

## THE EFFECT OF DEEMED DIVIDEND TAX ON DIVIDEND POLICY OF LISTED FIRMS: EVIDENCE FROM SRI LANKA

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**Abstract** - This study aims to discover the effect of the Deemed Dividend Tax (DDT) on the dividend payout policy of listed firms in Sri Lanka. The sample of the study comprises of 100 firms listed on the Colombo Stock Exchange, excluding financial and power and energy sectors, for the period from 2003 to 2014. Further, the study uses the Tobit regression model to analyse the data. The findings of the study suggest that a large number of firms have initiated dividend distribution after the introduction of DDT in 2007 and that dividend payout of firms have increased significantly due to the introduction of DDT. On the other hand, relaxation of DDT threshold in 2011 has prompted firms to decrease the dividend payout, but to a lesser extent compared to the impact of introduction. The findings also discover that dividend income of a firm has become a factor that affects dividend policy of a firm significantly, after the introduction of DDT. Additionally, the findings show that profitability, stability of earnings, leverage and institutional and corporate ownership affect dividend policy of firms in Sri Lanka significantly. However, it is evident that liquidity position of firms is not considered in dividend policy decisions in Sri Lanka, as the firms are more concerned about reducing their tax liability by avoiding DDT. Moreover, the findings support signalling, catering and tax clientele hypotheses, but refute the tax effect hypothesis. In conclusion, the DDT has affected dividend payout policy of listed firms and has altered the factors that affect dividend policy in Sri Lanka.

**Keywords** -Dividend Policy, Deemed Dividend Tax, Colombo Stock Exchange

### I. INTRODUCTION

#### A. Background of the Study

Dividend policy is concerned with the financial policies determining the size and pattern of distributions to shareholders overtime. The dividend policy is important, as evidenced by the large amount of money involved and the attention that firms, security analysts, and investors give to dividends (Baker & Weigand, 2015). A finance manager has to decide whether to distribute all or a proportion of earned profits in the form of dividends to the shareholders, or to be ploughed back into the business. Presumably, such decision should be taken, giving priority to the idea of

maximizing shareholder wealth. Hence, "A company should endeavour to establish a dividend policy that will maximize shareholder wealth" (Van Horne & Wachowicz Jr., 2014, p.480).

Even though a large number of researchers have studied dividends in the past few decades, it is one of the enduring issues in finance that remains unresolved. Black (1976) describes dividends as a "puzzle" four decades before, and since then a vast number of studies have been conducted to solve the dividend puzzle. However Al-Malkawi, Rafferty and Pillai (2010) conclude the paper 'Dividend Policy: A Review of Theories and Empirical Evidence' stating that, "Although numerous studies have examined various issues of dividend policy, they have produced mixed and inconclusive results" (p. 194). This suggests that Black's (1976) statement about dividends is still valid.

#### B. Tax System in Sri Lanka

Dividend income of a person is liable for income tax in Sri Lanka as per section 3(e) in the Inland Revenue Act, similarly to most of the other countries. Dividends are taxed at the rate of 10% on dividend distributed. Firms have to deduct 10% from dividend distribution as withholding tax and remit such amounts to the Inland Revenue Department (Inland Revenue Department of Sri Lanka, 2014). Since the tax is deducted from gross dividend and only the net dividend after deducting the tax is distributed to shareholders, ultimate tax burden is on shareholders. However, this 10% withholding tax is considered as a final tax, and as a result shareholders do not have to pay taxes on dividend income at normal increasing tax rates from 4% to 24% as per individual tax rate schedule. Therefore it is acknowledged that in Sri Lanka, dividends are taxed at a flat rate of 10% unlike other countries, where dividends are taxed at individual income tax rates.

In the year 2007, an innovative tax viz. 'Deemed Dividend Tax' (hereafter referred as DDT) was introduced with the intention of persuading firms to increase their dividend distribution. DDT should not be misunderstood with dividend tax, as dividend tax is payable by shareholders when dividend is distributed, whereas DDT is payable by

firms if a firm does not distribute a specified amount as dividends. Thus, DDT is payable by firms who do not distribute at least 25% of distributable profit as dividends according to section 61 of the Inland Revenue Act. Further, DDT is taxable at 15% on excess of 1/3rd of distributable profit over dividend distributed (Inland Revenue Department of Sri Lanka, 2007). Since DDT is payable by firms, unlike dividend tax, the tax burden of DDT is on the firms. In 2011, the threshold that makes firms liable for DDT was relaxed to 10% from 25%.

