DOUBLE DIVIDEND TAXATION RELIEF: A NEW VIEW FROM THE CORPORATE INCOME TAX PERSPECTIVE

Sebastian LAZAR
Faculty of Economics and Business Administration
"Al. I. Cuza" University
Iasi, Romania
slazar@uaic.ro

Abstract

Double taxation of dividends is a matter of great interest in the actual context of globalization and free movement of capital and persons. As the classical system is more and more abandoned, new solutions for the relief of double taxation are put into practice as a mean to reduce the fiscal burden on shareholders. With few exceptions, all these solutions are based on dividend tax relief. The paper aims at providing alternative solutions for double dividend taxation relief by taking some actions on corporate taxation and leaving aside personal income taxation. The goal of the research is to provide a new methodological approach of dividend taxation in various systems of taxation, the results showing which system is more suitable and easy to be put into practice. The results showed that the deduction system of dividends when computing taxable profits is the most appropriate for the Romania's flat tax fiscal framework.

Keywords: dividend taxation, relief, personal income tax
JEL classification: H21, H24, H25

1. INTRODUCTION

Double taxation of dividends is a matter of great interest and polemic debates. There is still an issue whether the dividends have to be taxed or not, some economists arguing for eliminating such taxation in order to eliminate double taxation on shareholders revenues, while others still plead for maintaining it, mainly due to social and equity reasons. While these polemics seems to be endlessly, many countries have adopted solutions for relieving the double taxation invoked by the majority part of the economists. With few exceptions (Czech Republic), all these solutions are based on partial/total imputation and/or exemption measures taken on personal income tax. The paper design a new methodology for relieving double taxation of dividends through partial/total imputation and/or exemption measures taken not on personal income tax, but on corporate profits tax. Basically, we try to diminish the fiscal burden, not by reducing the personal tax, but the corporate tax. We consider that such line of action have the advantage of fiscal neutrality both on the corporate level (same fiscal treatment applied to interests and dividends, and thus reducing the incentives for debt financing) and at the personal level (same fiscal treatment applied to earned income vs. unearned income). The new methodology has its limits, from which the most important consists in the difficulty of putting it into practice, mainly due to the ex-ante dividends which had to be known before the annual assessment of the corporate income tax.

2. DOUBLE TAXATION OF DIVIDENDS: A REALITY OR AN ILLUSION?

First of all, is there an issue double taxation of dividends? Can you speak of double taxation when it comes to dividends? Or, there is only a wide-spread cliché?

Double taxation of dividends is justified by proponents of this orientation [Auerbach, 2007; King, 1974; Poterba, 1984; Sorensen, 1995] as determined by the fact that individual investors pay a tax on dividends they received from the net profits distributed by companies, which already paid the corporate income tax. As such, the financial flow that remunerates individual investors "meets" the tax twice, first at the enterprise level (corporate tax) and a second in the individual (personal income tax). This approach (conduit approach), which sees the enterprise as a vehicle of transmitting the financial flows between businesses and individuals who own them, by means of specific legal entities (joint stock companies, limited liability companies, etc.), justifies, according to many famous economists, the double taxation of dividends. Double taxation has no legal significance in this case, but an economic one, which occurs when "the same income is taxed twice in the hands of two different taxpayers" [CEE, 2003, 3]. In fact, we consider that a more appropriate formula were not the "same income", but the same "flow of income", as dividends are different from profit, but are supported from it. Put it another way, the source of dividends are the profits, which are taxed twice, and thus, the double taxation arises.

By contrast, proponents of taxing dividends at the individual level focus on the legal distinction between companies and theirs shareholders which give rise to specific legal relationships, justifying taxation of dividends at the personal level. Exempting dividends from personal income tax would encourage the wealthiest members of society to buy shares and make their living only from dividend income, thereby avoiding the payment of any personal taxes. They also argue that this tax is paid as long as company pays dividends, companies having the possibility of avoiding such tax by choosing other forms of remunerating their shareholders: the incorporation of profits, repurchasing of shares. However, in such circumstances, shareholders will incur a tax on capital gains, as a tax on the difference between selling price (higher) of shares and the purchase price (lesser), so double taxation (in the economic sense) does not disappear, just changes its nature. Opponents of the double taxation of dividends tax argue that individuals can organize their affairs in other legal forms, and, as such, the tax on dividends can be avoided. In our opinion, such legal forms (sole proprietorships, S-corporations) not provide typical advantages of joint stock companies (civil liability, the free movement of capital, diversification of securities, etc) and not allow business to grow beyond a certain level.

