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The Effect of The Cash Dividend Tax on The Stock Return

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Dr. Hassan Radwan Mohamed Radwan: Obour higher institute for management and informatics, Egypt,
hasanradwan@oi.edu.eg
Dr. Ahmed El Sayed Zeidan: Obour higher institute for management and informatics, Egypt,
azedian@oi.edu.eg

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Abstract

The decision to distribute profits is one of the decisions that affect the value of the institution, And the decisions related to financing and investing therein, Therefore, the institution has many options between distributing those profits to shareholders, reinvesting them for expansion and growth, or holding them in the form of funds.

In order to identify this combination, all the factors surrounding the institution must be studied in order to reach the optimal decision. It should also be noted that the dividend policy is one of the most important financial policies, not only according to the institution's opinion, But also from the point of view of shareholders, consumers, regulatory and government agencies.

Therefore, one of the most important factors surrounding the institution, which must be studied, is the tax system and its developments, including the tax on cash distributions of securities. This research aims to identify the impact of the tax on cash distributions of securities.According to what was stated in the decision of the President of the Arab Republic of Egypt by Law No. 53 of 2014, with regard to the Egyptian shareholders, on the stock return.

Keywords: Stock, Tax , Cash Dividend

1. Introduction

On 30 September 2020, the Egyptian Government issued a Law No. 199 of 2020 recently issued by the Egyptian Government, amending certain articles of the stamp tax law and the income tax law around capital gains and dividends distribution, effective 1 October 2020, the day after the Law gets published in the official gazette. (Egypt: Law No. 199 of 2020)
In summary, A 10% Withholding tax (WHT) will be imposed on dividends paid by Egyptian companies unlisted on the EGX to resident corporate shareholders. The 10% WHT will be reduced to 5% if the dividends are paid by Egyptian companies listed on the EGX.

Dividends received by resident companies from other resident companies should not be added to taxable income, provided that the related/associated costs are not deductible from the recipient companies' taxable profit (only 10% of the dividends received should be added to the taxable pool subject to CIT at the rate of 22.5%), provided that the company receiving the dividends holds more than 25% of the shares or the voting rights of the subsidiary company and holds or is committed to hold those shares for at least two years. (Altshuler, R., Shay, S. E., & Toder, E. J. 2015).

Accordingly, dividend distributions made by Egyptian listed companies to Egypt tax residents or non-residents should be subject to WHT at a flat rate of 5%, regardless of whether or not the recipient of such dividends fulfills the conditions previously required for

Correspondence Author Hassan Radwan hasanradwan@oi.edu.eg

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applying the 5% WHT on dividend distributions (i.e. holding more than 25% of the subsidiary's shares, for at least two years).

