COMPARISON OF DIVIDEND TAXATION BETWEEN THE CURRENT U. S. TAX LAWS AND THE IMPUTATION SYSTEM

*Robert Maloney, College of Business and Public Policy, University of Alaska Anchorage, Anchorage, Alaska 99508, 907-786-4137, afrcm1@uaa.alaska.ed*u
*Suresh C. Srivastava, College of Business and Public Policy, University of Alaska Anchorage, Anchorage, Alaska 99508, 907- 786 4148, afscs@uaa.alaska.ed*u

ABSTRACT

This paper explores an alternative approach to taxing dividends in the U. S. using the imputation system that is employed in countries around the world. The imputation system is a combination approach between corporations and their shareholders that attempts to overcome the double taxation inherent in the U. S. system. We study the situation of three U.S. taxpayers in different marginal tax brackets with similar deductions and sizable dividend income, and examine the impact on their tax liability if the dividend taxation policy is changed from the current system to the imputation system.

INTRODUCTION

Effective for the 2003 tax year congress reduced the tax rate on qualifying dividends to a maximum of 15%. During the debate on this change in the law, there was considerable discussion of completely eliminating the taxation of dividends at the personal level. The primary justification for this proposal was to eliminate the double taxation of dividends. Corporations pay taxes on their profits without regard to dividends. The after-tax profits are then available for distribution to shareholders. When shareholders receive these dividends they are subject to personal income taxes, thus the double taxation of dividends. The reduction in the tax rate on dividends is scheduled to sunset at the end of 2008. Congress will need to extend this provision, change to a new approach to the taxation of dividends, or the law will return to its status prior to 2003. Prior to 2003 dividends were taxed as ordinary income at rates that vary from 10% to 35%. As the date of this sunset provision approaches we anticipate that the debate on alternative methods to tax dividends will resurface. With this paper we hope to offer an additional approach to consider when discussing alternatives to the current or prior law.

IMPUTATION SYSTEM

The 2-to-1 combination taxation system can be divided into eight approaches depending on the degrees and stages of tax combination, including: (1) partnership approach; (2) dividend-paid deduction system; (3) dividend-paid credit system; (4) split-rate system; (5) dividend-exemption system; (6) dividend-credit system; (7) imputation system; and (8) hybrid systems. Of these eight variations on the 2-to-1 combination system, the imputation system has a strong appeal because of its effort to ameliorate the effects of double taxation. Under the Imputation System, income taxes at the corporate level can be completely or partially used to reduce shareholders' personal income taxes. If all the taxes at the corporate level can be used to reduce shareholders' income taxes, the system is called complete imputation system; if partially effective, its is called a partial imputation system. In the partial imputation system, the higher the percentage that can be reduced from personal income taxes, the closer the system is to the complete imputation system; the lower the percentage, the closer it is to the independent taxation systems.