TAX ON DIVIDEND
THE ISSUES AND NON-ISSUES

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No. EP-1/88 October 1988

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by

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"Tax on Dividend" has of late figured prominently in the press and a plea has been put forward persistently for its abolition as a step required urgently to stimulate the capital market. Barring one or two dissenting voices (e.g., V R Gupte in Economic Times, June 21, 1988), however, the arguments so far have been totally one-sided. In fact, a virtual campaign seems to have been mounted to get dividends completely out of the tax net in utter disregard of the issues involved or the implications of such a move. While the question of double taxation of equity earnings and its possible ill effects under a system of separate taxation of corporate profits and dividends cannot be dismissed outright, it should be recognised that the subject is a highly controversial one with expert opinion sharply divided, and wholly one-sided pleadings for indefensible measures like total exemption of dividends only serve to weaken the case for relieving such double taxation. This note is an attempt to set out briefly the relevant issues and the implications of possible alternatives in order that the matter is examined in the proper perspective.

The Case for Dividend Exemption

The proposition that dividends should not be taxed when there is a separate tax on corporate profits, is based on an argument which is fairly straightforward, viz., that it involves double taxation of earnings from investment in corporate stocks and that such double taxation is undesirable on grounds of equity as well as economic efficiency.

The equity argument rests essentially on the view that companies are not "persons" and have no independent taxpaying capacity of their own, being "conduits" through which income accrues to their owners, viz., the shareholders. Hence, strictly speaking, there is no justification for levying a tax on corporate earnings as such and the profits of corporate entities, whether distributed or retained, should be attributed to shareholders and assessed as part of their income, that is, fully integrated into personal income taxation. On this view, separate taxation of companies offends both horizontal as well as vertical equity as persons in similar economic circumstance are taxed unequally and, under a system of progressive taxation, shareholders not otherwise liable to personal income tax are made to suffer taxation while those liable to tax are either undertaxed or overtaxed arbitrarily, depending on the payout ratio and the spread between the effective rate of corporation tax and the marginal rate of personal income tax applicable to them.

The only solution to such inequity is complete integration of corporate earnings into personal incomes. Advocates of the tax base for income taxation accept the logic of this argument and recommend integration as an important step towards equitable taxation. Despite its apparent appeal, however, integration has not found acceptance in any country because of the practical problem of identifying shareholders to whom the retained profits can be attributed, especially in the case of large corporations with a constantly changing body of equity owners. There is also the problem of liquidity shareholders have to face if taxed on imputed share of retained profits. Exempting corporate entities altogether from tax, on the other hand, opens up opportunities for avoidance by accumulating profits under the corporate cover and realising the gains later in the form of capital gains. Taxation of capital gains which is thought to offset the advantage does not quite plug the loophole since capital gains cannot be taxed like ordinary income and thus retention always remains advantageous. For these reasons, a system of personal income tax is invariably accompanied with a tax on corporate profits as well. Moreover, corporate income tax now constitutes a major source of government revenue in most countries and it is unrealistic to expect any government to give it up. Given that taxation at the corporate level is inescapable, it is argued, in fairness either the tax should be confined only to retained profits, or dividends should not be subjected to tax in the hands of shareholders.

The efficiency case draws attention to the distortions caused by the system of separate taxation of corporate earnings and dividends - the classical system as it is called - in decisions regarding (a) retention vis-a-vis distribution of corporate profits, (b) choice between debt and equity in financing corporate investment and (c) between corporate and non-corporate forms of business. An obvious consequence of the taxation of dividends in addition to the tax on companies is to discourage distribution, preventing the flow of corporate surpluses into the capital market and thus their efficient use. This, it is argued, helps companies with a large cashflow to expand at the cost of new entrants. Such a system would also seem to encourage mergers, accentuating the monopolistic tendencies, to the disadvantage of dynamic new enterprises. The classical system also puts a premium on debt financing as against equity financing, thereby discouraging risk taking while increasing the risks of bankruptcy by making the companies more vulnerable to adverse business conditions. Double taxation of company profits may also distort the choice between corporate and non-corporate forms of business with a premium on the latter, with the result that the allocation of capital between the corporate and non-corporate sectors gets distorted and the rate of return on capital in general in the economy is brought down with adverse impact on capital accumulation and growth. The logical answer to all these distortions and the resulting inefficiencies is again complete integration of corporate earnings with shareholders' incomes no matter whether such earnings are retained or distributed or, failing that, exemption of dividends from tax, either at the corporate level or in the hands of shareholders.

