REGIONAL DEVELOPMENTS

United Kingdom*

I. The New System of U.K. Dividend Taxation

On March 16, 1993, the Chancellor in his Budget Statement and in an Inland Revenue Consultative Document announced proposals for some highly significant changes in the U.K. system of taxation of dividends. The overall effect will be to increase the tax revenues from the earning and distribution of corporate profits (albeit with some alleviation of the burden of tax on those companies at present incurring surplus advance corporation tax (ACT)) at the expense of certain categories of shareholder, in particular pension funds and other tax-exempt institutions, U.S. and other foreign investors in the United Kingdom, and U.K. individual shareholders and trustees who pay tax at rates above the basic rate or who are below the basic rate threshold. The net after tax return to such investors will be correspondingly reduced.

The United Kingdom introduced ACT in 1972 as part of the far-reaching reform of the corporate tax system under which an "imputation system" came into being. An imputation system tries to reduce the problem of double taxation by giving shareholders a credit for tax paid by the company. Under the U.K. system, when a company pays a dividend it accounts to the Inland Revenue for ACT. The ACT not only serves as an advance payment on account of the company's own tax liability, it also franks part of the shareholder's tax liability. In practice the U.K. system does not completely solve the problem of double taxation because the difference in rates between ACT and corporation tax gives rise to unused ACT credits or "surplus ACT."

*Prepared by Clifford Chance, London.

A. New ACT Rates

The rate of ACT will be reduced from the 1992-93 rate of $1/3$ of the dividend (25 percent of the grossed-up dividend), to $9/31$ of the dividend in 1993-94 ($22\frac{1}{2}$ percent of the grossed-up dividend) and again to $1/4$ of the dividend in 1994-95 (20 percent of the grossed-up dividend). The effect of the reduction in the rate of ACT will be to reduce the cash-flow cost to companies of paying dividends. The reduction in the rate of ACT will also reduce the amount of new surplus ACT created in the future. At the same time, however, it will slow down the speed at which surplus ACT being carried forward from past years can be utilized, as discussed below.

The principal losers as a result of this change in the rate of ACT will be gross funds and foreign shareholders. Certain shareholders, such as pension schemes, companies carrying on exempt insurance business, and charities, are exempt from tax on dividend income and are entitled to recover an amount equal to the ACT credit from the Inland Revenue. Similarly, foreign shareholders may be entitled under the provisions of a relevant double tax treaty between their country of residence and the United Kingdom to recover part of the ACT credit from the Inland Revenue.

Usually, the rate of ACT applicable to dividends paid in any tax year exactly matches the tax credit available to shareholders. However, during 1993-94, exceptionally, the rate of ACT and the rate of tax credit will be different. Although ACT will be payable at a rate of $22\frac{1}{2}$ percent of the grossed-up dividend, the tax credit for shareholders will only be 20 percent. It may seem paradoxical that reducing the rate of ACT should increase the overall rate of tax on dividends, but this is the true effect. The reason is that the ACT payment and associated tax credit satisfies the tax liability of both the company and its shareholders; by reducing the size of this dual purpose payment the Chancellor increases the proportion of distributed profits that are effectively taxed twice.

B. The Surplus ACT Problem

The United Kingdom's ACT regime would work well if the economy were a closed system, but problems arise when the system has to cope with income received from abroad. This is the principal cause of companies' having to pay surplus ACT. Other causes include differences between a company's taxable profits and the profits it recognizes in its accounts as being distributable to shareholders, and the fact that a company may from time to time pay dividends that cannot be fully covered by current income.

C. Foreign Source Profits

The principal victims of the failures of the ACT system are those successful U.K. companies that have invested profitably abroad. ACT can be offset only against their U.K. corporation tax liability and not against their overseas tax liability.

D. What Can Be Done with Surplus ACT?

Surplus ACT can be carried back and set against the company's U.K. tax liabilities for the previous six years, and it can be carried forward indefinitely. However in many cases, particularly where the company regularly has a high proportion of foreign source profits, the problem is not restricted to a single year, but is a permanent feature, so that surplus ACT represents an absolute, and not merely a cash-flow, cost to the company.

