AN ACT AGAINST TRADE

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UK Tax Prejudice Against Trading Abroad: The Problem of Surplus ACT and its Solution

by

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I. INTRODUCTION

1. The first edition of *A Tax on Trade* was published in autumn 1989. Since then, there has been a growing interest in the problem of surplus ACT (advance corporation tax). Two substantial studies of the matter have been published: *The* Problem of Surplus *ACT* by Professor Chris Higson (London Business School, October 1991); and Imputation Systems and Foreign Income: the UK Surplus ACT Problem and its Relationship to Corporate Tax Harmonisation by Malcolm Gammie (Intertax 12/1991). The Institute of Directors published a policy paper on Advance Corporation Tax in September 1992. Surplus ACT has received much more attention from the Press than in previous years. And the Chancellor of the Exchequer referred to the problem of surplus ACT in his Budget Speech on 10 March 1992; this passage from the Budget Speech is reproduced in Appendix A.

2. These developments are welcome, particularly the mention of surplus ACT in the Budget Speech; it was a main purpose of A Tax on Trade to arouse interest in the problem of surplus ACT both inside and outside the Treasury. In addition to the companies affected, representations have been made to the Government on the subject of surplus ACT by the Confederation of British Industry, the Engineering Employers Association, the Hundred Group of Companies, the Institute of Chartered Accountants in England and Wales, the Institute of Directors, the International Chamber of Commerce and others.

3. The problem of surplus ACT is becoming more and more serious as the UK rates of corporation and income tax are reduced and as boundaries between national tax jurisdictions become increasingly irrelevant to the realities of International Business. Although the Chancellor said in his 1992 Budget Speech that the problem of surplus ACT is "highly complex", the present paper shows that the complexities of the problem can be contained and that there is a range of solutions available, at short-term costs to the revenue ranging from zero upwards, anyone of which (or a combination of which would be regarded by business and professional opinion as an improvement on the present situation.

4. The solution adopted should be world-wide in scope and not confined to the European Community; solutions at EC level diminish the distortions of trade and investment between the United Kingdom and the rest of the Community but at the cost of Increasing the distortions between the United Kingdom and the rest of the world. The first priority is a unilateral United Kingdom solution which could be extended to there rest of the world including the other members of the European Community.

With the recession lasting yet another year and Britain's trade remaining in deficit, it is ironical that the tax system is systematically biased against an important element of business activity overseas that serves to generate activity at home. The problem of surplus advance corporation tax (ACT) on foreign earnings dates from the reform of corporation tax in the Finance Act 1972, although an analogous problem dates back to the introduction of the "classical"

system of corporation tax in 1965[1]. Throughout this period surplus ACT has remained a cause of serious concern to the business community; but the general public are still largely unaware of it by reason of its technical nature. The present paper attempts to update the analysis of the problem for business readers and those professionally interested and, at the same time, to keep the treatment accessible to a wider readership.

6. Section n analyses the problem of surplus ACT on foreign earnings and Section III gives a brief discussion of surplus ACT in other forms. Section IV considers the effect of surplus ACT on business activity and Section V discusses the motives of businessmen and the Inland Revenue for adopting their respective policy positions. Section VI quantifies the principal magnitudes concerned. Section VII discusses the European dimension of the problem and Section VIII mentions other recent developments. Section IX sets out a number of possible solutions and Section X gives the implications for policy.

7. It is assumed that the present structure of corporation tax will continue, with partial (or even complete) imputation to the level of the shareholder of tax paid at the level of the corporation. It is also taken as agreed that direct investment overseas serves to increase rather than decrease visible and invisible exports and can contribute as much to the strength of the economy, pound for pound, as similar investment at home. It is no longer necessary to make the case for overseas investment in principle, as it was in the days of the CBI's Reddaway Report[2]; what is now required, is to translate this agreement into practice.

[1] In 1965 the rate of tax on undistributed profits was reduced; but a separate income tax charge was introduced on dividends. By comparison with the previous system, the lower rate of corporation tax reduced the value of double tax relief. Companies distributing dividends at home out of profits earned abroad thus lost much of the advantage of a lower rate of corporation tax; for companies distributing domestic profits this lower rate of lax at the corporate level provided some offset for the imposition of an additional tax on dividends. The 1965 system introduced an element of prejudice that had not existed before against the distribution of dividends at home out of profits earned overseas. In this sense, the problem of what is now called surplus ACT can be traced back for twenty-seven years. (Paragraphs 60. 66. 82, below)

[2] Effects of UK Direct Investment Overseas: W B Reddaway in collaboration with S J Potter and C J Taylor, Cambridge University Press, 1969, ISBN 0521 071 992.

II. ANALYSIS OF THE PROBLEM

8. Surplus ACT on foreign earnings is caused by the interplay of economic and international double taxation. Economic double taxation is the taxation of the same income in the hands of two persons (the company and the shareholder). International double taxation is the taxation of the same income in the hands of the same person by two different tax jurisdictions.

9. The present imputation system of corporation tax is neutral for taxpayers at the basic rate of income tax between distribution and retention of profits earned in Britain; imputation at 25 per cent is less than corporation tax at 33 per cent; but the difference is equally a charge on the corporation as such whether the profits are distributed or retained, so that economic double taxation is removed. The present tax-credit system of relief from international double taxation is neutral at the level of the company between profits earned at home and profits earned abroad in tax jurisdictions with tax rates no higher than at home. (The British tax system is biased in as much as the British investor pays the *higher* of the two taxes, home and abroad; but that is a side issue for the present paper). Economic and international tax neutrality, in the senses explained in this paragraph, are supported by both political parties.

10. The problem arises when economic and international double taxation are present, not singly, but in combination: when dividends are paid in Britain out of profits earned And taxed abroad. If dividends are not covered by profits earned in Britain, it may not be possible to credit the ACT levied on them against mainstream corporation tax. There is then economic double taxation by comparison with undistributed profits and international double taxation by comparison with dividend distributions out of profits earned at home. In a system where economic and international double taxation are relieved separately, there is no good reason to withdraw relief when the two forms of double taxation are present in combination.

11. The simplest example compares a dividend paid in Britain out of British profits. With ft dividend paid in Britain out of profits earned abroad; corporation tax abroad is assumed to be at the British rate of 33 per cent.

Table 1

The structure of tax prejudice

	Profits earned at home (1)	Profits earned abroad (2)	Profits earned abroad (3)
Pre-tax profits	100	100	133.33
Corporation tax (33%)	33	33	44.00
Profits net of corporation tax	67	67	89.33
Surplus act (25%)	-	16.75	22.33
Maximum dividend net of basic rate of income tax (25%)	67	50.25	67.00
Corresponding gross dividend	89.33	67.00	89.33

In column (1), ACT is set against mainstream corporation tax, and there is no surplus ACT. In columns (2) and (3); no ACT is set against mainstream corporation tax, and ACT is a final tax. Thus the maximum dividend out of the same pre-tax profits is a quarter lower (columns (1) and (2)) or, in order to pay the same dividend, the company must earn one-third more profits abroad than at home (columns (1) and (3)) Tax is 49.75 per cent (= 33 + 16.75) instead of 33 per cent (columns (1) and (2)) or 66.33 per cent instead of 33 per cent (columns (1) and (3)).

