Research Office
Legislative Council Secretariat

Information Note

Dividend tax in selected places

IN15/16-17

1. Introduction

1.1 In Hong Kong, there have been discussions about the introduction of dividend tax to broaden the tax base amid the spread of shareholding in the territory. The new tax is also considered as an avenue of bringing into the tax net those who earn considerable income from dividends which are not subject to tax. As early as in 1975, the then Financial Secretary Sir Philip Haddon-Cave[1] revived the idea of taxing dividend proposed by his predecessor, Sir John Cowperthwaite[2], a decade earlier. He first announced in his 1975 Budget Speech the Government's intention of introducing a tax on dividends[3], albeit to no avail in the end.[4]

1.2 The discussion of taxing dividend was reignited in the early 2000s, when the Government was faced with the possible appearance of "structural" fiscal deficits in Hong Kong. It conducted a consultation exercise in 2001 to solicit the public's view on the introduction of new types of broad-based tax in the territory. In 2006, the Government conducted another round of consultation on how to reform Hong Kong's tax system for broadening the tax base. In both rounds of consultation, the Government rejected introducing a dividend tax in Hong Kong as it considered, among other things, not worthwhile to complicate the tax system by introducing this new tax.[5]

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1 Philip Haddon-Cave served as Hong Kong's Financial Secretary from 1971 to 1981.

2 John Cowperthwaite was Hong Kong's Financial Secretary between 1961 and 1971.

3 According to Haddon-Cave, "another feature of the Hong Kong tax structure which is, to say the least of it, unusual, is the absence of any form of taxation on dividends as such". See Official Record of Proceedings of the Legislative Council (1975).

4 According to Littlewood (2010), introducing a tax on dividends met with opposition from unofficial Members of the Legislative Council.

5 See Advisory Committee on New Broad-based Taxes (2002), Financial Services and the Treasury Bureau (2007a), and Financial Services and the Treasury Bureau (2007b).

1.3 In recent years, there are views that individuals should be taxed on the basis of their ability to pay, and comprehensive income is a socially acceptable indicator of an individual's ability to pay. Under a comprehensive income tax regime, income from whatever sources will be brought into the charge of income tax. Yet, Hong Kong's schedular income tax system[6] only levies taxes on business profits under profits tax, property rental income under property tax, and employment income under salaries tax. It is possible for shareholder directors of large corporations, who may be very substantial income earners, to escape the personal taxation by receiving their income primarily through non-taxable dividends.

1.4 In contrast to Hong Kong, some developed economies such as the United States ("US"), the United Kingdom ("UK") and Australia have adopted a tax regime with structure similar to that of a comprehensive income tax regime, under which labour income, capital income (including dividends and interest) and other sources of income are totalled to form income for individual tax purposes. While dividend tax might help these economies raise revenue for the government, the introduction of such would easily lead to double taxation on corporate income. As such, they have put in place various relief measures to help avoid or ease the double taxation problem.

1.5 At the request of Dr Hon Fernando CHEUNG Chiu-hung, the Research Office has prepared this information note aiming to provide background information on (a) the nature of dividend tax; (b) debates on introducing dividend tax in Hong Kong; and (c) the treatment of dividend income in selected overseas places.

2. Nature of dividend tax

2.1 Dividend usually refers to the part of after-tax profits of a company for distribution to its shareholders in proportion to the number of shares they hold.[7] It can be in the form of cash payments, stocks or other forms of

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[6] Schedular tax system is a tax system in which income from different sources is taxed separately (i.e. under a different "schedule"); thus, separate tax assessments are made on business profits, wages and salaries, income from properties etc.

[7] Typically, a company does not pay all its after-tax profits in dividends and will, instead, retain some to re-invest in future projects. See Black (2017).

payment, but the most common type is cash dividend.[8] In Hong Kong, the Companies Ordinance (Cap. 622) identifies dividend as a kind of "distributions" of a company's assets to its members whether in cash or otherwise, and the company may only make a distribution out of profits available for distribution.[9] Similarly, the double taxation treaties signed between Hong Kong and foreign jurisdictions define dividend as income from shares or other rights, not being debt-claims, participating in profits.[10]

Treatment of dividend income

2.2 There is no dividend tax in Hong Kong.[11] Dividends repatriated to the territory are not subject to Hong Kong tax. In addition, dividends paid by a Hong Kong company to its shareholders are not subject to Hong Kong tax in the hands of shareholders, nor is there any withholding tax on dividends paid to shareholders outside Hong Kong.

2.3 Unlike Hong Kong, some developed economies have introduced dividend tax as a kind of income tax assessed on dividend payments made to stockholders.[12] The means of taxing dividends can be through a withholding tax regime, under which the corporation paying dividends withholds the amount of tax payable and pays out the remainder to the shareholders. Alternatively, dividend tax can be levied under a comprehensive income tax regime, under which dividends are included as part of personal income subject to the same tax rate schedule as other types of income. There is also dual income tax regime characterized by a schedular tax regime which divides total income into capital and labour income and regards them as different tax bases.

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8 Since it is common for shareholders to receive dividends in cash, this information note confines the study hereafter to cash dividends.

