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# **TAXING CORPORATIONS: SYSTEMS AND STRATEGIES**

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# Taxing Corporations : Systems and Strategies

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## Abstract

The purpose of this paper is to discuss the alternative methods by which companies are taxed and the consequences, including shortcomings, of those methods. Part 1 of the paper discusses the threshold question of whether companies should be taxed at all. Part 2 explores the two extreme methods used, or proposed to be used, to tax company profits, Part 3 discusses some of the hybrid methods actually in use throughout the world and Part 4 offers some concluding comments.

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The purpose of this paper is to discuss the alternative methods by which companies are taxed and the consequences, including shortcomings, of those methods.<sup>2</sup> The emphasis is on domestic shareholders and the international consequences of company tax systems is mentioned only in context. Throughout the paper the terms company and corporation are used interchangeably. Part 1 of the paper discusses the threshold question of whether companies should be taxed at all. Part 2 explores the two extreme methods used, or proposed to be used, to tax company profits, Part 3 discusses some of the hybrid methods actually in use throughout the world and Part 4 offers some concluding comments.

### **1. To tax or not to tax (companies)?**

There are many different methods of taxing companies and one of the first issues to be addressed in any discussion of the imposition of tax on corporations is whether such a tax is necessary or desirable.

There has been considerable debate as to whether separate taxation of corporations, as distinct from their shareholders, is a necessary part of an income tax system. However, most countries adopt income tax systems which provide for a tax on both companies and their shareholders. This is largely in recognition of the nature of companies as separate legal entities. There are a number of possible reasons for continuing to tax companies separately from the ultimate individual shareholders<sup>3</sup>:

1. ease of revenue collection, that is, it is politically easier to collect revenue from entities such as companies than, for example, from salary and wage earners who are more acutely aware of the burden, the taxation of companies is therefore convenient for revenue authorities;
2. as a mechanism for the collection of income tax from foreign resident shareholders deriving income through resident companies. Such shareholders may not otherwise fall within the domestic income tax net,

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<sup>2</sup> The author is indebted to Richard Fayle, Associate Professor, Department of Accounting and Finance, University of Western Australia for helpful comments on earlier versions of this paper. Any remaining errors and omissions are the responsibility of the author.

<sup>3</sup> These reasons are based on those put forward by Krever in "Companies Shareholders and Tax Reform" *Taxation in Australia* September 1985 pp 163 - 175 at p 163-4.

- and without company tax the domestic revenue would suffer. Cronin <sup>4</sup> describes it as an additional withholding tax. This aspect is particularly important for capital importing countries such as Australia and Canada with substantial foreign ownership of equity capital<sup>5</sup>;
3. as an indirect means of collecting tax from otherwise tax exempt entities which invest in companies; and
  4. in a capital gains tax free environment, such as that in Australia prior to 20 September 1985, to prevent the accumulation of tax free capital gains through the sale of shares. This is not relevant if capital gains are taxed as income<sup>6</sup>.

In the extreme there are two diametrically opposed views of the taxation of companies and shareholders which influence the choice of system adopted. The first view is that it is appropriate to tax companies on profits and shareholders on dividends in light of their distinct legal personalities which confers on each separate rights. The company, for example, generally has the right to sue and be sued as well as perpetual existence.<sup>7</sup>

The second view is sometimes referred to as the "conduit" view or the proprietary view under which companies are seen as being mere conduits through which profits flow into the hands of ultimate shareholders. Subscribers to this view state that there is no need for a separate tax on corporations if corporate profits are taxed adequately in the hands of the owners or shareholders.

Proponents of the classical system of company taxation subscribe to the first view, that companies are separate entities which should be taxed as such. A

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<sup>4</sup> Cronin: M.R. "Economic and Revenue Implications of Tax Reform in the Corporate Sector" in *Reform of Business Taxation*, J. Head ed, Australian Tax Research Foundation 1985 pp 23 - 72 at p.28..

<sup>5</sup> The Taxation Review (Asprey) Committee in Australia in its Full Report, AGPS 1975 noted that the company tax is the main means of taxing foreign residents deriving Australian income.

<sup>6</sup> Although most capital gains tax systems only tax gains on realisation and to achieve true parity between the treatment of retentions and distributions it would be necessary to tax capital gains on an accruals basis.

