Effective Tax Rates on U.K. and Foreign Income -The Impact of the U.K. Budget Proposals

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Introduction[1]

THE problem faced by United Kingdom companies of surplus advance corporation tax (ACT) is well documented.[2] In a bid to address the problem, the Chancellor proposed some changes to the system of advance corporation tax in the Spring 1993 Budget. The first was to reduce the rate of imputation from 25 percent to 20 percent Although this does not affect the threshold at which surplus ACT arises, it reduces the tax prejudice against foreign income by imposing an additional tax burden of 5 percent on income distributed by unprejudiced companies. The second was to establish a special tax regime for foreign-owned international companies. The third was to allow firms to nominate a distribution as a "foreign income dividend" (FID). Surplus ACT firms can recover the ACT on FIDS, but these do not carry a tax credit, which ensures that there is still substantial tax prejudice against foreign income for United Kingdom tax exempt investors.

This paper considers the tax implications on United Kingdom companies and United Kingdom investors.[3] Although the FID option reduces the average tax rate of prejudiced companies, tax exempt investors will lose their tax credit on any FID distributions. At the corporate level the FID appears to be a potential solution to the surplus ACT problem. However, tax exempt investors are the majority group in the ownership of United Kingdom listed equities and it is likely that they will favour ordinary dividends over FIDS, even in the instance that the company is prejudiced.

The United Kingdom Imputation System

In the United Kingdom, when a company makes a distribution, advance corporation tax must be paid to the Revenue. This ACT can be offset against the company's mainstream corporation tax so does not, in principle, represent an incremental payment of tax for the company. The ACT is payable shortly after the end of the quarter in which the dividend distribution is made, in contrast to the payment of

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[2] Amongst the many which have discussed this problem, recent papers are Chown, “International Aspects of the Imputation System” [1993] B.T.R. 289; Higson, “The Problem of Surplus ACT” (LBS/100 Group, 1991); Chown “Company Tax Harmonisation in the EEC” (Institute of Directors 1989); Bracewell-Milnes “A Tax on Trade” (Adam Smith Institute, 1989).

[3] We consider the primary tax costs using broad assumptions to create a tractable problem. We focus of corporation tax and do not evaluate other taxes such as VAT or capital gains

corporation tax which is paid normally nine months after the end of the fiscal year. The payment of ACT carries a tax credit to shareholders who are imputed with basic rate tax on the dividend gross of the ACT and are only liable for further tax if they are taxable at the higher rate. Those shareholders whose marginal tax rate is lower than the tax credit are eligible for a tax refund from the Inland Revenue. The United Kingdom imputation system is "partial" in that the imputation is at a rate which is less than the corporate tax rate. "Full" imputation requires a pound for pound offset.[4]

The offset of ACT against the corporate tax liability is limited to the ACT on a full distribution (dividend plus ACT) of the company's United Kingdom taxable profit. The ACT paid beyond this level is "surplus." There are significant carry-back and carry-forward provisions for surplus ACT: it can be carried back six years or carried forward indefinitely to offset against future mainstream liabilities. But until it is recovered the ACT becomes an additional tax-the investor still receives a tax credit but the company has to purchase it out of taxed income.

The United Kingdom operates a tax system which, in principle, imposes a tax burden on corporate income that is in the middle of the range for developed countries.[5] But beyond the offset limit for ACT the United Kingdom corporate tax switches at the margin to a classical system. Double-taxation of corporate income re-enters the picture, in the form of surplus advance corporation tax on distributed income, and implies a sharply higher effective tax rate at the margin. In effect the United Kingdom operates a dual system which provides an allowance of income which may be taxed with imputation. Beyond this, income bears classical double-taxation.