9 A company's profits available for distribution are its accumulated realized profits less its accumulated realized losses. A listed company may only make a distribution if (a) the amount of its net assets is not less than the aggregate of its called up share capital and undistributable reserves; and (b) the distribution does not reduce the amount of those assets to an amount less than that aggregate. See Sections 297-298 of the Companies Ordinance (Cap. 622).

10 See paragraph 2 of Article 10 of Part 1 of the Schedule of the Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Ireland) Order (Cap. 112BQ).

11 As mentioned in paragraph 1.2, Hong Kong's schedular income tax system only levies taxes via profits tax, property tax and salaries tax on profits/income sourced in Hong Kong. As dividend income is not included in one of these schedules, dividends received by shareholders are not chargeable to tax. See Section 26(a) of Inland Revenue Ordinance (Cap. 112).

12 See Harding (2013).

Issues relating to taxing dividends

2.4 Dividend tax seems to be a viable avenue for developed economies to raise revenue for the government, as this form of taxation could generally be regarded as being fairly broad-based given the spread of shareholdings in these economies. In addition, dividend tax may also be levied as a progressive tax to help maintain horizontal and vertical equity of tax.[13] This is particularly the case as an individual should be taxed on the basis of his or her ability to pay, and the introduction of a dividend tax may help reflect this principle. Added to this, labour income alone might be an imperfect measure of an individual's ability to pay, as some income earners can receive considerable income from dividends without paying any income tax on their earnings.

2.5 While taxing dividends might help broaden the tax base, the introduction of dividend tax would easily lead to double taxation on corporate income. As a legal "person", a corporation must pay tax on profits it earned. If the corporation is taxed on its profits and the dividends derived from that profits are also taxed when distributed to shareholders, the issue of double taxation arises. That means, the same corporate profit is taxed twice, once at the corporate level when earned and a second time at the individual level when distributed to shareholders in the form of a dividend.

2.6 In addition to the double taxation problem, some doubt whether dividend tax could provide significant and stable revenue for the government.[14] In particular, revenue from dividend tax is easily affected by corporate dividend policies. Companies can choose to re-invest their profits in future projects or share repurchases instead of paying out dividends even if they have made a profit. Furthermore, the amount of dividend income distributed also depends on economic cycles. Generally speaking, dividend payment will decrease during economic downturns when corporate profits are lower, and vice versa. A case in point is the volatility of dividend income reported by the US taxpayers during the ups and downs of economic cycles (**Figure 1**), visibly exhibited during the global financial crisis in 2008-2009 and the subsequent economic rebound since 2010.

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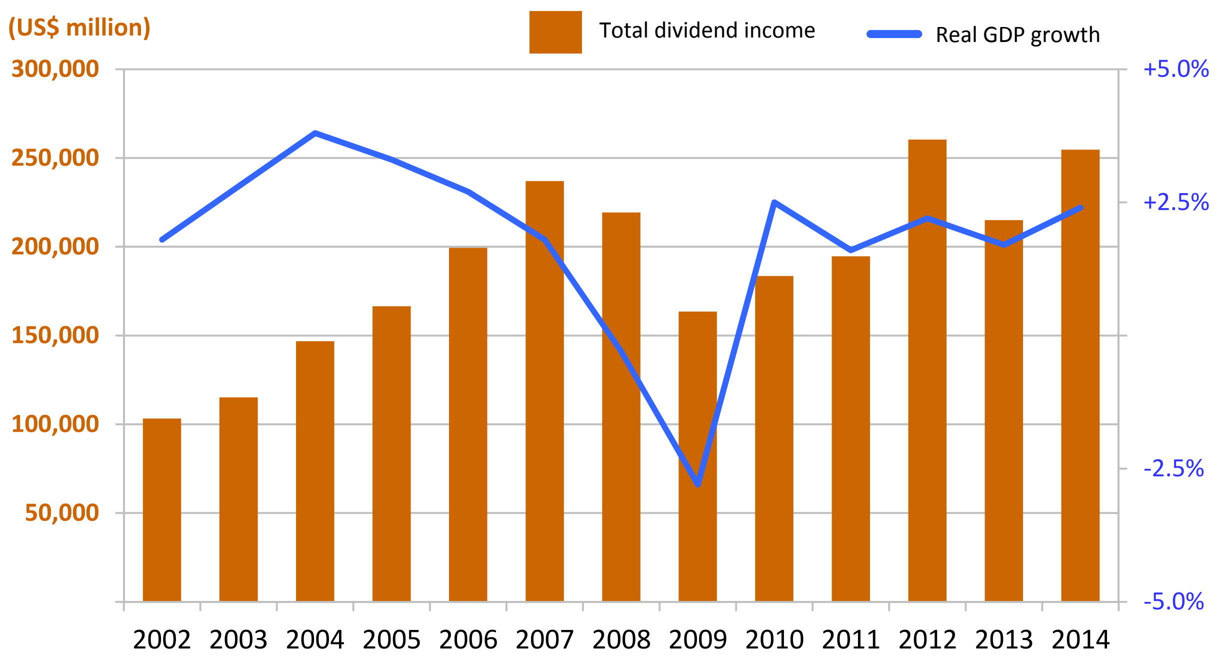
13 The ability-to-pay principle can be classified as horizontal equity and vertical equity. Horizontal equity means people with the same ability to pay should be taxed the same, while vertical equity is the principle that people with higher income should pay more taxes.