12. In accordance with what is called the Sterling Trust principle, foreign tax rates are not averaged (as in the United States) but each source is taken separately, with the lowest foreign tax rate taken first and then in ascending order. The taxpayer is able to reduce surplus ACT by paying dividends first out of profits earned at home and then out of profits taxed abroad at the lowest rate and then at the next lowest rate and so on; these profits lightly taxed abroad attract a correspondingly higher rate of corporation tax in the UK, so that there is more UK mainstream tax to cover the ACT. ACT can be deducted from mainstream corporation tax up to a limit of 25/33rds of the UK tax payable. Dividends may thus be covered, first by domestic earnings, and second by profits taxed abroad at not more than 10.67 per cent (10.67 = 33 - 22.33; 22.33 = 89.33 67; *tN.33* = 100 -10.67 (column (1) of Table 1»; if these profits cover the dividends, no surplus ACT arises. As the foreign rate of tax rises from 10.67 to 33 per cent, the amount of surplus ACT per pound of dividend increases; at 33 per cent and beyond, surplus (or final) ACT is charged in full at one-third of the net dividend or one-quarter 01 the gross (column (3) of Table 1).

13. Estimates of the magnitude of the problem from company figures are given in Appendix B. An algebraic analysis setting out the structure of the problem in more detail, in terms independent of the rates of tax charged in Britain at any particular time, is given in European Taxation May 1974, pages 165-169. The matter has also been discussed more recently in Julian Alworth *The Finance, Investment, and Tax Decisions of Multinationals* (Blackwell, 1988). The problem has intensified since the 1988 Budget as a result of the assimilation of capital gains tax to income tax and the consequent pressure on United Kingdom companies in general to increase dividends. The recent difficulties of Consolidated Goldfields and BAT Industries in resisting unwelcome takeovers may have been aggravated by the fiscal distortion *of* surplus ACT.

14. A tax prejudice *of* 101 per cent (=(44.00 + 22.33 - 33) divided by 33), in other words, an excess *of* 101 per cent in the rate *of* the higher tax over the lower tax as a proportion *of* the latter, which has been increasing in recent years as the rate *of* corporation tax has fallen, represents a severe fiscal distortion. So far from being a level playing field, this is a playing field at an angle *of* over 45 degrees or a slope *of* more than 1 in 1. This is becoming an increasingly important influence on behaviour. Fewer and fewer companies aim to maximise pre-tax profits and leave it to their Tax Departments to minimise the tax bill afterwards. It is post-tax profits that affect earnings, dividends and share prices. Tax is taken into account at an early stage *of* corporate policy-making, especially when the respective tax burdens on alternative courses *of* action differ by large percentages. Policy becomes thoroughly tax-driven and distorted.

15. Surplus ACT can be carried forward and is at best an interest-free loan to the revenue; but it is never ultimately usable if the same problem recurs year after year. This qualification for possible deferred tax must be noted in the accounts, and eventually irrecoverable ACT must be written *off*. The irrecoverability *of* ACT reduces earnings, dividends and the share price and artificially increases the company's vulnerability to a hostile take-over.

16. Means of resolving or mitigating the problem of surplus ACT at corporate level include reducing UK dividends or their rate *of* growth; increasing UK profits; reducing dividends from overseas or their rate *of* growth or the rate(s) *of* tax payable on them overseas; and other.

Reducing UK dividends or their growth rate:

(a) This is a necessary element *of* most companies' response to the problem: the "income effect" *of* surplus ACT reduces the maximum distributable as dividends and the 'price effect' increases the tax cost *of* profit distribution relatively to profit retention. Surplus ACT is a cumulative problem, so that absolute reductions in dividends are unnecessary as well as commercially unattractive; but it generally reduces their rate *of* growth. During the current recession, the problem has intensified as companies have come under pressure to maintain their dividends

despite their fall in profits.

Increasing UK profits:

(b) Sale of assets by UK resident companies. A lower price would be acceptable if the purpose was to reduce surplus ACT.

(c) Acquisition *of* UK income. A higher price would be acceptable if the purpose was to reduce surplus ACT[3]. The benefit *of* acquiring UK income for this purpose could be much diminished if the acquisition were funded by additional debt, because the additional debt would reduce the taxable income, at least in the short term. The effectiveness of the tactic of acquiring UK income depends in the longer term on the relative growth of income, at home and overseas.

(d) Acquisition of UK companies with a history of under distribution, (for example, unquoted companies). These companies could pay dividends with ACT to the acquiring company to reduce the ACT liability of the latter and could carry back their own ACT to obtain corporation tax refunds. A price of up to £122.33 could be acceptable for each £100 of such profits.

(e) Replacing UK debt with equity: the interest on debt is a charge against UK profits, although this is an advantage with a limited life-expectancy.

(f) Reducing UK costs: especially by charging out the cost of central functions to overseas associates, provided that it is tax-relieved in their hands, or by moving costs like headquarters, support services, or research and development services.[4]

Reducing inward overseas dividends or their tax rate:

(g) Charging out central costs, as in (f) above; however, companies with surplus ACT may have no choice but to take dividends from overseas to fund the dividends to their shareholders (and the associated ACT); the same comment applies to (h) below.

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[3] The usability of surplus ACT is a major influence on acquisitions.

[4] Explaining the move from St Helen's, Lancashire, to Brussels, Andrew Robb, Finance Director of Pilkington, said: "We made good profits in Britain: but dividends are based on worldwide profits. Last year Britain accounted for 50 per cent of profits; this year it will be less. So we will be unable to absorb all our advance corporation tax. There is not enough British profit out there to offset ACT." Roger Wood, Finance Director of George Wimpey and Chairman of the Group of 100 finance directors' committee looking at ACT, said: "The government should wake up to the fact that the effect of surplus ACT is forcing some companies to push their facilities overseas; and if you take the argument further, they will end up having quotes in Paris, Frankfurt or New York, and will bypass London altogether". It is reckoned that the problem affects more than 65 per cent of stock exchange companies by value. (*Sunday Telegraph*, 13 October 1991).

(h) Shifting the financing of overseas associates from equity to debt; maximising debt in overseas associates with taxable capacity.

(i) Repatriation of overseas capital to buy UK income.

Other

(j) Replacement of a proportion of dividends with stock dividends.

(k) Corporate reorganisation to establish a non-resident holding company; but there are fiscal and legal obstacles, and there might also be conflicts of interest between shareholders. The UK exempt shareholder, typified by the pension fund, is the greatest problem here.

(l) Sale to bidder. A company which is unable or unwilling to respond to the problem of 8urplus ACT in any of these ways is financially vulnerable to takeover by a company that would seek to resolve the problem of surplus ACT more actively.

(m) Emigration. This has been the solution adopted, for example, by a number of plantation and mining companies. However, since the Finance Act 1988, emigration is more difficult and attracts a tax charge.

17. Paragraph 16, above, shows how tax remains a serious distortion of the behaviour of the companies affected. Corporate strategy is tax-driven, because higher pre-tax profits can represent lower post-tax profits. It was the purpose of the 1984 reform of corporation tax to reduce or remove these tax distortions at the level of the domestic economy. It was the purpose of the 1972 reform of corporation tax to remove the tax bias against dividend distributions and in favour of retentions. For companies with permanent surplus ACT through the distribution of dividends out of profits earned abroad, these reforms might as well never have been brought in. Despite twenty-seven years of lobbying by these companies, the unreformed *ancien regime* so far remains in place.

