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POLICY WATCH

The Incentive to Locate a Multinational Firm: The Effect of Tax Reforms in the United Kingdom

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Abstract

The advent of the single European market has focused attention on the structure of international tax incentives for the location of multinational business. Multinationals that channel foreign income through the United Kingdom have been likely to suffer double taxation in the form of surplus advance corporation tax when they subsequently distribute the income to a foreign parent. This paper shows that the 1993 UK tax reforms create a significant reduction in the tax cost of locating in the United Kingdom, relative to traditionally favourable tax regimes such as the Netherlands.

1. Introduction

Many companies in the United Kingdom face a sharply higher marginal rate of corporation tax when they distribute foreign income than when dividends are paid from domestic income. Under the UK imputation system of corporation tax, the company pays advance corporation tax (ACT) when it distributes a dividend. This creates a tax credit, but the credit can be recovered only against corporation tax paid in the United Kingdom. In recent years the imputation rate has been 25 percent, so if the tax credit is irrecoverable and the firm has surplus ACT, this adds in the limit 25 percent to the effective rate of tax on foreign income. Though this tax prejudice against foreign income has long been a cause for controversy in the United Kingdom[1], government action has been prompted by a concern that surplus ACT would make the United Kingdom an unattractive location for European headquarter companies created in the wake of the single European market. A number of US firms currently located in the United Kingdom had threatened to relocate. While the United Kingdom has been relatively successful in attracting foreign direct investment and regional headquarter companies, there are clear signs of international competition in this area. Traditionally the Netherlands, Belgium, and Luxembourg are fiscally attractive places to

locate a holding company, and other European countries have improved tax treatment of holding companies. France operates modified imputation rules[2] while Germany allows reduced corporate tax rates on a holding company that remits dividends.

The United Kingdom has recently made legislative changes that attack the problem of surplus ACT. The spring 1993 budget reduced the rate of imputation from 25 percent to 20 percent. This reduces the tax prejudice against foreign income by imposing an additional tax burden of 5 percent on domestic income. The autumn 1993 budget allowed firms to nominate a distribution as a foreign income dividend (FID). Surplus ACT firms can recover the ACT on a FID, but FIDs carry no tax credit. For a domestic tax-exempt investor, who loses the dividend tax credit, there remains a substantial tax prejudice against foreign income. But for a foreign corporate investor such as a bank or industrial firm, the FID eliminates surplus ACT as a source of tax prejudice. Furthermore, if a company has international headquarter company status, it can distribute a FID without paying ACT in the first place.

This paper describes these changes and assesses their effect on the incentive to locate an international holding company in the United Kingdom. We compare the direct tax cost faced by a US firm that puts an intermediate holding company in the United Kingdom or in the Netherlands, which is often held to have a particularly favourable tax regime. We show that principally because of differences in corporate tax rates and because of credits and refunds available under double tax agreements, the 25 percent tax prejudice faced by a domestic company with surplus ACT does not translate into an international tax disadvantage of similar magnitude. Under old rules the UK company faces an average tax rate, when its income is largely foreign source and when it distributes half of its income back to Netherlands. In the limiting case that the European operation distributes all profits to its parent, this rises to 10 percent. But the ability to pay a FID reverses the half payout to the United Kingdom and the Netherlands. When there is half payout to the United States, the average corporate tax rate is 1.5 percent lower in the United Kingdom than in the Netherlands, and this rises to 3 percent with full distribution.

A number of papers report international comparisons of effective tax rates on the income from capital using the methodology of King and Fullerton (1984).[3] The existing literature, however, does not address either the nonlinearities in tax schedules that arise because of limit rules like the one that causes surplus ACT or, crucially, the effects of transnational ownership structures. These are particularly important limitations if conclusions are to be drawn about tax incentives for the location and structuring of international business. The present paper examines the effects of extending the analysis to capture these features by modelling a specific, but important, case. The paper proceeds as follows. Section 2 describes the UK tax system and the conditions that give rise to surplus ACT and outlines the 1993 UK tax reforms. Section 3 examines the effect of surplus ACT on the location decision faced by a foreign-owned holding company. The final section draws some conclusions.