14 See Financial Services and the Treasury Bureau (2007a).

Figure 1 – Total dividend income reported by taxpayers and real GDP growth in the United States, 2002-2014



Sources: Internal Revenue Service (2002-2014) and IMF (2017).

2.7 For Hong Kong, its territorial source principle of taxation should add to the difficulty in relying on dividend tax to raise revenue in a fair and efficient way. Under the principle, only assessable profits which arose in or are derived from within Hong Kong are taxable. Should Hong Kong introduce a dividend tax, investors may choose to invest in overseas companies in order to avoid the tax. In addition, the tax would only apply to dividends paid by Hong Kong companies, while dividends repatriated to the territory are exempt from the tax.

3. Debates on introducing dividend tax in Hong Kong

3.1 The nature of dividend tax as highlighted above might warrant a fundamental change to Hong Kong's taxation regime should the territory start to tax dividend. It would mean either introducing a new tax type or converting the existing taxation system into a comprehensive income tax regime in which income from whatever sources will be brought into the charge of income tax.

3.2 To solve the double taxation problem, it might be further necessary to introduce legislation on dividend imputation system which is generally complex and would complicate Hong Kong's tax system.[15] Given that rates of personal taxation in Hong Kong are generally lower than the standard rate of corporate tax, the tax credit transfer under the dividend imputation system would mean there is little or no yield from a dividend tax.[16, 17]

3.3 Against the above, taxing dividend has not been short of discussions in its introduction into Hong Kong, and the paragraphs below highlight the main discussions over the past years.

Cowperthwaite's idea in the 1960s

3.4 As early as in 1964, the then Financial Secretary John Cowperthwaite decided to investigate the possibility of introducing a withholding tax on dividends.[18] Under Cowperthwaite's scheme, distributed corporate profits would be taxed twice at a rate of 12.5%: first, the company would pay tax on its profits; then if it paid dividends, it would deduct tax from it.[19] However, Cowperthwaite did not propose any relief from this double taxation. As such, the Legislative Council did not support the idea of a dividend tax[20], which was subsequently abandoned in 1966.

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15 Under the full imputation system, the tax paid by companies on the portion of profits distributed to shareholders as dividends is transferred to the shareholders in the form of a tax credit. In the shareholder's hands, the cash dividend received is grossed up by the amount of the tax credit to obtain the full taxable value of the dividend. The company tax transferred to the shareholders (the imputed tax credit) is then deducted from the individual's total tax liability (see **Appendix I** for details).

16 See KPMG (2001).

17 There might be other issues with the use of dividend imputation system. For example, Singapore introduced one-tier system in 2003 to replace the imputation system. Under the one-tier system, profits in Singapore are taxed once at the corporate level and no further tax is imposed on distribution of profits at the shareholder level. According to the Singaporean government, the old imputation system could not cope with growing sophisticated business transactions and involved higher compliance cost to monitor tax avoidance. Furthermore, companies lacking credits refrained from distributing profits.

18 See Littlewood (2010).

19 According to Littlewood (2010), Cowperthwaite's intentions are not clear. It appears that Cowperthwaite was planning to establish a comprehensive income tax regime, and he intended the withholding tax on dividends as an interim measure, pending the achievement of the ultimate motive.

20 See Official Report of Proceedings of the Legislative Council (1966).

Haddon-Cave's proposal in the 1970s

3.5 A decade later, Haddon-Cave revived Cowperthwaite's idea with the announcement in his 1975 Budget Speech of the Government's intention to introduce a tax on dividends. He later fixed the tax rate at 3.5%, and proposed to provide inter-corporate dividends with tax relief in order to avoid the double taxation problem. To prevent companies from avoiding the new tax by retaining their profits and not declaring dividends, the tax on dividends would be complemented by a tax on undistributed profits fixed at a rate of 7%. Haddon-Cave's proposal met with opposition from the unofficial Members of the Legislative Council and some leading commercial and industrial associations. They argued that, among others, tax on dividends would involve double taxation and complicate Hong Kong's simple tax system, thereby discouraging investments.[21] As a result, Haddon-Cave announced in his 1976 Budget Speech to defer the dividend tax bill and ultimately accepted the recommendation of the Third Inland Revenue Ordinance Review Committee for shelving the dividend tax proposal in his 1978 Budget Speech.[22]

Public consultation on a broad-based tax system in 2001

3.6 After the afore-mentioned two failed attempts to implement dividend tax in Hong Kong, the discussions of taxing dividends reignited in the early 2000s. In 2000, the Government established the Advisory Committee on New Broad-based Taxes to consider the suitability of new types of broad-based taxes for introduction in Hong Kong. This was in response to the possible appearance of "structural" fiscal deficits in the territory amid the economic downturn after the outbreak of the Asian financial crisis in 1997. A two-month public consultation exercise was conducted in August 2001 to solicit the public's views on the introduction of new taxes.