<sup>7</sup> As Kreyer (supra note 3) states, it could be that if this is the basis for the separate taxation of companies, a licence fee may be more appropriate. (At p 164.) This view is also expressed by Kay and King in "The British Tax System" Oxford University Press, Oxford 1991, who point out that there is in fact no reason to assume that the benefits of incorporation are proportional to profits, indeed the reverse may be true. (at p 152)

description of this system and its potential problems follows. The second view leads to the conclusion that income derived by a company should be taxed in the same manner as income derived through a partnership, which does not generally have a legal existence independent of its partners, a full integration system. This has in turn led to several proposals which will be examined in more detail later.

## **2 Taxing Companies: What are the alternatives?**

### **2.1 The Classical System**

The classical, or, as it is sometimes called separate, system is the system of company tax under which corporate income is taxed at two levels; in the hands of the company in the first instance and then again in the hands of the shareholder on subsequent distribution by way of dividends. It is the system that prevailed in Australia between the start of World War II and the introduction of the dividend imputation system in 1988. It is still used in the United States ("US") and indeed was the prevailing system of taxing company income until the 1960's when a number of countries began adopting various forms of company tax systems aimed at reducing this "double taxation" of dividends<sup>8</sup>.

The notion of "double taxation" is perhaps misleading since the question of incidence of company tax is not fully reconciled and there is some doubt as to whether the incidence of company tax is actually borne by shareholders.<sup>9</sup> If not, and to the extent to which it is not, there is no actual "double" taxation, perhaps "overtaxation" would be a more appropriate term. Despite this, the term "double taxation" will be used as it has wide acceptance in the literature. According to Gerardi<sup>10</sup> "the economic consequences of company tax are one of the most controversial subjects in public finance."

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<sup>8</sup> for example in 1965 France replaced its classical system with one of imputation, in 1968 Austria replaced its classical system with a split rate system, 1970 saw Norway similarly introduce a split rate system, in 1972 the UK reverted to an imputation system following a brief time with a classical system and in the same year Canada introduced a partial imputation system.

<sup>9</sup>This point was noted by the Carter Commission in Canada. The incidence of a given tax refers to who actually bears the ultimate burden, and in the case of company tax there is doubt as to whether it is the shareholders, the consumers of the company's products in the form of higher prices or the company's labour force in the form of lower wages. In addition there may be a difference between the short run incidence and that in the long run.

<sup>10</sup>Gerardi:E.A.; Gertz: M.J.& Rosen: H.S. "Corporate Integration Puzzles" National Tax Journal Vol XLIII No 3 pp 307 - 314

Proponents of the classical system of corporate taxation justify its retention on the basis that there is no interaction between company and individual taxes, that the separation of ownership and control, particularly in companies with diverse and widely held shareholding, means that shareholders have no claim on corporate earnings until such time as dividends are declared, indeed that shareholders are "little more than subordinate creditors."<sup>11</sup>

There are several undesirable economic effects of the double taxation of distributed profits as follows:

1. double taxation of distributed income encourages companies to retain their profits which are then not subject to the "test of the market place" and may be utilised for less socially productive purposes<sup>12</sup>. This phenomenon has alternatively been referred to<sup>13</sup> as the nations savings being directed as "captive funds" into projects which may be less productive than those to which investors may otherwise direct them given a free choice. This may also place newer firms at a disadvantage compared to established firms;<sup>14</sup>
2. there is an incentive for profitable companies to use debt in preference to equity as a source of funds, since dividends are not deductible for income tax purposes. Given that the providers of capital seek the same after tax return, new equity is more expensive than new debt. This could lead to excessive gearing exposing companies to the possibility of bankruptcy<sup>15</sup>;
3. there is potential for distortion of the allocation of resources between the corporate and non-corporate forms of doing business. In its simplest form, if companies are taxed as well as shareholders on the same profits, perhaps investors would not be indifferent to different business entity

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<sup>11</sup>S. Cnossen *Alternative Forms of Corporation Tax* Australian Tax Forum; Vol 1 No 3, September 1983 pp 253 - 279 at p 259.

<sup>12</sup>Cnossen *supra* note 11 at p260

<sup>13</sup>Treasury Taxation Paper No 1 Australian Government Publishing Service; Canberra September 1974. It has also been referred to as "survival of the fittest", see the OECD publication on Company Tax Systems, Paris 1973.

<sup>14</sup>Charles McClure "Must Corporate Income be Taxed Twice?" Brookings Institute Washington DC 1979 Chapter 2.