2. The UK corporate tax system and surplus ACT

2.1 *The UK imputation system*

Systems of company tax can be helpfully classified in terms of the extent to which corporate income distributed as dividends is double-taxed - that is, taxed at the corporate level and again at the personal level. In classical tax systems found in the United States, the Netherlands, Luxembourg, Switzerland and Belgium, dividends are taxed twice - the shareholder receives a dividend out of profits that have borne corporation tax and then has to pay personal tax on the dividend. Since the 1970s, many countries have moved to reduce or eliminate this double taxation of dividends. Most countries do this by providing relief at the investor level,[4] by giving partial tax relief on dividend income (for instance in Japan and Canada) or by imputing the corporation tax to the investor - that is, by treating the corporation tax on $1 of corporate income as prepaying the subsequent personal tax on dividends. This imputation may be full, in which case there is dollar-for-dollar offset,[5] or partial, as in the United Kingdom, France and Ireland.

In the United Kingdom, when a company makes a distribution, advance corporation tax must be paid to the Inland Revenue. This ACT can be offset against the company's mainstream corporate tax so does not, in principle, represent an incremental payment of tax for the company. The offset is limited to the ACT on a full distribution (dividend plus ACT) of the company's UK taxable income. First, consider the case in which all income is domestic. Let c be the UK corporate tax rate on taxable income X, and m the imputation rate. If a company distributes a (net) dividend D, it pays ACT of $mD/(1 - m)$. Assuming there is no available capacity for carry forward, surplus ACT, S, arises when $D/(1 - m) > X$ and is

$$S = m.\text{MAX}[D/(1 - m) - X, 0].$$

The company's total tax payment is

$$T = cX + S.$$

Since a UK multination will typically base its dividend distribution on consolidated worldwide earnings, the constraint that ACT may only be offset against UK corporation tax is likely to bind. UK taxable income consists of UK source income[6] plus dividends remitted by foreign subsidiaries but is reduced by foreign taxes to the extent that relief is available under a double-tax treaty. So even remitted foreign income only creates capacity to offset ACT to the extent that the UK corporate rate exceeds the foreign rate plus withholding tax. Assume c_f is the foreign corporation rate including withholding tax, and p is the United Kingdom, and $1 - p$ the foreign, proportion of UK taxable income. One additional important assumption is that there is full remittance to the UK multinational from the foreign subsidiary. Surplus ACT arises when the gross dividend exceeds the capacity generated by UK and foreign earnings:

$$S = m.\text{MAX}[D/(1 - m) - (pX + (1 - p)\, X.\text{MIN}[\text{MAX}[(c - c_f)/m, 0], 1]), 0], \qquad (1)$$

In the United Kingdom, assuming full tax credit is available under a double-tax treaty, total tax paid is now

$$T = cpX + \text{MAX}[c, c_f](1 - p)X + S. \qquad (2)$$

Foreign income ($(1 - p)X$) is taxed at MAX[c, c_f] because the United Kingdom operates a credit rather than an exemption system for foreign tax. The ACT also provides tax credit to investors[7] who are imputed with basic rate tax on the dividend gross of the ACT; investors are liable for further tax only if they are taxable at the higher rate and may recover the tax credit if they are tax exempt. The investor's incremental tax liability, where t is the investor's marginal income tax rate, is $(t - m)D/(1 - m)$.

According to the OECD (1991) the UK tax system imposes a corporate tax burden that is in the middle of the range for developed countries, but this assumes there is no surplus ACT. With surplus ACT, double taxation of corporate income implies a sharply higher marginal tax rate, as equations (1) and (2) show. In the United Kingdom the imputation rate has been 25 percent, and the corporate rate 33 percent.[8] When a firm distributes a level of dividends below the ACT offset limit, it pays UK corporation tax of 33 percent on the marginal unit of income arising in the United Kingdom or abroad and there is no further tax cost if this is distributed. If a firm is prejudiced, UK source income is taxed at 33 percent, but this £1 provides capacity to recover surplus ACT at the imputation rate of 25 percent. In the case of £1 of UK income that is distributed as a gross dividend (of £l), the incremental tax rate is 33 percent because £1 of ACT capacity is both provided and consumed. If $c_f > c$, *£1* of foreign-source income that is received by the UK parent but not distributed is subject to 33 percent incremental UK tax because no ACT capacity is created. When the £1 of foreign source income is distributed, the incremental tax is 58 percent, made up of 33 percent corporation tax and 1.5 percent ACT. Therefore, in the presence of surplus ACT, foreign income suffers a tax prejudice of 25 percent relative to UK income, whether or not the income is distributed. In fact, surplus ACT can be carried back six years or carried forward indefinitely for offset against subsequent corporation liabilities, so these results describe a firm with permanent surplus ACT for which carry- forwards have no marginal value. We also assume this to be the case in the sub- sequent analysis.

