

# **Surplus ACT - A Solution in Sight?**

**Proceedings of the IFS Conference**

**24 June 1993**

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# Surplus ACT - A Solution in Sight?

## Overview

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*Institute for Fiscal Studies*

### 1. Introduction

In his last Budget Speech, in March 1993, the Chancellor, Norman Lamont, announced a series of changes to dividend taxation, along with the publication of a Consultative Document on possible changes designed to alleviate the problem of surplus advance corporation tax. On 24 June 1993 the Institute for Fiscal Studies hosted a conference on surplus ACT which was chaired by John Plender of the *Financial Times*. This focused on the Budget changes, and on the proposals in the Consultative Document to allow companies to pay 'Foreign Income Dividends', and to set up a special tax regime for 'International Headquarter Companies'.

This volume contains contributions from each of the speakers, who were chosen to reflect a wide range of possible views. The overview in this section is designed to supplement the opinions and analysis in the conference papers, provide a background to the debate, and pick out some themes which have run through the debate.

### 2. The Papers

In the opening session of the conference **Harold Freeman**, of IFS, emphasised the close link between shareholder and company taxes on dividends, and suggested that surplus ACT should be addressed in the context of other developments in international taxation. He argued that the Foreign Income Dividend scheme would not solve the surplus ACT problem, and would create conflict between shareholder groups. Finally, he suggested that cutting the tax credit to pension funds might be a simpler solution.

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<sup>1</sup> Harold Freeman is a Senior Research Officer and Rachel Griffith a Research Officer at the Institute for Fiscal Studies.

**Peter Lewis**, of the Inland Revenue, discussed the background to the Consultative Document and summarised the responses the Inland Revenue had received so far. These had broadly welcomed the proposal but some responses had expressed concern at the complexity of the proposed system and detailed ways in which it could be improved.

The first session was rounded up by **Edward Troup**, a partner at Simmons & Simmons. He discussed some serious practical problems with the proposed schemes, and suggested that it would be much simpler if companies did not have to pay and then reclaim ACT on FIDs. He also emphasised that the structure of the tax system should not be based on considerations of exchequer cost.

The second session was introduced by **Nicholas Dee**, Director of Taxation at SmithKline Beecham (speaking on a personal basis). He discussed some of the lobbying history and, while welcoming the FID scheme as a step forwards, suggested that the scheme was too limited to be a complete solution.

**Peter Randall**, UK Director of Taxes at Citibank (speaking in a personal capacity), finished the session, by concentrating on the effect of surplus ACT on the location of international headquarters and holding activities, particularly in the financial sector. He emphasised the positive effects on the domestic economy of attracting such international companies and, placing tax problems in the context of the liberalisation of European financial markets, argued that a full solution to the problem was vital if the UK was to retain its position as a key financial centre.

### **3. The Imputation System**

Corporate taxation was first introduced in the UK in 1964. Until 1973 companies were taxed at a single flat rate on all profits. Shareholders then had to pay income tax in full on any dividends received. This type of tax system, described as 'classical', remains in force in many countries, including the US and the Netherlands. Critics, however, argued that because dividends are taxed twice under a classical system - once when earned and again when paid to shareholders - the effect is to reduce the incentive to invest in companies, and to distort corporate financial policy, discouraging the payment of dividends and encouraging the use of debt.

These arguments culminated in the introduction of the imputation system in 1973. Under the new system, companies have to pay an additional tax, named advance corporation tax, on distributed profits, but are able to offset this payment against their mainstream tax liability. Shareholders now receive a tax credit on all dividends, equal to the basic rate of tax. The effect

is to reduce the overall rate of tax on distributed profits, so that, for basic-rate taxpayers, both retained and distributed profits are taxed at a total of 52 per cent. Exempt shareholders, such as pension funds, now receive a tax refund at the basic rate of tax on every dividend received.

ACT is an important part of the Government's revenues. For the fiscal year 1992-93 it is estimated to amount to about £8.7 billion out of a total corporation tax yield of nearly £16 billion. ACT is also important to the timing of revenues because it is paid at broadly the same time as dividends. Corporation tax is payable nine months after the end of the period in which the profits are earned.

#### **4. Surplus ACT**

Surplus ACT arises where a company pays out a dividend that exceeds its taxable profits, or when it has not paid enough UK tax on its profits to be able to offset the ACT.<sup>2</sup> When the amount of ACT reaches the limits set by the tax system, the company is no longer able to set the tax that it has paid against the tax that it owes. Instead the company finds itself paying both lots of tax.

Companies can find themselves in this position for a number of reasons. It can happen when a company pays dividends out of reserves, when there are timing differences between the earning of profits and the payment of dividends. It can happen because of differences between accounting profits and profits for tax purposes, for example if the capital allowances the company can claim exceed its depreciation provisions. And, most importantly, it can happen when companies pay dividends out of foreign earnings, which may have borne tax overseas.

In these situations, the company can carry the surplus backwards for up to six years, and get credit based on past tax and past profits. Or it can carry the surplus ACT forwards, to set it against future tax and profits. These provisions mean that companies with temporary surplus ACT, associated with a mismatch in the timing of dividends and profits, can expect to reclaim the tax paid eventually. Where the mismatch is permanent, if taxable profits are lower than accounting profits due to the structure of the tax system, or if companies earn substantial profits abroad, the company may find itself with a permanent stock of surplus ACT that it has no prospect of reclaiming.

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<sup>2</sup>The amount of ACT that a company is allowed to credit against the basic mainstream tax on its profits is subject to limits. The set-off limit is the amount of ACT that would have been paid if the whole of the taxable profits were paid out as a dividend.

## 5. The Stock of Surplus ACT

Until 1984, taxable profits were often significantly lower than accounting profits due to a series of fairly generous allowances. Although the tax system changed substantially in the decade after the introduction of the imputation system, by 1983 companies were able to offset 100 per cent of the cost of plant and 75 per cent of the cost of industrial buildings immediately. Because the allowances were 'front-loaded' relative to accounting rates of depreciation, this meant that taxable profits would be depressed in years of high investment, even if they matched accounting profits over the investment cycle. These problems were exacerbated in the 1970s by dramatic swings in profitability, and by the introduction of the stock-relief scheme in 1974 in response to a liquidity crisis. The scheme survived, with modifications, until 1984. Accordingly, many companies found themselves with surplus ACT.

Figure 1 gives an indication of the evolution of the stock of surplus ACT, based on the analysis of a group of large industrial and commercial companies. It is difficult to get accurate figures of the total amount of surplus ACT, but accounts do show the amount of 'irrecoverable ACT', the amount of surplus ACT for which the company does not have a reasonable prospect of recovery. Figure 1 shows the stock of *irrecoverable* ACT written off. The two lines show slightly different estimates depending on the treatment of companies leaving our sample. The true figure lies somewhere in between.

While this graph gives a reasonable idea of the evolution of surplus ACT, it is of course based on a sample, and the total figures for the stock are likely to be significantly higher. Recent official estimates, given in the Consultative Document, are of a stock of £5 billion, increasing at up to £1 billion a year.

In 1984, the reform of corporation tax lowered the allowances available to companies, and brought taxable profits closer to commercial definitions in any particular year. These reforms, combined with bullish profit growth in the mid- to late 1980s, meant that the stock of surplus ACT fell substantially.

As Figure 2 shows, the proportion of firms with irrecoverable ACT increased dramatically over the 1970s, reaching its peak in 1983 and declining during the late 1980s. The darker bar indicates firms that were in a permanent irrecoverable ACT situation.<sup>3</sup> It seems probable that many companies that had surplus ACT in the early 1980s have simply remained in that position.

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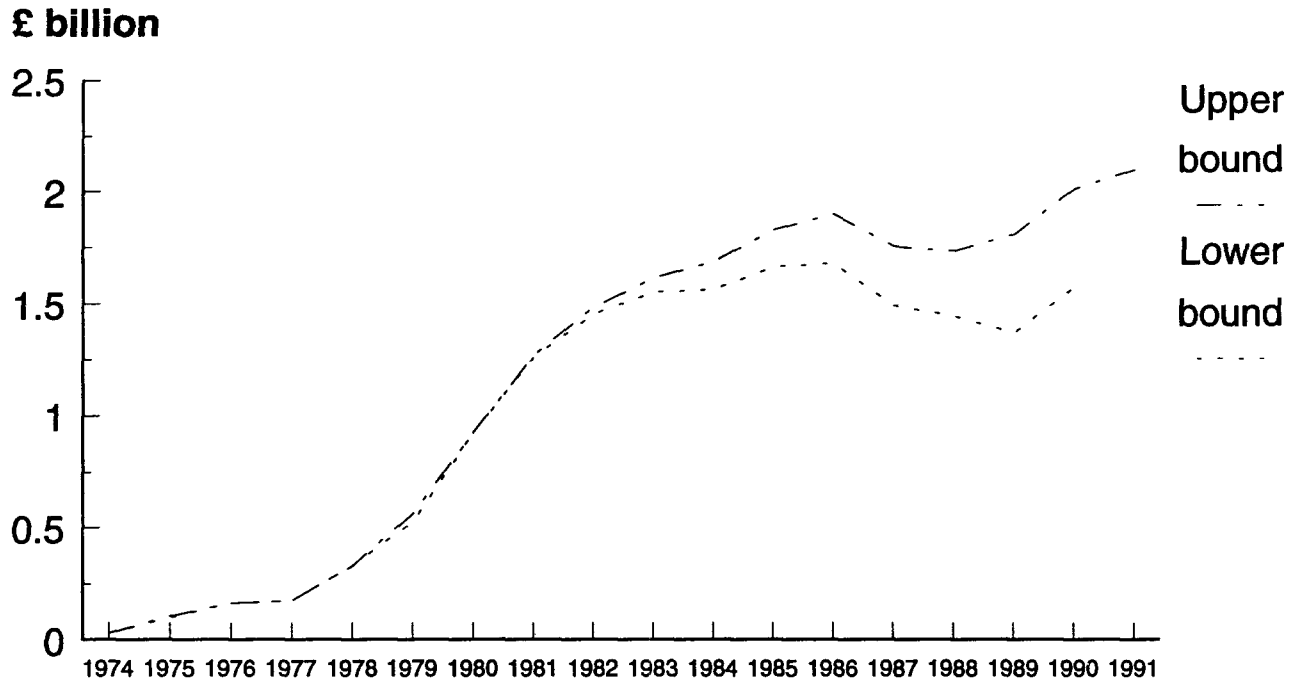
<sup>3</sup>We have defined this as firms that have had irrecoverable ACT in each of the last three periods.