18. The problem is worse for direct investment overseas than for portfolio investment. For portfolio investment overseas, the main fiscal distortion is that the individual UK investor has a strong incentive to invest through a UK finance house, since otherwise he is exposed to draconian anti-avoidance legislation; the main effect of the legislation is to give a tax advantage to indirect investment through a finance house by comparison with personal investment by the individual-- the opposite of the general thrust of Government policy towards portfolio investment in the UK. Many finance houses are not corporations; and for those that are, portfolio investment is sufficiently fungible that the main problems of fiscal distortion can be resolved by rearrangement of the portfolio. Investment in a factory overseas, by contrast, is far from flexible. For all these reasons, the main effect of the present rules abut ACT is to obstruct direct investment overseas by companies whose dividend distributions in the UK are not covered by domestic earnings. By contrast, in the years until the abolition of

exchange control in 1979, there was a consistent bias in the granting of exchange control permission against portfolio investment and in favour of direct. This bias was not justified; but neither is the present bias against direct investment justified - or even intended: it is just the unintended consequence of a tax discrimination that has never been properly thought through.

19. Although the main theme of this paper is tax discrimination against UK residents receiving dividends from profits earned abroad rather than at home, the problem goes wider. For example, it concerns the tax advantage of a US company buying a UK company over a UK company buying a US company; and the situation is still worse if the shareholder is resident outside the UK. Although double taxation treaties may provide for some repayment of ACT to some shareholders resident abroad, there is usually a withholding tax in such cases, with 15 per cent the most usual rate for portfolio investors. Foreign shareholders in non-treaty countries recover none of the ACT, and it would not normally be available for credit in their home country. The shareholder resident abroad will generally be subject to income tax in his country of residence, and the intent of the imputation system (that ACT should be an advance tax, as the name implies, and not a final tax) will be frustrated. This problem is important, not only at the level of the European Community (Section VII, below), but also more generally.

20. Tax prejudice against overseas income was a main theme of the Report from the Select Committee on Corporation Tax (House of Commons Paper 622, Session 1970-71) of the evidence submitted to that Committee[5]. Most of the considerations discussed at that time remain relevant; and since then the problem has become more pressing as the rate of corporation tax has fallen from 52 per cent to 33 per cent while foreign rates of corporation tax have in general fallen less rapidly. As is noted in paragraph 12, above, the problem of surplus ACT arises at present rates of tax if dividends are distributed out of profits taxed abroad at more than 10.67 per cent.

[5] In particular, pages ix, xviii. 19-20, 28-29, 54, 75, 85, 88, 104, 111, 134, 136, 145, 151, 183, 187, 221, 230, 236, 262, 272, 284, 289, 293.

III. OTHER FORMS OF SURPLUS ACT

21. Although surplus ACT on dividends from overseas income is the main focus of the problem at present and the main subject of the present paper, other forms of surplus ACT have been important in the past and remain important today (not least when companies maintain dividends that are not covered by current profits). Indeed, while companies still enjoyed stock relief and accelerated capital allowances on plant and machinery before the reform of corporation tax in 1984, a significant proportion even of companies with mainly UK earnings were paying little or no mainstream corporation tax year after year. This state of affairs acquired the name of fiscal exhaustion: its main consequences were that these companies could not absorb additional capital allowances (10 that depreciation on marginal investment was not tax-relieved) and that ACT on their dividends was a definitive or final tax and not an advance tax as its name implied. Another former source of surplus ACT was the rule that ACT could be offset only against mainstream tax on trading profits and not on capital gains; this was rescinded by the Finance Act 1987, though at the high price of taxing corporate capital gains at the full rate of tax on corporate trading profits.

22. At present, the main sources of surplus ACT additional to the payment of dividends .out of overseas income are restrictions on its use within groups (group relief) and restrictions on its use on change of ownership. As concerns group *relief,* surplus ACT is not particular to any trade or income source of the group, and there is no logical reason why it should not be freely transferable between different group companies, with the same rules on carry-back and carry-forward in the recipient company as in the transferor company, provided that both companies were members of the group throughout the relevant span of accounting periods. However, the present Government has resisted representations on these lines for many years and has introduced further restrictions (in Section 98 Finance Act 1989).

The argument for *losses* of ACT on change of ownership is similar. Virtually no business now can survive, let alone prosper, without making a single major change in six years in "the type of property dealt in, or services or facilities provided" or in its “customers, outlets or markets". Sections 768 and 245 Taxes Act 1988 are already lively restrictive in disallowing the carry-forward of losses and unrelieved ACT respectively in these circumstances following a change of ownership; and these restrictions have been further tightened (by Section 100 Finance Act 1989). For reasons explained in paragraph 22, above, the case for relaxation instead of further restriction is even stronger for ACT than it is for losses.[6]

24. It is also a cause for complaint that the present tax regime "devalues ACT by delay": the company should be able to set off ACT against the next mainstream

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[6] The Inland Revenue’s restrictive treatment of the use of surplus ACT and trading losses on a change of ownership was confirmed in a statement of Practice of 7th August 1991 (SP *10/91)* which "concerns existing interpretations and represents no change of practice".

payment of corporation tax instead of having to wait for the mainstream payment relating to the relevant accounting period.

25. The problem of surplus ACT, which is itself a derogation from fiscal neutrality, spills over into other areas and creates problems where none existed before. For example, a company repurchasing its own shares does so at an effectively much higher print if it has surplus ACT, although the presence or absence of surplus ACT is essentially irrelevant to share repurchase.

26 The solutions to the problem of surplus ACT in other forms overlap the solutions to the problem of surplus ACT through dividends from overseas income. These are discussed in Section IX, below.

IV. BEHAVIOURAL IMPLICATIONS

27. The implication of the argument in paragraph 16, above, and elsewhere is that business behaviour will be distorted: policy will be in large measure tax-driven, in other words, the actions and activities of the businesses concerned will be significantly different from what they would have been if the tax system had been neutral between different courses of action. Of the responses mentioned in paragraph 16, reducing UK dividends or their rate of growth is a classic example of what is known in the literature of public finance as "excess burden", the reduction of economic activity as a result of taxation. Increasing UK profits (for example, through artificial mergers) and reducing Inward overseas dividends are distortions of the pattern of economic activity rather than its volume: profits from domestic UK activities are given a fiscal preference over profits from foreign (and thus frequently export-related) activities; and among foreign, export-related activities the present tax system gives a fiscal preference to those whose profits are retained abroad over those generating inward dividends (and thus invisible exports) for distribution within the UK. The present tax system is thus biased against both visible and invisible exports. The Treasury's consistent refusal to reduce this bias particularly ironical given the large deficits on visible trade in recent years.

28. The most fundamental effect of tax prejudice on corporate behaviour is the effect, not just on the pattern of corporate activity, but on the location of the company itself. Mention has already been made of the emigration of numerous mining and plantation companies, for whom the British tax system has since 1965 been unacceptably harsh. The British Invisible Exports Council draw attention to the adverse effect of the UK tax system on the use of the UK as a location for the increasing number of international joint ventures being established nowadays; as a result of surplus ACT, the UK is not competitive with the Netherlands or Switzerland as a location for a holding company and is seldom seriously considered for this purpose. A large UK company with income mainly from overseas could avoid tax if dividends were paid to shareholders through a non resident holding company and has been actively reviewing possible routes with the aid of outside advisers. The routing of overseas dividends through an overseas holding company in order to achieve foreign-tax-rate averaging is compatible with the retention of the group head office in the UK; but this structure has been made less flexible by the 1984 legislation on controlled foreign companies -- a good example of how one fiscal 'distortion is used to remedy another. The Institute of Directors make the complementary point that within the European Community there is a major incentive for businesses to locate in the Member State from which they derive most of their income; we revert to this matter in Section VII, below.