The impact of DDT on dividend policy is not known for certainty, as no research has been conducted relating DDT and dividend policy, to the knowledge of the researcher. This may be mainly due to the fact that DDT is a new concept for taxation. This study bridges the above research gap through addressing the research problem: "What is the impact of Deemed Dividend Tax on dividend policy of Sri Lankan firms?" Therefore, the study is carried out with the objectives of finding the impact of introduction of DDT in 2007 on dividend payout policy of Sri Lankan firms, finding the impact of relaxation of DDT threshold in 2011 on dividend payout policy of Sri Lankan firms and finding the impact of dividend income received by a firm on dividend payout policy of Sri Lankan firms.

## II. METHODOLOGY

### A. Variables

Since the study aims to find the impact of DDT on dividend payout policy of firms, the dependent variable is considered as the dividend payout ratio of a firm. Dividend payout ratio (DIVPAY) is measured by dividing annual dividend per share by the annual earnings per share of firms. In order to capture the impact of the introduction of DDT in 2007, on dividend payout policy of firms, a dummy variable- POSTI, and to capture the effect of the relaxation of DDT threshold in 2011, on dividend payout policy of firms, dummy variable- POSTR, are used as key independent variables. Further, dividend tax is not payable when distributing firm pay dividends, using dividend income received from other companies. In order to check if there is an association between dividend payout and dividend income, the dividend income (DIVINC) variable is incorporated into the model as an independent variable. DIVINC variable is measured by the proportion of dividend income from profit after tax of firm, calculated by dividing annual dividend income by PAT.

In addition to the above variables, following factors possibly affecting dividend policy consistent with previous literature findings are also incorporated in the model as control variables. In the present study, profitability (ROE) variable is measured through annual return on equity of

firm. ROE is calculated by dividing profit after tax by total shareholders' equity in this study. Volatility of earnings of a firm is another factor that affects dividend policy of firms as indicated by previous studies (Desalandes et al., 2015). Thus, volatility of earnings (VOLA) variable is calculated by the firm-level standard deviation of ROE over three years (t-2 to t) following Desalandes et al. (2015). The study uses debt to equity ratio (DEBT) to measure leverage of firm and it is calculated by total liabilities divided by total equity of firm at the end of the year. DeAngelo et al. (2006) has used the cash balance of firms to measure the liquidity position. Correspondingly, this study uses the cash balance at the year-end as a proportion of PAT to measure the liquidity position of firm (LIQ). It is calculated by dividing cash balance as at the end of year by PAT of the firm. Several researchers including Sri Lankan studies have found that institutional ownership also influences dividend policy of firms (Al-Najjar, 2009; and Gunathilaka, 2014). In the current study, the corporate shareholders are also combined with institutional investors, when measuring INST variable. INST variable is measured by the percentage of institutional and corporate investors of the firm, extracted from investor information section in annual reports.

### B. Sampling and Data Collection

The study period contains 3 sub periods, namely; period prior to introduction of DDT in 2007 (PRE), period subsequent to introduction of DDT (POSTI) and period subsequent to relaxation of DDT threshold in 2011 (POSTR). The researcher has selected 2003 to 2014 (12 years) as the period of study in order to have similar duration sub periods (PRE: 2003-2006, POSTI: 2007-2010, POSTR: 2011-2014). The initial sample for the study is derived from the firms listed on the Colombo Stock Exchange (CSE) throughout the period 2003 to 2014. Financial institutions (27 firms) were excluded from the sample because of the high leverage that is normal for the financial institutions, perhaps does not have the same meaning as for non-financial firms, where high leverage more likely indicates distress as noted by Fama and French (1992) in 'The Cross-Section of Expected Stock Returns' (pg. 429). In addition there were no firms listed under the power and energy sector throughout the period of study. From the remaining sample, 100 firms were selected randomly using stratified sampling method, contributing to 1200 firm-year observations (annual data of 100 firms for 12 years). The population is stratified into 18 sub divisions according to the business sector the firms are classified in the CSE. Equal weightage was given for each sector when selecting the final sample.

