

DIVIDEND IMPUTATION:

The international experience

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An overlooked aspect of the debate surrounding Australia's dividend imputation system is the international experience with dividend imputation. Between 1999 and 2008, nine countries removed their dividend imputation systems. This raises a number of questions. What was the motivation for removing imputation? How were dividends taxed after imputation was removed? What happened to corporate tax rates? What are the lessons for Australia? This paper seeks to provide answers to these questions.¹

Along with Canada, Chile, Mexico and New Zealand, Australia is one of only five countries in the Organisation for Economic Co-operation and Development (OECD) that continues to operate a full imputation tax system where all corporate tax is credited to domestic shareholders. Malta, a non-OECD country, also has a full imputation system. The OECD lists Korea and the United Kingdom as operating partial imputation systems. However, as the tax credits provided in these countries are not linked to the amount of corporate tax paid, these are not true imputation tax systems. Many countries have shifted away from imputation systems, including the United Kingdom (1999), Ireland (1999), Germany (2001), Singapore (2003), Italy (2004), Finland (2005), France (2005), Norway (2006) and Malaysia (2008). Table 1 provides an overview of the changes.

TABLE 1: Overview of country-specific changes away from dividend imputation

Country	Date Removed	Before	After
United Kingdom	July 1997	Partial imputation. Tax credit of 25 cents per \$1	No refunds of credits to tax-exempt institutions (e.g. pension funds)
United Kingdom	April 1999	See above	Imputation rate cut from 20% to 10% and no refunding of unutilised credits
Ireland	April 1999	Partial imputation. Tax credit of 12.4 cents per \$1	Dividends double taxed and corporate tax rate reduced
Germany	January 2001	Full imputation. Tax credit of 43 cents per \$1	50% of dividend taxed
Singapore	January 2003	Full imputation. Tax credit of 32 cents per \$1	Dividends tax-exempt for shareholders
Italy	December 2004	Full imputation. Tax credit of 52 cents per \$1	Withholding tax of 12.5% for individuals
Finland	January 2005	Full imputation. Tax credit of 40.8 cents per \$1	57% of dividend taxed
France	January 2005	Full imputation. Tax credit of 50 cents per \$1	50% of dividend taxed
Norway	January 2006	Full imputation. Tax credit of 38.9 cents per \$1	28% tax rate on dividends if within rate of return allowance
Malaysia	January 2008	Full imputation. Tax credit of 37 cents per \$1	Dividends not taxed

United Kingdom and Ireland

The United Kingdom (UK) and Ireland both operated imputation systems with Advance Corporation Tax (ACT). ACT was essentially the prepayment of corporate tax on distributed profits. The UK government refunded 20 per cent out of the 33 per cent corporate tax rate, giving rise to a tax credit of 25 cents in the dollar. The UK essentially had a two-stage removal of its imputation system, with changes made in 1997 and 1999.

After July 1997, imputation tax credits were no longer refunded to tax-exempt shareholders, such as pension funds. This reduced the theoretical value that tax-exempt investors placed on the dividend by 20 per cent from \$1.25 to \$1. In the UK, there was considerable outrage from pension funds as it had the effect of taxing their dividend income (Trapp 1997). The net effect of the changes were not as severe for individual investors or companies. However, Bell and Jenkinson (2002) show that the valuation of dividends did decline after the refunding of excess tax credits was removed in 1997. They contend that the cost of capital increased for UK firms. In contrast, Lasfer (2008) and Armitage et al. (2006) argue that the change in taxes did not affect the valuation of dividends.

A consultative document released by the UK government states that the removal of ACT was designed so that companies could make investment decisions without being influenced by the tax system (Bond et al. 1995; UK Government 1997). In effect, ACT was removed to encourage investment by companies, rather than the distribution of profits. In April 1999, ACT was scrapped and the tax credit was halved from 20 per cent to 10 per cent. Tax rates on dividend income were reduced, so that there was no net effect on UK individual shareholders (Tontsch 2002). The refunding of excess credits was also abolished. The 10 per cent credit was then granted irrespective of any whether any corporate tax has been paid on the profit (Tontsch 2002). As such, it is not an imputation system. It is important to note that the UK reduced the corporate tax rate from 33 per cent in 1996 to 30 per cent in 1999.

Ireland removed its imputation system in 1999, shifting to a classical tax system. It also drastically lowered its corporate tax rate from 32 per cent to 12.5 per cent. The developments in Ireland generally reflected those that took place in the UK. Ireland had been slowly reducing the rate of imputation from 25 per cent in 1994 to 11 per cent prior to the shift to a classical tax system.