29. Among practical examples of the effect of the tax system on corporate behaviour, Company A says: "We are the major supplier in the United Kingdom in our core business." Our growth will almost certainly come from overseas and our stated policy is to generate 30% of our profits in the United Kingdom, 20% in mainland Europe, 30% in the United States and 20% in the rest of the world. We

have achieved this spread in sales terms but not yet in profitability. When achieved this will give us, for business purposes, an enviable geographic spread for a business which is one of the world leaders in its field. The present UK tax system, however, will seriously disadvantage this strategy."

30. The response of company B to the problem of surplus ACT has been to repay UK borrowings and shift the balance of group activity away from overseas and towards the UK: House- building companies have been purchased and their profits released to reduce surplus ACT.

31. Company C reports that non-UK investors are discouraged from taking share holdings in UK companies with international operations, as compared with companies in countries with more beneficial tax regimes. The UK is also ruled out as a location for holding company and headquarters of newly-emerging international groups and joint ventures at a time of increasing globalisation of markets, the UK is unable to capitalise on the advantages which its existing status as a financial and business centre.

32. Company D says that its ability to offset ACT will increase only if there is an increase in UK profits as a proportion of worldwide profits. This would not be feasible, because the Company is already close to saturation in the UK in its core businesses, so to generate more UK profits would require branching out into businesses in which it hasno expertise. Nor would it be desirable: it cannot be in the interest of its shareholders or of the UK economy for the company to turn its back on the rest of the world, particularly in an era of increasing globalisation of markets. But work is progressing to devise a suitable formula which will allow a genuine and even-handed comparison between UK and overseas investment in terms of shareholder value; this is being incorporated in the procedures for project appraisal. The consequence is that, in appraising the economics of overseas projects, the company is at a competitive advantage by comparison with United States and other companies which do not have surplus ACT to take into account.

33. The *Times* carried the following comment on 8 April 1988:

> "With every year that passes, the more pressingly obvious it becomes that Burmah Oil badly needs to make a significant British acquisition."
>
> "Its unrelieved advance corporation tax mountain now stands at £23 million, and is still growing."

34. A merchant banker's note carried the following in June 1989:

> "The equity structure adopted in the proposed merger between SmithKline Beckmann Inc and Beecham PIc is intended to avoid the problem of irrecoverable ACT for a UK company with large non-UK interests."

V. MOTIVATION

35. The motives of businessmen in seeking the removal of tax prejudice on overseas income are clear: they seek a level playing field for the competition between domestic and overseas activity and an end to the present situation in which higher profits earned can yield a lower dividend in the UK than lower profits earned at home. The tax system should not be used as a surrogate for exchange control, as it is to some by the 1984 legislation on controlled foreign companies and offshore funds. The prejudice in the present system against dividend distributions out of foreign earnings is widely regarded as contrary to the spirit of the reform of corporation tax in 1984, with its attempt to restore fiscal neutrality between different types of corporate investment in the UK.

36. The Inland Revenue's attitude in evidence to the Parliamentary Select Committee in 1970-71 is summarised by the Committee as follows (paragraph 11):

> "The Inland Revenue do not see the problem as limited to companies trading overseas where the cost of reverting to the pre-1965 system would be in 1973 about £100 m.p.a. Shipping companies and companies which at any time, as a result of economic measures taken by the government, might receive tax concessions would seek similar arrangements for themselves. The Public Accounts Committee in 1964 drew attention to the fact that the then accelerated investment allowances resulted in the exempt shareholders of some companies enjoying them being able to claim repayment of tax which had in fact not been paid. This type of anomaly is always possible under a system which allows corporate relief to spill over into personal income tax. It could, when perceived, b. remedied, but only piecemeal, at the cost of complicating the tax code. The revenue want none of it."

37. This argument was restated in the Government's own words in the 1972 White Paper on Corporation Tax (Cmnd. 4955) which was in turn cited in paragraph 14.14 of the 1982 Green Paper on Corporation Tax (Cmnd 8456):

"Advance corporation tax and the shareholder's tax credit form the core of the now system; they are the essential link between the company's corporation tax and the shareholder's own tax liability. In this way a single rate of "imputation" can be applied to all distributions regardless of the effective rate at which the company is liable to tax. In its absence there would be difficulties where dividends are paid out of profits which, for one reason or another, have not borne UK corporation tax in full. Clearly it would be wrong in such cases to give the shareholder a credit for tax which has never been paid; and the Select Committee therefore regarded some such preliminary payment as an essential element in the imputation system.

> "For much the same reason a company's liability to pay advance corporation tax is not dependent on the company's liability to mainstream

corporation tax, and is not affected by any reliefs which can be set against mainstream corporation tax."

38. Recent discussions of surplus ACT with Ministers and the Revenue indicate a continuing pre-occupation on the government side with the holding of shares in the distributing company by "an exempt, tax-exhausted or foreign shareholder" (paragraph 14.19 of the 1982 Green Paper) who would escape all UK tax if ACT could be fully offset against mainstream tax (instead of being restricted, currently to 25/33rds; paragraph 12, above).

39. Moreover, although the avoidance of double taxation on distributed profits is claimed as an advantage for imputation in the UK context, it does not seem to be accepted by the Government as a valid objective in the international context. It therefore seems to be thought right that the shareholder should pay tax again, even .h the underlying profits have already been taxed by a foreign country.

40. Revenue objections to particular proposals for relieving surplus ACT centre on their distributive implications and the losses that some proposals might inflict on certain groups of taxpayers.

41. In response to paragraphs 36 and 37, above, it may be said that the Government isn't to repay tax never previously paid when it finds it convenient to do so: the repayment of tax never previously paid is an integral element of MIRAS (mortgage interest relief at source) and of life assurance premium relief at source. The repayment of tax never previously paid on dividends from overseas income is one of the available options.

42. In response to paragraphs 38 and 39, total exemption from UK corporation tax is on occasion the logical consequence of charitable status or relief from international double taxation.

43. In response to paragraph 40, provided that the no-loser principle is satisfied, distributive implications of the various solutions are of minor importance or even me: there are gainers from any tax reduction.

VI. MAGNITUDES

44. This section discusses the cost of relieving surplus ACT on dividends from overseas income. This cost varies with the solution adopted (Section IX, below) and also with the possibility of its extension to other forms of surplus ACT, and it cannot therefore be uniquely quantified; but it is possible to indicate orders of magnitude and to relate these amounts to the relevant financial variables, so as to put the cost in its economic context.

45. The yield of corporation tax was £2,859 million in 1974-5 (effectively the first year of new system), of which £1,129 million or almost 40 per cent was advance corporation tax. In the March 1992 forecast for 1992-93, corporation tax was put at £16.8 billion with advance corporation tax at £8.2 billion or about 49 per cent. Until recently, mainstream corporation tax has risen more rapidly than ACT as companies that were fiscally exhausted before the 1984 reform started to pay tax; this relationship has been reversed 1989-90 as companies maintained dividends despite falling profits (or reduced less).

46. When the yield of tax rises, the cost of reducing it rises correspondingly; but there is an element of optical illusion in this additional cost because the resources to pay this t are rising in parallel: the additional cost and the additional resources are one and lime thing. Conversely, if the yield is falling, the cost of reducing the tax falls corresponding; but this lower cost has to be borne by a falling revenue. This argument applies with particular force to the yield of corporation tax, which was ahead of forecast at the end of the 1980s and below at the beginning of the 1990s. Within the total, advance corporation tax was ahead of forecast in 1988-89 and 1989-90 and accurately predicted in 1990-1 and 1991-92.