### C. Research Models

1) *Model 1*: The main model of the research study functions to find the impact of DDT on dividend payout of firms in Sri Lanka. The model captures the effect of introduction of DDT in 2007 and relaxation of DDT threshold in 2011, on dividend payout. The model also incorporates the other factors, possibly affecting dividend policy of firms as evidenced by previous literature. Therefore, the model measures the determinants of dividend policy of firms in Sri Lanka during the period of study as a whole (2003-2014). Following the model used by Desalandes et al. (2015) in their study of effect of tax cut in Canada, the researcher has developed the below mentioned modified model to examine the impact of DDT on dividend payout.

$$DIVPAY_{i,t} = \mu_0 + \mu_1 POSTI_{i,t} + \mu_2 POSTR_{i,t} + \mu_3 DIVINC_{i,t} + \mu_4 ROE_{i,t} + \mu_5 VOLA_{i,t} + \mu_6 DEBT_{i,t} + \mu_7 LIQ_{i,t} + \mu_8 INST_{i,t} + \epsilon_{i,t}$$

Where;  $DIVPAY_{i,t}$  - Dividend payout ratio of firm  $i$  at time  $t$ ;  $POSTI_{i,t}$  - Dummy variable for the post DDT introduction period, which takes the value 1 for period after introduction of DDT (2007-2014) for firms with positive profits, or 0 otherwise;  $POSTR_{i,t}$  - Dummy variable for the post DDT threshold relaxation period, which takes the value 1 for period after relaxation of DDT (2011-2014) for firms with positive profits, or 0 otherwise;  $DIVINC_{i,t}$  - Dividend income as a proportion of profit after tax of firm  $i$  at time  $t$ ;  $ROE_{i,t}$  - Return on Equity of firm  $i$  at time  $t$ ;  $VOLA_{i,t}$  - Volatility of firm  $i$ 's profits measured by the standard deviation of profits over three years ( $t-2$  to  $t$ );  $DEBT_{i,t}$  - Debt to Equity ratio of firm  $i$  at time  $t$ ;  $LIQ_{i,t}$  - Cash balance of firm  $i$  as at the end of year  $t$  as a proportion of profit after tax;  $INST_{i,t}$  - Percentage of institutional and corporate investors of firm  $i$  at time  $t$ .

In the model,  $POSTI$  variable captures the impact of introduction of DDT on dividend payout, and  $POSTR$  variable captures the impact of relaxation of DDT threshold in 2011 on dividend payout.  $DIVINC$  measures the effect of dividend income of a firm on dividend payout. All the other variables are incorporated as control variables.

2) *Model 2*: In addition to the main model, another model is used in order to measure the factors and their effect on dividend policy during the period before the introduction of DDT in 2007 (i.e. 2003-2006 period). This model functions as a supplementary instrument to compare results of the main model, as to find out the impact of DDT on the dividend payout and on the factors affecting dividend policy.  $POSTI$  and  $POSTR$  dummy variables are not included in the model, as  $POSTI$  and  $POSTR$  are time dummy variables for period after 2007 and 2011 respectively. All the other variables are same as the main

model and capture the effect of factors affecting dividend policy before introduction of DDT. Evaluating the determinants of dividend policy of Sri Lankan firms before the introduction of DDT helps to compare and find the impact of DDT on dividend policy of Sri Lankan firms.

$$DIVPAY_{i,t} = \mu_0 + \mu_1 DIVINC_{i,t} + \mu_2 ROE_{i,t} + \mu_3 VOLA_{i,t} + \mu_4 DEBT_{i,t} + \mu_5 LIQ_{i,t} + \mu_6 INST_{i,t} + \epsilon_{i,t}$$

#### D. Regression Analysis

Both the above models are analyzed using the Tobit regression model following Al-Kuwari (2009) and Desalandes et al. (2015). Tobit regression assumes that dependent variable has certain limitations, that it cannot take certain values (Tobin, 1958). Thus, Tobit regression is the most appropriate method to analyze the dividend payout policy of firms, because in the case of the dividend payout, it is limited only to positive values. Tobit regressions are run by censoring left side at value 0, because dividend payout ratio cannot be a negative value.