Germany

In 2001, Germany removed its imputation tax system in favour of a 'half-income' system. Under this system, 50 per cent of the dividend is taxed at the investor's marginal rate, while companies do not pay tax on dividends. According to data from the OECD (2016), the net personal tax rate on dividends for a top bracket marginal investor declined from 31.1 per cent to 25.6 per cent after imputation was removed. The OECD (2007) also reports that Germany removed imputation in order to reduce the corporate tax rate from 30 per cent to 25 per cent. Endres and Oestreicher (2000) state that the reforms were designed to reduce corporate tax, increase Germany's international competitiveness, increase foreign investment and increase retained earnings. A further motivation was the desire to satisfy concerns that the European Court of Justice (ECJ) would rule that dividend imputation was discriminatory, reflecting the fact that foreign investors were generally unable to use the imputation credits. EU rules require non-discriminatory treatment of investors so that capital can move freely.²

The changes removed the preferential treatment of dividends over capital gains for domestic investors so that theoretically investors should have been indifferent between the two. In the process, the removal of imputation resulted in the theoretical value of \$1 of dividends declining from approximately \$1.43 to \$1. However, McDonald (2001) uses a variety of techniques to show that around 50 per cent of the tax credit was valued by investors. Further, Haesner and Schanz (2013) find that after imputation is removed the value of a dividend declines by 15 cents in the dollar.

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Finland

The full imputation tax system was removed in January 2005 and replaced with a partial inclusion tax system where only a portion of the dividend is taxable. The taxable portion of the dividend was initially set at 57 per cent of the dividend, but has varied since. The tax rate levied on dividends paid to individuals initially increased from 0 per cent to 16 per cent after imputation was removed. The removal of imputation was accompanied by a decrease in the corporate tax rate from 29 per cent to 26 per cent. The changes to the tax system did not affect foreigners as a 15 per cent withholding tax continued to be levied on the majority of overseas investors (Korkeamaki et al. 2010). Tax-exempt domestic institutions were also unaffected as they were not eligible to receive any imputation tax credits.

According to Hietala and Kari (2006), the reform was driven by European factors rather than any Finland-specific factors. The ECJ had made it clear that it viewed imputation systems that provided tax credits only to domestic investors as discriminatory. In addition, Finland was concerned that some new entrants to the European Union (EU) had lower corporate tax rates, and that a number of incumbent EU countries were lowering their corporate tax rates around this time.

France

France abolished its full dividend imputation system in January 2005, under which the tax credit (*avoir fiscal*) was equal to 50 per cent of the face value of the dividend. It was replaced by a partial inclusion system where only 50 per cent of the dividend was subject to personal tax. For an investor on the top marginal tax rate, the effective tax rate on dividends increased from 29 per cent to just over 32 per cent. The corporate tax rate was lowered from 35.4 per cent in 2004 to 34.4 per cent in 2006. The removal of France's imputation system had an adverse impact on some foreign investors, as shareholders resident in certain countries that had a tax treaty with France could receive a refund of the imputation tax credits (HM Revenue and Customs 2010). The ECJ was the influential force in France's decision to remove dividend imputation because of discrimination against companies and residents of countries that did not have a tax treaty with France (Ernst & Young 2004).

Italy

Italy removed its dividend imputation system in December 2004. The corporate tax rate of 34 per cent in 2003 led to an imputation tax credit of 51.52 per cent. The IMF (2002) points out that the imputation credit was fully refundable to low-tax rate or tax-exempt shareholders. Under the imputation system, individual shareholders could elect to receive the imputation credit or pay a withholding tax of 12.5 per cent. Those shareholders with a marginal tax rate of less than 39 per cent would have been better off electing to pay the 12.5 per cent withholding tax, rather than taking the imputation credit, as it would have resulted in a lower tax bill.

The tax system that replaced imputation led to a 12.5 per cent withholding tax on ordinary dividends for the highest marginal tax rate shareholders. As such, the removal of imputation did not affect their after-tax value of dividends (IMF 2002). According to the OECD (2006), changes to the Italian tax system were intended to reduce both the company tax burden and the complexity of the tax system. Companies are taxed on only 5 per cent of the dividend, providing them with an effective tax rate of 1.65 per cent (Perin 2004). The corporate tax rate was reduced from 36 per cent in 2002 to 33 per cent in 2004. As with other European countries, the ECJ had a substantial influence on the decision to remove the imputation system in Italy.

Norway

Despite not being in the EU, there were concerns in Norway regarding the ECJ and their view on the preferential treatment of domestic shareholders relative to foreign shareholders (Report to the Storting 2011). There were also domestic factors at play. One concern was the significant difference in the tax rate on labour and capital, with labour income taxed at almost 65 per cent versus capital income at 28 per cent. This created an incentive for taxpayers to transform labour income into capital income (Sørensen 2005).