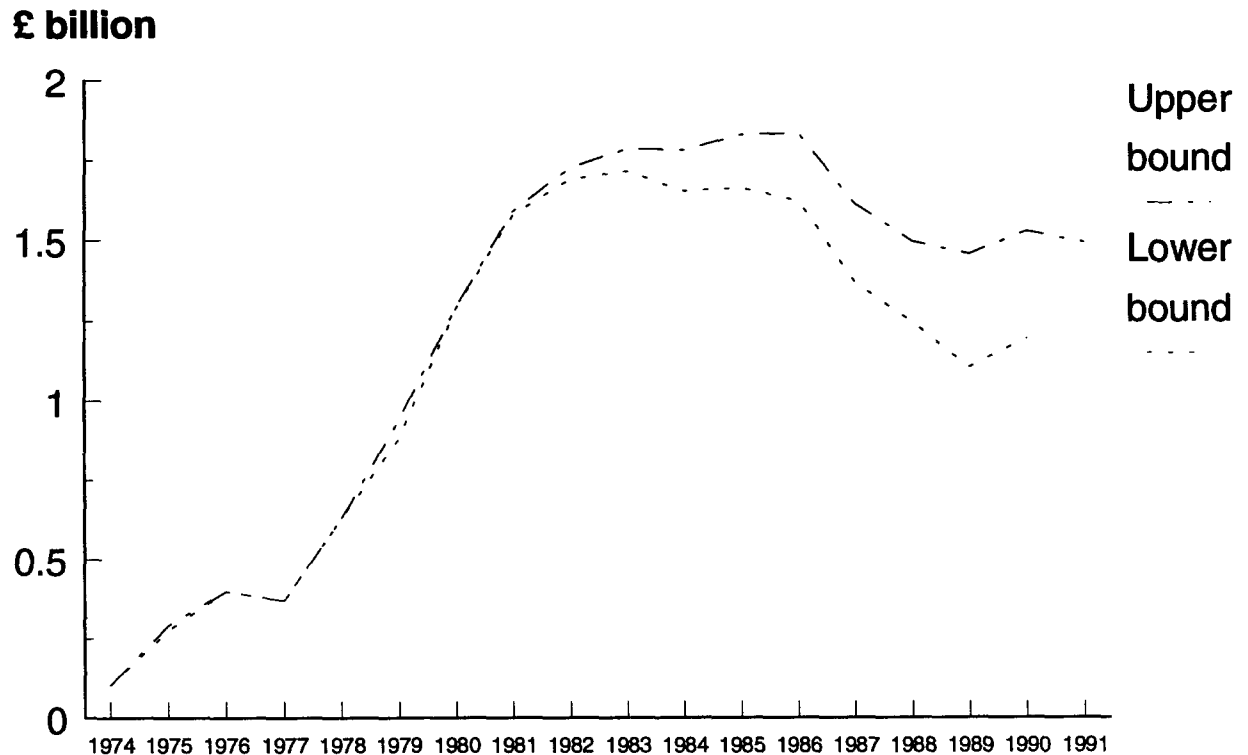
# Figure 1

## Stock of Irrecoverable ACT

### (a) Current prices



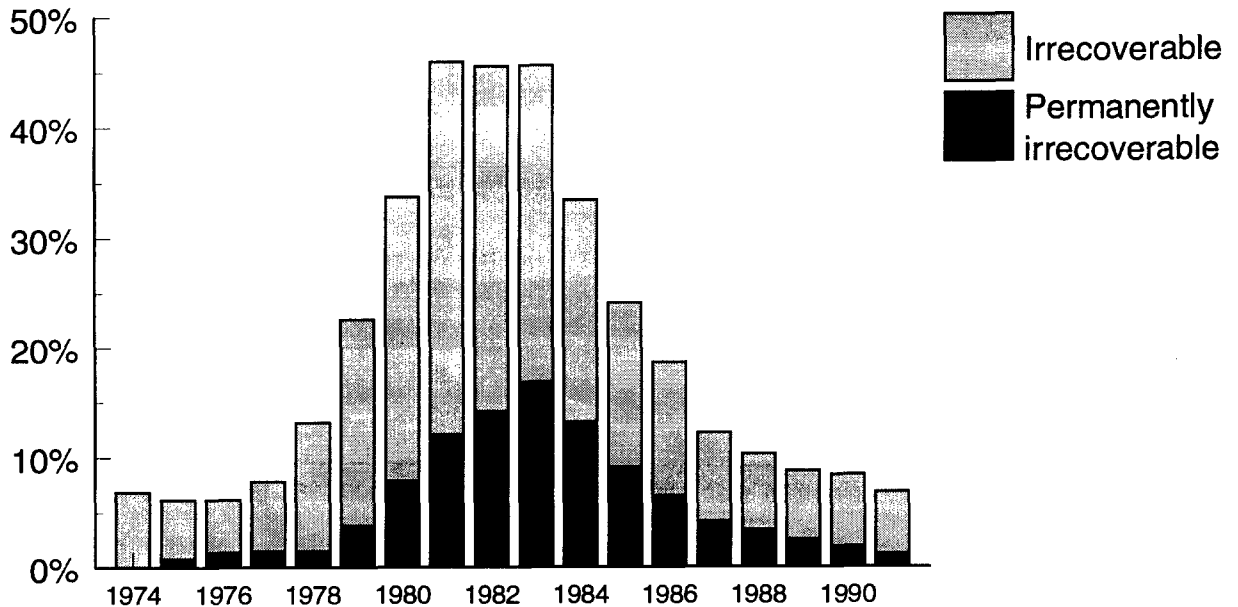
### (b) 1985 prices



Sources: Datastream; Economic Trends.

As the level of international investment increased in the 1980s, and following changes to the structure of the tax system from 1984 onwards, the problem has increasingly been focused on companies that pay dividends out of foreign earnings.<sup>4</sup>

**Figure 2**  
**Proportion of Firms with Irrecoverable ACT**



Source: Datastream.

## 6. Recovering the Irrecoverable - Take-overs

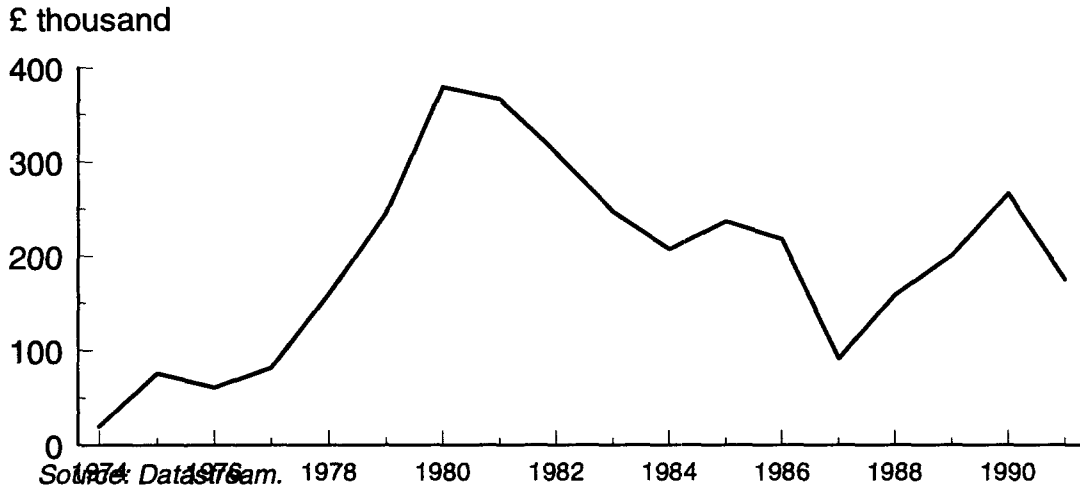
Companies can reduce their stock of surplus ACT by reducing their dividend payouts, or by increasing their proportion of domestic taxable profits. Not surprisingly, many companies choose

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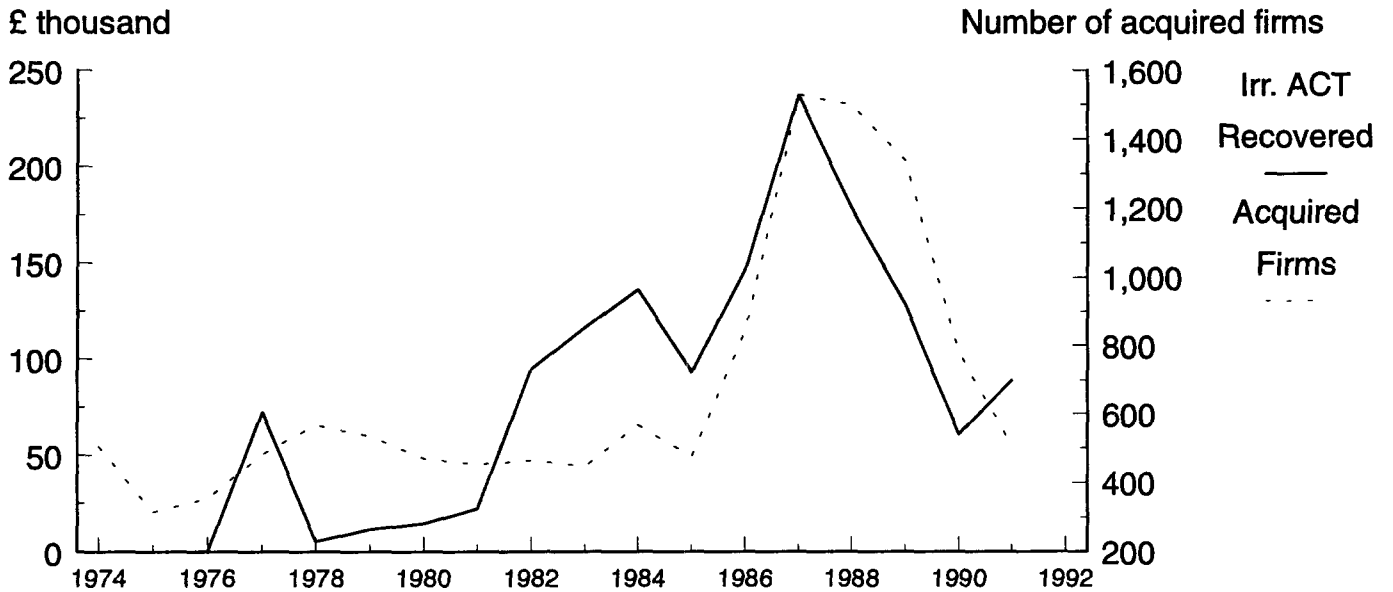
<sup>4</sup>These changes reversed the order in which companies with foreign earnings could offset ACT and double tax relief. Prior to this time companies with substantial foreign earnings might be able to offset all of their ACT, but would be unable to claim fully for tax paid abroad.

# Figure 3

(a) Irrecoverable ACT  
Written Off



(b) Irrecoverable ACT Recovered  
and Merger Activity



Sources: Datastream; CSO Bulletin 11/93.

the latter course. While domestic profits can be increased by changing investment policies, the simplest way to reduce surplus ACT is to 'buy in' a stock of past and future taxable profits in the form of another company.<sup>5</sup>

The more artificial schemes focus on using past profits, often abstracting from the transfer of real assets. However, changes in the 1993 Budget closed many of these loopholes. It remains the case, however, that there are mutual tax gains if a company with surplus ACT merges with (or takes over) a company with a substantial tax bill. The gains arise because the company with surplus ACT is able to use the tax paid by the taken over company to frank its dividend payments.

A cursory look at companies' accounts shows that a high proportion of 'irrecoverable ACT' actually is recovered at some point. Figure 3 splits the flows into write-offs of ACT and recovery of write-offs.

Clearly, recovery of ACT is highly correlated with the economic cycle as profits rise, but also highly correlated with merger activity, as shown by the lower panel, which also plots the level of merger activity. Disentangling these effects should prove a fruitful avenue for future research.

## **7. The 1993 Budget Changes**

In his 1993 Budget Speech, the Chancellor announced several changes to the taxation of dividends, and the publication of an Inland Revenue Consultative Document on corporation tax and surplus ACT.

The major changes in the Budget were:

- a reduction in the rate of ACT from 25 per cent to 22.5 per cent in 1993-94 with a further reduction in the rate to 20 per cent in 1994-95;
- a reduction in the tax credit to shareholders from 25 per cent to 20 per cent;
- a reduction in the basic rate of tax on dividends from 25 per cent to 20 per cent;
- further restrictions on the ability of companies to set ACT against past profits following a change in ownership.

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<sup>5</sup> Conversely, companies with substantial surplus ACT may find themselves the targets of companies with substantial past and future UK taxable profits.

The Chancellor described the cut in the rate of ACT as ‘a proposal which will help not just companies with surplus ACT, but all dividend paying companies; and it will do so in a way that will also raise considerable revenue’.

Clearly, all companies will benefit from the cut in ACT in terms of an improved cash-flow position in the next two to three years. However, since ACT can be offset against mainstream tax on profits, companies that do not have surplus ACT will not benefit from the cut at all in the long run. They will simply end up paying slightly less ACT and slightly more mainstream corporation tax.

Moreover, if we consider the position of company and shareholder taxation together, it becomes obvious that the cut in the credit to shareholders more than offsets any benefit to companies, whether they have surplus ACT or not. This is the reason that the package is expected to raise revenue, of the order of £1 billion a year in the medium term.

The effects of the Budget changes for companies and shareholders in different positions are shown in a highly simplified example in Table 1. The Budget changes covered are the cut in the rate of ACT, the cut in the tax credit to shareholders and the cut in the basic rate of tax on dividends. The first two columns show taxes and returns at the pre-Budget 25 per cent rate, while the last two columns show taxes and returns at the post-Budget 20 per cent rate. These are shown for two cases, the first (columns one and three) for £100 of gross domestic profits, and the second (columns two and four) for £100 of foreign profits, paid out to shareholders. For simplicity, we assume that the £100 is the company’s only income, we ignore differences in the timing of taxes and we assume that the foreign tax rate is 33 per cent.