### III. ANALYSIS AND DISCUSSIONS

#### A. Descriptive Statistics

Table 1 show that during the study period 817 firms (68.1% of total observations) of the sample have distributed dividends. It further shows that number of firms who distribute dividends have increased after the introduction of DDT in 2007; as, 284 during  $POSTI$  period and 287 during  $POSTR$  period compared to 246 during  $PRE$  period. The percentage of firms who distributed dividends from total observations for  $PRE$ ,  $POST$  and  $POSTR$  periods are 61.5%, 71% and 71.8% respectively. This hints that introduction of DDT in 2007 possibly has induced firms who did not distribute dividends earlier, to distribute dividends. Chetty and Saez (2005) also find that a large number of firms have initiated dividend payments after the 2003 US tax reform which included a large dividend tax rate cut. Additionally, the mean dividend payout ratio of firms which distributed dividends, have increased during the study period. Mean dividend payout ratio has increased gradually from 36.5% during  $PRE$  period to 37.3% during  $POSTI$  period and further to 45.3% during  $POSTR$  period.

Table 1. Summary of sample data

	Total sample 2003-2014	PRE period 2003-2006	POSTI period 2007-2010	POSTR period 2011-2014
No of firm-years obs.	1200	400	400	400
No of firm-years paid dividends	817	246	284	287
% of firm-years paid dividends from total obs.	68.1%	61.5%	71.0%	71.8%

No of firm-years with positive profits	1001	327	331	343
% of firm-years paid dividends who had positive profits	81.6%	75.2%	85.8%	83.7%
No of firm-years with positive dividend income	469	140	143	186
No of firm-years paid dividends who had positive dividend income	356	99	119	138
% of firm-years paid dividends who had positive dividend income	75.9%	70.7%	83.2%	74.2%
Mean dividend payout ratio of firm-years paid dividends	39.9%	36.5%	37.3%	45.3%

Further the percentage of firms distributed dividends as a proportion of firms who had positive profits for the period are 75.2% for PRE period, 85.8% for POSTI period and 83.7% for POSTR period. Number of firms who had positive dividend income and distributed dividends have increased over the years as, 99 for PRE period, 119 for POSTI period and 138 for POSTR period. However, the percentage of firms distributed dividends that had positive dividend income does not follow the same pattern. The percentage of firms distributed dividends that had positive dividend income has increased from 70.7% during PRE period to 83.2% during POSTI period, but has reduced to 74.2% during POSTR period.

Table 2. Descriptive statistics of the variables

Variable		Total Sample 2003-2014	PRE Period 2003-2006	POSTI period 2007-2010	POSTR period 2011-2014
DIVPAY	Mean	0.2713	0.2246	0.2647	0.3247
	SD	0.8876	0.3222	0.3384	1.4643
DIVINC	Mean	0.1225	0.0569	0.0581	0.2524
	SD	2.1913	0.3683	0.3123	3.7645
ROE	Mean	0.0783	0.0136	0.0904	0.1308
	SD	1.2126	2.0384	0.3002	0.4083
VOLA	Mean	0.1978	0.3788	0.1178	0.0966
	SD	1.4140	2.4124	0.2500	0.2827
DEBT	Mean	1.4128	2.1667	1.3379	0.7339
	SD	7.9180	11.8457	2.6703	6.3175
LIQ	Mean	2.4510	1.4032	4.5671	1.3826
	SD	29.7331	3.4715	51.2804	2.8532
INST	Mean	0.7409	0.7138	0.7426	0.7663
	SD	0.2266	0.2240	0.2251	0.2282

Table 2 show that mean of dividend payout ratio of firms during the study period is 27.13% with a standard deviation of 88.76%. Gunathilaka (2014) also finds that Sri Lankan firms rely largely on retained earnings and have retained more than 70% of the earnings during 2006 to 2010 period, which indicates a dividend payout of 30%.

