

DIVIDEND IMPUTATION

and the Australian financial system

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There is ongoing debate about the precise effects of the dividend imputation system on the Australian financial sector, company and investor behaviour, and real sector consequences. In discussions about the costs, benefits and the future of imputation, a critical but largely ignored issue is the need to identify the appropriate counterfactual. Any alternative will involve some differences between Australian and overseas tax systems and differential treatment between investors, which will involve various types of distortions. Based on the available evidence, this paper argues that the benefits of imputation outweigh its costs. Moreover, the disruption to financial markets caused by substantive change such as abolishing imputation would be substantial.¹

International financial market integration and dividend imputation

Much of the uncertainty about the effects of dividend imputation arises from different perspectives on the extent and consequences of global integration of capital markets. While there is little doubt that a high degree of integration exists between the Australian and international capital market, it is important to recognise that the imputation system introduces a 'tax wedge'. Imputation is essentially equivalent to a subsidy to domestic investors in domestic shares or the removal for these investors of the distorting double taxation of dividends in a classical tax system which applies (in various forms) to most international investors (and investments).

There is substantial debate and disagreement on the effects of this tax wedge. Based on different interpretations of relevant theory and empirical evidence, there are technical arguments about its effects on domestic equity market pricing and the cost of equity capital for Australian firms. But the debate plays out most clearly in the context of regulatory access pricing decisions such as by the Australian Energy Regulator. The value attributed to franking credits and incorporated into the 'building block' approach used to determine allowable revenue and prices has multi-million dollar consequences for the return on equity achievable by the companies concerned. The issue of imputation's effects on equity pricing and the cost of capital is considered in some detail in the companion piece in this issue of JASSA by Ainsworth et al., and is not pursued here other than to note the following important points.

First, at polar extremes of the debate are what can be termed the *international integration and domestic segmentation hypotheses*. The former hypothesis implies that the dominance of international investors means that equity prices and thus the cost of equity capital for Australian firms is determined in global markets. The implication is that the benefits of imputation accrue to Australian investors in the form of a higher than required rate of return arising through the tax benefits received. The latter hypothesis implies that domestic investors bid up the price of Australian stocks relative to comparable stocks overseas due to the tax benefits, such that Australian companies benefit from the lower (tax induced) required rate of return of domestic investors for domestic stocks. Either extreme view brings with it a large number of logical conclusions about a range of financial and real phenomena (discussed in the larger paper, see endnote), however, consistent application of one view is not always adhered to by participants in the debate.

Reality is undoubtedly somewhere in between these extremes, but it is worth noting that (often vague) assertions that global integration of capital markets and consequent arbitrage activities must remove scope for international differences in the cost of capital (under the international integration hypothesis) are not well founded. Arbitrage of any price differences between domestic and foreign stocks, resulting from domestic investors pushing up domestic stock prices due to the value placed on imputation credits, is not as simple as it might appear.

The arbitrage strategy involves short selling higher priced domestic securities to purchase similar, lower priced, foreign securities. There are obviously risk issues which make this a form of 'risk arbitrage', but there is a more fundamental impediment to profitable arbitrage. That impediment is the need to borrow securities to enable the short selling. Securities lending arrangements in Australia require the borrower of securities to reimburse the lender for any dividends received, with the reimbursement amount grossed up by the value of franking credits attached to the dividend.

Thus, for example, if there were similar Australian and foreign stocks each about to pay cash dividends of \$0.70, and the Australian stock were priced at \$10 and the foreign stock at \$7, it might appear that buying 10 shares of the foreign stock financed by short selling seven shares of the domestic stock would involve zero current cash flow and generate \$7 of dividend revenue (from the 10 foreign shares) and require paying only \$4.90 of dividend compensation to the lender of the seven Australian shares. However, the requirement to 'gross up' the amount paid to the stock lender means that \$7 in total would have to be paid, removing the arbitrage opportunity. This requirement removes the apparent but illusory gains from a simple arbitrage strategy and, while sophisticated investors may find ways around the tax wedge, the processes are not simple and are likely to be subject to legislative prohibition once identified.