47. One radical proposal for the removal of what is now called surplus ACT was costed by the Inland Revenue in 1970-71 at £100 million a year (Corporation Tax Select Committee Report, page 222). At present values this might amount to as much as £500 million a year; but the persistence over the intervening period of the problem of surplus ACT on dividends from overseas income has inevitably reduced the volume of such dividends that would have been paid under a less fiscally prejudiced system. (Sections II and IV, above). In addition, the oil companies are now UK taxpayers. A complete solution to the problem of surplus ACT on dividends from overseas income could for" reasons be expected to cost much less than £500 million, and partial solutions d cost substantially less again. (Section IX, below).

48. Another perspective is that, of the figure of £8.2 billion ACT forecast for 1992-3, the large majority is ACT on dividends from profits earned in the UK. Of the remainder, a large proportion is dividends on profits incurring little or no tax prejudice as a result of the Sterling Trust principle (Paragraph 12, above). These abatements from the total are compatible with a cost of much less than £500 million a year for resolving the problem entirely. The Inland Revenue have recently calculated that the cumulative total of surplus ACT is some £5 billion to £6 billion and falling: this figure includes surplus ACT in other forms. (Section

III, above). Professor Higson in The Problem of Surplus ACT (page 14) has put the total at the much lower figure of £3 billion, growing at £400 million a year, which implies costs of up to these amounts to the Exchequer. These figures are maxima and thus overestimates on their own terms, although they could be increased by behavioural changes.

49. Appendix B cites figures confirming this assessment. The aggregate of ACT debtors was £6.6 billion for quoted companies with financial years ending in 1991 (thus a more comprehensive sample), with an estimated £8 billion for all companies (including unquoted companies). The amount rose substantially between 1990 and 1991, although no year-by-year figure is given in Appendix B. A substantial but unquantified proportion of this total is ACT debtors other than surplus ACT; the cost to the Revenue of relieving surplus ACT would therefore be much less than these figures imply. The cost would also be reduced because the recovery of ACT written off in the past is often substantial and may even exceed ACT newly written off in the same period. In general, however, the Revenue are bound to gain, since surplus ACT precedes, and cannot be less than, any subsequent recovery. If the true cost were as much as £250 million a year, this would be about 1.5 per cent of the corporation tax yield or about one-sixth of a penny on the basic rate of income tax.

50. The benefit to the companies concerned of reducing or abolishing surplus ACT on overseas income would be larger than the cost to the Inland Revenue: much of the loss inflicted by surplus ACT is due to the necessity to provide in the accounts for its eventual write-off, and this liability yields no corresponding gain to the government, since the government keeps no accounts in a form in which such an item could be included.

51. The cost to the Revenue of most of the solutions specified below would be much reduced if they were made effective only after a period of years; the Excess Profits Tax post-War refund provides a precedent. If the Government introduced a reform and undertook to make the tax relief operative after a period of, say, 5 years, the incentive would be increasingly effective during this interval even though there would be no cost to the Revenue until the waiting period was over.

VII. THE EUROPEAN DIMENSION

52. Since the deliberations of the Commons Select Committee on Corporation Tax in 1970-71, the entry of the United Kingdom into the European Community and subsequent developments such as the passing of the Single European Act in 1986 have substantially changed the context in which the problem of tax prejudice must be discussed. Tax prejudice against dividends from overseas income is prejudice in favour of activities in the domestic market to the disadvantage of activities abroad. In the eyes of the tax system, the favoured domestic market is the UK market and the fiscally prejudiced activities are those in all other tax jurisdictions. But the logic of the Single European Act and the single European market is that the line is drawn elsewhere: the domestic market is the market of the twelve Community Member States.

53. This change of concept has not been assimilated into tax law either in the UK or elsewhere in the Community. UK tax law on this point remains nationalistic in the old fashioned sense. Nor has the European Commission, in its recent series of directives and draft directives on company tax harmonisation, addressed itself to this central question of tax compatibility[7]. The consequences of the persistence of fiscal nationalism in this area of policy within the European Community are spelt out by John Chown in his paper Company Tax Harmonisation in the EEC, published by the Institute of Directors in June 1989.

> "Under the tax systems of many EEC countries, including the United Kingdom and Germany, and certainly under the imputation system recommended as the base for harmonisation within the EEC, the total tax burden at company and shareholder level increases dramatically when the company passes the "prejudice point" -- beyond which it cannot entirely service its dividends out of profits which have borne tax in its home country. "It follows that, on present arrangements, such a company cannot really afford to diversify to the extent that its foreign profits are materially in excess of its domestic profits. So long as 'domestic' in this context means 'British' or 'Dutch' rather than community wide we cannot really have true European companies. The domestic markets of even the larger members do not exceed 20% of the whole Community market. This point is one of particular concern to smaller countries such as the Netherlands. It is of no concern at all to American and other third country parents."
>
> (Paragraph 24)

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[7] The proposed 1975 directive on the harmonisation of corporate tax systems (COM (75) 392 Final) would have gone a long way towards getting the right result: member states to adopt imputation systems; country of residence of the subsidiary to transfer the tax credit; country of residence of the parent to set the tax credit off against local distribution taxes such as ACT. (Especially Articles 10 and 13). However, these proposals for the cross-border recognition of tax credits were put forward as part of a package including other elements (notably the harmonisation of corporate tax rates) which were never acceptable to member states and are now out of date. Proposals for cross-border recognition have never been put forward by themselves.

Thus if a company follows a typical policy of distributing half of its profits in dividends, it starts to run into tax prejudice when its total profits in the rest of the Community surpass its profits from activities in its home country. Since even for the larger Member States the domestic markets do not exceed 20 per cent of the total Community market, this means that only 20 per cent or less of the rest of the Community market is exposed to commercial penetration on the same terms as the home market: the remaining 60 percent or more of the total Community market enjoys the company tax equivalent of tariff protection. For smaller countries, the domestic market is a smaller proportion of the Community total, and the proportion of the total Community market that is fiscally protected from competition from these countries is correspondingly higher, up to well above 90 per cent. The fact that this fiscal protection is not specific to particular countries conceals, but does not diminish, its economic reality: throughout the Community, the domestic markets of Member States are protected by corporation tax from competition from other Member States; this protection is higher for the larger Member States than for the sq1aller ones, and the level of protection encountered by exporters is higher for exporters from smaller countries than for exporters from larger ones. Thus fiscal protection through corporation tax (tax prejudice) discriminates doubly against smaller Member States. The European Commission has not so far reduced this market distortion against smaller Member States, although, at the time of writing it had just made proposals on the basis of the Ruding report. (Paragraph 55, below).

54. The declaration on economic and monetary union published on 27 June 1989 after the meeting of the European Council in Madrid gives the opportunity for governments of Member States to propose means of achieving economic and monetary union alternative to the proposals of the Delors report. This assessment remains valid after the signing of the Maastricht Treaty, whose future was uncertain at the time of writing as a result of the Danish referendum. The fact that under the Delors proposals true transnational European Community mergers continue to be impossible, and are likely to remain so, ought to be of interest to the European Commission as well as the business community. A major element in a free-market alternative to Delors, stressing competition and markets rather than regulation and tax-financed subsidy, is the removal of tax prejudice against competition from other Member States. Since this line of argument is conformable to general Government policy, it might even be supported by the Inland Revenue.