[21] See Official Report of Proceedings of the Legislative Council (1976).

[22] The proposal for a dividend tax was also firmly rejected by the Third Inland Revenue Ordinance Review Committee on the grounds of (a) complex legislative work required to implement the tax; and (b) the ease with which the same revenue could be raised by increasing the profits tax rate. The Third Inland Revenue Ordinance Review Committee was formed by the then Governor Murray MacLehose in 1976 to review the system of taxation of profits and other forms of income, including the treatment of dividends and its relation to the taxation of corporate profits. See Littlewood (2004).

3.7 After examining the various tax options proposed and the public's views received during the consultation, the Advisory Committee on New Broad-based Taxes did not support the idea of taxing dividend to broaden the tax base. According to the Advisory Committee, the implementation of dividend imputation system to avoid double taxation was potentially complex to legislate and difficult to administer. The Government's ability to raise additional revenue at meaningful levels might also be undermined by Hong Kong's territorial source principle of taxation and the provision of tax credit transfer under the dividend imputation system. Other concerns included corporates re-investing their profits to enhance their share prices rather than paying out dividends. Instead of resorting to dividend tax and other tax options, the Advisory Committee recommended the adoption of the Goods and Services Tax ("GST") as a broad-based tax to be introduced in Hong Kong to meet the need for additional revenue.

Public consultation on tax reform in 2006

3.8 In 2006, the Government conducted another consultation exercise to solicit the public's views on how to reform Hong Kong's tax system for broadening the tax base. The discussions had largely been focused on the introduction of GST as it was recommended by the Government as the most appropriate option to broaden the tax base. While dividend tax was also brought into the discussion when examining other tax options, the Government reiterated the stance of the Advisory Committee on New Broad-based Taxes as mentioned above. It also warned against the detrimental impact of dividend tax on Hong Kong's status as an international financial and commercial centre, as investors would choose or relocate to other jurisdictions without such tax as a base for their investment.

Recent discussions of dividend tax

3.9 In recent years, there have been arguments advocating the introduction of dividend tax to promote social equity as labour income alone is an imperfect measure of an individual's ability to pay.[23] Dividend tax might also help raise the government revenue to fund the expected increase in public expenditure resulting from population ageing. Alternatively, the introduction

[23] For example, see 張超雄(2014 年) and 李卓人(2013 年).

of a new tax – the dividend tax – might boost the public coffers, which in turn provides the leeway for the Government to lower Hong Kong's profits tax rate in a bid to improve its tax competitiveness.[24]

3.10 Meanwhile, opponents have set out their reasons for not supporting the idea of taxing dividend. According to them, dividend tax might result in double taxation, complicate Hong Kong's simple tax system, weaken Hong Kong's status as an international financial centre, and prompt investors to invest overseas.[25]

4. Treatment of dividend income in selected overseas places

4.1 While Hong Kong has yet to reach consensus on whether to tax dividends, some developed economies have over the years introduced dividend tax as a kind of income tax assessed on dividend payments made to shareholders. As shown in **Table 1**, the treatment of dividend income varies among these economies. Some of them adopt the classical system to tax dividend which results in double taxation. Under the system, the income underlying the dividend is taxed, then dividend is also taxed and no tax credit is given to the recipients.

4.2 Nevertheless, there are economies which use alternative tax regimes to avoid or relieve the impact of double taxation on corporate income. One is to ensure that profits are only taxed once either at the corporate level (dividends at the shareholder level are exempted from taxation) or at the shareholder level (full imputation system). The other is based on the provision of relief measures such as tax credits to shareholders and preferential rates for dividend income to mitigate the impact of double taxation.

[24] According to an economist, "we cannot afford to just dramatically reduce our profits tax rate without finding alternative sources of revenue… But we can argue that by cutting the profits tax rate by half we are effectively leaving half of profits not taxed, thus fully justifying taxing half the distributed dividends." See Ho (2017).

[25] For example, see 張華峰 (2013 年) and 鍾國斌 (2014 年).

Table 1 – Dividend tax arrangements in selected OECD countries*

System	Treatment of dividend income	Countries
Double taxation (classical system)	• Dividend income is taxed at the shareholder's personal tax rate in the same way as other types of capital income. There is no relief for underlying company tax paid, so company profits are taxed again.	• Ireland, the Czech Republic, and Hungary.
No double taxation (imputation system)	• Full imputation — dividend tax credit at shareholder level for underlying domestic corporate profits tax.	• Australia, New Zealand, Chile and Mexico.
Partial double taxation (some shareholder relief)	• Dividend income is taxed again at preferential rates (as compared with labour income) at the shareholder level.	• The United States, Austria, Belgium, Greece, Portugal, Slovenia and Switzerland.
	• A tax-exempt dividend allowance/threshold results in a portion of the dividend taxed again at the shareholder level.	• The United Kingdom, France, Finland and Italy.
Exemption	• No shareholder taxation of dividends.	• Estonia and the Slovak Republic.

Note: (*) Please refer to **Appendix II** for the calculation of dividend tax liability under different tax regimes.
Source: OECD (2017).