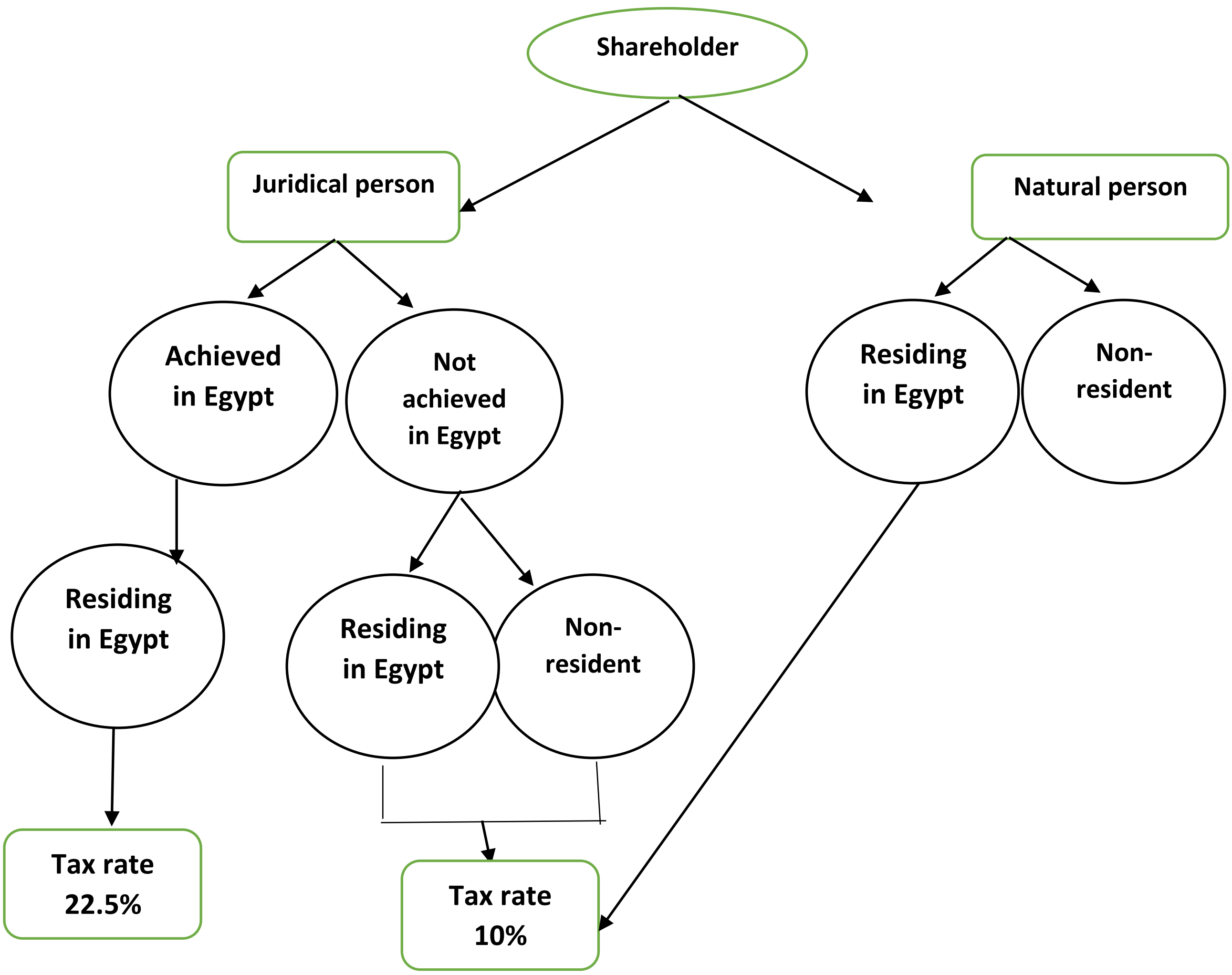
Dividend distributions from unlisted companies should be subject to a 10% flat WHT rate which can't be reduced.

2. The problem of the research

The research question is represented in this main question, what is the effect of the cash dividends tax on the earnings per share?

In order to cover all aspects of the topic, we will ask the following sub-questions:

- What is meant by cash dividend tax?
- How does the cash dividend tax affect the tax return per share?
- Is double taxation achieved when applying the tax on cash dividends?



The tax legislator defined dividends as any income derived from stocks or shares, including enjoyment shares or enjoyment rights, mining shares, founding shares or any other rights that give the right to participate in profits, whether these distributions are cash or free shares, or in the form of Bonds, foundation shares, or in any other form, and I have

The year 2014 witnessed in the middle of it a new and fundamental tax event, as the Decree-Law No. (53) of 2014 was issued and published in the Official Gazette in Issue No.

26 bis (a) on June 30, 2014, which stipulates the imposition of a tax at a rate of (10%) on dividends with the permission to reduce the price Tax to (5%) according to specific conditions.

The tax applies to dividends on shares and quotas obtained by a natural person residing in Egypt from capital companies or partnerships, and resident and non-resident legal persons, including companies established under the system of economic zones of a special nature, except for distributions that take place in the form of free shares, whether These distributions have been achieved in Egypt or abroad, and whatever the form in which the distribution takes place, and the event that gives rise to the tax on the dividends of the shares is achieved by putting the value of the distribution at the disposal of the beneficiary or by recording it in the accounts of the partners in the company. (Abuselidze, G. 2020)

(Egypt: Law No. 91 of 2005) Law No. (199) of 2020 was issued amending some provisions of the Stamp Tax Law No. (111) of 1980, and Income Tax Law No. (91) of 2005, and was published in the Official Gazette in Issue No. 39 on September 30, 2020, and these amendments are effective As of October 1, 2020, this law includes amendments to some provisions of the tax on dividends, and I present them briefly as follows:

The tax base on dividends is determined in relation to what a resident natural person receives in accordance with what is decided by the authority concerned with distribution, and the tax rate on dividends realized from a source in Egypt during the year that a resident natural person receives is (10%), without deducting any costs. This rate shall be reduced to (5%) if the securities are listed on the Egyptian Stock Exchange, and the parties that carry out this transaction shall withhold the tax and deliver it to the Central Administration for Withholding and Collection under the tax account at the Authority within a maximum of five working days from the beginning of the month following the month. in which the collection took place.