Although both orientations have their limitations, can not be denied that, legally, individual shareholders, on one hand, and companies, on the other hand, are different entities involved in economic activities in a legal framework, which provides protection to all those involved, and as such, all must pay taxes under the principle of universality. Moreover, the return of investment for an individual shareholder comes from the profits of company in which he invested, profits that are taxable under the corporate income tax. There are opinions which advocate for the elimination of corporate income tax, because it is not due by a real subject, but by a legal subject represented by the company. But we must not forget that the company, in its most representative form, the corporation, acquires rights and obligations distinct from those of its shareholders, thus justifying its taxation.

So, if we look at the issue of dividend taxation from an economic point of view, there is a certain double dividend taxation, as the flow of income from the corporation to the shareholder meets the tax twice. But if we look at the issue from a legal point of view, there is no such double taxation, as it comes of two separate entities (the company and the shareholders) and two different types of revenues, related, but not the same (profits and dividends).

The double taxation of dividends makes sense, only if we approach the issue from an economic point of view, and only if we consider corporate income tax and dividend tax altogether, and not separately, as the taxes that the stream of revenues from the company to shareholders have to met in order to enter in the pockets of those who invest their capital..

3. SYSTEMS OF RELIEVING THE DOUBLE TAXATION OF DIVIDENDS

In order to relief the double taxation of dividends, most countries adopted specific measures, which aim at tax exemptions or tax reductions, either at personal level or at the business level. So far, there are the following systems of taxation of corporate profits and personal dividends:

1. *classical system*: the enterprise is subject to corporate income tax, dividends distributed to shareholders enter into the composition of income and are taxed under personal income tax. This is the case of Switzerland, Ireland and Romania;
2. *modified classical system*: similar to the previous, the only difference being that the income from dividends are taxed at a lower rate than the one applied to other revenues of individuals. This is partly to compensate (at shareholders level) tax paid by the company. The rate of taxation of dividends is chosen in such way that the fiscal pressure arising from tax paid by company and tax on dividends to be close to that resulting from the taxation of income arising from personal maximum marginal rate. So, for high income individuals, double taxation shall be avoided almost completely, while for low incomes individuals, it is still present, although not at the same level as in the classic traditional. It is the case of U.S.A,, Austria, Belgium, Denmark, Japan, Poland, Portugal;
3. *full imputation system*: tax paid by the firm is charged to shareholders acting as prepayments on the account of personal tax on dividends. Thus, the total amount of dividend tax shall be reduced, being equal to the difference between the tax on dividends under normal circumstances and the tax paid by the company, but charged to shareholders. Such a situation is encountered in Australia, Mexico, New Zealand, Spain;
4. *partial imputation system*: shareholders receive a tax credit for dividends, expressed as a percentage of tax paid by the company, which is subtracted from the total tax payment (Canada, France, United Kingdom);
5. *total exemption system*: the dividends are fully exempt from personal income tax. It is the case of Greece;
6. *partial exemption system*: the dividends are partially exempt (usually 50%) from the tax on personal income. This is the case of Germany and Luxembourg (half income tax method);

7. *partial deduction system*: the company deduces from the corporate income tax, a fixed rate representing the dividend tax that shareholders should pay, corresponding to share of profit distributed to them as dividends. This solution, more difficult to be put into practice, is met in the Czech Republic;

The first variant does not correct at all the double taxation, dividends being taxed at the same rates as those for wages and other personal income. Variants 2-6 aim to correct the double taxation, by taxing dividends at rates lower than those applied to wages, or through full or partial imputation through tax credits related to corporate income tax paid by companies, or by total or partial exemption from taxation of dividends made by individuals. The last variant is distinguished from others in that it aims to correct the double taxation by reducing the tax paid by the company and not the tax on dividends paid by individual shareholders. In addition to these variations, there are mixed systems in which double taxation is partially corrected by applying simultaneous solutions of several characteristics mentioned (Italy, Finland).

