidance technicalities in order to reduce the taxes on their dividends. Our findings is not consistent with Hamid et al (2012) and differs in part with Nnadi & Akpomi (2008) who find using 50 banks quoted in the Nigerian Stock Exchange before the consolidation of the Nigerian banking industry that there is a significant correlation between taxes and dividend structure of the banks and but consistent with Nnadi & Akpomi (2008) that profit is a major variable in the formation of dividend policy of the banks. The results indicate that there are other factors that affects the dividend policy of banks other than profitability and taxes.

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Table 1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
DIVIDEND	19	402173	1623728100	97385903.58	369891342.90	4.348	.524	18.935	1.014
PROFIT	19	3095000	124867000	36412867.68	32408016.134	1.353	.524	1.702	1.014
TAXES	19	1264000	63274000	13928327.79	16674146.060	2.269	.524	4.715	1.014

Table 2 Pearson Correlations

		DIVIDEND	PROFIT	TAXES
DIVIDEND	Pearson Correlation	1	.188	.042
	Sig. (2-tailed)		.440	.865
	N	19	19	19
PROFIT	Pearson Correlation	.188	1	.937**
	Sig. (2-tailed)	.440		.000
	N	19	19	19
TAXES	Pearson Correlation	.042	.937**	1
	Sig. (2-tailed)	.865	.000	
	N	19	19	19

**. Correlation is significant at the 0.01 level (2-tailed).

Table 3 : Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.428[a]	.183	.081	354598812.800	.183	1.793	2	16	.198	2.424

Table 4: Panel data Regression results

Dependent Variable: DIVIDEND	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	-68859834.803	134589900.134		-.512	.616		
PROFIT	13.869	7.359	1.215	1.885	.078	.123	8.141
TAXES	-24.321	14.302	-1.096	-1.701	.108	.123	8.141