The Case Against

However persuasive they may appear at first sight, the arguments put forward above are yet to find universal acceptance. In fact, there are many including several influential fiscal economists like Musgrave who are in favour of retaining the classical system which, incidentally, still operates in the USA. The conduit view is rejected on the argument that companies are separate legal entities and can be looked upon legitimately as having taxable capacity of their own. This would appear to be true especially of large corporations where control and ownership do not go together, and the interests of the companies (management) does not coincide with those of the owners. An additional argument put forward by Stiglitz to strengthen the separate entity view looks upon the corporation tax as an excess profits tax. It is also believed by many that the corporation tax is not borne entirely by the owners of capital and a good part is passed on to suppliers, consumers or workers, depending on market conditions (*via* purchase and sale prices and adverse impact on investment, output and employment). The late Stanley S. Surrey of USA went so far as to say that preference for the conduit theory and integration is no more than "tax theology" and therefore beyond reason. Several other arguments are advanced in favour of maintaining the status quo where the classical system is operating since long, such as, that an old tax is a good tax, that the tax on dividend must have been capitalised through share prices and so any relief now will only benefit existing shareholders.

The efficiency arguments for integration or dividend relief also have not gone unchallenged. Whether the taxation of dividend encourages retention is itself not beyond doubt. On the face of it, - and this has been the traditional view - it would appear that under the classical system the overall tax rate on equity income works out as a weighted average of the tax rates on retained earnings and distributed profits and so depends on the proportion of dividend to total corporate earnings. According to a new view of equity taxation, propounded by Auerbach (vide *Journal of Economic Perspectives*, Summer 1987), the relevant tax rate on equity earnings is given by the effective capital gains tax rate, and does not depend on the payout ratio. If this view is correct, tax liability on equity earnings over time is independent of corporate decisions regarding distribution *vis-a-vis* retention and so, the form of corporate taxation is of no relevance for dividend decisions. Evidence in support of this hypothesis is, however, not conclusive.

Even granting that the tax on dividend discourages distribution, few among tax experts have in the past favoured elimination of dividend tax on the consideration that retention may not be undesirable for a developing economy. As Richard A. Slitor, another noted fiscal expert, said in the context of tax reform in Colombia:

"The realities of the Colombian situation suggest, however, that company reinvestment is a major source of growth funds and would not adequately be replaced by shareholder savings out of, or in response to, increased dividend payments on stock". (Quoted in The Taxation of Corporations and Shareholders by Martin Norr).

It is also pointed out that larger distribution of corporate funds may not lead to their efficient use unless there is an efficient capital market in the country. Even where there are well established long functioning capital markets (as in USA), not all corporations have equal access to the market and retained earnings constitute the main source of funds for those who do not have full access to the capital market. As noted in a summary of the recommendations by tax missions to underdeveloped countries, tax discrimination in favour of retained profits "is a rough, but reasonable incentive in the right direction". Another tax survey noted that retention of profits in business is "historically the primary source of capital accumulation in Western industrialized nations". Apart from the possible adverse influence on saving, integration or dividend relief by encouraging distribution, is likely to discriminate against new and expanding companies, in favour of big and well established ones, since a new company, however dynamic, is seldom in a position to distribute any dividend in the initial years.