This result encourages companies to make strategic decisions influenced more by tax considerations than by underlying business reasons. To that extent, it distorts the corporate decision-making process. As an example, companies with surplus ACT problems may try to reduce their overseas profits and increase their U.K. taxable profits through such tactics as moving cost centers (such as design and research and development) abroad.

The problem of surplus ACT also discourages overseas companies from using the United Kingdom as a base for their international, particularly European, operations, since profits arising in other countries that are channelled through the United Kingdom before being paid on to foreign shareholders suffer a high overall rate of tax because of the ACT system.

In this year's Budget the Chancellor announced measures to try to relieve the burden of surplus ACT in the British economy. Three aspects of the Government's proposals, although linked together, need to be considered separately: new rates of ACT; new anti-avoidance provisions; and foreign income dividends (FIDs).

1. *The New Rates of ACT*

The new rates of ACT have already been discussed above. These will help alleviate the surplus ACT problem by reducing the rate of build-up of surplus ACT in the future, but they do not go to the root of the problem by preventing surplus ACT arising at all.

2. *New Anti-avoidance Provisions*

A group with a surplus ACT problem used to be able to mitigate it by buying a target company with "mainstream corporation tax capacity." Such a company had realized profits and paid mainstream corporation tax in previous years, but had not made use of the maximum ACT offset. In the Budget the Chancellor announced new anti-avoidance provisions to end this type of tax planning. The new provisions took effect on March 16, 1993.

3. *Foreign Income Dividends*

The Inland Revenue has issued a Consultative Document proposing a new optional treatment for dividends paid out of foreign source income. Any company that chooses to do so could pay a special dividend called a Foreign Income Dividend or FID. When the company pays the FID it would account for ACT in the normal way. When the company calculates its overall tax liability at the end of the year, however, if it can show that the FID has been paid out of foreign source income, any surplus ACT that arises as a result of the FID would be repayable by the Exchequer.

The quid pro quo is that although a shareholder who receives an FID will be treated as receiving income on which basic rate income tax has already been paid equal to the grossed-up amount of the dividend, the shareholder will not be able to recover the ACT paid in respect of the FID. This result predominantly affects gross funds and foreign shareholders.

Foreign shareholders resident in a country that has a double tax treaty with the United Kingdom are likely also to be affected. The treaty will often allow them to recover a part of the ACT from the Inland Revenue in respect of a conventional dividend. But they will not be able to recover any of the ACT initially paid in respect of an FID.

The FID proposal offers a neat solution to a problem that has bedeviled the British economy for many years. Nevertheless, it will have practical difficulties. Most importantly, a company may find it difficult to calculate accurately, at the time it pays a dividend, whether it will have sufficient overseas profits to be able to justify paying the dividend as an FID. If the company miscalculates, and declares the FID at too high a level, it will not be able to recover the whole of the attributable surplus ACT in that year. The Consultative Document suggests that excess FID could be carried forward to the next tax year, but no further.

E. International Holding Companies

The current ACT system makes the United Kingdom an unattractive location for intermediate holding companies for non-U.K. based multinational groups. Since all or most of the income of such a company would be foreign source and carry foreign tax credits, ACT paid in respect of onward distributions to the ultimate parent company would largely constitute surplus ACT, thereby imposing a significant U.K. tax cost on the routing of dividends through the United Kingdom. This feature of the U.K. tax system means that the United Kingdom may fail to attract or retain international business that would be based in the United Kingdom if the location were judged on commercial considerations alone. The Consultative Document states that if the Government decides not to pursue a general FID scheme, it will nevertheless introduce in the Finance Bill due to be published in January 1994 (following the first Autumn Budget) a special scheme for international headquarter companies on the following lines.

