Tax- based preference for Dividend Reinvestment Plans: Australian evidence

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This study examines new issue dividend reinvestment plans ("DRPs") in the Australian market. A new issue DRP allows shareholders to have cash dividends on all or a portion of their shares automatically reinvested in the new shares issued by the firm. The study is motivated by the unique institutional setting of the Australian equity market under the dividend imputation tax system, the July 2000 tax reform and the lack of research on DRPs in the Australian market. The July 2000 tax reform introduced a cash refund for unused imputation tax credits enabling Australian resident individuals and superannuation funds to become entitled to a tax refund for their excess or unused franking credits.

To carry out the empirical analysis I modify Finnerty's (1989) model and show that a DRP under the Australian dividend imputation system can be the most cost effective way of raising new equity capital compared to retention-financed and new stock-financed equity capital. The study then investigates the factors that explain a firm's decision to adopt a DRP.

The results show that the tax induced preference for the distribution of franked dividends results in firms increasing their use of DRPs to offset the increased distribution of earnings and firms also adopt a DRP when they are faced with profitability constraints, and have high leverage.

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