4.3 As shown above, Ireland, the US, the UK and Australia have adopted a different approach in taxing dividends at the shareholder level. These economies are studied in order to provide a better understanding of the objective(s) of taxing dividends under different tax regimes and the recent developments of their tax regimes.

Classical system in Ireland

4.4 Ireland is among the few overseas places that adopt a pure classical system to tax dividend, which do not offer any dividend relief or preferential tax rates to the recipients. Its Dividend Withholding Tax ("DWT") came in place in 1999 to replace the partial imputation system[26], and Irish resident companies must withhold tax on dividend payments and other distributions that they make. DWT is currently set at 20%, and the Irish government further deducts an additional 20% of the dividend income from higher rate taxpayers.[27] Nevertheless, dividend income received by resident companies, pension schemes and charities are tax-free.

Policy objective

4.5 The introduction of DWT in 1999 and the abolition of tax credits to shareholders aim to set the stage for the subsequent reductions in Ireland's corporate tax rate, as the new DWT helped make up for the loss of government revenue from the lower corporate tax rates.[28] The change to the taxation regime represents the efforts made by Ireland to strengthen its tax competitiveness, as many of its competing economies had reduced their corporate tax rates in order to attract and/or retain foreign investment.

Recent developments

4.6 In Ireland, the standard corporation rate was at a high of 28% in 1999. It then came down to 24% in 2000, 20% in 2001, 16% in 2002 and 12.5% in 2003. The 12.5% standard corporation rate has remained unchanged since 2003 and is currently among the lowest in the European Union. Reflecting the competitiveness of its tax system, Ireland has seen a higher inflow of foreign investment than the Organisation for Economic Co-operation and Development ("OECD") country average and some OECD countries with a classical system in most of the time (e.g. the Czech Republic and Hungary) (**Figure 2**).

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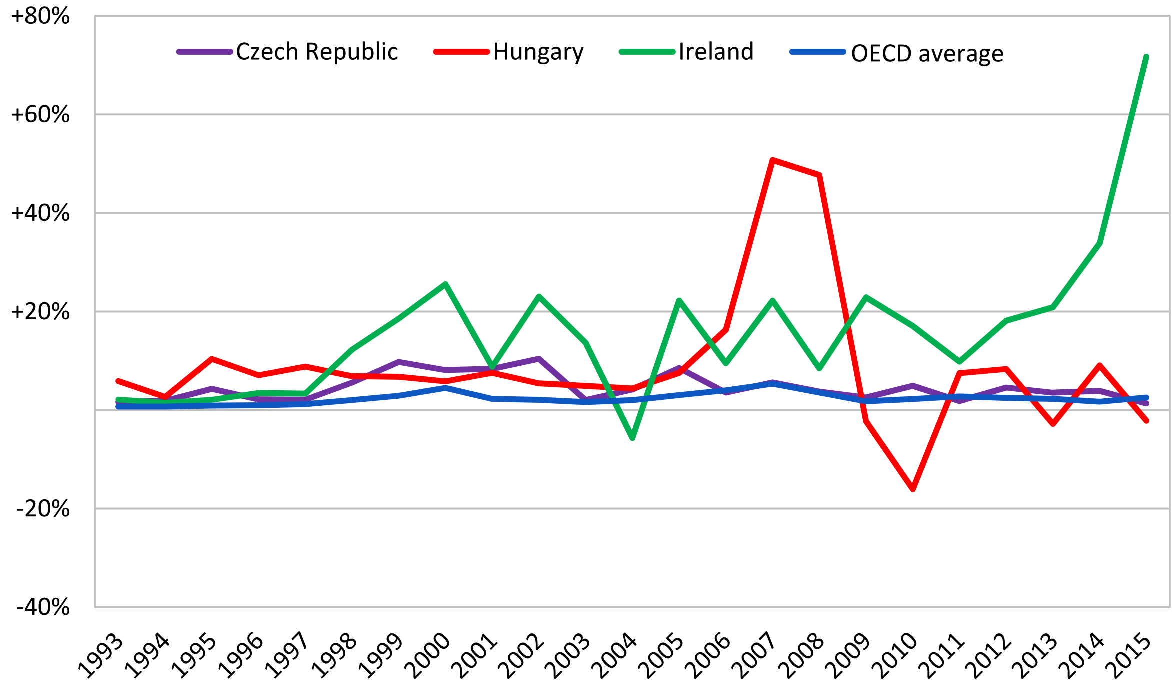
26 In its 1999 Budget, the Irish government increased personal tax allowance by 33.3% to relieve individuals' tax burden.

27 For single individuals, there are two tax brackets in Ireland: 20% for the first €33,800 (HK$291,018) (the standard rate) and 40% for the remainder of income (the higher rate).

28 Scanty information is available in the public domain about the net impact on the public coffers. According to the Irish Parliament, it was forecast that DWT would effectively draw an additional revenue of £60 million (HK$516.6 million) a year to partly offset the annual expenditure of £107 million (HK$921.3 million) from the reduction in the corporation tax rates. See Irish Parliament (1997).

Figure 2 – Net inflow of foreign direct investment as % of GDP in selected OECD countries



Source: The World Bank (2017).