In order to encourage multinational companies to locate their international, in particular European, holding companies in the United Kingdom, the Chancellor is proposing to apply a modified version of the FID scheme to international holding companies. To qualify for the modified FID regime a company would have to be at least 80 percent owned by no more than five non-U.K. shareholders. The advantage of this modified regime would be that such companies would be able to pay FIDs without incurring the cash flow cost of having to account for ACT and subsequently recovering it from the Inland Revenue.

The Government's recognition of the importance of encouraging the use of the United Kingdom as a headquarters location is welcome. Certainly the removal of the principal disadvantage in the U.K. system to basing international holding companies in the United Kingdom should at least prompt more detailed consideration of the benefits of using the United Kingdom for this purpose.

II. Interest Payable Within Multinational Groups

Over recent years tax planning that exploits the mismatch between U.K. tax rules on the taxation of interest and the rules in most other major European jurisdictions has generated considerable interest. The general rule in other jurisdictions is that interest is taxed (or a tax deduction for the payer is given) on an accruals basis—the interest that has accrued during a tax year enters tax computations rather than the amount of interest that has actually been paid. The United Kingdom follows this rule for interest paid to or from trading companies, but has a different rule for "investment" companies. Such companies pay tax on interest only when they receive it, and obtain a tax deduction only when they pay interest.

Over the last few years a practice has grown up of financing group companies in other European jurisdictions through an intermediary investment company located in the United Kingdom. The abuse arises when the U.K. company is funded by borrowing in the United Kingdom: it can obtain an immediate tax deduction for its funding costs, without recognizing its own income until a payment is actually made. The new rule is that interest, and sums equivalent to interest such as discounts, will now be taxed on an accrual basis.

III. Leasing

Action has been taken to remedy the loophole in the rules that allowed a U.K. lessor first to lease assets to a U.K. resident lessee for four years and afterwards to lease it to a nonresident. The full rate of depreciation will now be jeopardized if assets are leased to non-U.K. residents for the purposes of a trade carried on outside the United Kingdom at any time in the first ten years after acquisition.

On the positive side an anomaly in the U.K. VAT treatment of leasing is removed with the extension of zero-rating for VAT purposes to equipment and spare parts for ships and aircraft. Until now (and unlike most other European Community countries) U.K. suppliers of ships and aircraft have had to charge VAT on spare parts, which in the case of aircraft engines can be a substantial charge.

IV. Change in Residence Rules for Visitors to the United Kingdom

One point that may be of interest to nonresidents is that the United Kingdom has removed a technical peculiarity in the interpretation of the law on residence for tax purposes. The previous position was that individuals who, although only temporary visitors to the United Kingdom, had accommodation available for their use in the U.K. would be treated as resident for tax purposes if they stayed there for even one night in the course of a tax year.

In the future the availability of accommodation will be ignored in deciding whether an individual is a U.K. tax resident. Individuals will be treated as resident in the United Kingdom if they reside in the United Kingdom permanently or with an intention to stay for at least three years, or if they are present in the United Kingdom for 183 days or more in any one tax year, or if their visits to the United Kingdom average at least three months a year over a four-year period. These rules remain unchanged.

V. North Sea Oil Taxation

The Government has proposed a major overhaul of North Sea oil taxation, principally by abolishing the system of Petroleum Revenue Tax (PRT) for new fields, although it will continue to apply to existing fields. The main change is the introduction of a dual PRT regime that distinguishes between (i) fields given development consent on or after March 16, 1993 (nontaxable fields) and (ii) others (taxable fields). The Inland Revenue is also introducing legislation to ensure the proper allocation of expenditure between taxable and nontaxable fields.

VI. Foreign Exchange Gains and Losses

The Finance Bill 1993 has introduced extensive legislation on the taxation of foreign exchange gains and losses. The commencement date of such legislation will be determined by further provisions to be announced. In essence, the new system involves recognizing gains and losses on monetary assets and liabilities in taxable profits computations on an accrual basis. The final provisions of the legislation are as yet unclear, however, since a number of significant amendments have been set down for consideration during the committee stages of the bill.