From the late 1970s to the mid-1980s many UK companies reported low or zero UK taxable profits caused by generally poor corporate profitability and generous tax allowances for investment in fixed assets. This combination resulted in tax exhaustion, and consequently surplus ACT was prevalent (see Devereux, 1987; Higson, 1991b). In a multinational firm surplus ACT arises when the firm's dividend payments exhaust UK taxable income and exhaust the capacity provided by foreign income. It is a function of the company's dividend payout and the proportion of taxable income sourced overseas. This, in turn, reflects the international distribution of the company's assets, the profitability of those assets, and the company's internal dividend remittance policy. While a number of European countries have imputation tax systems with the potential to generate double taxation of foreign earnings (notably France, Germany, Ireland, and Italy), the problem has always been more acute in the United Kingdom because of the relatively high level of international investment by UK companies combined with the relatively high payout ratios (Higson, 1991a). An additional

factor in the 1980s has been the shift in the relative levels of UK and overseas corporate tax rates. Because the United Kingdom operates a credit system for relieving international double taxation, the amount of capacity available in overseas income to cover ACT is a function of the difference between the UK and overseas rates. From having one of the highest rates of corporate tax a decade ago, the United Kingdom now has one of the lowest among developed countries. The rate of corporate tax has decreased more sharply in the United Kingdom than in most other major developed countries during the last decade. It fell from 52 percent in 1981 to 34 percent in 1991 and subsequently 33 percent, when the rate of corporate tax was 42 percent in Canada, 34 percent in France, 56 percent in Germany, 50 percent in Japan, 35 percent in the Netherlands, and 38 percent in the United States.[9]

2.2. The 1993 UK reform

In 1993 the United Kingdom made several tax reforms relating to surplus ACT. The rate of ACT was reduced from 25 to 22.5 percent in 1993-1994 and then to 20 percent thereafter, and the tax credit to shareholders was reduced from 25 to 20 percent in 1993-1994. The effect of a reduction in the imputation rate by 5 percent is to reduce the tax prejudice against foreign earnings to 20 percent; the benefits of imputing UK income are reduced, but prejudiced foreign income is unaffected since it does not enjoy the benefits of imputation.

Second, UK companies were permitted to class any dividend paid out of overseas income as a foreign income dividend. 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 income, surplus ACT that had arisen in respect of the FID would be repayable by the Exchequer. In calculating any further tax due from shareholders on FIDS, they would be treated as receiving income that, under the proposals in the budget, had already borne income tax at 20 percent; but neither resident nor nonresident shareholders will be entitled to and able to recover tax credits on FIDS.[10] There is a facility for international head- quarter companies (IHC) to pay a FID without paying ACT in the first place. Two tests determine whether companies qualify for IHC status. First, at least 80 percent of the share capital of the company should be ultimately owned by shareholders who are not resident in the United Kingdom for tax purposes; and, second, no shareholder must own less than 5 percent of the shares. The election to distribute a FID must be made by the time the dividend is paid, after which time it is irrevocable. The proposals allow very limited carry forward of FIDs to the next accounting period only, and FIDs may be attributed to prior year income.

Clearly, a FID has no appeal to the tax-exempt UK investor. The maximum value of surplus ACT recovered by paying a FID (that is, when $p = 0$, $c < c_f$) is $mD/(1 - m)$, which is not more than the tax credit lost by the investor, substituting $t=0$ into the investor's incremental tax expression, $(t - m)D/(1 - m)$. The value of paying a FID is in avoiding potential surplus ACT generated by a normal dividend, so the company will not pay a FID beyond this limit:

$$FID = MIN[(1 - p)X(1 - c_f)/(1 - m), S/m]. \quad (3)$$

3. The tax incentive to locate

Surplus ACT appears to provide an incentive to locate a company with significant foreign income in a more propitious tax regime. A change of tax residence is fiscally difficult[11] and for most indigenous firms would also be organizationally highly costly. But location becomes a choice variable when a new enterprise is contemplated or when a foreign company has an international network of subsidiaries but wishes to designate a regional headquarters company. An analysis of the tax incentive to locate requires a comparison of tax rates in different locations. The large number of potential locations for an intermediate and the ultimate holding company, and the possible variety of sources and proportions of income, of structure, and of distribution policy, combine to suggest an analysis of unmanageable complexity. Our approach is to model a particular case. We compare the primary tax costs of locating the European headquarters of a US company in the United Kingdom and in the Netherlands, which is often cited as a favourable tax environment within Europe.[12] The existing literature, which employs the methodology of King and Fullerton (1984), compares the effective rate of tax on income from capital internationally and derives effective marginal tax rates across representative portfolios of assets, capital structures, and investor types. The approach of the current paper is different and is to examine the effect of alternative structures on relative tax rates. We hold the tax base constant, assume equity is the financing mode, and assume that the structure-generated differences in effective tax rate carry through whatever the tax rate of the ultimate (US) shareholder. We limit the comparison to 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. We assume continuing structures, and we do not, for example, examine the capital gains implications of dismantling the structure or of selling subsidiaries.