Surplus ACT arises in two ways. It arises in a *domestic* setting when a company's taxable profit is less than the gross dividend it wishes to distribute, perhaps because it has low accounting profits in the period but is maintaining its payout, or because, whilst it is basing payout on accounting profit, taxable profit is reduced by allowances. From the late 1970s to the mid 1980s many United Kingdom companies reported low or zero United Kingdom taxable profits and surplus ACT was prevalent.[6] In that period the widespread surplus ACT was caused by tax exhaustion generated by a combination of depressed corporate profitability and generous tax write-offs for investment in fixed capital and inventories. Tax exhaustion masked an underlying structural source of surplus ACT in the balance between United Kingdom and foreign earnings. Surplus ACT arises in a *multinational* setting since, though a United Kingdom multinational will typically base

[4] France and Ireland also operate partial imputation, while Australia, Germany, Italy and New Zealand operate full imputation. In the U.K. the imputation rate has been 25 percent, and the corporate rate 33 percent "Small companies" have a corporate tax rate of 25 percent so there has effectively been full imputation for small companies.

[5] "Taxing Profits in a Global Economy" (OECD, 199 1). This report estimates the average burden of tax on company income in different member states. This is done under necessarily limiting assumptions, and unfortunately does not model the effects oftax prejudice and surplus ACT on effective tax rates.

[6] See Higson "Estimates of Effective Corporate Tax Rates for UK Companies" (LBS IFA working paper 15 1-91, July 1991).

its dividend on consolidated worldwide earnings, the resulting ACT may only be offset against tax on UK income.

In this article we concentrate on the surplus ACT which arises in a United Kingdom multinational setting. This approach assumes that a United Kingdom company *does* make taxable profit, but that the level of dividend distribution exceeds the combined ACT capacity of the United Kingdom income and that (often small) proportion of overseas income which is available for ACT offset. This proportion depends on the relative levels of United Kingdom and overseas corporate tax rates.[7] The United Kingdom relieves international double taxation using the "credit" system,[8] which means that when the overseas rate is higher than the United Kingdom rate there is zero capacity for ACT relief.

The distortion caused by surplus ACT in the United Kingdom is more acute than in other European countries which have similar potential for the generation of double taxation on foreign c earnings. Coupled with the decline in United Kingdom tax rates compared with other developed countries, United Kingdom companies generally have relatively high levels of international investment and relatively high payout ratios. Further compounding the problem, the 1984 reform permitted firms to take double tax relief before offsetting ACT.[9]

The 1993 Budget Reforms

The United Kingdom Exchequer is reluctant to implement any changes which would reduce tax 51 revenues too significantly. The Inland Revenue's consultative document[10] (para. 8) emphasises that "no other country with an imputation system is prepared to put significant amounts of its own tax revenue at stake by relieving the sort of international double charge that can be involved when there is surplus ACT." The importance of ACT to the United Kingdom Government's tax revenues must not be underestimated. Not only are the timing of ACT payments beneficial to the tax authorities (coinciding with dividend payments, whereas mainstream corporation tax is payable nine months after the end of the accounting period) but ACT forms a

[7] OECD (1991) charts the drop in U.K. corporate tax rates from one of the highest to one of the lowest of developed countries. Including local taxes the U.K. rate fell from 52 percent in 1981 to 34 percent in 1991 and subsequently 33 percent, when the rate ofeorporate tax was 42 percent in Canada, 34 percent in France, 56 percent in Germany, 50 percent injapan, 35 percent in the Netherlands and 38 percent in the United States.

[8] Within the E.C., the Parent Subsidiary Directive (90/435) requires that distributions received by the parent company must he either exempt from tax or subject to a foreign tax credit. U.K., Ireland, Spain and Germany have selected the credit method (although Germany operates an idiosyncratic variation); Belgium, Denmark, France, Luxembourg and Italy have selected the exemption method. This is also consistent with the 1977/1992 OECD Model Double Taxation Convention on Income and Capital, under which residence countries relieve international double taxation through exemption or credit.