Table 2 further indicates that average dividend payout ratio of firms has increased in POSTI (26.48%) and POSTR

(32.48%) periods compared to PRE period (22.46%). Desalandes et al. (2015) also find that mean dividend payments of Canadian firms have increased after the dividend tax cut. Mean of dividend income as a proportion of PAT has risen significantly to 0.25 during POSTR period from 0.05 in PRE and POSTI periods. Mean value of ROE has gradually increased during the study period (PRE: 1.37%, POSTI: 9.05% and POSTR: 13.09%). On the contrary, mean value of SD of profits of firms over three years has decreased over the period, from 37.88% during PRE period to 11.78% in POSTI period and further to 9.67% in POSTR period. Average debt to equity ratio of firms has also fallen throughout the study period (PRE: 2.17, POSTI: 1.34 and POSTR: 0.73). Mean values of cash balance as a proportion of PAT during PRE, POSTI and POSTR periods are 1.40, 4.57 and 1.38 respectively. Average institutional and corporate shareholders percentage has increased gradually from 71.39% in PRE period to 74.26% during POSTI period and further towards 76.63% during POSTR period.

*B. Regression Analysis*

*1) Regression model for the total study period (2003-2014):*

Table 3 presents the results of the Tobit regression model for the total study period (2003-2014). Coefficient of POSTI dummy variable is 0.1857 which suggests a significant positive relationship with the dependent variable-dividend payout ratio, at 1%. This indicates that dividend payout ratio of firms have risen subsequent to the introduction of DDT in 2007. This supports the findings of Chetty and Saez (2005) and Desalandes et al. (2015), which suggest that firms have increased dividends payments after dividend tax cut in US and Canada respectively. This also supports the view that firms try to reduce their tax liability. As a result, the Government has been able to increase the dividend payout of firms through introducing DDT as expected.

On the other hand, POSTR dummy variable is negatively related with dividend payout ratio. However the effect of POSTR variable is not significant as POSTI variable and significant only at 10%. Even though, the firms have reduced the dividend payout ratio subsequently to the relaxation of DDT threshold in 2011, the impact is not as significant as the impact from introduction of DDT to increase payout. Hence supports Lintner's (1956) view that managers are reluctant to reduce dividend payout.

Table 3. Regression results for total study period (2003-2014)

Dependent variable: Dividend Payout Ratio (DIVPAY)				
Variable	Coefficient	Std. Error	z-Statistic	Prob.
POSTI	0.1857	0.0321	5.7687	0.0000***
POSTR	-0.0615	0.0334	-1.8422	0.0654*
DIVINC	0.3774	0.0055	67.8169	0.0000***
ROE	0.5142	0.0527	9.7458	0.0000***

VOLA	-0.8114	0.0890	-9.1097	0.0000***
DEBT	-0.0048	0.0020	-2.3384	0.0194**
LIQ	-0.0032	0.0027	-1.1577	0.2470
INST	0.1339	0.0622	2.1526	0.0313**
C	-0.0393	0.0514	-0.7658	0.4438
Mean dependent variable	0.2713	SD dependent variable		0.8876
S.E. of regression	0.3210	Akaike info criterion		1.1922
Sum squared resid.	122.6532	Schwarz criterion		1.2346
Log likelihood	-705.3388	Avg. log likelihood		-0.5877
Left censored obs.	383	Right censored obs.		0
Uncensored obs.	817	Total obs.		1200

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% levels, respectively.

Coefficient of DIVINC variable is positive and significant at 1% level. Positive association between dividend payout ratio and dividend income predicts that the dividend payout is higher when a firm has high portion of dividend income. Correspondingly, this suggests that firms try to distribute dividends using the dividend income they received, in order to transfer income tax exemption on dividends to the shareholders. Shareholders prefer tax exempt dividends as investors try to reduce their tax liability as found by Chaplinsky and Seyhun (1990). Thus, the positive association between dividend income and dividend payout ratio supports catering hypothesis of dividends as firms try to cater shareholders preferences.