It is subject to tax at a rate of (10%) without deducting any costs of dividend distributions made by capital companies or partnerships, including companies established under the special economic zones system for the non-resident natural person and the resident and non-resident legal person, including the profits achieved by the non-resident legal persons. Through a permanent establishment in Egypt, except for distributions made in the form of free shares. The rate of this tax is (5%) of the dividends if the securities are listed on the Egyptian Stock Exchange without deducting any costs.

The profits of non-resident legal persons achieved through a permanent establishment in Egypt shall be considered legally distributed within sixty days from the date of closing the fiscal year of the permanent establishment. The dividends obtained by resident legal persons from other resident legal persons and the corresponding cost shall be excluded from the tax base on profits legal persons,

The parties that carry out the transaction must withhold the tax and transfer it to the central department for deduction and collection under the tax account at the Authority within a maximum of five working days from the beginning of the month following the month in which the collection took place.

The amendments to the tax provisions on dividends show the following:

First: The tax rate is fixed without change, whether it is (10%) or (5%), but it is required to be subject to the rate of (5%) that the securities be listed on the Egyptian Stock Exchange, and the tax legislator aims from this text to encourage the listing of companies' shares in The Egyptian Stock Exchange.

Second: Dividends for shares in partnerships or other companies, as well as dividends for companies not listed on the Egyptian Stock Exchange, are subject to a price (10%).

Third: The tax base on dividends is determined according to what is decided by the authority concerned with distribution, for the total amount that is decided to be distributed without deducting any costs or expenses.

Fourth: The entities that carried out the profit distribution process are obligated to withhold the value of the tax and transfer it to the Central Administration for Withholding and Collection under the Tax Account at the Authority within a maximum of five working days from the beginning of the month following the month in which the collection took place.

Fifth: The profits of non-resident legal persons that you achieve through a permanent establishment in Egypt are considered legally distributed within sixty days from the date of the end of the fiscal year of the permanent establishment..

Sixth: The tax legislator allowed the deduction of dividends received by a resident financier from another resident financier in order to prevent double taxation..

Seventh: The exemption of an amount of ten thousand pounds from dividends received by a resident natural person who does not engage in an activity subject to tax on the profits of commercial and industrial activity in Egypt has been cancelled..

Eighth: The tax legislator excluded dividends from bonus shares from being taxed on dividends.

I believe that the practical reality of applying the provisions of the tax on dividends includes many problems, including the fact that some tax offices account for the tax on dividends on a taxable profit, and these offices assume the role of the authority concerned with distribution, especially in partnerships, in violation of the provisions of the law, because the competent authority With the distribution in the companies of persons, the joint partner who has the right to manage, sign and represent the company before external parties, or the general assembly in the capital companies, and that the distributable profit is represented in the net accounting profit after tax, and the value of the distributions is determined according to what is decided by the competent authority of the company, whatever the value of the distributed amounts. , and not the Egyptian Tax Authority. (Crawford, C., & Freedman, J. 2010)

Also, in some cases, the tax on dividends is accounted for the employee's share of the profits and the remuneration of the members of the board of directors, and these cases are not subject to the provisions of the tax on dividends.

Tax when the founder of the company is a legal person. And based on what was presented in this modest article, I see that the provisions of the tax on dividends require addition, modification, and a clear and simple interpretation of these provisions, and away from complex texts that may include more than one interpretation of different points of view. (Hanlon, M., & Hoopes, J. L. 2014)

Tax on Dividends was introduced by the Law no. 53 of 2014, and was made effective on the 1st July 2014.

Dividends paid by corporations or partnerships, including companies established under the special economic zone system, to resident juridical persons, nonresident persons or nonresident juridical persons who have a permanent establishment in Egypt shall be subject to tax on dividends. Tax Rates:

The standard tax rate is 10% without any deductions or exemptions, but this can be reduced to 5% if the following conditions are fulfilled: -

The person holds more than 25% of the distributing company's capital or voting rights, and; - Shares are held for a period not less than two years. Profits from foreign branches in Egypt are deemed distributed within 60 days following the financial year-end. Moreover, branch remittance is taxed at a rate of 5%.