[9] For accounting periods ending before March 31, 1984, the set-offof overseas corporation tax against U.K. corporation tax was wt made after deducting ACT, which often resulted in a loss of double tax relief. For accounting periods ending after March 31, 1984, the overseas tax is deducted before any relief is taken for ACT.

[10] “Corporation Tax, Surplus ACT – Proposals for Reform” (Inland Revenue, 1993)

substantial proportion of the total corporation tax yield. According to Datastream, the yields over the past five years are (where the corporation tax yield includes ACT):

	ACT£bn	*Corporation Tax Tax £bn*
1988	5.7	17.9
1989	6.8	22.1
1990	7.7	21.3
1991	7.8	17.3
1992	8.4	15.2

The Consultative Document estimates that the current level of surplus ACT is £5 billion, growing at £1 billion per annum. The Budget proposals are expected to slow this growth to below £500 million a year.

The three proposed changes are as follows. First, it proposed to reduce the rate of ACT in two stages, from 25 per cent to 22.5 per cent in 1993-94 and then to 20 percent in 1994-95, and to reduce from 25 percent to 20 percent in 1993-94 the tax credit that shareholders get when they receive a dividend. Secondly, it proposed to establish a special tax regime from 1994-95 to help foreign-owned international companies which are considering setting up their headquarters in the United Kingdom. Thirdly, the consultative document outlined a scheme under which British companies may choose to class any dividend paid out of overseas profits as a "Foreign Income Dividend."

As this paper investigates United Kingdom companies and not holding companies of foreign parent companies, we will consider only very briefly the implications of a special tax regime for foreign-owned international companies. The proposed tax regime for qualifying companies is extremely advantageous, yet unavailable to United Kingdom companies. The suggested criteria for qualification comprises a minimum shareholding by non-United Kingdom residents of about 80 percent (which precludes United Kingdom companies) and a maximum number of shareholders (about five). There are cash flow and tax planning advantages which arise because the special status companies will not have to pay ACT when a FID is paid.

The reduction in the imputation rate from 25 percent to 20 percent makes the tax system more neutral with regards to the origin of income, but less neutral with regard to the impact on capital structure and dividend policy. In the following section on the marginal tax rates under surplus ACT we show that this 5 percent reduction actually imposes an additional 5 percent tax burden on unprejudiced companies. The FID proposals carry new tax implications. Unlike normal United Kingdom dividends, FIDs will not carry a tax credit (para. 69) and although ACT would initially be payable in the usual way the company will be entitled to a refund if it gives rise to surplus ACT (contrast this with qualifying foreign-owned international companies, which will not have to pass over the initial ACT payment).

The consultative document describes the main features of the FID scheme.

(i) The FID scheme is an *optional* election on the part of companies. As FIDs do not carry tax credits the company might disclose their intended use of FIDs so that investors can determine their own investment decisions.

(ii) ACT would be payable on the FID in the normal way but if it was subsequently established that the FID could be treated as having been paid out of foreign source profits, surplus ACT which had arisen in respect of the FID would be repayable by the Exchequer. The precise definition of foreign source profits is integral to the FID scheme as the level of FIDs is limited by the level of foreign source profits. The paragraph 55 definition is "...any income or chargeable gain in respect of which the company was charged to corporation tax and was allowed a credit (double taxation relief) for foreign tax." Therefore foreign tax must be paid on foreign income for it to be eligible for ACT purposes.

(iii) The company will be required to make an irrevocable option for any dividends to be treated as FID by the time that these dividends are paid. There is very limited allowance of the carry forward of FIDs (to the next accounting period alone) and none for the carry back of FIDS.

(iv) The *streaming* of dividends will be prevented by legislation. Companies will not be allowed to stream ordinary dividends (which still carry a tax credit) to tax exempt shareholders whilst FIDs are paid only to those shareholders with a tax liability.