Columns one and three show the position for domestic profits. The total tax paid by the company equals the sum of corporate tax paid (CT paid) and ACT. The Budget changes, when fully worked through, do not alter the total tax paid by the company, although there is a change in the timing of payments. There is, however, an increase in the additional income tax due from higher-rate taxpayers, and a reduction in the tax credit refunded to pension funds. Only basic-rate taxpayers are unaffected.

The second and fourth columns show the position for foreign profits, assuming that the foreign tax rate is 33 per cent for simplicity - sufficiently high to eliminate any liability to corporation tax after double tax relief. In this case the cut in the rate of ACT does lower the tax paid by the company and the surplus ACT that is carried forwards. However, the cut in the tax credit to shareholders means that net returns are completely unaffected, except for basic-rate shareholders.

TABLE 1  
**Revenues and Returns:  
 Effect of Cut in ACT Rate**

	25% ACT rate		20% ACT rate	
	Domestic income	Foreign income	Domestic income	Foreign income
Gross profit	100	100	100	100
Foreign tax	0	33	0	33
CT paid	10.67	0.00	16.25	0.00
Surplus ACT	0.00	16.75	0.00	13.40
ACT	22.33	16.75	16.75	13.40
<i>Exempt shareholder</i>				
Income tax	-22.33	-16.75	-16.75	-13.40
Net return	89.33	67.00	83.75	67.00
UK revenue	10.67	0.00	16.25	0.00
<i>Basic-rate shareholder</i>				
Income tax	0.00	0.00	0.00	0.00
Net return	67.00	50.25	67.00	53.60
UK revenue	33.00	16.75	33.00	13.40
<i>Higher-rate shareholder</i>				
Income tax	13.40	10.05	16.75	13.40
Net return	53.60	40.20	50.25	40.20
UK revenue	46.40	26.80	49.75	26.80

To give an indication of the likely overall effects of this change, we have included Table 2 showing the distribution of share ownership between different shareholder groups. By 1989 pension funds were the largest group of shareholders. Even this substantially underestimates the proportion of exempt investors, because up to half of the figure for financial institutions may be attributable to the exempt (pension) business of insurance companies.

This table shows that the tax status of the average shareholder is likely to have changed significantly over the past two decades. This has been almost entirely due to the growth in pension funds.

**TABLE 2**  
**Share Ownership**

	1963	1969	1975	1981	1989	1992
Individuals	54%	47%	38%	28%	21%	20%
Non-profit-making bodies, public sector	4%	5%	6%	5%	4%	3%
Pension fund	6%	9%	17%	27%	31%	31%
Financial institutions	24%	27%	31%	31%	28%	29%
Companies	5%	5%	3%	5%	4%	3%
Overseas	7%	7%	6%	4%	13%	13%

*Sources: Share Register Surveys, Economic Trends.*

**TABLE 3**  
**Revenues and Returns:**  
**Current System, Full Offset and FID Scheme**

	Domestic	Surplus ACT	Full offset	FID
Gross profit	100	100	100	100
Foreign tax	0	33	33	33
CT paid	16.25	0.00	-16.75	-16.75
Surplus ACT	0.00	13.40	0.00	0.00
ACT	16.75	13.40	16.75	16.75
<i>Exempt shareholder</i>				
Income tax	-16.75	-13.40	-16.75	0.00
Net return	83.75	67.00	83.75	67.00
UK revenue	16.25	0.00	-16.75	0.00
<i>Basic-rate shareholder</i>				
Income tax	0.00	0.00	0.00	0.00
Net return	67.00	53.60	67.00	67.00
UK revenue	33.00	13.40	0.00	0.00
<i>Higher-rate shareholder</i>				
Income tax	16.75	13.40	16.75	16.75
Net return	50.25	40.20	50.25	50.25
UK revenue	49.75	26.80	16.75	16.75

A comparison of the returns to shareholders in the domestic and foreign cases illustrates the underlying problem of surplus ACT. Companies with foreign earnings and surplus ACT deliver substantially lower net returns to shareholders from any given pre-tax profit. The Budget changes have narrowed the gap, but by raising the tax on domestic earnings, not by lowering the tax on foreign earnings.

Along with these Budget changes the Chancellor also published a Consultative Document on a proposed new scheme for dealing with foreign earnings, called the Foreign Income Dividend (FID) scheme (see below for more details). Table 3 shows the return to shareholders under the current system, once the Budget changes are fully worked through. The first two columns are the same as the second two in Table 1. The third column shows the effect on government revenues of simply refunding surplus ACT, while the final column shows the effect of the proposed FID scheme.

From the second column we can see that the Treasury would be out of pocket if it were to simply return the surplus ACT. The company would pay no tax in the UK, while tax-exempt shareholders would get a credit. Under the FID scheme the Treasury does not gain any revenue from the company, but nor does it lose any. This is done at the expense of exempt shareholders since they no longer get a credit.

## **8. The Consultative Document**

The Consultative Document issued at the time of the Budget Speech outlined two basic proposals:

- (i) The *Foreign Income Dividend*. Under this scheme, companies can declare dividends paid out of foreign source profits to be a 'Foreign Income Dividend'. Although companies would continue to pay ACT on these dividends, they would subsequently be able to reclaim any surplus ACT. These dividends would then be treated as having borne basic-rate tax when received by shareholders, but exempt shareholders (mainly pension funds) would not get an income tax rebate.
- (ii) A scheme for *International Headquarter Companies*. Under this scheme, companies that fulfil various criteria, intended to target international holding companies, would be able to pay Foreign Income Dividends without having to pay ACT on the dividend, eliminating any disadvantages associated with cash-flow effects and technical difficulties with claiming refunds.



## **9. The Way Forward**

The Chancellor gave a commitment in the Budget Speech to introduce legislation in the January 1994 Finance Bill, covering a scheme aimed at International Headquarter Companies. The consultative paper suggests that, should the full FID scheme prove acceptable and workable, the Government would also aim to legislate for the full scheme in January. Many of the considerations in the papers that follow suggest that such a timetable is rather optimistic, but we are sure that they form a valuable contribution to the debate.

# Linking Company and Shareholder Taxation

*Harold Freeman*<sup>6</sup>

*Institute for Fiscal Studies*

## 1. Introduction

When the Chancellor stood up at Budget time and said that he would do something about surplus ACT, those of us who spend our working lives worrying about these things sat up and listened. When he said he would help all dividend-paying companies, we became quite excited. But when he said he would help companies in a way that would raise considerable revenue, we knew that it was too good to be true.

It would be marvellous if we could help people by taking an additional £1 billion a year in tax from them - and it would certainly improve the public finances. But the cut in the rate of ACT from 25 per cent to 20 per cent in April, and the consequent cut in the tax credit to shareholders, were simply a rise in dividend taxation, thinly, but quite cleverly, disguised as a technical improvement to the tax system. The real thrust of policy towards surplus ACT, and towards the taxation of dividends in general, lay elsewhere, in the Consultative Document on Foreign Income Dividends.<sup>7</sup> And that is what we are really here today to discuss. As the opening speaker, and as the representative of IFS, which is hosting this conference, I am going to try to set the scene a little, give a little background to the current situation from an economist's point of view, and pick out some themes which run through this policy debate.

## 2. Themes

The two most important strands in the debate seem to be these:

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<sup>6</sup>Harold Freeman is a Senior Research Officer at the Institute for Fiscal Studies.

<sup>7</sup>Inland Revenue, 1993.

- Surplus ACT is basically an international tax problem.  
Any serious reforms must be conceived in the knowledge that markets will become more integrated in the future and that there are other changes afoot, within Europe and elsewhere.
- Shareholder and company tax must be considered together.  
If we are concerned with the impact of tax on dividends, then we have to look at shareholder and company taxation at the same time. Dividends are a direct flow of cash from the company to the shareholder, and who formally pays the tax should not be an issue.

### **3. ACT and Surplus ACT**

From an economist's point of view, the problem of surplus ACT arises when there is a clash between an economic fact of life - that markets are getting more integrated - and a principle of the tax system - that ACT, despite its name, is in concept an income tax. To see why this is true, and why it is a problem, we have to step back and look at the overall tax bill on corporate profits.

When a company pays out a dividend it also has to pay advance corporation tax, at the new lower rate falling to 20 per cent. But from the shareholder's point of view this is really a pre-payment of income tax, perhaps an 'advance income tax'. Pension funds get the tax back; top-rate taxpayers can set it against their income tax bill. In essence it is no different from the prepayment of basic-rate income tax on deposit interest that a bank collects and pays on behalf of its customers.

The company also has to pay corporation tax at 33 per cent on the whole of its profits. If the profits are retained, the story ends there, but if the profits have already been paid out to shareholders as a dividend, we accept that tax has already been paid on the dividends, and let that count towards the tax on profits.

The problem really arises when companies have made a large proportion of their profits overseas, have paid tax on them there, and owe little or nothing in the way of UK corporation tax. Since they pay no mainstream corporation tax on these profits, many companies would argue, why should they pay advance corporation tax? The problem is that the ACT is essentially a part of the shareholder's income tax. If shareholders live in this country, perhaps some income tax on their dividend income is the minimum that we should ask of them, even if the source of that income is abroad. This seems a reasonable, if extended, interpretation of the point of principle

set out by the 1971 Select Committee on Corporation Tax,<sup>8</sup> that the payment of ACT by the company and the receipt of an income tax credit by the shareholder are two sides of a single coin. As the 1972 White Paper reported prior to the introduction of the imputation system: ‘Advance corporation tax and the shareholder’s tax credit form the core of the new system; they are the essential link between the company’s corporation tax and the shareholder’s own tax liability’.<sup>9</sup>

This principle is reiterated in this year’s Consultative Document, but in a form that pays lip-service to the idea that ACT remains in part a prepayment of corporation tax: ‘ACT is not only an advance payment of the corporation tax on profits, but is necessary to enable the Exchequer to accept the tax credit in satisfaction of a liability.... Any proposal for changes in the rules for paying ACT thus inevitably has implications for the availability of the tax credit’.<sup>10</sup>

The problem is at its most clear when we come to consider the tax treatment of dividends paid to exempt shareholders out of foreign profits. If the Government always returned surplus ACT to the company, and always returned the tax credit to pension funds, the UK exchequer would actually end up out of pocket. This effect is illustrated in the first two columns of Table 1, which shows the net returns to shareholders, and the revenue raised, when the maximum possible net dividend is paid out of pre-tax profit of £100.<sup>11</sup>

In practical terms, it would be most unwise to have as a feature of our tax system that a single payment of tax can automatically give rise to two refunds of tax. Such a structure would be inherently problematic, and we should not be surprised if the Government is concerned in this respect.

#### **4. Problems Caused by Surplus ACT**

Even if there is some support for the current system in principle, there is little doubt that surplus ACT causes problems in practice. These include:

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<sup>8</sup> Paragraph 16, Report of Select Committee on Corporation Tax, October 1971.

<sup>9</sup> Paragraph 9, *Reform of Corporation Tax*, Cmnd 4955, April 1972.

<sup>10</sup> Inland Revenue, 1993, paragraph 7.

<sup>11</sup> Details of this highly simplified example are shown in Table 1 of the overview of this volume.

- **Reduced earnings per share.**  
Surplus ACT reduces post-tax earnings because foreign profits are essentially taxed twice, once abroad and once here.
- **Bias against overseas investment.**  
The additional layer of taxation on foreign profits distorts company decision-making, discouraging overseas investment, even if it is relatively profitable.
- **Encouragement to shift cost-centres.**  
Surplus ACT encourages companies to increase UK taxable profits, by shifting cost-centres such as research and development and administrative centres abroad.
- **Encouragement to take-overs.**  
Surplus ACT creates costly tax-driven merger and take-over activity as companies search for UK profits, the tax from which can be used to frank dividends paid out of foreign income.<sup>12</sup> The incentives for merger and take-over are perhaps reduced since the Budget, which prevented the more artificial transactions, designed to take advantage of past payments of corporation tax. But it remains attractive for a surplus ACT company to take over a company with substantial UK earnings, in order to set surplus ACT against its target's future payments of corporation tax.
- **Deterrence of international holding companies.**  
Finally, surplus ACT deters international companies from choosing the UK as the site of their headquarters or regional headquarters. When profits are channelled through this country, the ACT system effectively takes a cut of profits that are neither made in this country nor destined for shareholders in this country. International holding companies of this kind are highly mobile, and to the extent that we benefit from their location here, through spin-offs in the business service industries and the profile of the UK as an international financial and commercial centre, it would be unwise to discourage them.

