Businesses who pay dividends to shareholders with tax credits attached pay more tax, new research finds. This occurs because of dividend imputation whereby shareholders get a credit for corporate tax the business pays, on the dividends they receive.

Over the period of 2004 to 2015, we studied financial statement data from companies listed on the Australian Stock Exchange. The study found that on average firms that pay dividends with tax credits have an effective tax rate of up to 16.9% higher than firms that don't. They also have an effective tax rate of up to 14.7% higher than firms that do not pay dividends at all.

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Because we looked at listed businesses the results encompass Australia's largest corporations. We found these results stand, despite a variety of reasons for why businesses are not paying tax in the current year, such as carrying tax losses forward.

This study shows there is a strong case for keeping Australia's dividend imputation system, but it also puts the debate on company tax cuts in a new light. If we reduced or changed the dividend imputation system, the budget impacts of a reduction in corporate tax would likely be offset by reduced imputation credits and by individual investors paying higher tax.

The largest potential beneficiaries of a reduction in the corporate tax rate are foreign multinationals with operations in Australia - but they tend not to pay tax in Australia anyway. In other words "much ado about nothing".

How Australia's tax system works against tax avoidance

In a "classical tax system", as exists in the United States, the European Union and most other countries, corporate profits are first taxed within the company at the corporate tax rate. Those

after-tax profits are then distributed to shareholders as dividends. Shareholders pay tax on those dividends at their individual marginal rate.

However, this arrangement has been labelled as “double taxation” because profits are taxed first, at the full corporate tax rate and then at the shareholders individual marginal tax rate.

In various countries governments adjust for this by taxing dividend income for shareholders at a lower tax rate. But this is also problematic.

Taxing income at different rates creates an incentive for both companies and individuals to make money in a way in which they will taxed the least, distorting the efficient allocation of resources and other investment decisions. For example, if capital gains are concessionally taxed, companies will repurchase shares, rather than pay dividends.

A more extreme problem is that it provides an incentive for big businesses to avoid corporate tax in order to maximise after-tax profits. But in Australia, the incentives for corporate tax avoidance are reduced because shareholders receive a benefit through dividend imputation.

Why we need to keep shareholder tax credits

Academics and policymakers have called for Australia to dismantle the dividend imputation system, and this was canvassed in an Australian Treasury Department discussion paper in 2015. They make the argument that Australia is one of the few countries with a system of dividend imputation, that it costs government revenues over A$19 billion each year, and that it does little to attract foreign investment.

However, as a consequence of imputation, there is a much lower incidence of corporate tax avoidance by large domestic corporations in Australia than in other countries. So any potential benefits to government revenues by dismantling or limiting dividend imputation would likely be diminished by increased corporate tax avoidance.

Australia would do better to focus its regulatory attention on foreign multinationals with operations in Australia. These companies do not utilise dividend imputation and appear to pay little tax in Australia
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If we limit the refunds of imputation credits to shareholders, it could also reduce the incentives for corporations to pay dividends, and it could create an incentive for shareholders to invest instead in firms that don't pay dividends with tax credits.

This may lead to less firms paying dividends with imputation tax credits and for these companies there will be increased incentives for corporate tax avoidance. This arises because limiting refunds for tax credits reduces the value of the credits to shareholders, and this restores the incentive for companies to engage in tax avoidance.

Tinkering at the edges of Australia's system, such as getting rid of dividend imputation, is likely to have significant indirect and unexpected impacts. This identifies just one part of the complexity that exists within Australia, not only in the tax system but also with its interaction with other systems such as health and welfare.

What Australia still needs is broad tax reform and a much simpler system.

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