(v) Although tax exempt shareholders cannot reclaim a tax credit on FIDS, shareholders would be treated as receiving income which had borne income tax at the ACT rate of 20 percent Higher rate tax payers will be liable to the difference between their higher rate and the lower rate of 20 percent

Marginal tax rates under surplus ACT

We analyse the marginal tax rates faced by a United Kingdom resident company with domestic shareholders in the presence of surplus ACT. We assume that the source of surplus ACT is the distribution of overseas income. Some of this company's income will be earned in the United Kingdom and some overseas. If overseas income is earned in a subsidiary, rather than a branch, it will be liable to United Kingdom corporation tax to the extent that the subsidiary pays dividend up to the parent. For convenience we assume all foreign income is remitted as dividend to the parent. Foreign income will be liable to United Kingdom corporation tax but is already likely to have borne local corporate tax and withholding tax on dividends too (depending on the country of source). In this section we assume that the foreign tax is the same as the United Kingdom corporation tax rate of 33 percent Assuming that there is full treaty-relief for double taxation and United Kingdom tax is only payable to the extent that the United Kingdom corporate tax rate exceeds the rate of underlying foreign corporation tax (plus withholding tax), there is no additional tax liability on foreign income.

The firm whose dividend distributions are below the ACT offset limit pays 33 percent corporation tax on the marginal unit of income from whatever source, and may distribute it at no further tax cost. But for the firm with surplus ACT, United Kingdom source income suffers only 8 percent incremental tax. The effective tax rate is 8 percent because the marginal £1 of United Kingdom income is taxed at 33 percent but it provides £1 of capacity for the recovery of surplus ACT at 25 percent By contrast the marginal £1 of foreign income is taxed at 33 percent and it provides no additional capacity for the recovery of surplus ACT. The £1 of United Kingdom income which is distributed as £1 of gross dividend provides, and consumes, £1 of ACT capacity, and so generates incremental tax at 33 percent The £1 of foreign income which is distributed bears 33 percent corporation tax and 25 percent of ACT; 58 percent in total. Hence in the presence of surplus ACT distributed foreign income suffers a "tax prejudice" of 25 percent (58-33 percent). At the investor level under existing United Kingdom rules the dividend payment carries a tax credit of 25 percent which is recovered by the exempt investor' The 40 percent rate taxpayer must pay an additional personal tax of 1 5 percent of the gross dividend, over and above the imputation rate of 25 percent.
Table 1 summarises these tax rates:

Table 1 Marginal Tax Rates, Imputation at 25 per rent.

	Corporation Tax			*Corporate plus Personal*			
	income		on incremental dividend	U.K.		Foreign	
	U.K.	Foreign	(surplus ACT)	Exempt	40%	Exempt	40%
No Surplus ACT	33%	33%	0%	8%	48%	8%	48%
Surplus ACT	8%	33%	25%	8%	48%	33%	73%

To simplify the exposition this example makes two important assumptions. First, we ignore the timing/discounting of tax flows, and we assume the firm is permanently in a surplus ACT position so that no value is attributed to the future resumption of imputation.

Secondly we make a particular assumption about dividend distribution. The example considers the taxation of a £1 increment of income in the presence or absence of surplus ACT. We are not assuming the firm fully distributes all income but that *this* £1 is "fully distributed" in that a dividend of 75p (£1 gross) is paid. This is the dividend which fully consumes the ACT capacity provided by the incremental £1 of income. But the firm will need £1.08 of cash to service this transaction. An alternative is to calculate effective tax rates assuming the firm fully distributes all income and that accounting profit after tax equals taxable profits less tax. In this case the firm is constrained to pay a net dividend of 67p (89.3 gross) in the unprejudiced case, and thus does not fully utilise its ACT capacity. But whilst losing the intuition of the rates shown above, this is not necessarily a more realistic model of "full distribution" since it equates taxable profit to the legal notion of distributable

profit.[11]

The 1993 Budget proposes to reduce the imputation by 5 percent to 20 percent (in 1994/95), which in turn will reduce the tax prejudice against foreign earnings by 5 percent Now tax prejudice against foreign income is reduced to 20 percent by the artifice of increasing the tax rate on distributed domestic income. However, tax prejudice against foreign earnings remains, and cuts in at the same level of dividend payout. Therefore, the £1 of domestic income distributed to a top rate investor attracts 53 percent corporate and personal tax (48 percent under the existing system), and £1 of foreign income attracts 73 percent combined tax (the same as the existing system).