Though our concern is taxation, this does not imply that taxes are necessarily the dominant factor in the choice of location.[13] Locations differ in the quality and cost of labour and of accommodation, in infrastructure, and in the congeniality of the culture they provide. Most important may be managerial and strategic considerations; for instance, many multinationals have created a regional European headquarters rather than direct ownership from, say, the United States or Japan in the belief that it was necessary to establish a clear European identity. These companies want to be seen as European by customers, regulators, and employees.

3.1. Background

The Netherlands offers the combination of a classical system in which double taxation is removed by a participation exemption for foreign investors.[14] The objective of the participation exemption is to ensure that profits are taxed at only one level when there is a qualifying parent/subsidiary relationship, and it ensure that dividends and capital gains received by resident or nonresident entities from qualifying shareholdings are exempt from Netherlands corporate income tax.[15] The Parent/Subsidiary Directive (90/435/EC), which was applicable from January 1, 1992, addresses the tax status of distributions from qualifying

subsidiaries to the parent company in different member states. The minimum holding requirement[16] for a parent/subsidiary relationship is 25 percent of the capital of the subsidiary.[17] Under this directive no withholding tax can be applied to profit that a subsidiary distributes to its parent[18] or the profits that a parent receive from its subsidiary. Moreover, those distributions received by the parent compan must be either exempt from tax altogether or subject to a foreign tax credit.[19] But a key exception is that the term *withholding tax* does not cover an advance payment or prepayment (precompte) of corporation tax to the member state of the subsidiary made in connection with a distribution of profits to its parent company

A Dutch holding company may be able to mitigate the withholding tax payable on dividends remitted to a US parent by adopting a highly leveraged financial,- structure, since in the Netherlands the Revenue authorities impose no ceiling on gearing other than the ability to service interest out of profit.[20] The United Kingdom is much stricter on the level of debt-to-equity ratios and the Inland Revenue will generally view thinly capitalized companies with debt-to-equity ratios exceeding 1:1 as unacceptable.[21] However, even if high leverage is acceptable in the European holding company's country, it runs the risk that the debt issued to the US parent may be treated as boot and therefore taxable in the United States.[22]

Obviously, direct ownership between each individual subsidiary and the US parent company restricts the channelling of foreign income through the UK holding company and eases the potential for surplus ACT in the United Kingdom. But there is a countervailing withholding tax cost that depends on the DTA between each different country and the United States. A powerful argument in favour of a European holding company is that it can be located in a member state that imposes a low rate of withholding tax when remitting to the parent. Direct ownership of subsidiaries by the parent might result in a range of withholding taxes from 5 to 25 percent.

For parent companies based in a relatively high tax jurisdiction such as the United States, deferral of tax by nonremittance might appear an attractive option since in common with most Jurisdictions the United States taxes only foreign in- come earned in a subsidiary, rather than a branch, when it is repatriated. However subpart F provisions were enacted in 1962 and apply to controlled foreign companies (CFC's) that are at least 50 percent owned by US persons with stakes of at least 10 percent. Subpart F prevents the indefinite deferral of US tax liability on foreign earnings passive income and income from investment in US property and treats it as though it were distributed to the US parent. The Tax Reform Act 1986 broadened the scope to include the income of foreign investors in the passive foreign investment of non-CFC companies. The aim of subpart F is that dividend distribution should take place when internally generated funds exceed local in- vestment opportunities, so we would expect the parent to be a net transferor of equity to the young subsidiary and a recipient from the mature subsidiary (see Hines and Hubbard, 1990). The role of the tax position of the subsidiary in the subsidiary dividend/reinvestment decision is discussed in Hines (1988).