55. Chapter 10 of the Ruding Committee report on company tax harmonisation,

> (i) Member States which apply imputation taxes on the distribution of profits earned in another Member State should be obliged, on a reciprocal basis, to allow such tax to be reduced by corporate income tax paid in the other Member State in respect of dividends remitted by a subsidiary, or profits earned by a permanent establishment (Phase I);
>
> (ii) Member States with various forms of tax relief for dividends received by domestic shareholders from domestic companies should be obliged, on a reciprocal basis, to provide equivalent relief from dividends received by

domestic shareholders directly from companies in other Member States Phase I).

56. The Ruding Committee's recognition of the problem of surplus ACT is welcome. Much of the rest of the report is not; this assessment requires confirmation when the rest of the report has been studied in detail, but it seems unwise to respond to the problem of surplus ACT on the basis of a controversial report that may command little support among the business community. Moreover, the multilateral solution proposed by the Ruding Committee is unlikely to secure the necessary agreement of the member states, at least for many years, and policy based on this proposal could be a prescription for extended delay. In particular, the United Kingdom has for many years been more important as an outward investor than other member states of the Community, and it is only prudent to recognise that other member states may be unwilling to change their tax systems in order to accommodate what may be regarded as predominantly a UK problem. At least in the short and medium term, a unilateral UK solution is required.

VIII. WHAT ELSE IS NEW?

57. Section VII, above, explains that the argument for relieving surplus ACT on overseas income now has an important European dimension which did not exist when the Select Committee was deliberating in 1970-71 (and was ignored by the Corporation Tax Green Paper in 1982). But the argument has also been strengthened by other developments, both in the market place and in the evolution of Government policy.

58. Commercially, the main development of the last two decades is the increasing internationalisation of business. For an increasing range of goods and services the United Kingdom is not a separate domestic market but part of a world market. There have been parallel developments in corporate structure, with an increase in international mergers and joint ventures, and in shareholding patterns, with investors increasingly spreading their portfolios between different countries and companies finding an increasing spread between countries in their registers of shareholders. But there has been no similar development in the UK system of corporation tax, which makes the same sharp distinction between the UK and overseas markets that may have been realistic a generation ago but does not fit the circumstances of international trade today. John Chown's paper (paragraph 53, above) is an essay on this theme in the context of the European Community; but the logic of the argument extends to third countries as well. The UK should be arguing, as part of its alternative strategy to the Delors Report, not only for a system of corporate taxation within the Community that is neutral between the home Member State and other Member States, but also for a system that is outward-looking and non-discriminatory towards the rest of the world.

59. There have also been developments in UK tax policy since 1970-71 and even since 1982 that should make the relief of surplus ACT more acceptable to the Government now than it was then. The reform of corporation tax in 1984 has relieved or removed most of the problem of surplus ACT except for surplus ACT from overseas income. The 1984 reform was largely motivated by an animus against fiscal distortion of business behaviour; and surplus ACT on overseas income is now the principal remaining form of such distortion. Chancellor of the Exchequer Nigel Lawson set out in Tax Reform: The Government's Record (Conservative Political Centre, 1988) the rationale underlying the Government's support for the principle that the tax system should be even-handed between competing activities; and this principle of "a level playing field" is now in common currency and widely agreed, largely as a result of the words and deeds of Ministers of the present Government. Finally, as is noted in paragraph 41, above, the principle that there should be no repayment of tax without prior payment has been massively breached and is not in practice a serious influence on fiscal policy: there is no good reason why this breach should not be extended to the repayment of surplus ACT on overseas income when there are strong arguments for such repayment on other grounds. However, the repayment of surplus ACT is only one of a number of possible solutions to the problem, and it is the range of possible solutions that forms the subject of the next section.

IX. SOLUTIONS

60. The problem of tax prejudice against income from overseas goes back to 1965. The solutions have been intensively discussed, notably in the Select Committee Report of *1970-71* and the Corporation Tax Green Paper of 1982, to the point where the solutions are better understood in some quarters than the problem itself. The focus of the present paper is on the problem -- its importance and the urgency of finding a solution in one *way* or another. It is not the purpose of the paper to rehearse the sometimes technical arguments for or against the various solutions but rather to list the main proposals that have been canvassed for resolving the problem. Most of the proposals would command a broad measure of support, though not all of them would be acceptable to all the taxpayers affected.

61. Some of the solutions would or could serve to relieve other forms of surplus ACT (surplus ACT originating otherwise than in the distribution of overseas income). There are arguments for extending relief in this *way*, particularly as the cost of such extensions would be modest.

62. The problem of surplus ACT and its relief is intimately related to the method of relief from international double taxation. The UK method of relief through tax credit with specific or slice-by-slice limitation for each source of income is to be contrasted with two other main methods of relief - the exemption method (as in the Netherlands) and tax credit with overall limitation or averaging or pooling (as in the United States, at least until recently)[8]. The exemption method is not part of the general UK tradition of granting relief from international double taxation; but it is exemplified by the particular concession of tax-sparing or pioneer relief (whereby tax cuts for UK investment in

named developing countries are not matched by corresponding increases in tax levied in the UK). An extension of the exemption method is one of the possible long-term options for mitigating the problem of surplus ACT: in a system of cross-border recognition of tax credits, the right result would be obtained only if incoming dividends from overseas were treated as franked investment income. United States-style averaging of foreign tax rates is more favourable than specific

[8] A similar provision has recently been introduced in France. The Lower House adopted a government proposal to exempt French holding companies from the equalisation tax (33.33 per cent) on certain dividend distributions. Normally this tax is due if a French holding company redistributes dividends received from its subsidiaries. An exemption will be available when :- the holding of shares is the French company'., exclusive purpose; at least two-thirds of its assets consist of participations in foreign companies which have subsidiary status (generally" participation of 10 per cent or more of the subsidiary's capital); they must derive at least two-thirds of their income (exclusive of capital gain.,) from these foreign participations.

Only that part of the dividend distributed which is derived from the foreign participation will be exempt, but the distribution will not entitle the shareholder to the imputation credit (avoir fiscal). If the holding company distributes a dividend to a shareholder in a non-treaty country, the 25 per cent withholding tax will be increased to 50 per cent. (Tax News Service, 10 January 1990, International Bureau of Fiscal Documentation. Amsterdam).

limitation for companies with no surplus ACT (because averaging avoids the loss of relief on foreign tax rates in excess of the UK rate); but it can be less favourable under the Sterling Trust principle (paragraph 12, above) for companies with surplus ACT (because the Sterling Trust principle enables companies to avoid surplus ACT partially or entirely in so far as they distribute less than 100 per cent of their overseas income). The Sterling Trust principle is itself a valuable option, enabling companies to rank their sources of overseas income in the order they prefer; and this option could be extended and combined with averaging, so that companies could use specific limitation and Sterling Trust for their dividend distributions and averaging for their profit retentions.

63. The following proposals are all intended to increase fiscal neutrality in the sense explained in this paper. They reduce present fiscal discouragements to overseas investment and trading and the distribution of the income so generated; they do not go so far as to provide active encouragement to these activities or a distortion in the opposite sense. They are listed in a logical order and not in order of policy priority. A number of the proposals can be combined, and a list of this kind cannot be comprehensive. Most of the proposals could be adopted by the United Kingdom unilaterally, and this may in practice be the only way of making progress in the next few years; a multilateral solution might well take many-years to realise.