Now consider the effect of paying a FID. The company may recover surplus ACT on a FID but the FID does not carry a tax credit. The proposals provide that the marginal tax rate for investors in the 40 percent tax bracket is now 53 percent for both United Kingdom and foreign income. In the tax prejudice instance, the company would opt for a FID to reduce the marginal tax rate on 40 percent investors from 73 percent to 53 percent The FID is deemed to have borne tax at 20 percent, and this investor is liable for a further 20 percent tax.[12] However, since FIDs do not carry a tax credit, prejudice remains for investors with a personal tax rate below the imputation rate, and the FID does not remove tax prejudice for tax exempt investors. Table 2 summarise these rates:

Table 2 Marginal Tax Rates, Imputation at 20 per cent, FID.

	Corporation Tax			*Corporate plus Personal*			
	income		on incremental dividend	U.K.		Foreign	
	U.K.	Foreign	(surplus ACT)	Exempt	40%	Exempt	40%
No Surplus ACT	33%	33%	0%	13%	53%	13%	53%
Surplus ACT	13%	33%	20%	13%	53%	33%	73%
with FID		33%				33%	53%

[11] Put another way, we do not assume that the net dividend distribution is limited to the post-tax income arising from a £1 increment in pre-tax income. We are assuming that the company is able to distribute a full £1 gross dividend, where the extra 8p of net dividend is available to the company. In the case of average tax rates, the additional 8p of net dividend represents a pre-tax income of 12p, but in the context of marginal tax rates, this 4p element of corporation tax is already borne by the company, regardless of the distribution decision. If we distribute only 67p of net dividend (89.3p of gross dividend), the marginal tax rate for U.K. exempt investors will be 10.7 percent. ((33-22.3)/100) and for 40 percent investors will be 46.4 percent ((33+13.4)/100).

	Corporation Tax			*Corporate plus Personal*			
	income		on incremental dividend	U.K.		Foreign	
	U.K.	Foreign	(surplus ACT)	Exempt	40%	Exempt	40%
No Surplus ACT	33%	33%	0%	10.7%	46.4%	10.7%	46.4%
Surplus ACT	10.7%	33%	22.3%	10.7%	46.4%	33%	68.7%

[12] As an administrative convenience the basic rate of personal tax on dividend tax on dividend income will now be 20 percent, so basic rate tax payers will not have to pay further tax on an FID.

Average tax rates for a United Kingdom Company with Foreign Income

The scale of the surplus ACT problem depends on the proportion of United Kingdom to foreign income. For some multinational companies, United Kingdom income might only account for a small proportion of total European income. This will severely restrict the maximum unprejudiced[13] dividend of a United Kingdom holding company, and generate a significant tax cost on plausible dividend assumptions. This section estimates the average tax rates of a United Kingdom company with foreign profits facing its United Kingdom investors. The analysis sets out the average tax rates pre- and post- the 1993 Budget and for varying levels of dividend distribution and proportions of foreign income. We compare cases where foreign and domestic income are similar in scale, and where foreign income is 10 times United Kingdom income, and we analyse the case where the European headquarters distributes 50 percent and 100 percent We assume that all foreign income is generated in E.C. Member States, which means that E.C. Directives apply to all income. We focus on corporation tax, and do not, examine other taxes, notably VAT, and the personal taxation of international executives, which would be an important part of the structure and location decision in practice. As stated in the Parent Subsidiary Directive, no withholding tax is applied to the profits remitted from the subsidiary to the parent.