Romania is currently applying traditional classical system, dividends received by individuals being taxed at a flat rate of 16%, similar to that applied to all categories of income an individual may earn. The corporate income tax rate is also of 16 percents. Dividends received by companies are deductible when computing taxable profit. The flat tax gives rise at certain specific issues when it comes to compute the tax rates in order to verify certain conditions, as for example, the Miller condition [Lazăr, 2009].

A summary of the incidence of corporate income tax and of dividend tax on net dividends received by individual shareholders is presented in Table. 1.

Table no. 1 The incidence of corporate income tax and of dividend tax on the net dividends received by individual shareholders

No.		**Classical system**	**Modified classical system**	**Full imputation system**	**Partial imputation system (50%)**	**Total exemption system**	**Partial exemption system (50%)**
1.	Profit	100	100	100	100	100	100
2.	Corporate income tax (%)	35	35	35	35	35	35
3.	Net profit =Dividends (1-2)	65	65	65	65	65	65
4.	Dividend tax base	65	65	100	100[i]	0	32,5
5.	Dividend tax (40% - normal rate) (20% - reduced rate)	26 (40%* 65)	13 (20%*65)	40	40	0	13
6.	Tax credit			35	17,5		
7.	Effective dividend tax paid(5-6)	26	13	5	22.5	0	13
8.	Net dividends (3-7)	39	52	60	42,5	65	52
9.	Countries	Romania, Switzerland, Ireland	USA, Austria, Belgium, Denmark, Japan, Poland, Portugal	Australia, Mexic, New Zeeland Spain	Canada, France, UK	Greece	Germany Luxemburg

Total exemption system appears to be the most advantageous for shareholders, as in this case, they do not pay any tax. Second place comes to full imputation system, whereas the shareholders can fully benefit from the deduction of corporate income tax paid by the company. Lowest net dividends are met in the case of the classical system, the system that currently works in Romania.

The classical system, through the effects induced by net dividends appropriated by shareholders, determines capital outflows from the corporate sector [Harberger, 1962, 3], thus reducing the capacity of companies to invest. In the classical system, the personal income tax rate does not depend on the nature of the income and, in these circumstances, the fiscal framework does not create any propensity for shareholders to increase their wealth either through dividends or through increasing the price of their shares, by a continuous reinvestment of the profits. Only if the tax rate for capital gains is lower than that for dividends, companies have an incentive to reinvest profits, but this can not be perpetuated indefinitely without consequences on business value. At one point in time, in order to not affect the market value of the company, it will have to distribute dividends to shareholders. Moreover, tax rules prohibit treating redemptions of shares by the company as capital gains in order to avoid the taxes. Poterba and Summers [1984, 7] concluded that the dividend tax cut investments made by enterprise and emphasizes intersectoral and intertemporal distortions in capital allocation. Gravel [1991, 4] concludes that the distortions induced by the classical system of dividend taxation diminish the growth of GDP.

4. RELIEVING THE DOUBLE TAXATION OF DIVIDENDS THROUGH CORPORATE INCOME TAX

All the solutions presented in the previous section are focused on reducing the double taxation of dividends, either by imputation (total or partial) or by exemption (partial or total) of personal income tax, while the corporate income tax is kept constant in all cases (line 2 of table 1). As the double taxation of dividends arises only when we look at the big picture, by taking into account the corporate income tax, so the relieving of such double taxation can be achieved by taking some corrective actions on either side of the issue: dividend tax and corporate income tax. So, we consider a methodology based on the Czech Republic case, which aims at relieving the double taxation of dividends through corporate income tax, while maintaining dividend tax constant.