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<sup>12</sup> Measures in the April 1993 Budget eliminated some of the more artificial tax-driven take-over schemes. However, companies with substantial current or future surplus ACT still have a tax incentive to acquire future UK taxpaying capacity in the form of companies with domestic operations.

## 5. How Big a Problem?

This is a problem that is large and growing. The official estimates in the Budget were that the stock of outstanding surplus ACT is around £5 billion and rising at a rate of £1 billion a year. Certainly, many companies are affected - research here at IFS on a panel of large industrial and commercial companies, shown in Figure 2 in the overview of this volume, suggests that between 30 and 40 per cent now carry a substantial stock of surplus ACT. Research at the London Business School<sup>13</sup> suggests that over 50 per cent of the very top UK companies are affected.

As the figure shows, the proportion of companies affected was actually slightly higher in the early 1980s, operating under a rather different corporate tax system. Over the decade the type of companies that are affected has changed, as the tax system and the economic climate have changed. The problem is still focused on large companies, but it is now very much large *international* companies which are affected.

## 6. How Serious a Problem?

To gauge the likely effect of surplus ACT on investment, we have looked at a theoretical measure of international investments incentives of the kind used in the Ruding Committee Report.<sup>14</sup> The tax wedges shown in Figure 1 summarise the effect of the tax system, by looking at the way that it changes the minimum return that an investment can make and remain viable - the investment hurdle rate.

The top part of the diagram shows the effect of tax on the required rate of return on new equity investment out of the UK, into the other G7 countries, based on a 5 per cent real expected post-tax rate of return. What this shows is that for exempt investors, the UK represents a remarkably good deal. The imputation system means that they end up paying very little tax, so that on average the tax system only raises the rate of return needed by 0.1 per cent. If the company invests abroad, more tax is generally due, but that is simply the effect of the foreign tax systems.

Once the company is in surplus ACT, as the lower diagram shows, the picture changes dramatically. The additional tax almost doubles the return required on foreign investment, massively

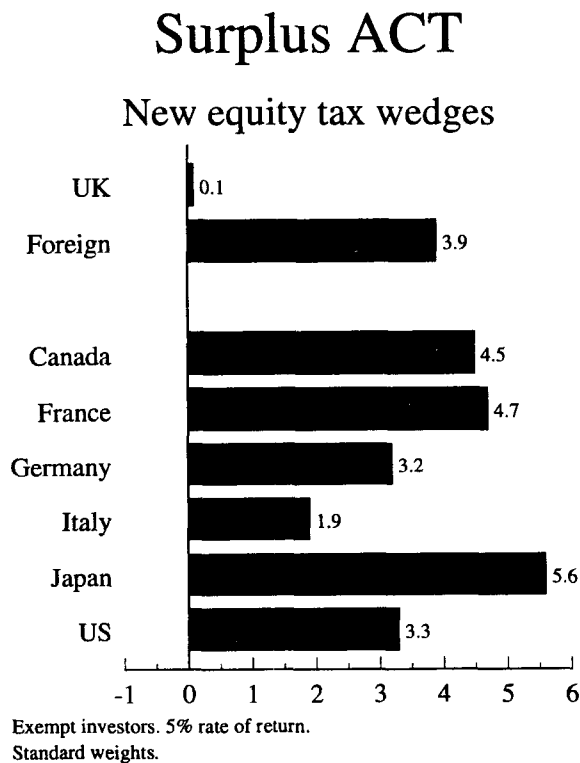
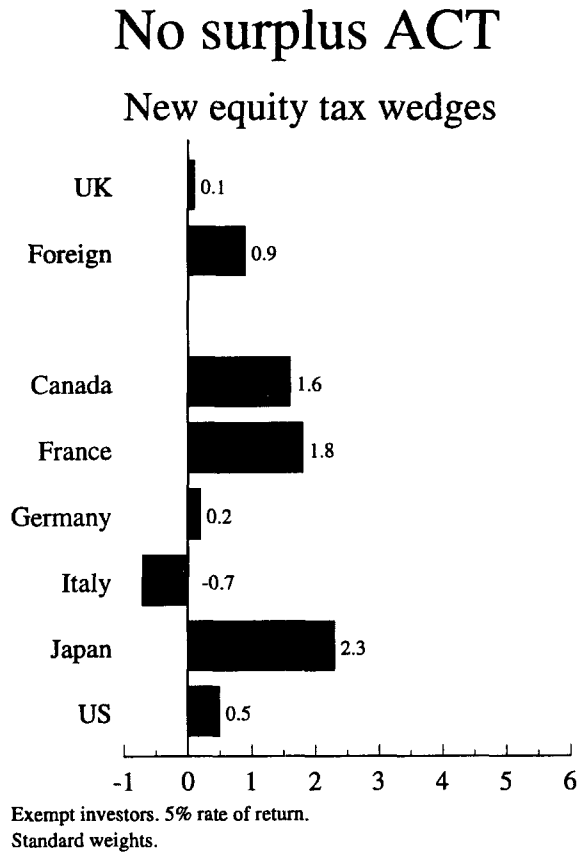
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<sup>13</sup> See Higson (1991).

<sup>14</sup> Ruding Committee, 1992. The methodology is outlined in OECD (1991).

# Figure 1

## Corporate Tax Wedges



reducing the incentive to invest abroad, relative to in the UK. If new equity finance is an important element in determining investment plans,<sup>15</sup> this makes surplus ACT a front runner in the list of international tax problems facing the UK.

## **7. The Consultative Document - Foreign Income Dividends**

The principles that underlie the Foreign Income Dividend scheme proposed in the Consultative Document appear refreshingly simple and straightforward. The scheme takes the principle that surplus ACT is a problem of foreign profits, and treats foreign profits differently. It does not completely jettison the idea that there is some minimum revenue that the UK might expect to receive from a profit paid to UK shareholders - zero seems like a sensible minimum. But it does give some revenue back to shareholders, at a revenue cost of some £200 million.<sup>16</sup> I will leave the technical details and difficulties, and the International Headquarter Companies scheme, to the other participants in this forum.

The general idea of the scheme is that a company can choose to pay a special 'Foreign Income Dividend' on which the company will always get a return of ACT, but on which exempt shareholders will get no tax credit. If the scheme works, the effect is to more or less solve the problem for taxpaying shareholders, but not to solve it at all for pension funds.

Table 1 shows net returns to shareholders and UK tax revenues, for a very simple example where a gross profit of £100 is passed through to shareholders.<sup>17</sup> In the domestic case, a higher-rate shareholder gets £50.25 and the exchequer £49.75 (with the new 20 per cent lower imputation rate fully in place). For foreign income, assuming a foreign tax rate of 33 per cent for simplicity, the shareholder gets only £40.20 out of a gross £100 if the company has surplus ACT. Under the FID scheme, this imbalance would be corrected, leaving higher-rate shareholders indifferent

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<sup>15</sup> The effect of dividend taxation on investment incentives depends on the view of corporate finance taken. Under the 'old' view of corporate finance, additional taxes on dividends are taken to be crucial in the investment decision, while in the 'new' view, such taxes are less important, or even irrelevant. See Zodrow (1991) for a survey of these issues.

<sup>16</sup> Inland Revenue, 1993, paragraph 95.

<sup>17</sup> Details are shown in Table 1 of the overview.



between foreign and domestic income. The foreign profit would effectively be exempt from UK corporation tax, both mainstream and ACT, and would bear only the additional slice of income tax due from higher-rate taxpayers.<sup>18</sup>

**TABLE 1**  
**Revenues and Returns under the FID Scheme\***

	Domestic	Surplus ACT	Foreign income Full offset	FID
<i>Exempt shareholder</i>				
Net return	83.75	67.00	83.75	67.00
UK revenue	16.25	0.00	-16.75	0.00
<i>Higher-rate shareholder</i>				
Net return	50.25	40.20	50.25	50.25
UK revenue	49.75	26.80	16.75	16.75

\* Details of the revenues and returns in this highly simplified example are shown in Tables 1 and 3 of the overview of this volume.

For pension funds, there is a similar contrast between the net returns on domestic and foreign income with surplus ACT. But here, the FID scheme does nothing to solve the problem. The company now receives a refund of surplus ACT, but the pension fund is denied a tax credit of exactly equal size. The scheme simply robs its shareholders to pay the company, and there is no increase in the net return. So the effects for pension funds are that post-tax earnings are reduced. They have an incentive to persuade managers to invest less overseas, to shift costs abroad, and to indulge tax-driven take-overs. In short, precisely the current problems of surplus ACT, but shifted to the level of the fund manager.

It is possible that managers will simply ignore their shareholders. It is certain the scheme will introduce a new area of conflict between shareholder groups, some willing to accept company investment policy, others with an incentive to interfere.

One of the topics covered in other papers in this volume is dividend streaming. Why should companies not be allowed to pay the dividends without refundable tax credits to shareholders who do not need a refund (the taxpayers) and those with a refundable credit to those who do?

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<sup>18</sup> The difference between the 40 per cent personal rate and the 20 per cent basic rate of tax on dividends.

The problem, when you look through the company to the overall tax position, is that streaming of this kind effectively moves us back to a system where surplus ACT is always refunded, where the incentive problems are eliminated, but the exchequer ends up paying out net revenue. Presumably, this is why the Inland Revenue will not allow streaming. The question that I shall leave for the other participants to answer is whether streaming can be stopped.

## **8. A More Radical Solution - Cutting Pension Fund Credits**

I want to leave you with an outline of a more radical solution. In the last Budget, the Government cut the tax credit to exempt shareholders. It is not a route that I would unhesitatingly recommend - but it does have some clear attractions. It would reduce or eliminate the problems associated with FIDs, by making ordinary dividends more like FIDs. It would improve financial neutrality in the payout decision. And, most importantly with the spectre of a PSBR of £50 billion looming, it would raise substantial revenue - £3 billion or more if the credit were completely removed, or the equivalent of two points on the basic rate of tax.

The Foreign Income Dividend scheme can only ever be a partial solution to the problem of surplus ACT. Perhaps the Government will be tempted with a more complete, and more lucrative, solution.

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## **1. Introduction**

The Institute for Fiscal Studies asked if I would say something on surplus ACT from the Government's point of view.

The Government has, of course, already had its say about surplus ACT, and in a quite detailed way, in the Chancellor's Budget Statement, in the proposals contained in this year's Finance Bill for reducing the ACT rate, and in particular in the Consultative Document which was issued on Budget Day. The proposals in the Consultative Document are the only open issue, but they do need to be seen against the background of the other measures the Government has already taken. The excellence of the drafting has, I hope, made the Consultative Document a very easy read. So I thought there would not be much point in going over all that ground again. Instead, it might be helpful if I do four things:

first, to summarise what the Government has done already and its proposals on surplus ACT;

second, to fill in some background points on the Consultative Document;

third, to mention some of the more significant points which have been coming up during the consultation period; and

fourth, to say something about the background to how this issue will be carried forward over the next few months.

## **2. Proposals to Help with Surplus ACT**

So, first, what are the Government's proposals? It has put forward three proposals to help with surplus ACT.

First, there are the proposals in this year's Finance Bill - which were approved by the Finance Bill Committee last week. They reduce the rate of ACT in two stages from 25 per cent to 20 per cent. A lower rate of ACT means that less surplus ACT will arise in the future. It was

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<sup>19</sup> Peter Lewis is Director of the Company Tax Division at the Inland Revenue.

estimated at the time of the Budget that this change would result in an annual benefit to companies of some £200-£300 million through reducing by that amount the surplus ACT which would otherwise have arisen in each of the next few years.

Second, the Government has undertaken to legislate next year for a special scheme to allow what are described in the Consultative Document as International Headquarter Companies to pay dividends to their foreign parent companies, out of foreign profits, without having to bear ACT. This proposal is designed to meet a specific point, namely that some overseas companies - including some which already operate in the UK - would like to have a company owning their European subsidiaries based in the UK, but the surplus ACT which would arise when they passed foreign profits on to their foreign parent through the UK can make that arrangement unattractive. The proposal goes wider than that, but that is the kind of case which the Government is seeking to help. Because the Government saw some urgency - with the advent of the Single Market - in dealing with that point, there is a firm commitment to legislate on it in the next Finance Bill.