3.2. The alternative structures

In our model a US parent has assets in the United Kingdom and in the Nether- lands, and considers three alternative structures: A, a UK company with a subsidiary in the Netherlands;[23] *B*, a Netherlands company with a subsidiary in the United Kingdom; and *C*, a structure containing two independent entities in the United Kingdom and the Netherlands each directly owned from the United States. The analysis is conducted both before and after the 1993 UK tax changes. The scale of the surplus ACT problem depends on the proportion of UK to foreign income and on distribution policy. To estimate tax rates for the three structures, we make a number of assumptions. We assume all the non-UK income arises in the Netherlands. We hold UK income constant at 100 and compare cases where foreign and domestic income are equal and where foreign income is ten times UK income. We assume full distribution that is, distribution of all local income after corporation tax-to the European headquarter company and then compare the case where the European headquarters distributes, D, 50 percent of profit after corporation tax, to the US parent, against the case where 100 percent is distributed. The tax parameters are a UK corporation tax rate of 33 percent, a UK imputation tax rate of 25 percent prebudget and 20 percent postbudget, a Dutch corporate tax rate of 5 percent on dividends remitted to the United States.[25]

In structure A, the company is taxed under UK law described in Section 2. Since cf > c, foreign income provides no ACT capacity, so equation (1) simplifies to

$$S = m.\mathrm{MAX}[D/(1 - m) - pX, 0] \qquad (1A)$$

Equation (2) must be modified when the shareholder is a foreign corporation. Under the relevant DTA a half tax credit (ACT refund) is available in the United Kingdom to nonresident companies owning 10 percent or more of the voting power, subject to a 5 percent withholding tax on the aggregate of net dividends and the half credit,[26] though the half tax credit is not available on a FID, so

$$T = cpX + S - \mathrm{REF} + c_f(1 - p)X, \qquad (2A)$$

where the refund is

$$\mathrm{REF} = .5mD/(1 - m). \qquad (4)$$

Withholding tax is

$$W = 0.5\ (D + \mathrm{REF}). \qquad (5A)$$

Equation (3) continues to define the amount of FID the company will pay in the new system.

In structure B the local UK subsidiary distributes up to the Netherlands. One source of tax advantage in this structure is that since the Netherlands give an exemption rather than credit to foreign income, the higher Netherlands corporate rate does not attach to the UK

source income. There is no withholding tax between the United Kingdom and the Netherlands, though ACT is charged an, as in the previous structure, partially refunded. So

$$T = cp\text{X} - \text{REF} + \text{c}_\text{f}(1 - p)\text{X}. \quad (2B)$$

A 5 percent withholding tax must be applied on the dividends remitted from the Netherlands to the United States:

$$W = .05D \quad (5B)$$

In structure C, the refund of ACT is based on the distribution of UK source income alone.

$$T = cpx - \text{REF} + \text{c}_\text{f}(1 - p)X \quad (2C)$$

and noting that D includes both the UK and the Netherlands distribution to the United States, and again REF relates to the UK distribution:

$$\text{W} = .05\ (D + \text{REF}). \quad (5C)$$

3.3. Analysis

Table 1 shows the tax rates that emerge under the different assumptions about payout to the US parent and mix of UK and foreign income, both before and after the 1993 UK reforms. The table shows total income, X, and the elements of the total tax (T) and withholding tax (W) in each case, and calculates the average tax rate (T + W)/X, and the marginal tax rate on £1 of UK and of Netherlands income.

When UK and foreign income are equal and when only 50 percent is distributed up to the United States, the average tax rates are similar under the old system with a UK holding company, and with a Netherlands holding company. The rates are 30.4 percent in structure A and 30.2 percent in structure B (Table 1, column 1). But if we increase the payout to 100 percent, and particularly when Netherlands income is ten times UK income, significant surplus ACT arises in the UK holding company (structure A, columns 2, 3, 4). When 1,000 of Netherlands in- come and 100 of UK income are channelled through the United Kingdom, the average tax rate is 47.2 percent, around 10 percent more than if a Netherlands holding company were used. At this point the marginal tax rate on £1 of UK income and £1 of Netherlands income channelled through structure A diverge by over 25 percent.

This tax prejudice in the UK structure is entirely due to surplus ACT. Without this the underlying UK tax rate is favourable compared to the Netherlands, as can be seen from the marginal tax rates in structure C in which each income source is remitted straight to the United States. So again, as in structure B, no surplus ACT arises. In this case, a lower corporate tax rate in the United Kingdom is reduced further by the availability of a partial ACT refund that is more valuable the more is distributed. In our limiting case (column 4) the UK marginal tax rate is 10 percent below the Netherlands rate.