Another line of argument - put forward by David Bradford - based on theoretical analysis drawing on the rational expectations hypothesis, suggests that dividend taxation may not have the adverse consequences on corporate financial structure attributed to it, since the present value of the tax liabilities remains the same whether the distribution is made currently or with a lag. While one may not accept the abstract reasoning of Bradford, many would be inclined to think that, in the Indian context, if distribution is encouraged, corporate saving may decline without a compensating increase in shareholder saving. In any event, the funds that might ultimately flow into the capital market would go mostly to the established giants with high payout ratios, of which there are only a few, totally bypassing new companies, and their share prices will soar, conferring windfall gains on existing shareholders and little benefit to new entrants. As it is, with the dividend tax the top notch companies carry huge premium on their new issues while many of the less known ones, even when backed by powerful underwriters like SBI, find no takers. The situation will in probability get aggravated if dividend is exempted totally from tax.

Foreign Practice

Nevertheless, it ought to be noted that primarily on efficiency considerations the tax system of several countries, especially in the EEC, do provide some relief on the tax on dividend through a system of "partial integration or imputation" whereby credit is given to shareholders for a part of the tax paid by the company. But none of the methods followed to implement it is simple.

The system of partial integration which is in vogue in the UK requires companies paying out any dividend to deposit an "Advance Corporation Tax" (ACT) on the amount paid to the shareholders at a rate given by the formula $t/1-t$ where t is the basic rate of personal income tax. The ACT is allowed to be set off against the mainstream corporation tax and short-falls, if any, in the mainstream tax (because of tax preferences, etc. or any other reason), are allowed to be offset against the tax of the two previous years or carried forward. The cash amount of dividend received by the shareholder is grossed up by the tax paid by the company and included in the income of the shareholder to be taxed at the rate applicable to his income and credit is given for the ACT paid by the company in the assessment of the shareholder. If the shareholder happens to fall below the taxable income bracket he gets a refund. To take an example, if a company distributes dividend of Rs 75 and the basic rate of personal income tax is 25 per cent, the company will be required to pay ACT of Rs 25 and the shareholder will be deemed to have received dividend of Rs 100 with a tax credit of Rs 25. If he happens to be below the taxable limit he will get a refund of Rs 25, but if liable to be taxed at a marginal rate of say 40 per cent, he will be required to pay an additional amount of Rs 15 (Rs 40 - Rs 25) as tax on his dividend income. The benefit of gross-up and credit are not available to non-residents except under a treaty. Tax exempt organisations however get the credit.

France operates a system of "partial imputation" with a tax credit to shareholders equal to half the corporation tax paid by the company on the underlying profit. Where dividend is paid out of profits partly or wholly exempt from tax or taxed concessionally, the company is required to pay a tax ("precompte") equal to the tax credit given on the dividend or the part of the dividend paid out of untaxed profits. West Germany has a two-rate imputation system with distributed profits taxed at a lower rate than retained earnings (36 per cent and 56 per cent respectively) and full credit allowed to the shareholders for the tax paid by the company on distribution. Thus West Germany completely eliminates double taxation of dividends not by exempting dividend from taxation but through a system of split rate taxation and full credit for tax paid on distributed profits.

It needs to be emphasised that all the three systems seek to ensure that relief is available from double taxation only when there is double taxation and no relief is available if the profits out of which the dividend is paid do not suffer taxation because of exemptions or allowances or any other reason. Thus in the UK, the ACT has to be paid with distribution and France allows credit only for corporate taxes actually paid. In West Germany, companies have to enter their retained earnings available for distribution under three different accounts: (1) amounts which have suffered tax at the full rate (56 per cent); (2) amounts taxed at 36 per cent and (3) those which have suffered no tax. Companies with effective tax rate falling between the specified rates are required to allocate the profits between the two rates so that the weighted average rate equals the actual rate. Dividends are presumed to be distributed first out of the account bearing the highest rate and the balance set off against the next account No. (2) and so on. Tax has to be deducted on dividend distributed out of tax-free retained profits.