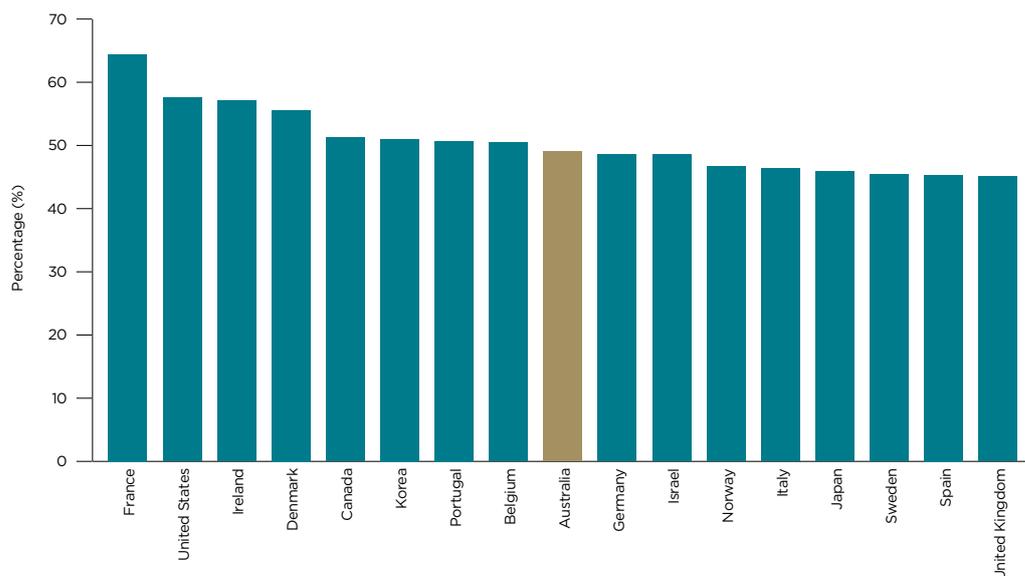
Perceptions of, and behavioural responses to, imputation and corporate tax

The perspectives and behaviour of market participants is another important consideration in determining the consequences of, and perceptions of the effects of imputation.

First, do company managers 'look through' corporate tax consequences to consider overall tax consequences for their shareholders in making decisions? The answer appears to be both yes and no. The available evidence suggests that some financial (dividend policy and capital structure) decisions and some operational decisions (offshore expansion) are influenced by imputation (see later and the Ainsworth et al. for more discussion on this). On the other hand, limited explicit attention paid to imputation in capital budgeting decisions and arguments about an excessively high corporate tax rate, and its consequences, suggest that this is not so.

In assessing the debate about the level and consequences of the Australian corporate tax rate, first, it is important to put it into the proper perspective by focusing on the overall taxation of corporate income - taking into account taxes paid directly at the corporate level and subsequently by shareholders. While some Asian jurisdictions have very low corporate tax rates (which draw attention), Australia's overall taxation of company income distributed as dividends is not that high by international standards - because of the effect of imputation. Figure 1 makes the relevant comparison of the overall tax rate on corporate income distributed as dividends, in which it should be noted that the investor level tax rate used is the highest marginal tax rate. If an 'average investor' tax rate were used, the important role in Australia of superannuation funds and charitable foundations (with 15 per cent and/or zero per cent tax rates) might be expected to improve the relative position on the international league table.

FIGURE 1: Overall dividend tax rate – 2015



Source: [OECD Dataset Tax Database: Table II.4](#). Overall statutory tax rates on dividend income.

Once recognition of the role of imputation credits is recognised, it becomes apparent that reducing the corporate tax rate under an imputation system is of little benefit to Australian investors if high dividend payout ratios prevail. Companies may be able to pay higher cash dividends, but these would be accompanied by a correspondingly lower level of franking credits. On the other hand, such a change would benefit foreign investors and foreign-owned companies operating in Australia (or managers of Australian companies who would prefer to retain earnings rather than face the discipline of the market in raising funds for expansion).