In all cases we define full distribution relative to profit after corporation tax. So that comparable dividends are analysed across cases, we ignore the effect of surplus ACT, which arises in structure A, in reducing profit available for distribution. So in this sense the tax prejudice caused by surplus ACT may be overstated in structure A. Surplus ACT will constrain the feasible dividend in a legal sense if accounting and taxable profit correspond and if there are no distributable reserves, and in forms of cash flow depending on the financial condition of the firm. Practitioners commonly reduce the feasible dividend to 1 - m in the presence of surplus ACT, as a first approximation. The effect of doing this is to reduce the apparent tax disadvantage of the United Kingdom from 10 to 7 percent in our limiting case.

The new system, which involves a lower imputation rate and the possibility of a FID, significantly reduces the average tax rates of UK holding companies that remit dividends to their US parent company (structure A). The benefit is greater the higher the proportion of overseas profits and the higher the level of dividend payout. Once a UK holding company elects to pay a FID, the average tax rate for a given level of foreign income is stationary and independent of dividend policy. Compare the results for the company with 1,000 Netherlands income. Under full dividend payout, the average tax rate under the new system of 34.3 percent (structure A, column 8) is 13 percent better than under the old system's rate of 47.2 percent (structure A, column 4). Under half payout, the average tax rate is 5.6 percent better (compare structure A, columns 3 and 7). The advantage conferred by a FID diminishes as the level of dividend payout is reduced and as the proportion of foreign income decreases, and in the half payout case with equal UK and foreign income this advantage reverses. Under the old system the unprejudiced average tax rate is 30.4 percent compared to 31.7 percent under the new, which simply represents the effect of the drop in the imputation rate from 25 to 20 percent (structure A, columns 1, 5). In the full payout case the marginal rate of tax on UK income increases (27.5 versus 23.1 percent) under the proposed system due to the removal of ACT refund on the part distribution of FID. The marginal rate of tax on Netherlands income decreases (35.0 compared to 49.6 percent) under the new system because surplus ACT can be avoided when there is sufficient foreign income (structure A, columns 2, 6). When the UK firm is tax prejudiced and opts to pay a FID, the average tax rate in the United Kingdom is now lower than in the Netherlands. In the limiting case, the United Kingdom shows a 3.1 percent advantage over the Netherlands with average tax rates of 34.3 versus 37.4 percent (structures A, B, column 8). In the half payout case the advantage to the United Kingdom is 1.4 percent (structures A, B, column 7).

In the case where European subsidiaries each remit separately to the US parent (structure C), it is only the reduction in the imputation rate from 25 to 20 percent that affects the average tax rates. As the UK subsidiary earns zero foreign income and is not prejudiced, the FID scheme does not apply. When there is full payout with equal levels of UK and Netherlands income the new system raises average tax rates from 32.0 to 33.3 percent (structure C, columns 2, 6). For full payout with 1,000 Netherlands income, the rate rises slightly from 37.1 to 37.4 percent (structure C, columns 4,8).

Table 1. Comparative analysis of tax structures

	Structure A: UK holding company with Netherlands subsidiary								
Equ.		Old System				New System			
	UK income	100	100	100	100	100	100	100	100
	NL income	100	100	1000	1000	10 0	100	1000	1000
	Total income (X)	200	200	1100	1100	200	200	1100	1100
	Dividend payout	0.5	1	0.5	1	0.5	1	0.5	1
3	Foreign income dividend (FID)	-	-	-	-	0.0	65.0	348.1	796.3
1A	Surplus ACT (S)	0.0	19.0	94.5	214.0	0.0	0.0	0.0	0.0
5A	Withholding Tax (W)	3.9	7.7	20.9	41.8	3.7	4.5	4.5	4.5
4	Partial refund of ACT (REF)	11.0	22.0	59.8	119.5	8.3	10.0	10.0	10.0
2A,5A	Total tax ($T + W$)	60.9	72.7	438.7	519.3	63.5	62.5	62.5	377.5
	Average tax rate $(T + W)/X$	30.4%	36.4%	39.9%	47.2%	31.7%	31.3%	34.3%	34.3%
	Marginal tax rate on:								
	£1 of UK income	29.4%	23.1%	15.5%	23.1%	30.7%	27.5%	30.7%	27.5%
	£1 of NL income	31.5%	49.6%	42.3%	49.6%	32.8%	35.0%	32.8%	35.0%

