

# The tax-effectiveness of dividend streams

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The Hawke-Keating era is renowned for its micro-economic reforms. Next year will mark the 25th anniversary of one of the most significant changes for share investors – the end of the double taxation on dividends. The importance of “dividend imputation” – for that’s what the new system is called – is that it changed the post-tax considerations of investing in favour of Australian shares, especially over cash.

Up until 1987, company earnings paid out as dividends were largely taxed twice. The first time was when companies paid tax on their gross profits (for dividends come from net profits). The second time was when the investors who received the dividends paid tax on this income.

Dividend imputation abolished the double tax whammy on dividends by allowing shareholders to claim a tax credit for some, or all, of the tax an Australian company has paid on its earnings. These tax credits are known as franking credits. Companies that pay all their tax in Australia often offer “fully franked” dividends.

So low-income earners could gain the full benefit of new tax system for dividends, the Howard government made franking credits refundable in 2000. This means that low-income earners can receive franking credits back in cash as part of their tax refund.

The tax law surrounding franking credits carries restrictions and exemptions that may change the tax benefits received for different people. But its mainstream application is significant because other asset classes generally don’t offer such tax-effective income streams as Australian shares.

An Australian company, for instance, that offers a fully franked dividend of 5% (its expected dividend payment divided by its share price) is offering a more tax-effective income stream than a bank term deposit offering a 5% return. In reality on a pre-tax basis, this Australian company is offering a 7% yield for investors on the highest marginal tax rate, versus 5% still for the term deposit.

As shares have fallen in recent weeks, the dividend yield on Australian shares has risen to about 5% overall, and many large stocks offer dividend yields far in excess of the average<sup>1</sup>. This dividend yield would carry a franking credit in excess of 90%, if the franking credit offered by the typical managed Australian share fund on their distributions is any guide. This means that the effective yield of Australian shares overall is closer to 7%. At the same time, term deposit rates are falling.

The drive behind the introduction of dividend imputation was to encourage investing in shares. It’s still working just as policy makers thought it would a quarter of a century or so ago.

1 Bloomberg. As at 7 September 2011. Based on the S&P/ASX 200 Index

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