In order to simplify the construction of our model, a series of hypothesis are considered:

- integral distribution of profits as dividends;
- the resulted tax credit or tax savings form corporate tax are fully appropriated by individual shareholders in order to reduce the double taxation of dividends;
- the dividends to be distributed are known before the profit tax computation (ex-ante dividends).

In this context, possible solutions to be applied are based on full or partial imputation of corporate income tax or on full or partial deduction of dividends from taxable profits.

In the first case (full or partial imputation), corporate income tax is calculated ex ante, and then the dividend tax is imputed, resulting a lower ex post profit tax. The difference between ex-ante corporate income tax and ex post corporate income tax is appropriated by shareholders to offset regular dividend taxes paid (unadjusted base and normal tax rate). Basically, the company receives a tax credit equal to full or partial dividend tax, which will be distributed to shareholders as dividends.

Table no. 2 Incidence of imputation systems regarding corporate income tax on net dividends received by individual shareholders

No.	Indicator	Total imputation system	Partial imputation system (50%)
1	*Profit*	*100*	*100*
2	*Ex-ante corporate income tax (35%)*	*35*	*35*
3	*Net profit =Dividends (1-2)*	*65*	*65*
4	*Dividend tax base*	*65*	*65*
5	*Dividend tax (40% - normal rate)*	*26 (40%*65)*	*26 (40%*65)*
6	*Dividend tax effectively paid*	*26*	*26*
7	*Ex-ante net dividends (3-6)*	*39*	*39*
8	*Imputed corporate income tax (tax credit)*	*26*	*13 (26/2)*
9	*Ex-post corporate income tax (2-8)*	*9*	*22*
10	*Ex-post net dividends (7+8)*	*65*	*52*

Full or partial deduction consists in the deduction from profit tax base of ex-ante dividends similar to the deduction of interest, which has the effect of reducing taxable profit and therefore profit tax. This reduction of profit tax is appropriated by shareholders to offset regular dividend taxes paid (unadjusted base and normal tax rate). Basically, dividends are tax deductible when computing taxable profits, in the same manner as interest, thus generating tax savings equal to difference between profit tax in case of nondeductibility of dividends and profit tax in case of deductibility of dividends. These tax savings are then appropriated by the shareholders.

Table no. 3 Incidence of deduction systems regarding corporate income tax on net dividends received by individual shareholders

No.	Indicator	Total deduction system	Partial deduction system (50%)
1	*Profit*	*100*	*100*
2	*Dividends*	*65*	*65*
3	*Deductible dividends*	*65*	*32.5 (50%)*
4	*Profit tax base (1-3)*	*35*	*67.5*
5	*Profit tax (35%)*	*12,25*	*23,625*
6	*Dividend tax base*	*65*	*65*
7	*Dividend tax (40% - normal rate)*	*26 (40%*65)*	*26 (40%*65)*
8	*Ex-ante net dividends (2-7)*	*39*	*39*
9	*Tax savings generated by corporate income tax (if dividends were not deductible)*	*22,75(35-12,25)*	*11,375 (35-23,625)*
10	*Ex-post net dividends (8+9)*	*61,75*	*50,375*

In order to better illustrate the distribution of the 100 monetary units of profit in both versions of relieving the double taxation of dividends, we consider the data on table 4.

Table no. 4 The distribution of profit in both versions of relieving the double taxation of dividends

Double taxation relief measures taken on dividend tax side

A	*Classica l system*	*Modified classical system*	*Full imputation system*	*Partial imputation system (50%)*	*Total exemption system*	*Partial exemption system (50%)*
Profit	*100*	*100*	*100*	*100*	*100*	*100*
Corporate income tax	**35**	**35**	**35**	**35**	**35**	**35**
Dividend tax	*26*	13	5	22,5	-	13
Net dividends	*39*	52	60	42,5	65	52

Double taxation relief measures taken on corporate income tax side

B	*Total imputation system*	*Partial imputation system (50%)*	*Total deduction system*	*Partial deduction system (50%)*
Profit	*100*	*100*	*100*	*100*
Corporate income tax	*9*	22	12.25	23,625
Dividend tax	***26***	***26***	***26***	***26***
Net dividends	*65*	52	61,75	50,375

One can notice the fact that in case A, the corporate income tax is the same in all systems of relieving the double taxation, while in case B, the dividend tax is kept constant, while corporate tax is varying according to the system adopted. Also, we can see that total exemption (total or partial) system on dividend tax side is equivalent to total imputation (total or partial) system on corporate income tax. The deduction system on corporate income tax gives some unique results.