The third proposal the Government has put forward - in the Consultative Document - is a more general scheme for UK-based international companies which have surplus ACT. It would allow them to pay a special kind of dividend out of foreign profits which in the Consultative Document is imaginatively called a 'Foreign Income Dividend', or FID as it is already known in the trade. The surplus ACT applicable to a FID would be repaid when the company's surplus ACT position was established. But the treatment of a FID in the hands of a shareholder would differ from that of an ordinary dividend. Although shareholders would be treated as having borne tax at the lower rate of income tax when it comes to calculating their tax liability, FIDs would not carry a tax credit which could be paid to exempt, non-liable or overseas shareholders. That is the proposal the Government has put out for consultation and, in contrast to the proposals for International Headquarter Companies, the Government has given no commitment to legislate on it.

Looking forward from where we are now, it can be seen that the surplus ACT problem, while not solved, is already for the time being clearly in retreat, whether or not the Government goes ahead with the general FID scheme. In very broad terms, as a result of the changes already announced, combined with the expected recovery of profits over the next few years, the growth of surplus ACT is expected to be halved from its recent level of around £1 billion annually.

### **3. Background to the Consultative Document**

Perhaps I could now make a few points about the background to the Consultative Document. First, it cannot be said too often that advance corporation tax is not just corporation tax pure and simple. It serves a crucial purpose in funding the tax credit attaching to dividends. A lot of the representations which have been made over the years - and some of the solutions proposed - disregard that crucial point.

Another fundamental point is that surplus ACT is not just an 'accident' or 'unintended effect' of the present system. It was clearly seen by the Government of the day, and the Parliament which introduced it, that an essential feature of the new system was that ACT would always be collected in full on dividend payments; and consequently that surplus ACT would regularly arise, especially where significant profits were earned and taxed abroad.

It follows that there has always been an element of inconsistency in those representations which say in effect 'We love the imputation system; we just don't like surplus ACT'.

So if you come to the conclusion that something should be done about surplus ACT perhaps the first question you should ask is 'Should we have a different type of corporation tax system?'

It would certainly be possible to get over the surplus ACT problem by a change of corporation tax system - going back to the classical system we had between 1965 and 1973, perhaps to a dividend exemption system or to a 'hard' imputation system of the kind operated in some countries where the imputation franks a shareholder's liability but never gives rise to a 'repayment'.

But you have only to mention those possibilities to realise that they all raise very wide-ranging questions about the basic characteristics of the corporation tax system you wish to run - questions such as the treatment of distributions compared to retentions, and the treatment of investment financed with debt rather than equity.

Even if you found a system which you thought, looking at the balance overall, was better, there would still be serious questions about whether changing to it was attractive. Any change of system, as we found on the introduction of the present system, means a very big upheaval for business and the financial markets. Would you want to announce the change 'out of the air'; or would you want a long period of consultation with all the additional uncertainty that entails? And would you want to face up to renegotiating double taxation agreements, almost certainly a lengthy and difficult process and another cause of uncertainty?

If you conclude that considerations of that kind mean that you do not want the drastic remedy of changing the corporation tax system to deal with surplus ACT then, of course, you are forced back to doing something within the present imputation system.

But that means you are necessarily bolting on to the system something which hitherto has always been seen as incompatible with it. As I have said, ACT and the tax credit are the key features of the current system, and have always been seen as an essential part of it. It follows that any surplus ACT solution within the present imputation system is likely to sit none too easily with it and have some degree of awkwardness and rough edges to it.

But I hope it is clear to everyone that, in trying to find a way of easing surplus ACT through FIDs, the Government has taken a major step in being prepared to contemplate for the first time circumstances in which UK dividends might be paid which are no longer fully franked by the payment of UK tax, that is by ACT. That basic principle of the imputation system has been fully maintained for the past 20 years. Not only would the easing of that rule envisaged by the International Headquarter Companies and FID proposals be a major step for the UK corporation tax system; it goes I suspect beyond the treatment given in other countries in comparable circumstances. I put the point somewhat tentatively because international comparisons are always tricky. But in general, corporation tax systems do not allow foreign tax paid by the company to frank the shareholder's liability on dividends received. Yet that is precisely what the IHC and FID proposals would allow.

Another key background consideration was, and inevitably is, exchequer cost. That has also always in the past been a major stumbling-block to any action on surplus ACT, because the costs of some proposed solutions are large, and some virtually open-ended. Given the size of the PSBR, the Government has quite deliberately focused the exchequer resources which might be available on a specific part of the problem - not on surplus ACT which has already accumulated, not on cyclical ACT. The proposals focus solely on structural surplus ACT, i.e. surplus ACT which arises when foreign profits which have already been fully taxed overseas are distributed. And, further, it will not have escaped your notice that the Government's proposal is framed in such a way that part of the benefit to companies may be met by exempt and foreign shareholders who are able to claim payment of some or all of the tax credit on ordinary dividends.

Why has the Government focused only on structural surplus ACT? The reason is that for companies which need to have extensive overseas operations it is largely unavoidable, year in year out, and thus more likely to lead to undesirable distortions of business decisions. At the extreme, companies with large amounts of surplus ACT are in effect operating under a classical

system - under which dividends are taxed entirely separately from profits - while the rest of the economy is working under the imputation system which integrates the taxation of the company and shareholders. Clearly that is not an ideal situation.

By contrast cyclical surplus ACT, as the name implies, only arises at certain stages of the economic cycle, and the solution here may well be, in part at least, in the company's own hands, by cutting the level of its dividend relative to profits. The Government's proposals on FIDs are not directed towards that kind of case. But the reduction in the rate of ACT will help cyclical as well as structural ACT.

I have mentioned the importance of exchequer cost. But that was of course not the only reason the proposals take the form they do. A fair number of last year's representations suggested a revised form of the old net UK rate system, which would have had a rather similar effect on exempt shareholders. And the CBI's front runner was the scheme it advocated way back in 1971, which had many similarities to the proposals in the Consultative Document. So the idea of tackling surplus ACT through a scheme which had costs both for government and for exempt shareholders was very much a feature of the representations from industry which the Chancellor was receiving last year. The Government decided to propose an optional scheme so that - unlike the old net UK rate scheme which was compulsory - companies and their shareholders could decide together whether the gain outweighed the disadvantages, and thus whether they wanted to participate.

Finally, by way of background, I ought to mention the European dimension. The Chancellor's 1992 Budget Statement referred to the work of the Ruding Committee on the harmonisation of corporate taxation in Europe and the need to have regard to the outcome of that work. At that time, of course, the Ruding Report was imminent but not published. I think it is fair to say that on the already well-studied subject of surplus ACT the Ruding Committee did not offer any really new insight or solution. And developments since the report suggest that action with a European dimension is unlikely to any early time scale. So the Government has, of necessity, brought forward its own proposals, for consultation.

#### **4. Points Raised in Consultation**

I turn now to the main points that have been raised in consultation. I hope you will recognise, however, that at this point in time I cannot give the Government's views on them - for the very simple reason that Treasury Ministers have not yet come to a conclusion on the many detailed points which have been raised in consultation. So my comments will necessarily reflect views

at the time the Consultative Document was written. But the whole purpose of consultation is of course to expose these ideas for discussion, and I am sure Treasury Ministers will take a very open-minded look at the points that have been raised.

I ought to start with thanks to all those who have responded to the Consultation Document. There have been over 60 responses, many from representative bodies, and some from professional firms, and individual companies. They are nearly all comprehensive responses, not just on one or two particular points, and the time and effort that has gone into them is self-evident. And however the subject of surplus ACT develops in the future, there is, it seems to me, already one clear gain from this consultation. The scheme outlined in the document has in many cases clearly focused minds on the underlying problems and the practicalities of a solution as never before. So, from the responses, the Government will have a much clearer perception of the detail of many issues than could ever have been obtained from the ordinary annual representations. That is one clear gain.

On substantive points, I ought perhaps to start with the alternative 'solutions' to surplus ACT which the document discussed but set aside in favour of the FID scheme. My impression is that the clear majority of people who commented on this either wholly or very largely accepted that analysis of alternative approaches. The only significant exception was on an updated version of the old net UK rate scheme which some respondents thought would serve equally well. Virtually everyone accepted that a FID-type scheme would be a satisfactory way ahead. But, for many people, that was subject to some significant modifications being required.

Turning to particular issues on the general FID scheme, the major issue is clearly dividend 'streaming'. This entails arrangements, of various kinds, to enable a company to pay ordinary dividends to exempt shareholders who want to benefit from tax credit payments, and FIDs to taxable shareholders who are indifferent between FIDs and ordinary dividends. Quite a lot of people have said this scheme would be much more useful and attractive if streaming arrangements could be adopted. Some have gone so far as to say that, without streaming, it will be hardly worthwhile at all. The other side of that coin is, inevitably, exchequer cost. The Government has proposed a scheme which it thought last March it could afford on the basis that streaming would not be allowed. Open house for streaming would increase the exchequer cost substantially; and I do not need to remind you of the very tight constraints at present on government expenditure and revenue.

A lot of people have also asked for a more flexible scheme, even if that makes it more complex. There is a widespread feeling that a company must at all costs avoid declaring a FID, which deprives some of its shareholders of their tax credit payments, if it then gets less surplus ACT



benefit than it has envisaged. So, in the interests of certainty, there have been suggestions for linking FIDs to the foreign income of the previous accounting period as well as the current one; or for greater flexibility in carrying excess FIDs backwards or forwards or foreign income backwards or forwards. We always recognised, of course, that the scheme in the Consultative Document is a fairly simple one. That seemed in keeping with the general desire for simplifying the tax system and the Government's objectives on deregulation. But I am sure Ministers will look very carefully at these requests.

The final main point on the general scheme is that many responses have asked whether it would be possible, as in the International Headquarter Company proposals, to pay out FIDs without accounting for ACT. That, it is said, would be simpler and save companies that financing cost. Well, again, I am sure that is something which Ministers will look at very carefully. But there are cash-flow implications for the Government - and government accounting is of course in cash-flow terms. As we had not seen it as an entirely open-and-shut question as to whether or not accounting for ACT initially would be a simpler system. Not accounting for ACT implies an interest regime if the company gets the answer wrong, possibly a penal one. And in some ways the more natural point in time at which to determine a relief which turns on surplus ACT is when the actual figure of surplus ACT emerges when the company's liability is computed and returned.

Turning to the scheme for International Headquarter Companies, I should perhaps first comment on the name which was something of a compromise to cover a variety of situations which might benefit from the relief. These include pure holding companies, companies which combine a headquarters and holding function, and also companies which combine a UK trading operation with a holding function. In other words there is no special magic in the word 'Headquarter'.

A lot of people have said that the qualifications for IHC treatment are satisfactory. But some have wanted relaxations, e.g. to a minimum 5 per cent holding to tie in with the rules for consortium relief.

Some people have suggested a need to have some specific rule to enable it to be established easily that the ultimate ownership of the UK Headquarter Company is overseas in straightforward cases where the ultimate ownership rests with a foreign publicly quoted company. It is in everyone's interest to get a satisfactory working rule for that.

Another question which has been put is whether the Government's objectives will be achieved without giving UK Headquarter Companies other tax privileges beyond the ACT exemption described in the Consultative Document. The one most often mentioned - but by no means the only one - has been exemption from a capital gains charge on the sale of a UK subsidiary. Some

people have drawn up quite long shopping lists of other tax reliefs they consider necessary, or at least desirable, including some personal taxation relaxations. Again, I am sure that Ministers will look at these additional points carefully. They do of course raise the question of the point at which you slip over from removing unintended tax impediments to ordinary commercial arrangements into something closer to a tax haven stance where specially favourable tax arrangements are designed to attract business which, on purely commercial grounds, would not come your way. The proposals in the Consultative Document clearly fall into the 'removing unintended tax impediments' category, and they deliberately focus solely on surplus ACT.

## **5. The Way Ahead**

Well, the final question is 'Where do we go from here?'. As I have mentioned, Ministers have said that they will legislate next year on International Headquarter Companies but have given no such commitment on the general FID scheme.