Expressing concern at the distortions in corporate decisions regarding capitalisation, etc., caused by the disparate tax treatment of debt and equity, the US Treasury I proposals which led to the sweeping tax reforms of 1986 had suggested that 50 per cent of dividend be allowed to be deducted from the corporate tax base provided the dividend was paid out of profits actually taxed and not out of "tax-preference income". For this purpose, a "Qualified Dividend Account" would have to be maintained. The proposal was not put into legislation finally but it underlines the problems which are encountered in any scheme of dividend relief, especially when there are exemptions or concessions in corporate taxation in any form.

Very recently a Consultative Committee has recommended full integration in New Zealand but the system envisages maintenance of "Memorandum accounts" such as an "Imputation Credit Account", which is not going to be easy.

It may be recalled that the Indian income tax also provided for partial integration through a system of gross-up of dividend by the effective rate of income tax (but not supertax) borne by the company on the profits out of which the dividends were paid out and equivalent credit was given to shareholders. With the introduction of various incentive provisions in the tax system (tax holiday, development rebate, etc.) gross-up became very difficult to operate and was given up in 1959-60 in the wake of a spate of litigations.

On Balance

This is not to assert that the question of double taxation of corporate earnings in the classical system of taxation which is in vogue in our country merits no consideration, but only to point out that the case for exempting dividends from tax is not as obvious as is being made out in the current writings. The classical system of taxation which taxes company profits and dividends separately has its merits in that it helps to promote retention and corporate saving. Moreover, complete neutrality is unattainable since full integration involves acute practical problems. The only feasible way to relieve the tax on dividend is to devise some form of partial integration either through imputation or deduction of dividend from corporate tax base (though according to many, integration is the real answer and partial integration serves no purpose, as it does not achieve neutrality, rather causes unanticipated distortions). But imputation or integration, whether complete or partial, gives rise to serious practical problems.

There is no escape from such complications so long as the tax system permits tax preferences of any kind and the incidence of tax on corporate profits becomes uncertain. It should not be overlooked that a large number of Indian companies belong to the zero tax category (according to the latest ICICI survey, as many as 107 out of 417 surveyed in 1986-87), and even with a minimum tax provision such as has been introduced recently the effective tax rates on corporate incomes can vary widely across companies, depending on their capital structure, payout ratios, quantum of tax-exempt earnings or the extent to which the company is able to manipulate its accounts to vary its book profits.

It is also worth pointing out that dividend exemption has nothing to commend itself from the equity angle and in fact may give rise to greater inequity than at present, as between top bracket income earners and those in the tax-exempt or lower tax brackets. The appended table indicates the extent of overtaxation and undertaxation under the existing system of taxation at varying rates of effective corporation tax and personal income tax, (a) with zero dividend and (b) with 50 per cent dividend payout. It will be seen that with separate taxation of company profits and dividend, shareholders who fall below the taxable limit are overtaxed, whether dividend is taxed or not, while as noted earlier, shareholders liable to pay personal income tax are undertaxed or overtaxed, depending on the spread between the rates of corporation tax and the marginal rates of personal income tax. With zero dividend distribution, and an effective corporate tax rate of 30 per cent, shareholders in the tax bracket carrying 25 per cent rate are overtaxed while those in the top brackets are undertaxed. With 50 per cent dividend payout ratio the degree of undertaxation in the top brackets gets reduced while overtaxation in the 25 per cent bracket, gets accentuated. (It may be noted in passing that payout ratio in Indian companies is on an average below 50 per cent. For ICICI-assisted companies the average was 31 per cent in 1985-86 and 40 per cent in 1986-87). With total exemption of dividend, the extent of undertaxation of top bracket shareholders increases while overtaxation in the lower brackets continues and those in 25 per cent tax bracket, get undertaxed if one assumes an effective corporation tax rate of 20 per cent. The effective rate of tax on corporate profits is unlikely to exceed 30 per cent on the average, thanks to the funding scheme, investment allowance and other incentives. In a large number of cases, the effective rate would be 20 per cent or even less, the mininum tax notwithstanding. The effective tax rate would be less if allowance is made for the possibility of shifting. This takes no account of the capital gains tax. However, the incidence of capital gains tax in India is not terribly high as many ways are available of avoiding or reducing it. Further, taxation of capital gains with no tax on dividend would give rise to a new distortion by exercising a strong disincentive for any retention and punishing those who prefer to retain their profits in the companies.