The law has granted some exemptions for investment funds, parent companies and holding companies under certain conditions. It should also be noted that dividends in the form of free stocks/shares are not subject to tax on dividends.

If a double taxation treaty exists between Egypt and the home country of the shareholder which provides a reduced tax rate or a tax exemption it should be applied. Dividends distributed by free zone companies/ projects are not subject to tax on dividends. (Lang, M. 2021)

Dividends may be taxed at long-term or short-term capital gains rates, depending on the type of dividend you received. The IRS can help you determine whether you have qualified or ordinary earnings.

Buying low and selling high is not the only way to make money on your investments. Many investments also pay a dividend to their shareholders. Dividends provide periodic income that you can use to spend, save, or reinvest. But where there is income, there are usually taxes. Dividends are taxable income, and they are taxed differently depending on the type of dividend you receive. (Dackehag, M., & Hansson, A. 2016)

3. The Relation Between Tax Dividend and Stock Return

According to the 'new view', taxes on dividends do not affect the marginal cost of capital and therefore have no influence on corporate investment decisions, Dividend tax can be thought of as a lump sum tax. The basic argument states that corporations finance their activities through retained earnings and thus avoid double taxation.

Instead of issuing new equity, existing dividends are reinvested rather than distributed to shareholders, and so dividends are not taxed. According to this view, future dividend taxes do exist capitalized in share prices, which means that a reduction in dividend taxes would result in a windfall for existing shareholders who would benefit from the increase in share prices. Cancel doubling thus, taxes would be undesirable and would result in large losses of revenue for the government, leaving capital costs of investments unchanged but providing large windfall gains for the list. (Li, O. Z., Liu, H., & Ni, C. 2021)

Contributors. Moreover, although taxation of dividends may reduce domestic savings, it is believed that it does not affect the volume of investments, as domestic capital is replaced by foreign capital.In small, open economies, foreign capital is assumed to be an ideal substitute for domestic capital, which makes taxation of dividends irrelevant to corporate investment costs.

On the new point of view, we do not expect a negative relationship between dividend tax and economic growth; On the contrary, if it is assumed to be a lump sum tax, it is an effective tax to use. Experimental support for a new view of equity taxes is found by.

In contrast to the New View, the Old View posits that taxation of dividends is distorting because it reduces the equity capital available to firms and investments an increase in the dividend tax rate will raise the effective tax rate on investment income and discourage investment. In addition, an increase in the tax rate will discourage payments and reduce the capital available for new investments.

Jacob, M., & Jacob, M. (2013) compile a comprehensive international dividend and capital gains tax data set to study tax-based explanations of corporate payout for a panel of 6,035 firms from 25 countries for the period 1990–2008. We find robust evidence that the tax penalty on dividends versus capital gains corresponds closely with firms' propensity to pay dividends and repurchase shares, and with the number of dividends and shares repurchased. Our coefficient estimates suggest a smaller tax effect than reported in recent single-country, single-event studies. Instead, our results correspond more closely with historic long-term estimates of the elasticity of dividends

Jacob, M., & Michaely, R. (2017) examine how dividend taxation affects payout. Utilizing an exogenous shock to dividend taxation, we show that absent any frictions, dividend taxation has a large impact on payout. As agency issues and shareholder conflicts increase, owners' tax preferences have significantly smaller impact on payout. Three mechanisms reduce the dividend-tax sensitivity: Coordination among owners, heterogeneity in tax preferences, and diverging objectives between managers and owners. Altogether, taxation has a first-order impact on payout, but agency issues and shareholder conflicts mute its impact substantially. Keim, D. B. (1985) examines the empirical relation between stock returns and (long-run) dividend yields. The findings show that much of the phenomenon is due to a nonlinear relation between dividend yields and returns in January. Regression coefficients on dividend yields, which some models predict should be non-zero due to differential taxation of dividends and capital gains, exhibit a significant January seasonal, even when controlling for size. This finding is significant since there are no provisions in the after-tax asset pricing models that predict the tax differential is more important in January than in other months. Ayers, B. C., Cloyd, C. B., & Robinson, J. R. (2002) investigate the effect of an increase in the individual (shareholder-level) income tax rate on share values. We regress cumulative daily abnormal stock returns surrounding the passage of the Revenue Reconciliation Act of 1993 on firm dividend yield, tax status of the investor as represented by level of institutional ownership, the interaction of these two variables, and control variables. Consistent with our expectations, we find that (1) the higher the firm's dividend yield, the more negative the firm's stock price reaction to the increase in the individual income tax rate (i.e., the dividend tax rate) enacted in the Revenue Reconciliation Act of 1993, and (2) institutional holdings mitigate this negative reaction. Our results suggest that both the dividend policy of the firm and the tax status of the marginal investor influence the extent to which dividend taxes are reflected in share values. Our evidence is consistent with the traditional view that firm dividend policy influences the extent to which tax rate changes affect share values.