To estimate tax rates we make a number of assumptions. We hold United Kingdom income constant at 100 but assume foreign income is respectively 150 (Case 1), 200 (Case 2), and 1,000 (Case 3). The assumptions in all cases are of a United Kingdom corporation tax rate of 33 percent, a United Kingdom imputation tax rate of 25 percent pre-Budget and 20 percent Post-Budget, a foreign corporate tax rate of 35 percent, and full remittance to the European headquarter company.

Table 3 describes the average tax rate of the United Kingdom company and the combined corporate and personal tax rates of two classes of United Kingdom investor (tax exempt and 40 percent rate taxpayers). In addition, we calculate the marginal rate of tax on £1 of extra income from both the United Kingdom and overseas, and the marginal rate of tax on £1 of extra dividend distribution. The selected income mixes and distribution policies are constructed to analyse a *prejudiced* United Kingdom company under the current system and under the proposed system.

Average tax rates

Under the current system (panel A), the average tax rate of a prejudiced United Kingdom company increases with both the proportion of overseas income and the level of dividend distribution. When the overseas income is 50 percent higher than United Kingdom income and the gross dividend payout is 50 per cent (1b), the company generates a small amount of surplus ACT and there is an average tax rate of 34.9 percent In contrast, the level of surplus ACT is at its highest when there is a

[13] Meaning a dividend payout policy which does not incur surplus ACT liabilities.

high proportion of overseas income. If overseas income is 10 times higher than United Kingdom income and there is full payout, the company generates surplus ACT of 160.5 and an average tax rate of 49.4 percent

Under the proposed system (panel B), the company can opt to pay a FID. FIDs will reduce tax prejudice (or eliminate it given an adequate level of foreign source profit) but they do not carry a tax credit. In our example the company does have sufficient foreign overseas income to recover all surplus ACT. The average tax rate is bounded by the corporate tax rates in the United Kingdom and overseas, with the lower bound of 33 percent (United Kingdom rate) and an upper bound of 35 percent (overseas rate). For prejudiced companies it is the proportion of foreign income, rather then dividend payout which determines average tax rates. When the foreign income is 50 percent higher than United Kingdom income the average tax rate is 34.2 percent, rising to 34.8 percent when the foreign income is 10 ten times higher than United Kingdom. These computations assume that the company distributes exactly the correct amount of FID to recoup surplus ACT. The improvement in the average tax rate is just under 15 percent for case 3a, but only 0.7 percent for case lb. Therefore on the basis of average corporate tax rates alone, United Kingdom companies with high dividend payout and high proportions of foreign income would appear to benefit from the option to pay FIDS.

Marginal Tax Rates

For prejudiced companies under the existing system, the marginal tax rate on £1 of extra income (both United Kingdom and foreign) depends on the dividend payout *not* the proportion of foreign income. Once the company is in a surplus ACT position, £1 of extra United Kingdom income will have a marginal tax rate of 31 percent (full payout) or 22.6 percent (half payout) and £1 of extra foreign income will have a marginal tax rate of 5 1.3 percent (full payout) or 43.1 percent (half payout). An extra £1 of dividend will be taxed at 25 percent-the imputation rate of ACT.

Under the proposed system, if the FID paid is exactly the right amount to recover all surplus ACT, the marginal tax rates are independent of the payout policy and proportion of foreign income. The marginal tax rates are 33 percent on United Kingdom income, 35 percent on foreign income and 0 percent on dividend distributions.