64. The four categories of UK shareholders affected or potentially affected by surplus ACT are: (1) UK resident individuals; (2) UK resident gross funds (with entitlement to a total refund of imputation credit); (3) foreigners entitled by treaty to a refund of imputation credit; (4) foreign investors not entitled to such a refund. Category (1) is more deserving than (2) because almost all the individual taxpayers concerned are paying income tax at the basic rate or above and therefore use the tax credit as credit only, whereas gross funds, as non-taxpayers, use the credit to reclaim tax from the revenue. Some reforms could have the side-effect of giving foreigners in category (3) an artificial incentive to receive payments of third-country dividends out of third-country profits through the United Kingdom. By contrast, in category (4), the Revenue is clawing back ACT in circumstances' in which it is not required to grant even an imputation credit, much less a refund. The following solutions have been put forward with the foregoing order of priorities in mind.

A special category of company

65. The present system could be retained for the generality of companies but ameliorated for a special category of company "International Trading Company", for example holding companies of groups more than half of whose turnover comes from outside the UK. The relief for the special category of company could be one or more of the reliefs listed below, others of which could be extended to companies in general (including the special-category companies). Overseas Trade Corporations provide a precedent for companies with a special fiscal status. This solution is most appropriate for pure holding companies owned almost entirely outside the United Kingdom; it is less appropriate' in so far as

there are UK resident shareholders.

A special rate of tax

66. Under the pre-1965 system, shareholders who were liable at less than the standard (or basic) rate of income tax on their dividends had their repayments restricted to the "net UK rate" of income tax which these dividends had borne: the higher the tax paid abroad, the higher the tax credit in the UK and the lower the net UK rate and the lower the maximum repayment. This was a finely-tuned method of avoiding the problem, or alleged problem, of the repayment of tax not previously paid: any such repayment was avoided for every company, every shareholder and every dividend. It was the abolition of the net UK rate in 1965 that created the problem of tax prejudice against income from overseas. A limit on the rate of repayment might seem to inflict losses on exempt taxpayers; but any such losses are more apparent than real. The reduced rate of repayment would apply to a correspondingly higher dividend; and in any case, exempt taxpayers are not obliged to invest in the shares concerned. During the regime of the net UK rate, it was little criticised by gross funds. Similar considerations apply to paragraphs 67-69, below.

67. It would be possible to have a system in which repayment was limited, not by company, but in terms of some aggregate. Thus, for companies not covering their dividends out of UK profits or foreign profits enjoying relief on the Sterling Trust principle (paragraph 12, above), repayment might be limited by the proportion of exempt shareholders to taxable shareholders. This would be a partial analogue of the former "composite" rate of tax levied on banks and building societies, since it would ensure that the Exchequer would not lose in aggregate as a result of repayment claims; but, by contrast with the "composite-" rate, which permitted no repayments at all, the lower rate of repayment for exempt taxpayers would reflect their relative importance. In terms of Table 1, columns (1) and (2), surplus ACT of 16.75 would not be levied, because foreign tax would be creditable against ACT. The gross dividend would be 89.33 if there were no exempt taxpayers, but it would be lower as the proportion of exempt taxpayers increased: the gross dividend would be 82.46 where a quarter of the shareholders were exempt taxpayers and the tax credit was limited to 18.75 per cent of 82.46 or 82.46-67; the gross dividend would be 76.57 where half the shareholders were exempt taxpayers and credit was limited to 12.5 per cent of 76.57 or 76.57-67[9].

68. These gross figures would apply only to taxpayers claiming repayment. But this raises the question of the extent to which a UK individual would be able to claim a credit in respect of such dividends against his own tax liability. Even if the right to repayment of the credit was limited to the net UK rate, there could be a problem as far as foreign shareholders are concerned. Their entitlement under a treaty to repayment of a tax credit is dependent upon the amount of the tax credit that a UK resident individual receives. Even though the amount of the tax credit repayable to such an individual might be limited by the net UK rate, the

[9] 18.75 per cent is three-quarters of 25 per cent and 12.5 per cent is half of 25 per cent

credit against this income tax liability would still be the full basic rate liability.

Franking credits system

69. It would also be possible to operate the imputation system on the Australian or New Zealand basis with a franking credits system. The company would be subject to corporation tax in the normal way, so bringing into charge any UK-source income and foreign income to the extent that it was not covered by foreign tax credits. Dividends paid by the company would, however, carry a tax credit only up to the amount of UK corporation tax paid by the company.

Two classes of dividends

70. Paragraph 66, above, discusses the restoration of the net UK rate, which would vary from company to company and would be the basic rate of income tax for companies with no dividends distributed out of overseas income. Paragraph 67 discusses a rate of tax credit and repayment that would be less than the basic rate of income tax but the same for all the dividends concerned.

71. A variant of the idea in paragraph 67 is that the rate of ACT, of tax credit and of tax repayment should be nil. This regime could be confined to International Trading Companies or made more generally available. The company would be able to elect that ACT should not be paid in relation to the whole or any part of its dividends; the election should apply to the whole of any particular dividend but could be varied from one dividend to another. If ACT were paid, the dividend would be taxed as at present in the hands of the shareholder. If no ACT were paid by virtue of an election:

(i) the dividend would not be a qualifying distribution for the purposes of Section 14 Taxes Act 1988;

(ii) no entitlement to tax credit would therefore arise under Section 231 and Section 232 Taxes Act 1988 or under most double tax treaties, neither would any withholding tax be levied on payments to non-residents;

(iii) UK resident individuals liable to a higher rate tax would pay the difference between higher and basic rates (compare the treatment of stock dividends under Section 249 Taxes Act 1988).

This would eliminate the double taxation of income arising outside the UK and passing through the UK to a non-resident shareholder (the fourth of the four categories in paragraph 64, above).

Stapled stock

72. In Spring 1991 an oil company was planning to offer shareholders redeemable preference shares in a subsidiary "stapled" to its own shares. Investors would have been able to opt to receive a dividend payment from the subsidiary rather than from the company. There would have been no cash incentive for shareholders to accept the subsidiary shares; but the company would have ended up saving money by offsetting the advance corporation tax payments against the subsidiary's tax liabilities. This plan was frustrated by a Ministerial Statement of 2 May (Inland Revenue Press Release of that date), which foreshadowed section 66 Finance Act 1991. The company said that it was "just trying to prevent the double taxation of dividends"; if the government had not introduced retrospective legislation, earnings per share could have increased by 2p. The Government said that it was introducing legislation "aimed at preventing the circumvention of the corporation tax ring fence".

Increase in the ACT offset limit

73. Another possibility is an increase in the ACT offset limit (currently 25/33 of the corporation tax bill, the numerator and denominator being explicitly linked to the income tax basic rate and corporation tax rate respectively). This can be insufficient, since the corporation tax bill is based on taxable profits while ACT is a function of dividends which are based on accounting profits; and these measures of profit normally differ. In any case, an increase in the ACT offset limit, while reducing the tax burden on corporations as such and on distributions out of their income, would primarily benefit distributions out of domestic income.

Offset of foreign withholding tax against ACT

74. It would also be possible to permit UK companies which receive dividends from foreign subsidiaries to offset any withholding tax on the foreign dividends against ACT. Underlying foreign tax would continue to be credited against mainstream tax.

Overseas income and UK capital allowances

75. At present, the problem of surplus ACT on overseas income is aggravated if the company has unused UK capital allowances (whether as a result of adverse current trading conditions or exceptionally rapid expansion). If ACT on overseas income were repayable to the extent that a company had unused capital allowances, this would serve not only to relieve surplus ACT on overseas income but also to achieve the purpose for which capital allowances were introduced.