Lestari, I., & Abubakar, I. (2023), One of the main types of investment that promises substantial returns for investors is investing in stocks. However, investing in stocks also carries risks. This dividend policy is a decision in determining the largest profit contribution with the lowest investment risk. The amount of tax rate that will be borne will affect the rise and fall of share prices in each company. Based on the results of the simultaneous regression test involving the independent variables Tax Rate and Dividend Policy on the dependent variable Stock Price, it was found that the f-count value is greater than the f-table with a significance level of F less than 0.05. This shows that the Tax Rate and Dividend Policy variables together have a significant effect on the Share Price variable. Ayers, B. C., Cloyd, C. B., & Robinson, J. R. (2002) investigate the effect of an increase in the individual (shareholder-level) income tax rate on share values. We regress cumulative daily abnormal stock returns surrounding the passage of the Revenue Reconciliation Act of 1993 on firm dividend yield, tax status of the investor as represented by level of institutional ownership, the interaction of these two variables, and control variables. Consistent with our expectations, we find that (1) the higher the firm's dividend yield, the more negative the firm's stock price reaction to the increase in the individual income tax rate (i.e., the dividend tax rate) enacted in the Revenue Reconciliation Act of 1993, and (2) institutional holdings mitigate this negative reaction. Our results suggest that both the dividend policy of the firm and the tax status of the marginal investor influence the extent to which dividend taxes are reflected in share values. Our evidence is consistent with the traditional view that firm dividend policy influences the extent to which tax rate changes affect share values.

Dhaliwal, D., Li, O. Z., & Trezevant, R. (2003) find that a firm's dividend yield has a positive impact on its common stock return that is decreasing in the level of institutional and corporate ownership, our indicator of whether the marginal investor in a firm's common stock is more likely to be a low-tax or a high-tax investor. These results suggest that (1) a dividend tax penalty is incorporated into the return on a firm's common stock and (2) both a firm's dividend policy and its ownership structure impact the size of the dividend tax penalty.

Amromin, G., Harrison, P., & Sharpe, S. (2008) test the hypothesis that the 2003 dividend tax cut boosted US stock prices and thereby lowered the cost of equity capital. Using an event-study methodology, we attempt to identify an aggregate stock market effect by comparing the behavior of US common stock prices with that of foreign equities and the equities of real estate investment trusts (REITs). We also examine the relative cross-sectional response of prices of high- and low-dividend-paying stocks. We do not find any imprint of the dividend tax cut news on the value of the aggregate US stock market. On the other hand, high-dividend stocks outperformed low-dividend stocks by a few percentage points over the event windows, suggesting that the tax cut may have induced asset reallocation within equity portfolios. Finally, the positive abnormal return on no dividend paying US stocks in 2003 does not appear to be tied to tax cut news.

Conclusions

- The imposition of a tax Dealing in the market, whether it is cash dividends or capital gains, will have negative effects on the market, and will lead to a decrease in the price index and to sales of some investment funds for their shares.
- It was found that there is a difficulty in applying the tax in the form that was mentioned in the law and the proposed instructions.
- Also, the collection process requires additional capabilities and burdens on taxpayers and financial intermediaries, and many of them will not be able to provide them, especially in these circumstances.
- The application of the tax needs new mechanisms that are in line with the information technology revolution and the rapid development of artificial intelligence, which reduces the negative effects on the stock market.
- These amendments will lead to the establishment of the majority of companies through boards of directors, especially in the event that there is a large representation of investors in those boards By making many amendments to the dividend distribution policies, some of which will be positive and some will be negative, according to the type, nationality and objectives of the investors.
- Although corporations calculate taxes at the entity level, they do not take into account capital gains at the shareholder level and dividend taxes.
- Dividend taxes reduce investors' implicit valuation of the reinvested portion of profits.

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