<sup>15</sup>Per Cnossen *supra* note 11. In Australia the Bureau of Industry Economics in its paper "Imputation of Company Taxation" AGPS 1985 noted that this increased the cost of risk capital for industries such as mining and manufacturing where the non corporate form is less feasible.



structures This issue is further complicated by the fact that in some industries incorporation is almost mandatory<sup>16</sup>;

4. a further source of distortion occurs when the rate of tax applicable to companies is less than the higher marginal rates applicable to individual taxpayers. In such situations there may be a tax induced preference for the corporate form, particularly where there is no capital gains tax to effectively tax the increase in market value of shares attributable to retained profits; and
5. there are indirect detrimental effects on national savings and investment, which arise as a result of distortions of payout rates, debt/equity ratios and the forms in which business may be carried on.<sup>17</sup>

## 2.2 Full Integration

If the classical system of company taxation can be viewed as being at one end of the spectrum, then at the other lies the notion of full integration.

Under a system of full integration, all company profits, either distributed by way of dividends, or retained, are attributed to shareholders and brought to tax at the shareholder's appropriate marginal rate of income tax.

Full integration of company tax and income tax applicable to shareholders has been acknowledged by many commentators as a theoretical ideal<sup>18</sup>. Strong support for a system of integration was enunciated by the Royal Commission on Taxation in Canada <sup>19</sup> (hereinafter referred to as the "Carter Commission") where *inter alia* the subject of integration was given significant attention and has often been quoted in subsequent studies<sup>20</sup>. The detailed proposals

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<sup>16</sup> for example see *Federal Commissioner of Taxation v Bunting* 89 ATC 4358 where a computer systems analyst found it necessary to offer his services to prospective "employers" via a company.

<sup>17</sup>Per Cnossen supra note 11 at p 261

<sup>18</sup>For example, Cnossen supra note 11 at p6 describes it as "a perfect solution in an imperfect world."

<sup>19</sup> Royal Commission on Taxation (Carter Report) Ottawa: Queens Printer, 1966

<sup>20</sup>See for example the Australian Treasury in Tax Reform Problems and Aims, Treasury Taxation Paper No 1, AGPS, Canberra 1974, Bureau of Industry Economics, Imputation of Company Taxation, and the Asprey Committee's Full Report 1975.

contained in the Carter Commission report "provide useful benchmarks against which other proposals can be evaluated."<sup>21</sup>

Full integration is sometimes referred to as a "conduit" system, under which companies are effectively transparent and are treated in the same manner as partnerships are in most jurisdictions. Partnerships, are not usually legal entities separate from their owners, the partners, and are rarely taxed in their own right<sup>22</sup>. As a general rule, income derived, or losses incurred, by partnerships, are directly attributed to the partners for income taxation purposes and are thus immediately exposed to the marginal rate of income tax applicable to the partners.

In its pure form full integration is a system of attribution far more comprehensive than the practical alternatives of partial integration which have developed, and which generally tend to deal only with distributed income as discussed below.<sup>23</sup>

It has been argued that the economic principles of equity and efficiency *require* integration of company and individual tax rates, in order that the tax ultimately paid reflects the ability to pay of the individual shareholders who benefit from equity ownership.<sup>24</sup> Indeed "ability to pay" is a concept which some commentators consider can only be properly attributable to individuals<sup>25</sup>.

Full integration places pressure on companies to distribute in order to provide shareholders with funds to meet their tax liabilities. The "S Corporation" system in the United States, under which small companies are effectively treated as partnerships, is the closest that any country has gone towards full

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<sup>21</sup>Krever, *supra* note 3. In an Australian context the Committee of Enquiry into the Australian Financial System (the Campbell Inquiry) also acknowledged full integration as being a desirable goal in taxation policy formulation, see chapter 3 for details.

<sup>22</sup> In Australia the partners are directly taxed on the income and losses of the partnership as is the case in Canada, New Zealand and the United States of America. In the United Kingdom there is similar treatment for income tax purposes, notwithstanding that in Scotland partnerships are in fact separate legal entities (*Partnership Act 1890* s.4(2).)

<sup>23</sup>These are sometimes referred to as partial integration systems, meaning that integration occurs only in respect of distributed profits and not those profits which are retained by the coy.

<sup>24</sup>Krever, *supra* note 3 at pp164-5

<sup>25</sup>According to Cnossen *supra* note 11, since ability to pay is an equity notion, it can only relate to natural persons.



integration. This failure to embrace full integration is probably explained by the administrative difficulties which such a system presents.