Norway operated an imputation system until January 2006, under which domestic investors did not pay any tax on dividends (Dai and Rydqvist 2009). Capital gains tax is complex, and in the interest of brevity we will ignore this complication. Under the current system dividends and capital gains do not attract tax in the hands of shareholders if they are below some benchmark rate, such as the average risk-free rate, termed the 'rate of return allowance' (Denk 2012). In this case only a 28 per cent corporate tax is levied. If the rate of return exceeds the benchmark, then the additional return is taxed at the personal level of 48 per cent (= 28% corporate tax + 28% personal tax on the remaining 72 %). There remains considerable debate about whether the new system removes or creates distortions for investors. Furthermore, the rate of return allowance creates an additional administrative burden for taxpayers (Report to the Storting 2011). Unlike many of the other European countries that removed dividend imputation, Norway did not reduce its corporate tax rate.

Singapore and Malaysia

Singapore and Malaysia are two non-OECD countries that have also removed full dividend imputation systems. Singapore's corporate tax rate of 24.5 per cent in 2002 gave rise to an imputation credit of 32 cents per \$1 dividend ($0.245 / 0.755$). Singapore replaced imputation with the so-called one-tier corporate tax system in January 2003, under which tax was applied only at the company level and dividends became tax-exempt for shareholders (Hennig 2004). As part of the transition to the new tax system, Singapore allowed companies to distribute accumulated tax credits for up to five years, or until they had depleted their balance (Hennig 2004). This transition period was implemented to benefit individual shareholders (Teck 2006). There is also no capital gains tax in Singapore. Singapore reduced its corporate tax rate from 24.5 per cent in 2002 to 20 per cent in 2005, in conjunction with the removal of dividend imputation (KPMG 2007).

In its Economic Review Committee Report, the Singaporean Ministry of Trade and Industry (2002) put forward three reasons why imputation should be removed. First, it was noted that companies did not always have sufficient tax credits to frank the dividend, which led to lower company distributions. They argued that this created a disincentive for companies to use Singapore as a regional hub. Second, imputation led to higher compliance costs and was inflexible with respect to an increasing number of complex business transactions. Third, imputation reduced the ease with which new tax changes could be introduced.

Teck (2006) discusses the effect on shareholders in Singapore. Domestic shareholders with a marginal tax rate higher than the corporate tax rates were better off after the introduction of the single-tier system. Low marginal tax rate investors were adversely affected as they had previously been entitled to a refund of unutilised credits. Teck (2006) also argues that the removal of imputation could have left certain foreign investors worse off.

The removal of Malaysia's full imputation system mirrored that of Singapore in terms of both motivation and structure. Malaysia shifted to a single-tier system from January 2008 with a six-year transition period during which the imputation system continued to apply to certain companies. The corporate tax rate was reduced from 26 per cent in 2008 to 25 per cent in 2009 (Taxand 2007).

What are the lessons for Australia?

There are some notable differences between Australia and those countries that have removed imputation, as well as contrasts in their political and economic circumstances. However, there are considerable similarities in the imputation systems that countries had been operating. So, what can we learn?

Firstly, the ECJ has played a significant role in the shift away from dividend imputation in Europe. Based on the reasons provided for the removal of imputation by these countries, it is not clear that the mass removal would have taken place without the pressure from the ECJ, perceived or otherwise. The shift away from imputation thus seems to be motivated more by concern with anti-discriminatory taxing of shareholders than economic efficiency. In this sense, Singapore and Malaysia are notable exceptions as they clearly made 'voluntary' decisions to remove imputation.

For the most part, the reasons used to justify removing imputation overseas do not seem directly applicable to Australia. In addition to the role of the ECJ, other motivations have included improving investment (UK, Singapore), reducing cost and improving flexibility (Italy, Singapore), and tax rebalancing aimed at reducing the burden on individuals (Norway). While the impact on investment has been a focal point in Australia, the debate here contrasts with that in the UK where the motivation seems to have been to discourage high dividend payouts.

With the exception of Norway, all of the countries discussed above lowered the corporate tax rate at, or around, the time when imputation was removed. It is on this point that the overseas experience has its closest parallels with the debate in Australia, where removing imputation is seen as a way of potentially funding a lower corporate tax rate. It is also worth noting the transition period used in Singapore and Malaysia, as a means to allow for more orderly behaviour by companies and market participants.

It remains to be seen where the debate surrounding the removal of imputation in Australia will go from here. If the debate continues, there are two questions that will need to be addressed. What system might replace dividend imputation? Do we understand any potential unintended consequences from these different tax systems? The continued changes to how dividends are taxed by some of the countries that have removed imputation suggests that the answers to these two questions are not straightforward.

Despite attempts to make the shift away from imputation tax that is neutral from the shareholders' perspective, it is evident that in some countries certain shareholders were better off and others were worse off. The burden varied across investors, with tax exempt or low marginal tax rate investors in many countries being most adversely affected when the refunding of imputation credits ceased. Many of the countries that removed imputation have continued to alter their tax systems by either changing the rates, taxable proportions of dividends, or other rules. In contrast, dividend imputation in Australia has been stable for over decade.

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Notes

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2. See Graetz and Warren (2007) for details on the ECJ and its role in dividend taxation.

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