Structure B: Netherlands holding company with UK subsidiary

	UK income	100	100	100	100	100	100	100	100
	NL income	100	100	1000	1000	100	100	1000	1000
	Total income (X)	200	200	1100	1100	200	200	1100	1100
	Dividend payout	0.5	1	0.5	1	0.5	1	0.5	1
	Foreign income dividend (FID)	-	-	-	-	0.0	0.0	0.0	0.0
	Surplus ACT (S)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5B	Withholding tax (W)	3.6	7.2	18.2	36.4	3.5	7.0	18.1	36.3
4	Partial refund of ACT (REF)	11.2	11.2	11.2	11.2	8.4	8.4	8.4	8.4
2B,5B	Total tax $(T + W)$	60.4	64.0	390.0	408.2	63.1	66.6	392.7	410.9
	Average tax rate $(T + W)$/X	30.2%	32.0%	35.5%	37.1%	31.6%	33.3%	35.7%	37.4%
	Marginal tax rate on:								
	£1 of UK income	23.8%	25.7%	23.8%	25.7%	26.5%	28.4%	26.5%	28.4%
	£ of NL income	36.6%	38.3%	36.6%	38.3%	36.6%	38.3%	36.6%	38.3%

Structure C: Netherlands and UK subsidiaries remitting to the US parent

	UK income	100	100	100	100	100	100	100	100
	NL Income	100	100	1000	1000	100	100	1000	1000
	Total income (X)	200	200	1100	1100	200	200	1100	1100
	Dividend Payout	0.5	1	0.5	1	0.5	1	0.5	1
	Foreign income dividend (FID)	-	-	-	-	0.0	0.0	0.0	0.0
	Surplus ACT (S)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5C	Withholding tax (W)	3.6	7.2	18.2	36.4	3.5	7.0	18.1	36.3
4	Partial refund of ACT (REF)	5.6	11.2	5.6	11.2	4.2	8.4	4.2	8.4
2C, 5C	Total tax $(T + W)$	66.0	64.0	395.6	408.2	67.3	66.6	397.0	410.9
	Average tax rate $(T + W)/X$	33.0%	32.0%	36.0%	37.1%	33.7%	33.3%	36.1%	37.4%
	Marginal tax rate on:								
	£1 of UK income	29.4%	25.7%	23.8%	25.7%	26.5%	28.4%	26.5%	28.4%
	£ of NL income	36.6%	38.3%	36.6%	38.3%	36.6%	38.3%	36.6%	38.3%

4. Conclusion

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There has been much concern that the United Kingdom would be an unattractive location for European headquarters companies created in the wake of the single European market, and a number of US banks, currently headquartered in London had threatened to move to the continent. The spring 1993 budget, followed by a consultative document (Inland Revenue, 1993), and the autumn 1993 budget outline proposals that address the problems of surplus ACT. The first measure reduces the tax prejudice against foreign income by lowering the rate of imputation from 25 to 20 percent. This device actually imposes an additional tax burden of 5 percent on income distributed by unprejudiced companies. The second measure introduces optional foreign income dividends (FID). This form of distribution allows the recovery of any surplus ACT that arises on the payment of the FID. Even though FIDs do not carry any tax credit, foreign banks and industrial firms are very likely to favour this tradeoff. A third proposal concerns the creation of a special international headquarters company (IHC) status. Qualifying companies will be allowed the significant advantage of paying a FID without paying the corresponding ACT that nonqualifying companies would have to pay and then re cover later. The combined effect of these proposals is an increase in the attractiveness of London as the location of a foreign multinational's European head office.

Under the assumptions outlined in this paper, we find that although surplus ACT has made the United Kingdom relatively unattractive, the tax cost to locating in the United Kingdom depends on whether companies persist with high-dividend distributions when prejudiced. In the example that we analyse, under the old regime the company faces an average tax rate, when its income is largely foreign source and when it distributes half of its income back to the United States, which is 4.5 percent[27] higher in the United Kingdom than in the Netherlands under existing rules. In the limiting case that the European operation needs to remit all profits to its parent this cost rises to 10 percent.[28] The FID proposal in the budget appears to eliminate the tax disadvantage created by the risk of surplus ACT to the international firm locating in the United Kingdom. Indeed, under the same assumptions, the proposed system reverses the relative tax positions of the United Kingdom and the Netherlands. When there is half remittance to the United States, the average corporate tax rate is 1.5 percent lower in the United Kingdom than in the Netherlands. This advantage rises to 3 percent under a full remittance policy.