Under full integration, tax may or may not be collected from the company in the first instance. If it is, it is by way of a withholding tax credited to shareholders against their individual tax liabilities and should be refunded in the event of excess credit if the progressivity of the personal income tax rate scale is to be maintained. Collection of taxation from the company in the first instance, albeit as a form of withholding tax is administratively convenient, involving fewer taxpayers. As previously mentioned (at 1.1) it is also a convenient means of collecting income tax from non-residents.

#### **Advantages of Full Integration**

There are a number of perceived advantages of a system of full integration. Firstly, and perhaps most importantly, it achieves tax neutrality as between corporate and non-corporate forms of doing business.<sup>26</sup>

Adoption of a system of full integration also results in greater horizontal and vertical tax equity, as a result of aligning the taxation of company profits to the ability to pay of the ultimate shareholders.<sup>27</sup>

In addition it has the advantage of removal of any perceived tax bias in favour of debt financing over equity.

#### **Disadvantages of Full Integration**

A number of difficulties have been identified which lead ultimately to the abandonment of integration as a workable system in practice.

Timing difficulties arise due to the need for companies to transmit information to shareholders to allow them to complete their taxation returns. This is aggravated where there is a chain of interposed entities between the originating company and the ultimate individual shareholder.

Given that some point in time has to be chosen to determine who the relevant shareholders are for the purposes of attributing to them the company's profits or losses for the year<sup>28</sup>, there may be an incentive for high marginal rate

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<sup>26</sup> but not neutrality in the commercial sense recognising the principle of limited liability

<sup>27</sup> This presupposes profitability as an acceptable measure of ability or faculty to pay tax - a matter which is itself open to dispute

<sup>28</sup> since allocation on a day to day basis is clearly not feasible

taxpayers to seek to acquire shares in companies with losses in order to obtain the benefit of their attribution<sup>29</sup>.

Freebairn<sup>30</sup> suggests that full integration creates a higher demand for dividend payouts. In addition, making shareholders liable for tax on retained profits can lead to cash flow problems by taxing them on income not actually in their hands.

Full integration will result in a loss of revenue. The loss of revenue is a direct result of removing one layer of taxation, that is, the taxation of companies separate and distinct from their shareholders.<sup>31</sup>

Difficulties arise in an integration system where companies have different classes of shares. For example, a company that wishes to maintain a consistent record of preference share dividends may be forced to pay a dividend to preference shareholders out of previous years' accumulated earnings if there is not enough in the current year to fulfil the obligation. Those undistributed profits may have already attributed to ordinary shareholders in the year in which they were earned.<sup>32</sup> To overcome this problem it may be necessary to re-open the assessments of the ordinary shareholders to reduce the company profits on which they were previously taxed, adding to the administrative costs of the system.

### **2.3 Classical and Full Integration Compared.**

The following table compares the impact on the revenue of the classical and full integration company tax systems.

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<sup>29</sup> Cnossen, *supra* note 11. The Carter Commission recommended a variation on full integration to overcome this perceived problem by not allocating losses to shareholders. Another solution is to choose the first day of the fiscal year as being the "day of record" and allow market forces to determine a sale price for the shares which will reflect the tax credit likely to accrue before the end of the year.

<sup>30</sup> This problem was identified by John Freebairn in a paper presented to the Conference on Reform of Business Taxation, Australian Tax Research Foundation Conference Series No 4, 1985.

<sup>31</sup> The Australian Treasury recognised this as a major consideration, as did the Carter Commission. Even if the loss of company tax is offset by an increase in individual income tax rates, the offset will only be partial as many shareholders are tax exempt bodies, low rate taxpayers or non residents from whom little or no tax can be collected. This point was made by the Australian government in its Reform of the Australian Taxation System, 1985.