So far as the FID scheme is concerned, the next step is for Ministers to reach conclusions in the light of all the comments that have been received during the consultation. We shall of course try to enable them to take on board any new points emerging here today. The consultation period is, of course, now closed; but if, following the conference, anyone has a burning desire to register a new point with us, I would not wish to be discouraging - provided you can write immediately.

One of the factors likely to be relevant is the general reception of the proposals. I think it is probably true to say that on the whole, for the scheme in the Consultative Document, that has been lukewarm rather than enthusiastic. But that is perhaps not entirely surprising for an optional scheme, focused solely on new structural surplus ACT, under which different groups of shareholders and the company may have differing interests, or perspectives. And many responses have indicated a much greater degree of enthusiasm for a scheme incorporating the kind of modifications I have mentioned.

Another consideration - I have to mention it again - must be exchequer cost. The new Chancellor will inevitably want to look at estimates of the cost of this scheme against the background of the Government's very tight financial position and its other tax and spending priorities. Our statisticians will be looking at the exchequer effects again in the light of comments which have been made about take-up, and with and without a facility for 'dividend streaming'.

In that context it is of course relevant that the changes the Government has made this year to the ACT and tax credit should, as I have said, have a quite significant effect in reducing the

future build-up of surplus ACT. And the growth of surplus ACT is also likely to fall over the next few years anyway as profits recover. So the general position is one of a quite marked reduction in the growth of surplus ACT, even if the FID scheme were not introduced.

If the Government decides to go ahead, in an ideal world a further round of consultation on draft clauses would be very valuable. But the prospects for that do not look at all bright, given the compressed timetable this year to the next Budget and Finance Bill. That is certainly, however, something we will be keeping in mind, to see if anything can be done.

## **6. Conclusion**

Well, I hope I have added a little by way of background, commentary and forward look to what is in the Consultative Document. As I have tried to explain, the Government has taken a major step in being prepared to contemplate, for the first time since the imputation system was introduced 20 years ago, action on surplus ACT which modifies the basic principle that ACT to frank the tax credit attaching to dividends must always be paid. Given the importance of the surplus ACT issue, and the fact that the proposals break new ground, I hope you will agree that a consultation exercise was the right way to proceed.

# Surplus ACT - A Practitioner's Comment on the Consultative Document

*Edward Troup*<sup>20</sup>

*Simmons & Simmons*

## **1. The Foreign Income Dividend Scheme**

Any commentary on the Consultative Document must start with some comments on the mechanical provisions which the Foreign Income Dividend regime imposes. The regime allows a company to treat a dividend it pays which would otherwise generate surplus ACT as a FID. Payment of a FID would not generate surplus ACT and would not carry the benefit of a repayable tax credit to the shareholder. To achieve this, a FID should initially require the company to account for ACT but, once it is proved that the ACT is indeed surplus, the ACT would be repaid to the company.

The FID ACT will be payable on the normal quarterly ACT payment dates and will be repayable on the corporation tax payment date nine months after the end of the accounting period. To obtain repayment the company with the FID ACT will have to show that it has surplus ACT and that surplus ACT is attributable to foreign source profits chargeable to corporation tax. The reclaiming of FID ACT will therefore require the Inland Revenue's agreement, not only to the normal corporation tax computations but also to the determination of the foreign profits chargeable to corporation tax and the amount of foreign tax borne on those profits. If ultimately the FID ACT proves to be excessive (because in fact the foreign source profits are not as great as was previously contemplated or the foreign tax charge is lower) any surplus FID ACT can only be carried forward one accounting period and cannot be carried back or surrendered to other group companies.

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The requirement to account for ACT on FIDs seems to be motivated largely by concern over exchequer cost even though the issue is only one of timing. The restriction on carry-forward, carry-back or surrender to other group companies is, apparently, to avoid over-complicated drafting in the legislation.

As a result, groups will have to ensure that the foreign profits from which a FID must be paid arise in the correct company and that the FID is paid in the same or preceding accounting period as those profits are earned. This will result in considerable practical difficulties; it is normal corporate practice for the final dividend to be paid after the period is over but FIDs paid after the end of the period will not be eligible for ACT recovery by reference to the foreign profits and surplus ACT of the period to which they relate.

Similarly, there would seem to be no technical or practical objection to allowing unlimited carry-forward (as is the case with real ACT) or to allowing FID ACT to be treated as real ACT if it proves to be excessive.

These issues, and related difficulties with groups which are discussed below, would largely disappear if FIDs could be paid entirely free of ACT with the obligation to account for that ACT (together with an appropriate interest charge) if it is subsequently proved that a FID was not in fact paid out of foreign profits in respect of which surplus ACT arose.

Leaving other issues aside, the requirement to account for ACT, and the related administrative and compliance complications, must be regarded as a major criticism of the proposals.

## **2. Anti-avoidance Rules**

The FID regime, if it is to work, achieves an overall advantage only to the extent that shareholders are not currently able to reclaim the tax credit associated with the ACT. To the extent that such a reclaim is currently possible, removing the surplus ACT burden from the company results in no overall saving as the shareholder is deprived of an equivalent right to tax repayment. It is therefore only in respect of FIDs paid to taxable shareholders (including those not resident in the UK who cannot take the benefit of the tax credit) for whom any benefit arises. Put another way, only taxable shareholders will want to receive FIDs as their yield will be unaffected but the company will be better off.

Exempt shareholders should, in theory, be indifferent as, although their dividend will be effectively reduced, the company's retained earnings will be correspondingly increased. In practice, of course, an exempt shareholder will wish to see his yield maintained and hence not wish to receive FIDs.

It will therefore be in the interest of all shareholders that FIDs should be paid to taxable shareholders and 'ordinary' dividends paid to exempt shareholders. The Consultative Document states that any streaming of dividends is to be forbidden and anti-avoidance rules will be introduced to prevent this. This raises two questions - is such an approach defensible and is it workable?

If streaming is defined as the allocation of UK taxable profits (from which 'ordinary' dividends are paid) to exempt shareholders and foreign profits (from which FIDs are paid) to taxable shareholders then this is in effect what takes place already for those companies without an ACT surplus. Provided the proportion of their profits which they pay out as dividends is less than the proportion of profits earned in the UK, ACT will always be absorbed and the benefit of the ACT will allow the company to pass a proportion of profits which include foreign income to its exempt shareholders and reduce its shareholders' overall tax burden on overseas investment. The mixing of UK and non-UK income in a single company under existing rules reduces the overall effective tax charge on overseas profits.

Allowing streaming under the FID regime amounts to no more than allowing those companies whose proportion of UK profits falls below the proportion of overall profits they pay out by way of dividend to be given some of the advantages available to UK companies not subject to this restriction. Looked at this way, streaming is defensible as it merely extends an existing advantage of the UK tax system to other companies and shareholders.

However, there is no doubt that this approach fails to address the fundamental difficulty giving rise to the surplus ACT 'problem' which is that so long as the effective rate of corporate tax on UK profits is only 13 per cent (the difference between the corporation tax rate and the tax credit imputed), any company with overseas profits taxed at a higher rate (typically around 35 per cent) will be at a disadvantage in suffering a higher overall tax charge.

To solve this problem either the tax burden on overseas profits has to be reduced or that on UK profits has to be increased. The repayment of foreign tax credits by the UK Revenue is not a workable solution and an increase in the corporation tax charge on UK profits is unlikely to be acceptable (although the reduction in ACT rates this year is a move in this direction). There are therefore good arguments for allowing streaming under the FID regime as an interim measure to equalise the overall rate of tax on corporate profits.

Whether or not the prevention of streaming is defensible, is it workable? The Consultative Document is unclear as to how the legislation would seek to prevent streaming, although it does refer to shareholders not being allowed an option to treat a dividend as a FID on a particular date: only the company may decide whether a particular dividend should be a FID. This still

leaves the possibility of a company creating different classes of shares - some always being FID paying and some not. No doubt the legislation will seek to prevent these and other perceived abuses and there is a real danger of anti-avoidance rules becoming unnecessarily complicated. Anti-avoidance rules, if they are to be introduced, should be simple and clearly understood; complex rules to deal with the creation of different share classes or with the issue of shares by subsidiaries may well make the FID legislation unworkable in practice.

### **3. Groups**

The operation of the FID regime in relation to a group of companies poses particular problems.

Under the current tax regime, ACT can be surrendered by a parent company to any of its 51 per cent subsidiaries, can be carried back up to six years and carried forward without limit of time. ACT planning is not straightforward but a group can at least be reasonably confident that by paying ACT in its parent company it will maximise its flexibility for ACT utilisation and be able to surrender down to the various taxpaying subsidiaries appropriate amounts of ACT to offset against their mainstream corporation tax as and when their tax liability is determined.

The FID regime reverses the logic of the existing ACT system. FID ACT cannot be surrendered and therefore FIDs must, in the first instance, be paid by the company that has the foreign profits which will generate the surplus ACT. Once paid it can be passed up through the group to its own shareholders without further ACT.

The difficulties arise in determining how much of a FID to take out of any particular company. Overseas profits, particularly those earned through a branch operation, may well not be determined for some time and the overseas tax charge may well be subject to uncertainty for a number of years. While the group may have an accurate idea of its overseas tax position in total, the position of individual subsidiaries may be far from clear. Quite apart from the administrative complications of having to pay FIDs from a number of overseas subsidiaries and making separate computations for each of them, there would seem to be a real risk that FID ACT is paid in the wrong companies and that once the foreign tax bills are finally determined it will be found that surplus ACT and the FID ACT are in different companies. In the absence of any provisions for the surrender of FID ACT, the group will be no better off than it is at present. Even if the regime is modified to allow unused FID ACT to be treated as real ACT (a proposal which would seem to cost the Treasury nothing but make companies' tax planning much easier), the inability to surrender ACT up or sideways within a group would restrict any effective offset.

If FID ACT has to be paid then it should be subject to the same administrative rules as ordinary ACT. It should be capable of surrender to subsidiaries or alternatively available for recovery in the parent company by reference to subsidiaries' foreign income. The existing regime for the surrender of ordinary ACT and its carry-forward and carry-back would seem to be capable of easy adaptation to allow for this.

Of course, the simpler solution would be not to require ACT to be paid at all on a FID, so that the only computation to be performed would be an annual computation of the comparison of FIDs paid and foreign income received on a group-wide basis with appropriate rules to deal with companies leaving and joining the group (as already exist).

#### **4. Shareholder Issues**

The basic FID rule is that no repayment can be made of the tax credit attaching to a FID and, as noted, this will affect those shareholders who can currently reclaim the ACT credit. This affects not only the pension funds and shareholders whose income falls below the income tax threshold but also shares held in PEPs. It is obviously a matter for the market to determine what the result of paying FIDs will be, but to the extent that a company's equity is held by exempt shareholders, the result may merely be to increase the dividends. While in cash terms this is neutral (as a payment of surplus ACT to the Government is replaced by a payment of increased dividend to the shareholder), the accounting effect is more subtle as an above-the-line reduction in profits (ACT paid and not recoverable) is replaced by an increased dividend. The earnings per share of the company concerned are actually enhanced. (This might suggest that the accounting treatment of surplus ACT under the current regime is wrong and that surplus ACT should in fact be treated as an appropriation of profits to shareholders. Such a suggestion might be regarded as somewhat heretical as it leads to the thought that surplus ACT is not a tax problem at all but an accounting issue.)

The creation of different types of dividends may have a number of consequences in the market. The possibility of dividend stripping has been noted above. The problems of manufactured dividends raise a new level of complication. A very significant proportion of activity in equities arises through short sales and stock lending transactions pursuant to which synthetic or manufactured dividends are paid by one party to another. These dividends may or may not correspond to real dividends actually paid by the company but under existing rules, where UK equities are involved, 'synthetic' ACT with a corresponding tax credit is also created when a manufactured



dividend is paid. The logic of the FID regime requires synthetic FID ACT to be created, i.e. ACT which can be offset against other tax liabilities but not reclaimed in cash. While technically possible this will create a level of complication which is clearly undesirable.