Given this background, exempting dividends totally from tax would be irrational and will serve no useful purpose. Rather it will create grave inequities and only serve to enrich the few established big companies with no gain to newcomers. Indeed, it is not a solution worth serious consideration. To my knowledge, no tax system in the world, with possibly the exception of Pakistan, allows such exemption.

The present practice in India of allowing exemption of dividend income upto a certain limit, viz., Rs 10,000 (under Section 80L of the Income-tax Act) is open to all the objections mentioned above against total dividend exemption without reference to the profits from which the distribution has taken place. In many cases, this may result in total remission of tax on company earnings even after distribution (e.g., when dividends are distributed out of past profits), which obviously militates against all norms of equity in taxation. The only point in its favour is that the damage caused is contained by the ceiling of Rs 10,000.

In sum, while it is doubtful if the economy will gain, the equity of the tax system will suffer grievously if dividend is exempted totally with all the concessions and exemptions in corporate taxation. If relief from double taxation is to be provided to equity owners, there must be a system to ensure that the corporate profits would indeed be doubly taxed otherwise. For that, as pointed out in this note, there is no simple way. Whether the complications which would unavoidably creep into the law if some relief was provided on dividends through a system of imputation or partial integration or dividend deduction against corporate tax base are worth the benefits likely to flow, is the real issue and not whether the tax on dividend should be eliminated. It is a pity that proposals for tax measures which may have a profound impact on the tax system are put forward with little evidence of any awareness or recognition of their likely consequences overall.

TABLE

Tax Incidence on Rs 100 of Corporate Source Income

At Varying Rates of Personal Income Tax and Corporation Tax

		Dividend Payout Ratio					
		Zero			50%		
1. Shareholder's marginal tax rate	(%)	0	25	50	0	25	50
2. Effective corporate income tax*	(a)	40	40	40	40	40	40
	(b)	30	30	30	30	30	30
	(c)	20	20	20	20	20	20
3. Net corporate income	(a)	60	60	60	60	60	60
	(b)	70	70	70	70	70	70
	(c)	80	80	80	80	80	80
4. Dividend	(a)	-	-	-	30	30	30
	(b)	-	-	-	35	35	35
	(c)	-	-	-	40	40	40
5. Personal I.T. on dividend	(a)	-	-	-	0	7.5	15
	(b)	-	-	-	0	8.75	17.5
	(c)	-	-	-	0	10	20
6. Total tax (2+5)	(a)	40	40	40	40	47.5	55
	(b)	30	30	30	30	38.75	47.5
	(c)	20	20	20	20	30	40
7. Overtaxation (6-1)	(a)	40	15	-10	40	22.5	5
	(b)	30	5	-20	30	13.75	-2.5
	(c)	20	-5	-30	20	5	-10
8. Percentage overtaxation (7/1 x 100)	(a)	∝	60	-20	∝	89.0	10
	(b)	∝	20	-40	∝	55.0	-5
	(c)	∝	-20	-60	∝	20	-20
9. Overtaxation with no tax on dividend (2-1)	(a)	40	15	-10	-	-	-
	(b)	30	5	-20	-	-	-
	(c)	20	-5	-30	-	-	-
10. Percentage overtaxation with no dividend tax (9/1 x 100)	(a)	∝	60	-20	-	-	-
	(b)	∝	20	-40	-	-	-
	(c)	∝	-20	-60	-	-	-

* On assumption of 40%, 30% and 20% effective rate respectively.

Adapted from Table 2:1 of Must Corporate Income Be Taxed Twice? by Charles McLure Jr. (Brookings Institution, 1979).