Modified classical system in the United Kingdom

4.7 A modified classical system features the provision of tax reliefs at the shareholder level to relieve the impact of double taxation. The tax reliefs can be in the form of tax-exempt allowance/threshold and/or preferential tax rates for dividend income received by shareholders.

4.8 In 2016, the UK reformed its dividend tax system with the introduction of tax-exempt allowance and preferential tax rates for dividend income. Before that, the UK had operated a partial imputation system where a tax credit of 10% was given to all shareholders in recognition of the corporation tax paid by the companies. Currently, a tax-free dividend allowance of £5,000 (HK$50,350) is provided to all individual shareholders receiving UK dividends for them to offset their dividend tax liability. Only dividend income received in excess of the allowance are taxed at rates of 7.5% where this falls within the basic rate income tax band, 32.5% in the higher rate band, and 38.1% in the additional rate band.[29] They are lower than the

[29] There are three income tax bands in the UK. Taxpayers with a taxable income of £11,501 to £45,000 (HK$115,815 to HK$453,150) are charged at basic rate, £45,001 to £150,000 (HK$453,160 to HK$1.51 million) at higher rate, over £150,000 (HK$1.51 million) at additional rate.

corresponding personal income tax rates of 20%, 40% and 45% charged respectively on taxpayers in the basic rate, higher rate and additional rate tax bands. Dividend income received by pension funds and charities, and received on shares held in an Individual Savings Accounts ("ISAs")[30] are tax-free. In addition, domestic inter-corporate dividends are generally tax-exempt.

Policy objectives

4.9 The introduction of the tax-free £5,000 (HK$50,350) dividend allowance, which replaced the more generous 10% tax credit granted under the previous partial imputation system, is a measure to counteract tax-avoidance. The change is expected to help address the incentive for some self-employed individuals to set up a company and make payments as dividends rather than as wages simply for the purpose of reducing their tax bill.[31] It also targets at those shareholder directors of large corporations who pay themselves dividends rather than as wages to avoid tax.[32]

4.10 According to HM Revenue and Customs, the UK's tax collector, the change of dividend taxation system is expected to boost the public coffers by £1.7 billion (HK$17.12 billion) in 2018-2019, £2.74 billion (HK$27.59 billion) in 2019-2020, and £2.78 billion (HK$28 billion) in 2020-2021. The additional tax revenue generated should enable the government's plan to reduce the rate of corporation tax from the current 19% to 17% in 2020, in a move to establish the UK as one of the most competitive economies in the world.

4.11 HM Revenue and Customs also expects the introduction of dividend allowance to help modernize, reform and simplify dividend taxation, creating a fairer system. With the abolition of the tax credits, only those with significant dividend income or those who are able to pay themselves dividends in place of wages will pay more tax.

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[30] In the UK, successive governments are concerned at the relatively low level of savings in the country. They have over the years introduced various means by which individuals can save through a tax-free environment. ISAs are tax-exempted savings account created to encourage UK residents to save and invest their money through equity ownership. Capital returns from investments and interest on cash in an ISA are granted a tax-free allowance up to £20,000 (HK$201,400).

[31] In so doing, they could save on paying (a) personal income tax which is subject to higher tax rates than dividend tax; and (b) the National Insurance contribution which depends on the amount of gross wage.

[32] In the UK, directors are classed as employees and pay the National Insurance on annual income from salary and bonuses over £8,164 (HK$82,211).

Recent developments

4.12 Shortly one year after the introduction of dividend allowance, the UK Chancellor of the Exchequer proposed in his 2017 Budget a reduction of dividend allowance from £5,000 (HK$50,350) to £2,000 (HK$20,140) with effect from April 2018.[33] As explained by the Chancellor, the current level of "dividend allowance has increased the tax advantage of incorporation [by allowing] each director/shareholder to take £5,000 of dividends of their company tax-free. It is also an extremely generous tax break for investors with substantial share portfolio".[34] As such, he has decided to reduce the tax-free dividend allowance to address the unfairness around director/shareholders' tax advantage, as well as raising the much-needed revenue. Nevertheless, the Chancellor has increased personal allowance and ISA allowance by 4.5% and 31.2% respectively, in a move to ease the impact of reduced amount of tax-free dividend allowance.

Modified classical system in the United States

4.13 Before 2003, the US had a classical system of taxing dividends where dividends were included in gross income and taxed as ordinary income at rates up to 39.6%. Starting from 2003, the US shifted to a modified classical system under which dividends are divided into ordinary dividends and "qualified dividends". As shown in **Table 2**, qualified dividend income is taxed at preferential rates of 0%, 15% or 20%, which are lower than the typical income tax rates that ordinary dividends are subject to.[35] In this connection, the shift to the modified classical system represents tax cuts for dividend income.

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[33] See HM Treasury (2017).

[34] Ibid.

[35] To consider an example of an investor in the 28% tax bracket receives US$20,000 (HK$155,760) in annual income from dividends, if the dividends are counted as ordinary dividends, the investor is required to pay US$5,600 (HK$43,613) as dividend tax. However, if those dividends meet the definition of qualified dividends, the tax payment would be reduced to US$3,000 (HK$23,364).