Additionally, ROE positively affects dividend payout ratio of firms significant at 1%. This suggests that firms pay higher dividends when the profitability level is high, and pay lower dividends when profitability of firms is diminished as discovered by Lintner (1956). This is in line with the findings of Abayadheera and Senaratne (2001), who find profitability as a significant factor affecting dividend policy of firms in Sri Lanka. Abdelsalam et al. (2008) also find that firms with higher return on equity distribute higher level of dividends. However, this finding refutes the findings of Gunathilaka (2014), which proposes a negative relationship between profitability and dividend payout in Sri Lanka. Gunathilaka suggests that firms with high earnings distribute lower dividends, whereas firms with low earnings distribute higher dividends in Sri Lanka.

Further Table 3 shows that coefficient of VOLA variable is -0.8114 and significant at 1%. This means that firms pay higher dividends when they have stable profits and dividend payment is low when profits are highly volatile. This finding supports the findings of Desalandes et al. (2015), which indicate that volatility is negatively affecting dividend payout of firms. Dividend payout ratio's positive association with ROE and negative association with VOLA variables support signalling hypothesis of dividends. Firms

use dividends as a tool to signal the profitability, stability of profits and future prospects of the firms. Thus when firms have high and stable profits, they distribute higher dividends. This supports the findings of Pathirawasam (2009), who also find a considerable amount of information content of dividends in Sri Lanka supporting signalling hypothesis of dividends. Debt to equity ratio negatively affects dividend payout ratio significantly at 5% level. Higher leverage weakens the dividend distribution capacity of firms, hence decreases the dividend payout. The finding supports the findings of DeAngelo et al. (2006); but contradicts with the finding of Gunathilaka (2014) that suggests leverage has no influence over payout policy of Sri Lankan firms.

Coefficient of INST variable is positive and significant at 5%. This suggests that high institutional and corporate shareholder ownership leads to high payout ratio. Institutional and corporate shareholders prefer dividends due to differential tax treatment favouring them as found by Han, Lee and Suk (1999) supporting tax clientele hypothesis. Gunathilaka (2014) also finds that institutional ownership of firms has significant positive relation with dividend payout in Sri Lanka. Additionally, Al-Najjar (2009) discovers that institutional ownership positively affects dividend payout of firms in Jordan. Alternatively, the positive association of dividend payout and institutional and corporate ownership suggests that institutional and corporate investors prefer to invest in high dividend paying firms supporting the findings of Allen, Bernado and Welch (2000).

Conversely, LIQ variable is negatively related to dividend payout but statistically insignificant which means cash balance of firms is not a significant factor that affects dividend policy in Sri Lanka. This result is conflicting with the findings of DeAngelo et al. (2006), who suggest liquidity position of firms significantly affects dividend policy of firms. However, supporting the current findings, Komrattanapanya and Suntrauk (2013) find that liquidity is insignificantly related to dividend policy of firms listed in Thailand Stock Exchange.

2) *Regression model for the PRE period 2003-2006:* Table 4 shows the results of the Tobit regression model for measuring the determinants of dividend policy of firms for the period before introduction of DDT (2003 to 2006). This shows the factors that affected the dividend policy of Sri Lankan firms before the introduction of DDT in 2007.

Table 4. Regression results for the period 2003-2006

Dependent variable: Dividend Payout Ratio (DIVPAY)

Variable	Coefficient	Std. Error	z-Statistic	Prob.
DIVINC	-0.0648	0.0838	-0.7735	0.4392
ROE	0.8113	0.1268	6.3992	0.0000***
VOLA	-0.5547	0.1121	-4.9487	0.0000***
DEBT	-0.0173	0.0039	-4.4801	0.0000***
LIQ	0.0097	0.0068	1.4173	0.1564
INST	0.2577	0.1152	2.2374	0.0253**
C	-0.1017	0.0891	-1.1418	0.2535
Mean dependent variable	0.2246	SD dependent variable		0.3223
S.E. of regression	0.3037	Akaike info criterion		1.2272
Sum squared resid.	36.1674	Schwarz criterion		1.3070
Log likelihood	-237.439	Avg. log likelihood		-0.5936
Left censored obs.	154	Right censored obs.		0
Uncensored obs.	246	Total obs.		400

\*\*\*, \*\*, \* Significant at 1%, 5% and 10% levels, respectively.