<sup>32</sup> Krever, *supra* note 3 at p 171



**Table 1.1 : A comparison of the effect of the classical and full integration systems under varying marginal personal rates and varying dividend payout ratios <sup>33</sup>**

	Item	Classical System						Full Integration	
		20	20	20	50	50	50	20	50
1.	Marginal personal tax rate (see note 1)	20	20	20	50	50	50	20	50
2.	Percentage of profits retained	0	50	100	0	50	100	n/a	n/a
3.	Net company income before tax and dividends	100	100	100	100	100	100	100	100
4.	Company income tax (see note 1)	30	30	30	30	30	30	30	30
5.	Net company income (5-4)	70	70	70	70	70	70	70	70
6.	Dividend to shareholder	70	35	0	70	35	0	70	70
7.	"Gross up" for shareholder	n/a	n/a	n/a	n/a	n/a	n/a	30	30
8.	Assessable personal income	70	35	0	70	35	0	100	100
9.	Gross personal income tax (1 x 8)	14	7	0	35	17.5	0	20	50
10.	Shareholder credit (from 7)	n/a	n/a	n/a	n/a	n/a	n/a	30	30
11.	Net personal income tax (9 - 10)	14	7	0	35	17.5	0	-10	20
12.	Total taxes (11 + 4)	44	37	30	65	47.5	30	20	50

Note:

1. Marginal rates of personal income tax of 20% and 50% have been assumed in line with current world-wide trends towards reducing personal income tax rates. Similarly the company tax rate is assumed to be a flat rate of 30% in keeping with world-wide trends.
2. The table ignores any capital gains tax that may capture the increase in market value of the shares as a result of retentions and assumes refund of excess credit to the shareholder.

The table illustrates that under a classical system, the degree of excess taxation of dividends increases as the marginal rate of personal income tax increases and the profit retention ratio decreases. Under a system of full integration, however, all company income is taxed at the applicable marginal rate of the individual shareholder irrespective of the payout ratio of the company.

### 3. Hybrid company/shareholder tax systems.

Hybrid systems have evolved in light of the difficulties in attributing undistributed profits to shareholders and relate to distributed income only by way of a compromise between the two extremes of classical taxation and full integration.

Relief of dividends from taxation at both the company level and (as shareholders) at the individual shareholders level can be achieved in a

<sup>33</sup> This table and those following are loosely based on a table produced by Charles McClure in his book *Must Corporate Income Be Taxed Twice?* Washington D.C.; Brookings Institution 1979, at p.6

number of ways. These include at the company level, dividend deduction and split rate systems and at the shareholder level, dividend exemption and partial integration systems (partial in that it applies only to dividend distributions).

### **3.1 Dividend relief at the Company Level**

#### **3.1.1 Split Rate System**

A split rate system taxes the company at different rates for distributed and retained profits respectively. This system is a variation on the classical system, retaining double taxation, albeit at differential rates of tax. As with the classical system, there is a tax disincentive to retain profits.

The split rate system discourages retention of profits by imposing a higher rate of tax on retentions, thereby modifying one of the disadvantages of the classical system.<sup>34</sup> Whether or not subsequent distributions from the profits which have been subjected to a higher rate of tax, sometimes referred to as undistributed profits tax, are taxed again in the hands of shareholders depends on the particular type of system adopted.

Criticisms levelled at the classical system are also relevant to the split rate system.

The split rate system lacks neutrality and equity, both horizontal and vertical.<sup>35</sup> It is biased in favour of distribution since the corporate tax burden of the company is dependent on its payout ratio, it provides a positive incentive to distribute. Its effect depends on the differential between the rate of tax applicable to retained earnings and that applicable to distributed earnings. If the differential is small, the system is similar to a classical system as seen in the following table.<sup>36</sup>

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<sup>34</sup> A form of split rate system operates in Australia in the context of trusts where distributions taxed at a nil rate in the hands of the trustee and retentions are taxed at the highest marginal rate of individual tax. sections 99 and 99A *Income Tax Assessment Act 1936* (as amended). Retentions in this situation being income to which no beneficiary is presently entitled. Trustees may, of course receive assessments as "agent" for a beneficiary under legal disability or who is not a resident of Australia. Subsequent distributions from such taxed profits are not taxed again in the hands of the beneficiaries.