Table 2 – Tax rates of ordinary dividends and qualified dividends

<table>
<tr><th>Ordinary income tax rate</th><th>Ordinary dividends tax rate</th><th>Qualified dividends tax rate</th></tr>
<tr><td>10%</td><td>10%</td><td rowspan="2">0%</td></tr>
<tr><td>15%</td><td>15%</td></tr>
<tr><td>25%</td><td>25%</td><td rowspan="4">15%</td></tr>
<tr><td>28%</td><td>28%</td></tr>
<tr><td>33%</td><td>33%</td></tr>
<tr><td>35%</td><td>35%</td></tr>
<tr><td>39.6%</td><td>39.6%</td><td>20%</td></tr>
</table>

Source: Internal Revenue Service (2017).

4.14 Qualified dividends are generally dividends from shares in domestic corporations and certain qualified foreign corporations[36] which investors must hold for at least a specified minimum period of time, known as a holding period. For common stock, the share must be held for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date. As to preferred stock, the holding period is at least 91 days during the 181-day period beginning 90 days before the ex-dividend date.[37] Dividends do not satisfy the above requirements are treated as ordinary dividends and taxed at the rates of ordinary income. The definition of qualified dividends and the holding-period aim to address tax abuses and speculative behaviour.

Policy objectives

4.15 According to the US Congress[38], taxing shareholder-level dividend income at preferential rates should help rectify the tax-induced distortions under the classical system. These distortions included (a) undue tax burden on investment income as a result of the double taxation problem; (b) distortion of corporate financial decisions favouring debt financing over equity

[36] A qualified foreign corporation is defined as any foreign corporation that is either incorporated in a possession of the US or eligible for benefits of a comprehensive income tax treaty with the US. A foreign corporation that does not satisfy either of the above two requirements can still possibly pay qualified dividend if the dividend paid by that corporation is with respect to stock that is readily tradable on an established securities market in the US.

[37] See Internal Revenue Service (2017).

[38] See US Congress, Joint Committee on Taxation (2005).

financing[39]; (c) risk of more bankruptcies during an economic downturn due to increased corporate borrowing amid corporates' preference for debt financing; and (d) tendency for corporates to retain profits rather than to distribute them as taxable dividends.

4.16 With the easing of the tax-induced distortions, the Congress expects the enhanced efficiency of the capital markets would lower the cost of capital needed to finance new investments. The ensuing increase in aggregate national investment by the private sector should, in turn, boost the US economy in terms of higher output and productivity.

Recent developments

4.17 With the taxation of dividend income at preferential rates at the shareholder level, the US has shifted from a classical system to a modified classical system which has allowed the final tax liability of shareholders to approximate that under the dividend imputation system (see Appendix II). This in turn helps relieve the impacts of double taxation such as undue tax burden on income derived from owning corporate stock and the use of debt financing rather than equity financing.

4.18 The 2003 tax cuts for dividend income were originally set to expire in 2010. After many discussions and political negotiations, the US Congress extended the preferential treatments for dividend income for two more years, through the end of 2012. The preferential rates were made permanent on 1 January 2013, albeit with the tax rate for qualified dividends increasing from 15% to 20% for the highest income band.

Imputation system in Australia

4.19 Historically, Australia had a classical system of dividend taxation that resulted in double taxation on company profits when they were distributed to shareholders as dividends. Dividend imputation system was introduced in 1987 to relieve the problem. Under the system, Australia allows domestic

[39] Debt financing occurs when a company raises money by selling debts to investors, while equity financing involves the sale of a company's stocks to investors in exchange for cash. Under the US tax law, interest payments on the debt are tax deductible, but dividend payments to shareholders are not.

companies to pass through taxes that have already been paid on corporate profits in the form of a tax credit (i.e. franking credit) to shareholders. Investors receiving stock dividend will also receive franking credits to offset their income tax liability.[40]

4.20 When filing personal income taxes, investors will record both the amount of the dividend received and the amount of franking credit. The dividend received is grossed up by the amount of franking credit to obtain the full taxable value of the dividend. The income tax payable by the investor is then calculated, and the franking credits can be applied to offset the tax payable (please refer to Appendix I for an example showing the calculation of dividend tax under Australia's full imputation system).[41] If the dividend credit exceeds the income tax liability, the excess corporate tax paid may be refundable to the investor. With the introduction of full imputation system, investors who receive dividends will only be taxed the difference between the corporate income tax and their own marginal tax rate.[42]

Policy objectives

4.21 The objective of Australia's full imputation system is to integrate its corporate tax system with the taxation of resident shareholders. This should be conducive to reducing a number of biases in the classical system, which includes preference for debt financing in company financing decisions and tendency for companies to retain profits.[43]

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40 The amount of franking credits is calculated as follows: franking credits = (dividend amount/(1 − company tax rate)) − dividend amount. For a company that paid a 30% corporate tax rate and distributed a \$70 dividend to shareholders, franking credits = (\$70 / (1 − 30%)) − \$70 = \$30.

41 Shareholders receiving over AUS\$5,000 (HK\$28,900) franking credits are required to hold the shares for at least 45 days (90 days for preference shares), not counting the day of acquisition and disposal, before they are entitled for the tax offset.

