# FNCE20005 CORPROATE FINANCIAL DECISION MAKING 2021

## TUTORIAL 5: PAYOUT POLICY: FORMS AND INFLUENCES

## SECTION A - SOLUTION

### Question 1
The validity of the statement depends critically on whether dividends are franked or unfranked, whether investors realise capital gains before or after 12 months, and whether investors are residents or non-residents. If dividends are franked, it is true that most resident investors will pay a lower rate of tax on dividends than on capital gains. However, if dividends are unfranked they will be taxed at the same rate as short-term capital gains, while long-term capital gains will be taxed at much lower rates. This suggests that resident investors will prefer that companies pay dividends only to the extent they can be franked. If a company has additional cash to distribute, resident investors will generally prefer that it be distributed via share buy-backs that allow investors to receive returns as capital gains. Non-resident investors do not benefit directly from the dividend imputation system, and they would generally prefer capital gains to dividends, even if dividends were franked. This suggests a preference for low-dividend payout companies. As a result, the existence of tax-induced clienteles, and hence a demand for shares in companies with various dividend policies, is suggested.

### Question 2
a) The demand for dividends would fall, and dividend payout ratios could be expected to fall.
b) As in part (a), dividend payout ratios should fall.
c) Retention of profits would become more attractive and dividend payout ratios should fall.
d) Profits would be expected to fall, but dividends are likely to be maintained so that payout ratios would increase.
e) Dividends are likely to be increased, but the rate of increase would generally be lower than the rate of increase in profits. Therefore, dividend payout ratios would fall.
f) The higher costs of raising capital by issuing shares would make retention of profits more attractive. Therefore, dividend payout ratios would be expected to fall.

### Question 3
This behaviour is consistent with the proposition that dividends are relevant. In particular, the behaviour suggests that managers are reluctant to reduce dividends. Possible reasons are the existence of dividend clienteles, the adverse information content of a reduction in dividends, and the desire to transfer tax credits to shareholders as quickly as possible.

### Question 4
The problem of running short of cash can be overcome by introducing a dividend reinvestment plan. In this way, the twin objectives of distributing franking credits to resident shareholders and retaining cash in the company are achieved.