Finally on the shareholder issues the position of overseas holders needs to be considered. Where a double tax treaty exists between a foreign shareholder's country of residence and the UK it will often provide for a proportion of the ACT credit to be repaid to the foreign holder. The wording of the UK's double tax treaties is such that this repayment credit is only available where such a repayment would be made in respect of the same dividend to a UK resident. The effect of the FID regime for an overseas holder is therefore the same as that for a UK holder. Credit can be claimed against UK tax liability but no tax repayment will be made.

## **5. FIDs - Conclusions**

Any attempt to address the surplus ACT problem is welcome, but the intractability of the problem must be recognised. Unless structural reform of the system is brought about, all that can be done is to try to 'fudge' the gap between the lower tax rate on UK profits and the higher rate on overseas profits to reduce the discrimination that the system gives in favour of UK investment. The existing regime allows this to be achieved by multinational groups with a sufficient proportion of UK business. The FID regime would allow this to be extended further if 'streaming' were allowed. Given the high proportion of tax-exempt shareholders in UK quoted companies, introduction in its proposed form is likely to have only a limited attraction.

Some form of anti-avoidance provisions seem inevitable if the legislation is introduced. Anti-avoidance provisions are never (or are only very rarely) repealed and UK tax law is currently tottering under the weight of existing anti-avoidance legislation. The presumption should be only to introduce anti-avoidance provisions when abuse occurs and not to cover every conceivable eventuality. While all-embracing anti-avoidance provisions may protect against a modest loss to the exchequer, their cost in terms of tax advisers' and compliance time must surely outweigh any perceived saving. The legislation should therefore be introduced in as simple and straightforward a way as possible with appropriate warnings that abuse or perceived abuse will be corrected without hesitation.

Finally, the requirement to account for ACT on FIDs creates numerous compliance and technical difficulties apparently only for the benefit of a small amount of exchequer revenue - and in cash-flow terms only. Exchequer cost should not determine the structure of the UK tax system;

it should determine the tax rate to be charged and, in some cases, the subject matter to be taxed. To complicate the FID regime with a requirement to account for ACT on the grounds of exchequer cost would seem to me a severe case of the tail wagging the dog.

## **6. Headquarter Companies**

Related to the FID regime are the proposals for headquarter companies. The Government has undertaken to introduce these provisions regardless of whether the FID regime meets with approval. The provisions will, in the same way as the FID regime, allow for the pass-through of foreign source profits without any ACT obligation arising.

To qualify for the relief the headquarter company must satisfy a test, yet to be specified in detail, of foreign ownership - the typical candidate might be the European holding/headquarter company of a US multinational group. However, it is somewhat unclear from the document precisely whether the intention is to discourage existing headquarter companies from leaving the UK or encourage new ones to set up here, nor is it apparent why it is felt necessary to introduce a regime for holding companies (as the tax benefit is for the flow-through of profits) to a regime described as applicable to headquarter companies. Nevertheless these provisions must be welcome as increasing the attractiveness of the UK as the location of multinational groups doing business in Europe and the proposals raise fewer technical issues than the FIDs regime.

In particular, dividends paid by a qualifying headquarter company need not be subject to any ACT so the problems created in relation to FIDs of reclaiming the FID ACT do not arise. Furthermore, the nature of the operation of a headquarter company is likely to involve a far simpler UK group structure than that of a UK-based multinational which might wish to pay FIDs and such a company will be in a far better position to arrange its affairs so as to maximise the benefit of this new regime.

The UK tax regime does, however, contain a number of potential pitfalls for such a company. First, the question of corporate residence remains unresolved. UK tax law will treat a foreign subsidiary as UK resident if its central management and control are effected from the UK. The precise scope of this test is not subject to clear definition and the Inland Revenue is known to wish to extend its scope wider so as to treat passive subsidiaries of UK groups as resident here. A multinational group would not want to be subject to the uncertainty of existing rules.

Second, the UK controlled foreign company (CFC) rules may impose a charge to tax on income accumulated overseas by subsidiaries of a UK company. If a headquarter company regime is intended to encourage foreign-owned groups to use the UK as the location for an intermediate holding company, such companies should also be excluded from the scope of the CFC legislation.

As with FIDs there is concern that anti-avoidance rules would be needed to protect the Revenue. In particular the UK's liberal rules for utilisation of interest expense - broadly speaking all interest paid is tax deductible - could allow multinational groups to shelter the profits of their UK subsidiaries by transferring other European subsidiaries to the UK company for a cash price financed by borrowings.

While a headquarter company regime therefore suffers some disadvantages and may well be hedged about with further anti-avoidance rules, there are significant advantages. The benefit of the Parent/Subsidiary directive would allow dividends from all European subsidiaries to be paid free of local withholding tax to such a company and from there to be repatriated to the ultimate parent free of any further withholding. This must offer significant attractions to any multinational group.

The headquarter company regime should be welcomed as a specific and useful initiative and the FIDs regime given cautious approval, but concern must remain over the Government's lack of clear strategy over the corporate tax system. Tax reform cannot be achieved overnight and inevitably any changes can only be made to the system as it exists. Changes such as these and the reduction in ACT rates in the Budget should be accompanied by some clear statement as to the general direction in which the Government wishes the corporate tax system to move.

*Nicholas Dee<sup>21</sup>*

*SmithKline Beecham plc*

I want to start with two disclaimers. Firstly my views do not necessarily represent those of my employers or any other organisation to which I belong. Secondly while I shall be making some criticisms of the Inland Revenue, none of these are intended to apply to Peter Lewis and his team who have done a good job in moving forward this issue of surplus ACT.

## **1. The Lobbying History - Five Years Hard Grind**

As it happens I joined Beecham in 1987 at a good time in this lobbying effort. While the company had lobbied in the early 1980s we had never achieved much visibility. The CBI set up a working party in 1988 and the subject began to grow in importance. Then in 1989 the Chairman of BP and the Chairmen of twelve other large UK-based multinationals wrote to the Chancellor stressing the importance of this matter. I always thought the acknowledgement from the Financial Secretary one month later was a little less than such a distinguished representation deserved.

In 1990 we encountered sheer intransigence from the Inland Revenue. Its view seemed to be that surplus ACT was an inevitable and indeed intended result of the system. Therefore suggestions for reform were out of place. This included the nonsensical suggestion that our request to offset ACT at the then 35/35 rate amounted to our proposing that the imputation system be dismantled. This is of course absurd. I am pleased to say that the position has improved and we welcome the more open and sensible approach now being taken to this structural issue.

In 1991 the Hundred Group of Finance Directors increased the pressure on this issue. One of their major contributions was commissioning a report from Professor Chris Higson of London Business School which reported late that year on the economic impact of surplus ACT. This was a very valuable contribution to the lobbying effort. It again showed it as a major economic and competitive issue, rather than a narrow technical tax point.

Finally in 1992 we had the recognition from the then Chancellor that this was a matter to which the Government would have to return. When the Government was duly returned, we thought it

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should honour this pledge. There was then much lobbying of the Department of Trade and Industry, in its role of sponsor of British industry, during 1992, culminating with what one could call success question mark in 1993.

## **2. Tax Policy**

At this stage I would like to digress for a moment to discuss how tax policy is established in this country. The Inland Revenue reaction to the efforts of some of Britain's largest and best-known companies on surplus ACT was narrow minded. By definition such companies frequently operate on a world scale, such as my own where the UK market is small, and expansion overseas is the only way to become world class. There was also the excessive focus on revenue neutrality, as opposed to the more helpful approach typically shown by Governments in Japan and Germany. I should add we have often received the same reaction on US tax issues, until this year when the UK Fisc suddenly realised that it could lose out unless it supported UK plcs.

I think there is a clear need for wider economic and competitive considerations to be brought into taxation policy. I was pleased to see the new Chancellor at his recent Mansion House speech talk about commerce generating the prosperity to raise living standards. While often maligned, multinationals do provide jobs, skills and balance of payment flows for the benefit of this country.

What is needed is a tax policy unit outside the Inland Revenue and Customs and Excise. The job of tax collectors is to collect taxes, not set tax policies. And tax authorities should be the slaves of tax policy, not its master. Such a unit should also be outside the Treasury, in view of recent economic débâcles.

There is also a need for outside membership from commerce and industry. Again the new Chancellor got it right in stating that it is commerce alone which generates the wealth.

## **3. The 1993 Consultative Document**

Let me turn now to the 1993 Consultative Document. I welcome the prominence surplus ACT has now attracted. Norman Lamont did a good job on this, in listening to the suggestions for reform.

I also think the document is a useful analysis of the position, but could have been drafted from a wider commercial angle. The criteria for change are probably right, but again would have benefited from more focus on commercial issues. Incidentally for those of you who have not

read all the representations, may I commend to you the Institute of Chartered Accountants, which to my mind has come up with a representation that is tough, clear, in some cases critical, but certainly extremely good.

I am certainly disappointed that industry's preferred solution of 33/33 offset has been dismissed in paragraph 29 of the Consultative Document on grounds that I myself regard as theoretical. 33/33 is what we asked for and this is what we would like.

There is also, as has been referred to, the excessive focus on cost to the exchequer. This is the normal short-term view from a Government which apparently sees little reason to heed the concerns of major UK-based multinationals. We also need to look at the benefits of long-term economic prosperity, not just the cost of any sensible tax reform. Otherwise, as with the Treasury focus on inflation, you may end up with a zero economy.

#### **4. Foreign Income Dividends**

On Foreign Income Dividends themselves, I consider them a useful option. However, I am not sure how much they will be taken up. They are not of course a comprehensive answer to the problems.

Certainly the existing restrictions are probably excessive in three ways.

- (i) The proposal not to allow streaming smacks of anti-avoidance mentality. At SmithKline Beecham we effectively have dividend streaming following the merger of Beecham Group plc and SmithKline Beckman Corporation some four years ago. The old Beecham shareholders - typically based in the UK - receive UK dividends from our top company SmithKline Beecham plc and ACT applies in the normal way. The old SmithKline shareholders - typically in the US - receive a dividend from a US company with no ACT. This involves no avoidance whatsoever. The situation is exactly the same as before the merger when the Revenue equally received no ACT on the dividends paid to SmithKline Beckman shareholders. We therefore believe strongly that there should at the very least be grandfathering for existing structures no matter what anti-avoidance rules are brought in.
- (ii) The prohibition on carry-back is likely to lead to low take-up of FIDs. Particularly with quarterly dividends there would be a real problem in paying FIDs in the earlier part of the year for a prudent tax director. It is therefore likely that any FIDs would only be

paid out as a fourth quarter dividend when the position for the whole year was clearer. I should add that this shows again the complexity and cost of quarterly reporting and dividends.

- (iii) The fact that the ACT has to be paid up front is also a problem. It seems illogical by reference to the rules regarding International Headquarter Companies.

Overall there is a need for greater flexibility before FIDs are likely to take off or be recommended by a prudent Board of Directors. It will certainly be very difficult to lay down a policy for future FID payments.

It is also likely that FIDs may encourage too high dividend payouts. This is already a problem in the UK where the payout ratio is much higher than in other successful industrial nations. This may be caused in part by the demand from institutions for a stream of income upon which they themselves are judged.

There are also two other potential problems.

- (i) Institutions could invest direct in non-UK companies, thus avoiding the UK equity market altogether. This is possible in a world-class industry sector such as my own where there are acceptable alternatives in the US, Switzerland, Germany etc.
- (ii) The perceived complexity of FIDs could also lead to investors shunning companies that pay them as being just too difficult to understand. Again this would hardly attract investment into the UK equity market. At SmithKline Beecham we have encountered this with our stapled stock, over which we have had to expend considerable efforts to explain to the investment community.

## **5. Other Suggestions for Reform**

Let me finish by offering some other ideas for reform.

Firstly, there could be an offset against surplus ACT where a company incurs significant R&D expenditure. This could be on a sliding basis, not necessarily pound for pound. While it is admittedly a tax distortion, I believe this is a good one to encourage R&D in which again British industry is often lacking.

Secondly, one could follow the Australian example when they reduce their tax rate from 39 per cent to 33 per cent. Dividends franked at 30 per cent continue in a separate pool. This would mean in the UK an offset of 25 per cent for ACT paid at that rate until it is exhausted. After all we have paid the tax: we would like the offset.