42 If the corporate tax rate is 30%, the investor will not have to pay tax on the dividends if his or her marginal tax rate is 30%. If the marginal tax rate is 46.5%, the investor will only pay difference which is 16.5%.

43 See Reinhardt and Steel (2006).

Recent developments

4.22 In Australia, only resident shareholders are eligible to claim franking credits to offest their income tax liabilities. Such discriminatory tax treatment in imputation system brings unintended consequences such as the bias of Australian companies against investing in foreign businesses. The benefits of tax credit might also entice domestic investors to focus on investing in domestic firms with domestically-focused investments, which would affect their investement decisions and increase risk from a less diversified portfolio.

4.23 The Australian government conducted consultation exercises in 2008 and 2015 respectively to solicit the public's views on the taxation structure. In both consultation exercises, it raised the concerns about whether Australia's imputation system could adapt to a globalizing economy characterized by growing sophisticated business transactions and increasing competition for foreign investment among recipient countries. Other concerns included increased compliance cost required and the burden on the public coffers under the full imputation system (particularly amid the growing refund claimed by taxpayers who receive more franking credits than their tax liabilities). However, the majority of submissions received during the consultation exercises reportedly urged no change to the full imputation system. In the end, the Australian government has kept the system unchanged.[44]

5. Concluding remarks

5.1 All the overseas places studied have tax structures that are close to a comprehensive income regime where dividend income is included part of personal income subject to the same progressive rate schedule as other types of income. This brings into the tax net those who earn considerable income from dividends which are not subject to tax. A higher level of comprehensive income, revealing a higher ability to pay, leads to a higher tax payment. Apart from improving the social equity of taxation, Ireland and the UK have made use of increased tax revenue to lower their corporation tax in a bid to attract and retain foreign investment.

[44] Based on the email from the Treasury dated 21 June 2017.

5.2 The introduction of a dividend tax would easily lead to double taxation on corporate income. This might results in problems such as (a) distortions in corporate financing decisions favouring debt financing over equity financing; (b) tendency for corporates to re-invest their profits in future projects or share repurchases instead of paying out dividends even if they have made a profit; and (c) investors choosing to invest in overseas companies in order to avoid the tax. All the overseas places studied, except for Ireland, have put in places relief measures (such as tax credits to shareholders and preferential tax rates for dividend income) to avoid or relieve the double taxation problem. Yet, these measures might complicate the tax system and reduce the tax yield from taxing dividend.

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Appendix I

Example of how to avoid double taxation under dividend imputation system[45]

A.I.1 Suppose a corporation in Australia earns $100. This corporation would need to pay the corporate income tax of 30%. It then decides to pass the remaining $70 of after-tax profits to its shareholder.

Table 3 – Credit imputation method, Australia

Corporate profits	$100.0
Corporate income tax (30%)	$30.0
After-tax corporate profits	$70.0
	↓
Distributed dividends	$70.0
Grossed-up dividends	$100.0
Individual income tax (46.5%)	$46.5
Tax credit for corporate taxes paid	- $30.0
Net personal tax	$16.5
After-tax personal income	$53.5
Total tax on corporate income	
$100.0 - $53.5	$46.5
Rate:	46.5%

A.I.2 The shareholder receives the $70 of after-tax profits. For tax purposes, the shareholder then grosses up the dividends, which means that he or she adds back the taxes the corporation already paid on those profits ($30). This makes his or her taxable dividend income $100. This shareholder faces a marginal tax rate of 46.5%, which means a tentative tax bill of $46.5. The Australian tax code then provides a credit that reduces the shareholder's tax liability by the amount the corporation already paid in taxes on those dividends, in this case, $30. On net, the shareholder's tax bill is $16.5. To combine that with the corporation's bill of $30, the total tax rate on corporate profits was $46.5, or 46.5% of the original $100 of corporate profit.

45 The example discussed in this Appendix is extracted from Pomerleau (2015).

Appendix II

Methods to prevent double taxation of distributed profits[46]

A.II.1 Assume a corporation makes a profit of \$100. The corporate income tax is 30%, and the top marginal tax rate for personal income tax is 40%. Also assume that shareholders have a high earned income so that dividends should be taxed at the top marginal tax rate.

(a) In a *classical system*, dividends are subject to both corporate income tax and personal income tax. The final tax liability is \$30 + (\$100-\$30) x 40% = \$58. Hence, there is double taxation;

(b) In an *imputation system*, dividends are subject to corporate income tax; however, corporate income tax is credited against personal income tax. The final tax liability is \$30 + (\$40-\$30) = \$40, so that there is no double taxation;

(c) A *modified classical system* works like a classical system, except that income from capital is taxed at a lower rate or tax-exempt allowance/threshold is given. Assume, for example, that under the modified classical system, the flat tax rate for capital income is 15%. The final tax liability is \$30 + (\$100-\$30) x 15% = \$40.5. The final tax liability thus approximates the dividend imputation system; and

(d) In an *exemption system*, dividends are subject to corporate income tax but exempt from personal income tax, so that the tax liability is \$30. No double taxation occurs.

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46 See Brixi (2003).

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