Also important, and reflecting the incomplete ‘look through’ in the discussion, is the issue of the relative taxation of different types of assets. It is often asserted that there is a tax bias against debt securities/bank deposits because interest payments are taxed at the investor’s marginal tax rate whereas imputation credits on equities reduce tax payable by the investor. These arguments are sometimes misguided because they typically assume the same pre-tax rate of return (ignoring risk differences). But, more significantly, they ignore the effect of imputation on the relative pre-tax rates of return available to different types of securities.

The imputation system means that a given amount of corporate income generated is subject to the same overall amount of taxation regardless of whether it is distributed to Australian residents via interest on debt or dividends on equity. In the absence of imputation, the pre-tax rate of return on equity would be higher, although by how much depends on the position taken on the relative importance of international versus domestic factors in equity price determination. Under the extreme international integration view, Australian equity investors do get a ‘free kick’ from the tax concessions which means a higher after-tax rate of return than they require. Under the extreme domestic segmentation view, they are paying a higher share price for domestic equities which wipes out the benefit to them of the tax concessions (and transfers them to the company via a lower cost of capital).

One final aspect of imputation and perspectives lies in international comparisons of stock market performance. Much media focus is upon movements in the stock price index (such as the S&P/ASX 200) for the Australian market relative to similar indices overseas. When such comparisons are made over a short period (of days or weeks) there is little distortion introduced by focusing on price indices. But over longer periods of time, such as a year or more, relative market performance is distorted by ignoring the effect of substantially different dividend payout rates across countries. Dividend imputation, by encouraging high dividend payout, *ceteris paribus* depresses the price index relative to those of other countries with lower dividend payout rates. Appropriate comparison requires examination of accumulation indices which allow for such differences through an assumption of reinvestment of dividends. While institutional and sophisticated investors are well aware of this, the focus of media on price index comparisons does not help in the financial education of retail investors.

Imputation and capital gains tax interactions and consequences

If there is a tax bias affecting relative asset returns it is due to capital gains tax concessions which need to be considered jointly with imputation in assessing the consequences of imputation. This is important because companies can provide returns to investors via capital gains arising from retaining and reinvesting earnings rather than by paying dividends. This option has significant, differential effects depending on the company type. For listed Australian companies there is an incentive to pay dividends due to the prevalence of low-tax rate investors, such as Australian superannuation funds, in their shareholder base.

However, for private companies, with owners on marginal tax rates above the company tax rate, retention avoids current payment of some investor-level tax on franked dividends, and generates favourable (and deferred) taxation of realised capital gains. It is also relevant that the absence of double taxation of dividends (and tax deferral capital gains strategy possibilities) removes that tax bias against a business operating under a company structure rather than as an unincorporated enterprise. International data on comparisons of small business legal structures, while not conclusive, suggests that might be so.

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Imputation and other tax system features

The interaction of the imputation system with other aspects of the tax system is also important to consider, and not always well recognised. First, consider corporate tax concessions such as Research and Development allowances and accelerated depreciation. These are of limited benefit to Australian-owned companies. Less corporate tax may be paid directly, but more personal tax needs to be paid when dividends are paid. Higher cash dividends can be paid, but these are offset by lower franking credits being received. Again, capital gains tax interactions are relevant here since company managers have the option of retaining earnings whose investment hopefully generates capital gains tax concessions. Clearly, such tax concessions are of value to foreign-owned companies operating in Australia (and paying Australian company tax) for whom the reduction in franking credits payable is irrelevant.

Another potentially important interaction is with the taxation of superannuation. If a large/increasing percentage of Australian equities is held by super funds on a 15 per cent tax rate (in accumulation mode) or by super funds in retirement mode and charitable foundations both on a 0 per cent tax rate, then a large/increasing part of corporate profits escapes (or is subject to low) tax. With the continuing growth of superannuation and large investment in domestic equities, this is potentially a major problem for future government budgetary revenue.

Identifiable consequences of imputation

While there is ongoing debate about the overall effects of imputation, there are some relatively clear and discernible effects of imputation on financial and real sector decisions.