Combined Tax Rates on United Kingdom investors

The combined tax rates assume that the whole distribution is paid in turn to either the tax exempt investor or the 40 percent rate investor. The combined rate reflects changes in both the corporate tax structure and the personal tax structure. As described earlier, the FID option actually reduces the average corporate tax rate. However the tax exempt investors themselves are not able to reclaim a tax credit. The combined effect of these two shifts on tax exempt investors is to increase the combined rate. Under existing rules, this tax rate ranges from 24.2 percent (1 a) to

32.6 percent (3a) (for our selected examples). Under the proposed system, the combined rates increase so that the range is now 26.2 percent to 33.0 percent

The 40 percent rate investors are deemed to have borne a reduced imputation rate of 20 percent and they must pay the balance of 20 percent. The effect of the proposals on 40 percent rate investors is a decrease in the combined tax rate. Under existing rules, as the proportion of overseas income increases so does the level of surplus ACT and therefore so too does the combined tax rate. Under the proposed system, the combined rate decreases as the proportion of overseas income rises. Comparing both systems, under case 1 a, the combined rate falls from 54.5 percent to 49.0 percent and under case 3a it falls from 59.5 percent to 48.2 percent.

Table 3 Comparative Analysis of Tax Structures

This table computes average and marginal tax rates for the existing and proposed systems. The level of foreign income and the level of dividend distribution are varied across each case. In the existing system when there is tax prejudice, the gross dividend and surplus ACT are adjusted using a 75 percent provision. We assume a United Kingdom imputation rate of 25 percent, corporation tax rates of 33 percent in the United Kingdom and 35 percent overseas. In the proposed system when there is tax prejudice the company distributes a FID which fully recovers surplus ACT if there is sufficient overseas income. We assume a United Kingdom imputation rate of 20 percent for the proposed system.

Panel A – UK Multinational company under the existing system						
	Case 1a	Case 1b	Case 2a	Case 2b	Case 3a	Case 3b
UK income	100	100	100	100	100	100
Overseas income	150	150	200	200	1000	1000
UK corporate taxes	33	33	33	33	33	33
Overseas corporate taxes	52.5	52.5	70	70	350	350
Gross Dividend Payout (UK)	100%	50%	100%	50%	100%	50%
Gross Dividend	189.5	107.3	222	123.5	742	383.5
Surplus ACT	22.4	1.8	30.5	5.9	160.5	70.9
Average Tax Rate	43.2%	34.9%	44.5%	36.3%	49.4%	41.3%
Marginal Tax Rate on:						
£1 of UK income	31.0%	22.6%	31.0%	22.6%	31.0%	22.6%
£1 of overseas income	51.3%	43.1%	51.3%	43.1%	51.3%	43.1%
£1 of UK dividend	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
Combined tax rate on:						
Tax exempt investor	24.2%	24.2%	26.0%	26.0%	32.6	32.6%
40% tax rate investor	54.5%	41.4%	55.6%	42.5%	59.5%	46.5%

Panel B – UK Multinational company under the proposed system						
	Case 1a	Case 1b	Case 2a	Case 2b	Case 3a	Case 3b
UK income	100	100	100	100	100	100
Overseas income	150	150	200	200	1000	1000
UK corporate taxes	33	33	33	33	33	33
Overseas corporate taxes	52.5	52.5	70	70	350	350
Gross Dividend Payout (UK)	100%	50%	100%	50%	100%	50%
Gross Dividend	184.5	102.3	217	118.5	737	378.5
FID	84.5	2.3	117	18.5	637	278.5
Repayable Surplus ACT	16.9%	0.5%	23.4%	3.7%	127.4%	55.7%
Average Tax Rate	34.2%	34.2%	34.3%	34.3%	34.8%	34.8%
Marginal Tax Rate on:						
£1 of UK income	33.0%	33.0%	33.0%	33.0%	33.0%	33.0%
£1 of overseas income	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%
£1 of UK dividend	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Combined tax rate on:						
Tax exempt investor	26.2%	26.2%	27.7%	27.7%	33.0%	33.0%
40% tax rate investor	49.0%	42.4%	48.8%	42.2%	48.2%	41.7%

Conclusion

Indigenous United Kingdom multinationals cannot easily relocate, without the radical restructuring of the business which might take place when there is a merger. These firms can either change their behaviour to reduce the burden of surplus ACT, or they can bear the tax. We have no evidence on the extent to which multinationals have modified real and financial behaviour in response to surplus ACT, in other words how much surplus ACT has been avoided. But it is clear that companies have borne large amounts of surplus ACT. Higson (1991)[14] estimated that the stock of surplus ACT in the United Kingdom system was in excess of £3bn in 1991 and growing at a rate of £400m per year. Inland Revenue figures in the Consultative Document accompanying the March 1993 Budget put the cumulative sum at £5bn, growing at £1bn per year.