<sup>35</sup> Treasury Taxation Paper No1 AGPS Canberra 1974

<sup>36</sup> Cnossen supra note 11 at p 266



**Table 1.2 : A comparison of the effect of a split rate system under varying marginal personal rates and company tax rates**

	Item	Retentions taxed at 50%, distributions at 30%					
		20	20	20	50	50	50
1.	Marginal personal tax rate (see note 1)	20	20	20	50	50	50
2.	Percentage of profits retained	0	50	100	0	50	100
3.	Net company income before tax and dividends	100	100	100	100	100	100
4.	Company income tax (see notes 1 & 2)	30	40	50	30	40	50
5.	Net company income (5-4)	70	60	50	70	60	50
6.	Dividend to shareholder	70	35	0	70	35	0
7.	"Gross up" for shareholder	n/a	n/a	n/a	n/a	n/a	n/a
8.	Assessable personal income	70	35	0	70	35	0
9.	Gross personal income tax (1 x 8)	14	7	0	35	17.5	0
10.	Shareholder credit (from 7)	n/a	n/a	n/a	n/a	n/a	n/a
11.	Net personal income tax (9 - 10)	14	7	0	35	17.5	0
12.	Total taxes (11 + 4)	44	47	50	65	57.5	50

Note:

1. Marginal rates of personal income tax of 20% and 50% have been assumed in line with current world-wide trends towards reducing personal income tax rates. Similarly the company tax rate on distributed income is assumed to be a flat rate of 30% in keeping with world-wide trends. The rate of company tax applicable to retained income is assumed to be 50%
2. It is assumed that the split rate system taxes shareholders on gross dividends received and that the company tax on retained income is met out of retentions and the company tax on distributed income is met out of distributions.
3. The table ignores any capital gains tax that may capture the increase in market value of the shares as a result of retentions.

Obviously where no income is retained by the company, the result for the shareholder is the same as with the classical system. Correspondingly the greater the degree of retention, the higher the level of total tax where the rate applicable to the shareholder is less than that of the company. As with the classical system, the total revenue raised is a function of the company's distribution policy, the company tax rate and the shareholder's marginal tax rates.

Pari passu, compared to the classical system the split rate system encourages distributions, and thus diminishing the bias in favour of retentions inherent in the classical system. Of course the decision to retain income within the corporate entity also involves non-tax considerations<sup>37</sup>. To this extent the split rate system may impose constraints on sound corporate management.

<sup>37</sup> for example liquidity or strengthening the company's financial position, to provide funds for the purchase of capital equipment, to finance other activities or expansion.



### 3.1.2 Dividend Deduction System

This system reduces company taxable income by dividends in whole or in part, paid during the year. Distributed profits are therefore only taxed to shareholders. This addresses to some extent a perceived inequity in the classical system. However, it maintains the bias against distributing income in the case of those shareholders whose marginal tax rate is higher than that borne by the company itself. Such shareholders will prefer the income to be retained by the company notwithstanding its deductibility if distributed.

The effect of a dividend deduction system depends on the proportion of the dividend deduction which is allowed. A full deduction imposes a disincentive to retentions in the form of an undistributed profits tax, whilst reduced deductions tend, in effect, to the classical system.<sup>38</sup> In essence, the system is similar to a split rate system with a zero company tax rate on distributions.

A dividend deduction system corrects the bias in favour of debt financing over equity, since dividends are treated in the same way as interest expense<sup>39</sup>. However, *all* shareholders benefit from the reduction in corporation tax that the deduction provides irrespective of their residency status.<sup>40</sup>

Krever states <sup>41</sup> that, "without a capital gains tax, a dividend deduction system can achieve complete neutrality between the decision to distribute profits and the decision to retain profits within the company." If there is a capital gains tax, there will be a significant bias towards distribution. "The only way double taxation can be avoided is through the adoption of a cumbersome and complicated credit system in which shareholders' capital gains are reduced by the undistributed income that has been subject to company tax at the time the shareholder realises the capital gain."

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<sup>38</sup>Cnossen, *supra* note 11 at p 264

<sup>39</sup> where the withholding tax rates for non residents in receipt of dividends and interest are different, however, the bias is not entirely removed for non resident investors.

<sup>40</sup>However, because dividend and interest withholding tax rates vary the bias is not entirely removed for non resident investors.

<sup>41</sup>Krever (*supra* note 3) at p 170

**Table 1.3 : A comparison of the effect of a dividend deduction system under varying marginal personal rates. (Full deduction)**

	Item	Company deduction allowed for dividends at 100%					
		20	20	20	50	50	50
1.	Marginal personal tax rate (see note 1)	20	20	20	50	50	50
2.	Percentage of profits retained	0	50	100	0	50	100
3.	Gross Company income	100	100	100	100	100	100
4.	Dividend deduction	100	50	0	100	50	0
3.	Net pre- tax Company income	0	50	100	0	50	100
4.	Company income tax (see note 1)	0	15	30	0	15	30
5.	Net after- tax company income (5-4)	100	85	70	100	85	70
6.	Dividend to shareholder	100	50	0	100	50	0
7.	"Gross up" for shareholder	n/a	n/a	n/a	n/a	n/a	n/a
8.	Assessable personal income	100	50	0	100	50	0
9.	Gross personal income tax (1 x 8)	20	10	0	50	25	0
10.	Shareholder credit (from 7)	n/a	n/a	n/a	n/a	n/a	n/a
11.	Net personal income tax (9 - 10)	20	10	0	50	25	0
12.	Total taxes (11 + 4)	20	25	30	50	40	30