Surplus ACT and double taxation relief (DTR)

76. Section 53 Finance Act 1984 (deferred from the Finance Bill 1983) was a limited and belated rather than a radical step towards fiscal neutrality as between income earned by companies overseas and income earned in the UK. Allowing double tax relief to be deducted from a company's income before offset of ACT (as recommended by the Ruding Committee) helps the company with an occasional problem of DTR which would otherwise be lost. For the company which always derives the majority of its income from overseas and which, being quoted, must maintain regular dividend payments to its shareholders in the UK, section 53 merely replaces surplus DTR which is immediately lost by surplus ACT which, although it can be carried forward indefinitely, still has to be written off immediately because there is no prospect of there ever being sufficient mainstream tax liabilities against which to offset it.

77. Where a company has insufficient profits to absorb all the double tax relief available and also has surplus ACT not otherwise recoverable, it could therefore be allowed to claim repayment of that surplus ACT up to the amount of DTR not utilised under section 100 (6) (b) FA 1972 (now section 797 (4) (b) TA 1988).

78. A complementary relieving provision would be to extend to unused DTR the same facilities for carry-forward as are already available for surplus ACT.

79. The reform in paragraph 77, above, treats the surplus foreign tax credit as if the credit were United Kingdom corporation tax. It thus raises questions about the allocation of tax revenues between countries. For reciprocation with the UK's trading partners, this would require recognition by other countries of the UK's taxes against their own, and this in turn would require renegotiation of the UK's double taxation treaties. Within the European Community, this might be best achieved by agreeing national shares of the total tax taken from income and profit flows across internal EC frontiers. (John Chown has suggested 2/3 for the country of source and thus 1/3 for the country of residence; but these are arbitrary proportions).[10]

A market in surplus ACT

80. It was noted in paragraph 23, above, that the present tax treatment of ACT on a change of ownership is excessively restrictive. The logical conclusion of this line of argument is that surplus ACT should be freely marketable; in other words, companies should be able to buy and sell surplus ACT which would be usable by the buyer in accordance with his circumstances. This is a variant of the general argument for a market in corporation tax losses, which has long had its

[10] *Company Tax Harmonisation in the European Economic Community* (with William Hopper), Intertax, 1982; *Imputation System - an Overview*, Journal of Strategy in International Taxation, 1986; *Company Tax Harmonisation* in *the European Community*, Institute of Directors, 1989.

advocates[11].

A unilateral UK solution at the level of the European Community

81. Finally, it would be possible for the UK to take unilateral action to set up a model system on its own, which would involve treating as eligible for ACT credit corporation tax borne not only in the UK but also in other Member States. Unless other countries followed, there would be a net cost to the UK Exchequer; the offsetting benefit would b that the UK could become the ideal location for independently quoted Communitywide and other international holding companies.

[11] Barry Bracewell-Milnes: *A Market in Corporation Tax* Losses, Institute of Directors, 1983.

X. CONCLUSION

82. This paper has discussed the twenty-seven-year-old problem of what is now called surplus ACT, caused by the abolition of the net UK rate on the introduction of corporation tax in 1965. The problem of surplus ACT has hardly been mitigated over this period, and for some companies it has become even worse. The problem is also a serious one for the UK economy, since it distorts behaviour and inhibits exports.

83. Section IX, above, lists a number of possible remedies, some going further than others. The 1993 Budget should start making serious inroads into the problem of surplus ACT by adopting those proposals most acceptable, or least objectionable to the Government. The strongest proposal would seem to be the net UK rate; alternatively, there would be many advantages in establishing a market in surplus ACT through the reduction or preferably removal of the present fiscal obstacles to its sale and purchase.

84. The recognition of the problem of surplus ACT in the 1992 Budget speech should be rapidly followed by action on the part of the Treasury. The problem has been well known for twenty-seven years, and major improvements in the present system should be announced not later than the Budget speech of March 1993.

85. The initial response to the Ruding Report confirms that it is likely to be a long time before agreement on the solution of the surplus ACT problem can be obtained at the level of the European Community; and, even if agreement could be obtained, the problem would remain for relations with third countries. Given the historic importance of the United Kingdom as an outward investor, it would be unwise as well as unnecessary to wait for agreement with other countries. The United Kingdom should act unilaterally.

APPENDIX A: Excerpt from the Budget Speech, 10 March 1992

Over the last year I have received many representations about surplus advance corporation tax. ACT is paid by companies when they pay dividends. It serves two purposes - first, to discharge the shareholders' basic rate income tax liability, and second, as a payment towards the company's own corporation tax liability. But some companies paying dividends out of foreign profits taxed abroad find that they are now paying more ACT than they can set against UK tax.

This is a significant problem for those affected. But it is also highly complex, and huge amounts of revenue are potentially at stake.

A satisfactory and lasting solution will need to address the ways in which different national systems of corporation tax interact. This is currently the subject of a review sponsored by the European Commission, and it is clearly an issue to which the government will have to return.

APPENDIX B: Advance Corporation Tax Magnitudes From Company Figures

Advance Corporation Tax - the Quoted Companies by Robin D Joyce was published in September 1992 by Leigh Philip Publishing Limited (11/13 Young Street, Kensington, London W8 5EH, telephone 071 938 1951). The present appendix is based on the findings of this publication (ACT /QC), to which the reader is referred for further details.

By contrast with the Inland Revenue, Professor Higson and others, ACT /QC disclaims any attempt to quantify surplus ACT. '1t soon became clear that it would not be possible to quantify surplus ACT. Too many companies have either written back ACT (previously written off as surplus) or written off ACT previously not considered as recoverable we have therefore provided the combined ACT figure, incorporating both the elements considered by the boards of directors to be surplus and the element considered recoverable. Future acquisitions or disposals could radically affect the recoverability of ACT" (Page 7). This combined ACT figure is described as *ACT* debtors.

The aggregate of ACT debtors for UK quoted companies (almost 2,000 in number) rose by 27% from £5.2 billion in 1990 to £6.6 billion in 1991. (Financial years ending in the calendar years concerned). Over the same period profit before tax fell by 12 per cent and the total tax charge by 14 per cent. Thus in a period of recession or slump, ACT has become both a much more important charge on pre-tax profits and a much more important component of the tax on those profits.

To calculate the total amount of ACT debtors for all companies, the unquoted companies must be added to the total of £6.6 billion. ACT /QC would expect "a total, for all UK companies, quoted and unquoted, of about £8 billion". This is an interest-free loan to the government and a corresponding burden on the companies concerned; the burden is all the heavier since these companies are concentrated in certain sectors and all the more damaging since these companies are disproportionately strong as exporters and generators of dividends from overseas.

These results were representative of British business and industry in general. The five subsectors with the most ACT were oil and gas, conglomerates, banks, chemicals and motors. The five sub sectors with the least ACT were merchant banks, life assurance, insurance brokers, investment trusts, contracting/construction. The five sub sectors with the highest surplus ACT (or surplus ACT for the longest period), in the sense of ACT divided by the tax charge, were composite insurance, water, contracting/construction,

textiles, conglomerates. 31 out of 35 sub sectors had an increase in ACT debtors between 1990 and 1991; ACT is a growing problem for most subsectors.
These findings are consistent with what the Adam Smith Institute has found in discussions with individual companies. The policy recommendations of ACT / QC are also consistent with those of the present paper.