The marginal tax rate analysis which we undertake in the paper suggests that the effects of the 1993 Budget on United Kingdom multinationals with surplus ACT may he limited. The reduction in imputation rate reduces the prejudice on distributed foreign income from 2'5 percent to 20 percent by the device of raising the tax rate on distributed United Kingdom income. The FID proposal removes tax prejudice altogether but only for investors with a tax rate at or above the imputation rate, and companies will not be able to "stream" dividends of different types to different investors.

Compared with the potential benefits available to foreign multinationals, in several respects the new rules may appear unattractive to United Kingdom companies and investors. The FID distributed by a United Kingdom multinational requires ACT to be paid then recovered with a cash flow cost to the company and with uncertainty as to whether there will be sufficient foreign source income to cover the FID. Moreover an effect of the FID rule is to erode the relative value of tax exempt investor status.

A recent CBI[15] publication emphasised the importance of tax exempt investors. Using CSO/ISE source date for 1963 to 1981 and CBI estimates for 1989, the report described the transitions in ownership of United Kingdom listed equities. The ownership by institutions (including pension funds; insurance; unit and investment trusts) has increased from 29.2 percent in 1963 to 60 percent in 1989 (47.4 percent in 1975; 57.5 percent in 1981). Pension funds alone increased from 6.5 percent in 1963 to 32.0 percent in 1989. The personal sector (individuals; government; other United Kingdom, and overseas) represents the remainder with individuals' ownership falling from 53.8 percent in 1963 to 20 percent in 1989.

The Inland Revenue Budget Press Release on the "Taxation of Dividends" (March 16,1993) estimates that the new proposals will produce the following benefits to the United Kingdom corporate sector:

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[14] See n. 2 above.

[15] "A nation of shareholders, report of the CBI wider share ownership task force". (CBI, 1990).

(£m)

1993-94	1994-95	1995-96
+900	+1000	+300

This compares with the costs to the recipients of tax credits (pensions funds, charities, non resident shareholders).

1993-94	1994-95	1995-96
+800	+1000	+1100

In the increasingly vocal debate about tax reform which preceded the Spring 1993 Budget, one proposal was to increase the ACT offset limit, perhaps to offer full, "33/33", offset. An alternative advocated by a few, was a return to a classical system with zero offset. The Chancellor has taken a small step in the latter direction. From the perspective of a domestic company the reduction in tax prejudice is quite small, taking corporate and investor taxes together, and so might be predicted to have little effect on incentives. But this begs the question of the extent to which companies embrace shareholders' taxes in their analyses. The effect of reducing the imputation rate is, at least in cash flow terms, to shift part of the tax burden from the company to the investor. It remains to he seen to what extent companies find it appropriate to increase dividend to "compensate" investors for the increased tax burden, or to reduce it in response to the reduced incentive to pay a dividend which follows the withdrawal of imputation.

One aspect of the proposals which will certainly face criticism and lobbying is the prevention of "streaming." The press release on the "Taxation of Dividends" illustrates that the FID proposals will shift tax benefits from tax exempt institutions to the corporate sector. A direct consequence of the tax advantage of FIDs for prejudiced companies is the loss of tax credit privileges by tax exempt institutions. These institutions are likely to oppose the implications of FIDS, presuming that United Kingdom companies would opt to distribute FIDS. Alternatively, companies may attempt to distribute earnings using devices which do allow an unofficial form of “streaming."