Table 4 indicates that DIVINC variable is negatively related to dividend payout ratio but insignificant. This implies that dividend income has not affected firms' dividend payout significantly during 2003 to 2006 period. Coefficient of ROE is 0.8113 and significant, which means profitability has positively affected dividend payout during 2003-2006. Further, VOLA has negatively affected dividend payout significantly. Debt to equity ratio (DEBT) also has negatively affected dividend payout of firms during the period before introduction of DDT in 2007. Coefficient of LIQ variable is 0.0097, which suggests a positive relationship with dividend payout ratio as suggested by previous researchers. However, the relationship is not significant. Institutional and corporate shareholders percentage (INST) also has affected dividend payout of firms and significant at 5%.

3) *Comparison between the two regressions:* Several important indications can be derived by comparing the results of regression models presented in Table 3 and Table 4. Table 4 shows that dividend income was not a significant factor affecting dividend payout of firms during the period prior to the introduction of DDT (2003-2006). Further, it shows a negative association with dividend payout in that period. However, the regression results in Table 3 for total study period after incorporating the period after introduction of DDT with the period before introduction of DDT, shows that dividend income is a significant factor that positively affects dividend payout policy of firms. This provides evidence to that dividend income received by a firm has become a significant factor that affects dividend payout of firms after the introduction of DDT in 2007.

Further, the positive association between liquidity position (LIQ) and dividend payout during period prior to introduction of DDT (Table 4) has changed to a negative association after incorporating the period after the

introduction of DDT (Table 3). However, the association is not significant in both regression models. This suggests that firms consider reducing the tax impact rather than considering the cash balance of the firms when distributing dividends. Thus, the high cash out flow of dividend payment compared to paying only DDT (without distributing dividends) has not restricted firms to distribute dividends. Additionally, significance of leverage (DEBT) factor has reduced after the introduction of DDT. These changes in coefficient signs and significance demonstrate that introduction of DDT has affected the dividend payout policy of firms as a whole and also has altered factors affecting firms' dividend payout. Coefficient signs and significance of all the other factors remain similar to their impact before the introduction of DDT.

#### IV. CONCLUSIONS

It is found that a large number of firms have initiated dividend distribution after the introduction of DDT in 2007. Further, it is found that firms' dividend payout ratio has increased due to the introduction of DDT. Thus, it can conclude that introduction of DDT in 2007 has affected dividend payout of firms significantly. However, the relaxation of DDT threshold in 2011 has prompted firms to lower the dividend payout compared to the period 2007-2010, but to a lesser extent as indicated by the coefficient value-0.06 of POSTR variable which is only significant at 10% level.

Additionally, it is found that dividend income of firms was not a significant factor that affected dividend policy before 2007 i.e. before introduction of DDT. However, dividend income has become a significant factor that affects dividend payout policy of firms in Sri Lanka after the introduction of DDT in 2007. In addition, the findings of the study suggest that profitability of firms and institutional and corporate ownership of firms positively affect dividend payout policy of firms, whereas leverage and volatility of earnings affect negatively. However, it is observed that firms try to reduce tax liability of firms by distributing dividends to avoid paying DDT, rather than giving considerations to liquidity position of the firm. Therefore, it is found that liquidity is not a significant factor that affects dividend payout policy of firms in Sri Lanka.

The findings of the study support signalling theory of dividends as they reveal that the managers of firms have paid high dividends when they have large and stable profits to signal the future prospects of the firms. Further, the findings support catering theory of dividends as it is observed that managers have distributed dividends using dividend income received by the firms to cater the

preferences of shareholders. Furthermore, it can be settled seeing that high percentage of institutional and corporate investors have invested in high dividend paying firms, that tax clientele theory is also supported by the findings of the study since institutional and corporate investors prefer dividends to benefit from taxation. However, the findings of the study repudiate the tax effect hypothesis as paying dividends in order to avoid paying DDT does not result in decreasing the firm value.

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