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Notes

1. This potential for tax prejudice against foreign Profits predates the introduction of imputation to the United Kingdom in 1975 and has been noted by commentators for over two decades. For recent discussions of the problem, see Chown, 1993a; Higson, 1991a; Chown, 1989; Bracewell-Milnes, 1989.
2. The French imputation system exempts précompte (50 percent prepayment of income tax, where French holding companies redistribute foreign source dividends. Furthermore, foreign tax credits on dividends may be set off against any withholding tax on the redistribution of these dividends to foreign shareholders.
3. Most recently OECD (1991) estimates the average burden of tax on company income in different OECD states.
4. Among countries that give relief at the corporate level, some make dividends partly deductible for corporation tax (Spain, Sweden), while income that is distributed pays a lower corporate tax rate in Germany (and zero in Greece and Norway).
5. Australia, New Zealand, Italy, and again, Germany.
6. Plus the income of foreign branches.
7. Foreign resident shareholders may be entitled to a part repayment of the tax credit under a double tax agreement.
8. The imputation rate is set at the basic rate of income tax in the United Kingdom, and the UK imputation system is partial in that the imputation rate is less than the corporate tax rate ($c > m$). Small companies have a corporate tax rate of 25 percent so there has effectively been full imputation for small companies.
9. Overall rates, including local taxes, source OECD (1991).
10. Whether companies will opt for FIDs may also be influenced by their structure of shareholders. Exempt shareholders will lose their tax credit.
11. Particularly since the Finance Act 1988 in the United Kingdom.
12. Indeed the new US-Netherlands treaty may have reduced the relative attraction of the Netherlands to certain Investors (see Lier and North, 1993).
13. For a review of some of the factors that influence the location of holding companies, see ICAEW (1993).
14. In practice, another benefit of choosing the Netherlands has been the existence of a special arrangement between the Netherlands and Switzerland, permitting the Dutch holding company to operate a finance branch in Switzerland. A ruling from the Dutch tax authorities would allow any income generated by the finance branch to be taxed at a nominal rate in both Switzerland and the Netherlands.
15. The original participation exemption dates back to the Enterprise Tax Act in 1893.
16. In UK legislation, the minimum holding for parent company status is 10 percent (Taxes Act 1988, section 790).
17. Consistent with the Parent/Subsidiary Directive the participation exemption now also applies to passive investments (where the participation in a foreign subsidiary is held as a portfolio investment) that are situated in member states and subject to the 25 percent qualifying ownership of share capital. The participation exemption does not apply to passive investments in nonmember states. With regard to nonpassive investments in any foreign subsidiary, the qualifying holding in that foreign subsidiary

must be at least 5 percent of nominal paid-up share capital (although if certain conditions are met the holding may be less than 5 percent) or at least 25 percent of the voting rights (of a subsidiary in the United Kingdom, Ireland, Germany, Italy). In addition, the foreign subsidiary must be subject to a tax that is similar to that in the Netherlands (though the actual rate is unimportant).

18. Germany, Greece and Portugal are still permitted to operate some form of withholding tax arrangement.

19. The United Kingdom, Ireland, Spain, and Germany have selected the credit method (although Germany operates an idiosyncratic variation); Belgium, Denmark, France, Luxembourg, and ltaly have selected the exemption method.

20. In this case excess interest might be deemed dividend and subject to withholding tax.

21. Though the tax authorities are open to negotiations on higher capitalisation ratios if special circumstances exist.

22. Also, the US tax rules are likely to include cross-border dividends between foreign subsidiaries under subpart F income of the US parent.

23. In some cases it may be advantageous to have a branch rather than a subsidiary overseas. A fundamental advantage of a branch structure is that the losses due to foreign *loss-making* branches are offset directly against UK source income. In a subsidiary structure, the foreign income in the holding company depends on the level of distribution as dividend by the subsidiaries to the holding company. Losses cannot be distributed, so foreign losses cannot be used, in a subsidiary structure.

24. There is no loss of generality here; income from other European countries could be channelled into the Netherlands free of withholding tax, as we noted above.

25. For qualifying corporate structures the US/NL DTA reduces the withholding tax to 5 percent.

26. This is contained in both the UK/US and the UK/Netherlands double tax agreements. However the Parent/Subsidiary directive will remove the withholding tax in the UK/Netherlands case for qualifying companies.

27. In practice, if we adjust the gross dividend distribution by $(1 - m)$, the disadvantage is reduced to 3 percent.

28. In practice, if we adjust the gross dividend distribution by $(1 - m)$, the disadvantage is reduced to 7 percent.

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