Note:

1. Marginal rates of personal income tax of 20% and 50% have been assumed in line with current world-wide trends towards reducing personal income tax rates. The company tax rate is assumed to be a flat rate of 30%
2. The table ignores any capital gains tax that may capture the increase in market value of the shares as a result of retentions.

It can be seen from the table that a full deduction system has the same result as a split rate system with a zero rate on distributions (see table 1.3), and a system of full integration (see table 1.1).

### 3.2 Dividend Relief at the Shareholder Level

#### 3.2.1 Dividend Exemption

Under a dividend exemption system, dividends are exempt from tax in the hands of the ultimate natural person shareholders, and tax is imposed only at the corporate level. Although one level of tax is eliminated, biases remain, however, in that investment in companies is more or less attractive to individuals based on their respective marginal tax rates relative to the company rate, that is, the non-neutrality in terms of choice of entity remains where the company rate is proportional and the individual rate is progressive.

Where the company rate falls between the individual rate extremes, the system operates regressively in that the amount of relief increases according to the tax bracket of the recipient shareholder, with those in the highest tax bracket receiving the benefit of the greatest relief.

**Table 1.4 : A comparison of the effect of a dividend exemption system under varying marginal personal rates.**

	Item	Company deduction allowed for dividends at 50%					
		20	20	20	50	50	50
1.	Marginal personal tax rate (see note 1)	20	20	20	50	50	50
2.	Percentage of profits retained	0	50	100	0	50	100
3.	Gross Company income	100	100	100	100	100	100
4.	Company income tax (see note 1)	30	30	30	30	30	30
5.	Net after- tax company income (5-4)	70	70	70	70	70	70
6.	Dividend to shareholder	70	35	0	70	35	0
7.	"Gross up" for shareholder	n/a	n/a	n/a	n/a	n/a	n/a
8.	Assessable personal income	0	0	0	0	0	0
9.	Gross personal income tax (1 x 8)	0	0	0	0	0	0
10.	Shareholder credit (from 7)	n/a	n/a	n/a	n/a	n/a	n/a
11.	Net personal income tax (9 - 10)	0	0	0	0	0	0
12.	Total taxes (11 + 4)	30	30	30	30	30	30

Note:

1. Marginal rates of personal income tax of 20% and 50% have been assumed in line with current world-wide trends towards reducing personal income tax rates. The company tax rate is assumed to be a flat rate of 30%
2. The table ignores any capital gains tax that may capture the increase in market value of the shares as a result of retentions.

The total tax revenue under a dividend exemption system remains the same irrespective of the company's dividend payout ratio or the shareholder's marginal rate of tax, that is, for dividend income individual taxpayers are assessed proportionately not progressively on dividend income.

### 3.2.2 Dividend Imputation

Dividend imputation systems involve levying tax at the corporate level and then allocating or imputing that tax, by way of both assessable income and a compensating tax credit, to the shareholder in receipt of dividends. Dividends which carry imputed company tax in this manner are commonly referred to as "franked".

For example, assume a company with taxable profits of \$1,000 which pays company tax at the rate of 30%, ie \$300 and fully distributes its after tax profits. The shareholder will include in his or her taxable income the cash dividend of \$700 and under a system of full imputation, also the company tax paid of \$300 as notional assessable income. A credit or rebate is then allowed in respect of the company tax paid. For a shareholder with a marginal tax rate



of 30% this will result in no net tax liability, as the tax on the grossed up dividend is fully covered by the company tax already paid. For a shareholder with a marginal tax rate of 50%, the net liability will be \$200.

Imputation usually operates on a "gross up and credit" basis<sup>42</sup>, that is, the shareholder includes in his or her assessable income both the cash, or credited, dividend and the company tax attributed to that dividend. Imputation without such a gross up mechanism would provide a result similar to that of dividend exemption, in that the relief would be distributed regressively with respect to income.<sup>43</sup>

There is neutrality between individual shareholders on differing marginal rates of tax, to the extent that the company tax rate is not lower than the top marginal rate.