Thirdly, there is the proposal in Germany, where it is envisaged that dividend income that German companies receive from active foreign subsidiaries should be tax exempt not only on receipt, but on redistribution; a credit in respect of foreign tax paid would be given to the German company's domestic shareholders. While this may be revolutionary, I understand it is agreed between the Federation of German Industry and the Federal Finance Ministry, which implies some strong support for it. It does also mean that a Fisc will be repaying foreign tax to domestic shareholders.

## **6. Conclusion**

Let me conclude by offering three suggestions:

- Still more imagination is required in solving the economic and competitive issue of surplus ACT.
- The Government should encourage UK-based multinationals which create employment and skills, and bring funds into this country.
- The Consultative Document is a good try, but further attention should be paid to representations from industry as to how reform should proceed.



# Surplus ACT - The European Perspective

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*Citibank*

This is a personal view and does not necessarily represent the view of Citibank.

## 1. Introduction

The current UK taxation regime is a barrier to a foreign company establishing a holding company in the UK or a branch network from a UK resident company. The Second Banking and Investment Services directives have highlighted this issue for the international financial industry, resulting in a review and modification of the way such institutions are structured and operate in Europe, with every likelihood of investment migration from the UK.

## 2. The ACT Problem

The major issue for the UK revolves around advance corporation tax and its interaction with foreign income. When a UK company pays a dividend, it must account for ACT. ACT may be set off against corporation tax on taxable profits. However, where a portion of the company's profits comes from overseas dividends, and the UK tax liability is sheltered by foreign tax credits, there may be no UK tax against which to set ACT.

Excess ACT can be carried back for up to six years, forward indefinitely or surrendered to other group members. This is of little comfort if a full dividend policy is required, or if foreign earnings are required to be paid as dividends, in which case surplus ACT (i.e. ACT not utilised) may be carried forward without the prospect of future offset, creating additional taxation, or a 'toll charge'.

The amount of additional tax depends on many variables and it is difficult to quantify as a generalisation. However, research has indicated that there can be an increased burden of over 10 per cent of foreign income earned, an unacceptable 'toll charge' for investing in the UK.

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<sup>22</sup> Peter Randall is UK Director of Taxes at Citibank NA.

Clearly, a tax regime with this impediment provides a major disincentive to UK corporations investing overseas, or, more particularly, overseas corporations investing in the UK.

Multinational corporations have in the past utilised more productive jurisdictions to alleviate these problems, basing headquarter or holding companies in the Netherlands (which has an exemption system for foreign source income), Belgium and Luxemburg (co-ordination centres) or Ireland (international financial services centres).

Should the UK be the designated base for commercial reasons, the problem has been solved, in full or in part, by the use of a Dutch 'mixer' company, or a structure utilising a more tax-friendly jurisdiction and share structure, to 'bypass' the UK. Other methods have involved the purchase of companies with deferred tax liability, or franked investment income, and stock dividend schemes, all of which have from time to time come under Inland Revenue scrutiny.

There are added problems in the financial services sector, as it is traditional to use a branch network, or branch/subsidiary network, rather than a pure subsidiary network, and therefore the schemes and structures open to a manufacturing concern are not necessarily applicable.

### **3. Recent European Developments**

The last decade has seen a closer liaison between European countries, with harmonisation in many areas - social, financial and commercial. In June 1985, the EC Commission issued a White Paper which identified a practical programme designed to 'achieve a single large market by 1992 thereby creating a more favourable environment for stimulating enterprise, competition and trade'. From 1985 to date, almost 300 legislative measures have been implemented with a view to creating 'an area without internal frontiers in which free movement of goods, persons and capital is ensured'.<sup>23</sup>

The European Community has expanded to 12 countries, with additional countries preparing for membership so that by the end of the century there could be as many as 20 members. Despite set-backs surrounding the Maastricht Treaty and the Exchange Rate Mechanism, the trend is towards greater co-operation and alignment.

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<sup>23</sup> Article 12 of the Single European Act.

On 23 July 1990, three important EC directives relating to taxation were adopted: the Mergers directive, the Parent/Subsidiary directive, and the Arbitration Convention, all to be effective on 1 January 1992. The Mergers directive and the Parent/Subsidiary directive had been in draft form for some 20 years and are a key part of organisational freedom within the Community.

An important area for harmonisation is in the financial services sector, for which the Second Banking directive was adopted. This was the first of the second-generation 'Passport directives'.<sup>24</sup> The concept was to promote the use of a common entity, regulated by one member state, but able to market freely in other member states. The ability to use a common capital base, and therefore operate more effectively, is a fundamental ingredient in this vision.

On 18 March 1992, the Ruding Committee published its recommendation as to changes required in the direct tax system in the longer term following the establishment of the Single Market, and recognised the problem created by surplus ACT in the UK.

This activity has created an environment in which many organisations are either rethinking their current European structures, or are encouraged into investing into Europe. This requires the UK to revisit the problem of surplus ACT, notwithstanding the £50 billion public deficit and the £5 billion stock of surplus ACT outstanding. A solution is vital if the UK is to remain the prime financial centre for Europe, if not the world. The traditional advantages of London in terms of culture, language and regulatory environment will not extinguish the threat of financial centres such as Frankfurt, Paris, Dublin and the Benelux countries.

Once a corporation decides to move its European headquarters or holding company, the shift will not be limited to a few key personnel. The traditional brass-plate company cannot exist under the 'Passport' directives and headquarters will therefore require the presence of substantial senior management. There is then a natural migration effect in that, however much a corporation tries to restrict such transfer to senior personnel, less senior personnel will follow in the long term. Either senior management will feel vulnerable without their safety net of specialist staff, or the staff concerned will feel that they should be nearer the seat of power. In addition, ancillary services, including professional advisers, accountants and lawyers, will naturally migrate to the new headquarters. The Irish Development Authority has estimated that the creation of one job has a multiplier effect of 2.7 ancillary jobs. It can be anticipated that a similar effect would operate, in reverse, for the loss of key jobs of this kind.

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<sup>24</sup> Followed by the Investment Services directive and the Insurance directive. There are also proposals for an interest/royalty directive and a losses directive.

The UK has responded to this problem, and to lobbying from industry bodies and certain overseas corporations, by the Chancellor announcing in his Budget Speech the publication of a Consultative Document, including a proposal for a 'Foreign Income Dividend' scheme, and the reduction of the rate of ACT from 25 per cent to 20 per cent.

#### **4. The Consultative Document**

The main body of the Consultative Document outlines general proposals for a Foreign Income Dividend scheme to alleviate the surplus ACT problem, with a later section referring to proposals for 'International Headquarter Companies'.<sup>25</sup> The salient features of these discussions are:

- (i) The general FID scheme outlined would require a company to pay ACT on a FID and subsequently claim any appropriate repayment. However, it is also proposed that International Headquarter Companies should be allowed to pay a FID without paying ACT.<sup>26</sup> This will naturally offer a cash-flow advantage, or more correctly alleviate a cash-flow disadvantage, and make the scheme easier to administer.
- (ii) The Government has confirmed that, should for any reason it decide not to proceed with the FID scheme (and there would seem to be a general disapproval of the scheme as currently proposed), it would nevertheless introduce a special scheme for International Headquarter Companies in the Finance Bill to be published in January.<sup>27</sup>
- (iii) An International Headquarter Company is defined as meeting two tests:<sup>28</sup> first, that most (at least 80 per cent) of the share capital should ultimately be owned by non-UK resident shareholders and, second, that the company should have no more than five shareholders.

The proposals raise many questions, perhaps the most important of which is 'does it work?'

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<sup>25</sup> Paragraphs 85-90.

<sup>26</sup> Paragraph 85.

<sup>27</sup> Paragraph 90.

<sup>28</sup> Paragraph 89.

(a) Does 'foreign source profits' refer to branch profits as well as dividend income? Does it include foreign source interest?

If branch income is not included then utilisation of the UK for the purposes of the 'Passport' directives will not be encouraged by the FID proposal. The Inland Revenue has confirmed that foreign income will include branch income, but while the question of foreign source interest has not been addressed, it is doubtful if it will be included.

The definition given is that 'foreign source profits' are confined to income or gains which have actually suffered a creditable foreign tax. There are of course rules in the tax systems of other jurisdictions which may cause taxable income or losses to arise in different years from those under UK tax rules or under financial accounting provisions, for example due to differences in capital depreciation rates and the treatment of bad debt provisions. The result is that even when book (accounting) earnings are shown to arise in a foreign branch or subsidiary and there is UK taxable income from that source, there may still be no current foreign tax payable. If the difference was of a temporary nature there may well be problems in that such income would, by definition, fall outside of the FID scheme for that year.

In addition, the delay in settlement of foreign taxes may impinge on the smooth running of the FID system. In these circumstances, it may be simpler to utilise a system whereby a specified country source falls within the scheme, similar to controlled foreign company (CFC) legislation.

(b) What does ultimate shareholder mean?

Discussion has taken place as to whether the ultimate shareholder is meant to mean the ultimate corporation quoted or whether it is the actual shareholder. If it is taken to mean the actual shareholder, there would be a considerable administrative burden to ascertain the proportion of UK and non-UK shareholdings, for the test on foreign ownership. For the second test (on the restriction of the number of shareholders), one has to feel that it cannot mean the actual shareholder, since any quoted company will have many shareholders and most companies would therefore be excluded from the scheme.

If the scheme is to succeed, the shareholding limitation must stop at the quoted company level, possibly with special provisions for close companies, consortiums and partnerships.

I understand that this has not been decided to date.

**(c) Tower-tier companies**

Income may be redirected by a tower-tier UK company and still be within the FID scheme.<sup>29</sup> This is an essential provision and its inclusion is welcomed.

**(d) Will approval be automatic?**

Will approval be automatic, or will advance approval be required, similar to that in Section 215 ICTA 88? It is hoped that the system will be self-regulating and that prior approvals will not be required.

**(e) How will the scheme fit in with double tax conventions entered into by the UK?**

If the scheme is adopted in its entirety, I do not perceive a problem from an international perspective. However, if the International Headquarter proposals are adopted in isolation, there could be an issue with treaties that provide for a refund of ACT to a parent company. It is not clear if the proposals would overrule such provisions. Clearly domestic legislation can overrule treaty provisions.<sup>30</sup>

**(f) Record-keeping**

Obviously, more record-keeping would be required, but the ring-fencing of income from certain sources is not new in the UK tax system, as illustrated by the current treatment of the insurance and petroleum industries.

## **5. Postscript**

If the legislation in the Finance Bill<sup>31</sup> addresses these issues, the UK will be in a reasonable position to compete on a 'level playing-field' with other proactive European regimes to attract

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<sup>29</sup> Paragraph 55.

<sup>30</sup> Otherwise S.182-5 ICTA 88 would have no merit.

<sup>31</sup> We understand that the legislation may not be issued in draft form prior to the January 1994 Finance Bill.

the establishment of European headquarters and holding companies, and not only those in the finance industry. In particular, the change of status of Hong Kong in 1997 may well offer opportunities to attract hitherto Hong Kong-based multinationals.

However, these prospects depend on the resolution of a number of other problems. In particular, the Tenth EC Company Law directive needs to be implemented before many groups are able to reorganise. In most member states, cross-border mergers cannot yet be legally achieved, despite the implementation of the 'Tax' Merger directive, enabling such mergers, if achieved, to be tax-free.

Moreover, the possible imposition of sections of UK tax law affecting companies with a presence in 'a unitary state',<sup>32</sup> essentially US companies, may act as a deterrent to inbound investment from the US. While it would not affect the payment of FIDs, as no ACT credit would be available in these cases, it would affect ordinary dividends paid from income arising in the UK and in low-tax jurisdictions. This would be regrettable however much sympathy there may be for companies under US unitary tax provisions. Furthermore, there has been comment that the International Headquarter provisions could be suspended to supplement the retaliatory provisions. Again, this would be regrettable as the UK would lose an opportunity to attract the inbound investment necessary to maintain its status.

Finally, is there perhaps a simpler solution?

If the International Headquarter Company issue were taken in isolation, it would be feasible to amend the legislation to enable the payment of dividends to a non-UK company without accounting for ACT.<sup>33</sup>

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<sup>32</sup> S.812 ICTA 1988.

<sup>33</sup> Specifically, it would be feasible to supplement s.212 ICTA 88 in order to create an exemption to s.209 and accordingly pay a dividend to a non-UK company without accounting for ACT.