There is evidence that Australian listed companies generally have higher dividend payout ratios than comparable companies overseas. There have been a number of studies that demonstrate an increase in dividend payout ratios following the introduction of imputation such that Australian dividend payout ratios exceed those found overseas. Several other features of company financial behaviour follow from this, including: less use of on-market share repurchases; and greater use of dividend reinvestment schemes.

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An important effect on operational decisions can also be identified in the data (and anecdotal evidence). Because income generated and taxed offshore does not generate franking credits, offshore expansion reduces the ability of a company to maintain the same franked dividend payout ratio. To the extent that shareholders value franking credits and this is reflected in the cost of equity capital, the higher cost of equity capital for offshore expansion provides a disincentive to such activities. At the same time, however, higher leverage (to take advantage of the interest tax shield) of foreign-domiciled subsidiaries involved in such activities may partly offset that effect.

Turning to investors, the imputation tax system appears to create a further 'home equity bias' among domestic investors. There is some support from international comparisons for the proposition that Australian superannuation funds are relatively more heavily invested in domestic equities than their offshore counterparts. But given different institutional features, the evidence is not conclusive and the effect appears to be more one of a tilt of portfolios than a dramatic shift.

Finally, imputation can be argued to have significant effect on financial structure and financing decisions. First, the use of preference share (rather than debt) structures for design of hybrid securities has been facilitated by the absence of a tax bias against such securities. Second, companies have endeavoured to find ways to 'stream' franking credits to domestic investors. This has been most apparent in two ways. One is the use of off-market share buyback structures to include a significant component of a franked dividend in the repurchase cost. Domestic investors, who value the attached franking credits have found participation attractive such that repurchase prices have been substantially below current market prices.

The second is the use of preference shares which specify a dividend with a gross amount explicitly incorporating franking credits such that foreign investors will not participate due to the correspondingly lower cash component. This is most apparent in the recently popular listed 'bail-in' hybrid securities issued by Australian banks as part of regulatory capital requirements. As a final example, Australia is the only country with significant use of stapled security structures by A-REITS and Infrastructure funds, with approximately 9 per cent of ASX market capitalisation taking this form. While there are a range of factors behind the use of such a structure, the consequent 'streaming' of much of the profits of operating activities through a trust structure rather than via the stapled company has less adverse consequences for government tax revenue under an imputation tax system than under a classical tax system. Consequently, unlike most overseas jurisdictions, such structures are permitted in Australia – even though there is some avoidance of tax when the withholding tax on trust distributions to foreign investors is less than the corporate tax rate.

Conclusion

The benefits of the imputation tax system are relatively clear. Corporate financial policies and the operation of the financial system are less distorted than under a classical tax system. Reduced (tax-induced) corporate leverage and higher dividend payout ratios are both advantageous for financial stability, market discipline and corporate governance.

There are some potential costs. The first of these is the consequence for government tax revenue. Removing imputation, without reducing the company tax rate would lead to a substantial increase in tax revenue. More realistically, estimates of a 'tax neutral' classical corporate tax rate tend to lie in the 15–20 per cent range such that government tax revenue could be increased by removing imputation and a smaller reduction in the company tax rate than that. A second possible 'distortion' lies in the effect of imputation on cross-border real and financial investment decisions both by Australian and foreign companies and investors.

But, in making such comparisons, the difficult problem is identifying the appropriate counterfactual or baseline scenario. Regardless of the alternative tax system considered, there will remain tax distortions induced by differences (and interactions) between the Australian system and the diverse variety of tax systems found globally. Whether these distortions would be of greater, or lesser, consequence than those that currently exist is difficult to ascertain.

Based on the available evidence, this author's admittedly subjective judgement is that the benefits of imputation outweigh its costs. Moreover, the disruption to financial markets caused by substantive change, such as abolishing imputation, (discussed in more detail in the larger paper, see endnote) would be substantial. Consequently the conclusion drawn is that the case for change is not proven.

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Note

1. This paper is based on a much larger study undertaken as part of the [Funding Australia's Future Project of the Australian Centre for Financial Studies](#). I am grateful to participants in that project for valuable advice and feedback.