### **Design Features of Dividend Imputation Systems**

There are a number of issues in the design of an imputation system. Different approaches to these issues form the basis of differences between imputation systems in place in different tax jurisdictions.

The *degree* of imputation must be determined, either full or partial. A partial imputation system is one in which only part of the company tax paid is attributed to the shareholder, and it is essentially a compromise between full imputation and the classical system.

Decisions must also be taken in the design of an imputation system as to whether to refund any excess credits to the shareholders, and whether to extend the benefits of imputation to tax exempt shareholders or non-resident shareholders.

Imputation systems become complicated when companies distribute income which has not borne tax at the company level, for example through the operation of tax preferences, that is, preferential treatment of certain types of income or deductions<sup>44</sup>. Adjustment mechanisms may be required to prevent

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<sup>42</sup>as does a dividend withholding tax

<sup>43</sup>Cnossen supra note 11 at p269-270

<sup>44</sup> for example accelerated depreciation, inflation adjustments for capital gains and in an Australian context the 150% research and development deduction provided by s. 73B of the ITAA.

“super-imputation”, that is, allowing shareholders a credit in excess of the amount of tax actually *paid* by the company.

One means of overcoming this “super-imputation” problem is the levying of some form of compensatory tax, payable when a dividend distribution is made but the appropriate company tax has not been paid

Sometimes a compensatory tax is levied on corporations and credited to individuals at a rate equal to the imputation credit attached to gross dividends. According to Cnossen<sup>45</sup> “[t]his means that countries with a partial imputation system nevertheless permit a full credit with respect to dividends distributed out of exempt profits .... Although the imputation system is meant to promote profit distributions, the compensatory tax forms an inducement to retain exempt profits in the company as a means to minimise the company tax liability. Also to the extent that exempt profits are distributed, the tax nullifies the intended effect of tax holidays and other incentives.”<sup>46</sup>

The following table demonstrates the effect of dividend imputation under varying personal marginal tax rates and degrees of gross up and credit. It will be seen that the lower the degree of gross up and credit, the greater the “overtaxation” of distributed income.

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<sup>45</sup>Cnossen Supra note 11 at p 271

<sup>46</sup> This “washing out” of tax preferences occurs in Australia through the crediting only to shareholders of company tax actually paid, dividends without company tax credit attributed are fully taxed to the shareholder.



**Table 1.5 : A comparison of the effect of a dividend imputation system under varying marginal personal rates.**

Item						
1. Marginal personal tax rate (see note 1)	20	20	20	50	50	50
2. Degree of Gross up and credit	100	50	20	100	50	20
3. Net company income before tax and dividends	100	100	100	100	100	100
4. Company income tax (see note 1)	30	30	30	30	30	30
5. Net after- tax company income (5-4)	70	70	70	70	70	70
6. Dividend to shareholder	70	70	70	70	70	70
7. "Gross up" for shareholder	30	15	6	30	15	6
8. Assessable personal income	100	85	76	100	85	76
9. Gross personal income tax (1 x 8)	20	17	15.2	50	42.5	38
10. Shareholder credit (from 7)	30	15	6	30	15	6
11. Net personal income tax (9 - 10) (see note 3)	(10)	2	9.2	20	27.5	32
12. Total taxes (11 + 4)	20	32	39.2	50	37.5	62

Note:

1. Marginal rates of personal income tax of 20% and 50% have been assumed in line with current world-wide trends towards reducing personal income tax rates. The company tax rate is assumed to be a flat rate of 30%
2. The table ignores any capital gains tax that may capture the increase in market value of the shares as a result of retentions.
3. This assumes that excess credits are refunded to the shareholder

#### 4. CONCLUSION

Systems of corporation tax vary between tax jurisdictions and often entail a compromise on the pure forms of classical and integration systems, combining features of the above methods, dividend imputation combined with an exemption for certain classes of dividends, classical system with an exemption for a certain amount of dividend received, and so on.

The presence or otherwise of a capital gains tax will affect the manner in which company tax systems create economic distortions. The bias in favour of retentions in a classical system for example is ameliorated in an environment that taxes accretions in share values resulting from the accumulation of profits by the company.

Inevitably, it is largely political rather than equity considerations which determine the design of a country's corporation tax system by a process of compromises.