Using the templates formulated in Table 2 and 3, the results can be formulated in a synthetic manner using the following notations (see Table no. 5):
P = gross profit;
t_c = corporate profit tax rate;
D = gross dividends;
t_c = dividend tax rate;
k = percent of partial imputation/deduction (50% in our example);

Table no. 5 Net dividends in the case of double taxation relief measures taken on corporate income tax side

No.	**Indicator**	***Total imputation system***	***Partial imputation system (k%)***	***Total deduction system***	***Partial deduction system (k%)***
1.	*Profit*	*P*	*P*	*P*	*P*
2.	*Dividends*	*D*	D	D	D
3.	*Deductible dividends*	-	-	D	kD
4.	*Corporate income tax base*	*P*	*P*	P-D	P-kD
5.	*Corporate income taxe ex ante*	$t_c P$	$t_c P$	$t_c(P\text{-}D)$	$t_c(P\text{-}kD)$
6.	*Dividend tax base*	*D*	D	D	D
No.	**Indicator**	***Total imputation system***	***Partial imputation system (k%)***	***Total deduction system***	***Partial deduction system (k%)***
7.	*Dividend tax*	$t_d D$	$t_d D$	$t_d D$	$t_d D$
8.	*Ex-ante net dividends (2-*	$D - t_d D =$	$D - t_d D =$	$D - t_d D =$	$D - t_d D =$

	7)	$D(1-t_d)$	$D(1-t_d)$	$D(1-t_d)$	$D(1-t_d)$
9.	*Corporate income tax credit*	$t_d D$	$t_d kD$	-	-
10.	*Corporate income taxe ex post (5-9)*	$t_c P - t_d D$	$t_c P - t_d kD$	-	-
11.	*Tax savings generated by the deductibily of dividends*	-	-	$t_c P - t_c (P-D)$	$t_c P - t_c (P-kD)$
12.	*Ex-post net dividends(8+9)/(8+11)*	$D(1-t_d) + t_d D = D$	$D(1-t_d) + t_d kD = D[1-t_d(1-k)]$	$D(1-t_d) + t_c P - t_c (P-D) = D(1-t_d+t_c)$	$D(1-t_d) + t_c P - t_c (P-kD) = D(1-t_d+kt_c)$

These results give some specific conclusion when analyzing the fiscal framework of Romania. As it is widespread known, the flat tax implemented in Romania consists in a 16 percents tax rate applied to all income, no matter of their nature (wages, dividends, interest, capital gains). In this context, one interesting conclusion resides in the fact that, for Romania, **the imputation system is equivalent to the deduction system** as corporate profit tax rate equals dividend tax rate ($t_c = t_d$).

5. CONCLUSIONS

Such measures for relieving double taxation of dividends taken on corporate income tax side are more difficult to put into practice because they involve calculating both ex-ante and ex post corporate income tax and net dividends. On the other side, there are some advantages, among which the most important consists in **fiscal equal treatment applied to interest and dividends in computing taxable profit** (valid only for the deduction system). In this case, the tax neutrality is increasing, thus reducing the preference for debt financing instead of equity financing. In countries with bank-based financial systems, this fiscal treatment may spur companies to equity financing, with positive implications on primary capital market development. Another advantage is the possibility of **maintaining the same flat tax rate for all personal incomes, while still relieving the double taxation of dividends**, which is in accordance to the core philosophy of Romania's flat tax. Further research in the field is appealing, as major finance theories can be reassessed according to this new view.

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This work was supported by CNCSIS-UEFISCSU, project no. PN-II-RU-PD, code 340/2010