Dividend Imputation Should Change

This will be short and likely controversial. There’s a lot of vitriol about dividend imputation these days. Much of it is misguided. However widely practised around the globe, double taxation of corporate earnings is unfair. Most countries acknowledge that fact indirectly by having low tax rates on dividends. Our dividend imputation system deals with it more directly, neatly and, generally, fairly. At least, it did as the system was originally designed.

Where I think our system might have fallen off the rails was in a 1 July 2000 rule change. In the 1990s, Australian businesses that paid their fair share of tax did so at the corporate rate of 36%. They were then able to distribute dividends with attached franking credits. If you were a shareholder on a marginal income tax rate of 50%, you effectively paid the 14% differential to the tax man. Those on a higher tax rate than the corporate rate topped up the tax. That's also how the system still works today, although the numbers have changed.

If you are on a lower tax rate, though, the change was significant. If your marginal tax rate was lower than the corporate rate there was, of course, no differential to pay. But, prior to that 1 July 2000 change, there was also no refund of the difference.

Reverse tax

The rule changes shifted that. Low tax rate investors and, importantly, investing entities get refunded the difference today. The ATO sends you cash. This would be a trivial discussion if we were talking only about a small number of low-income share owners. But Australia’s superannuation system means there is a substantial number of very large savings pools that pay tax rates of 0% or 15%. As a result, the effective tax rate on a large proportion of Australia's corporate profits is 0% or 15%.

As a general principle, I think that corporate earnings should be subject to the corporate tax rate at a minimum. That should apply whether those profits flow to shareholders as dividends or are retained by the company and reinvested.

For one, it would remove a large distortion in our system, one that sees a dollar retained by a company worth less than one paid out to a low-tax rate shareholder. This explains the immense pressure on Australian companies not to cut dividends unless they’re on their death bed. In a sensible world, there's no such thing as an underwritten dividend reinvestment plan.

More broadly, though, it’s fairer. If we’re going to have a tax system, why shouldn’t the full profit stream of successful entities like the Commonwealth Bank, Woolworths, BHP or Forager Funds Management Pty Ltd be subject to corporate tax? Or should it only be wage slaves paying for hospitals, schools, defence and roads?

Many of us on the gravy train (which certainly includes me) might disagree. Even if the fairness argument doesn't appeal, maybe self-preservation will. Scrapping dividend imputation refunds seems preferable to scrapping imputation entirely. And that’s what they're calling for in some quarters.