ADVANCE CORPORATION TAX AND FOREIGN INCOME DIVIDENDS - SOME SHAREHOLDER PERSPECTIVES

Reginald S Nock & Yvonne M Metcalfe[1]

Introduction

Advance Corporation Tax ("ACT") is an item of tax that straddles both corporate taxation and shareholder taxation, including individuals and trustees as well as corporate investors who may have special status, such as exempt funds and charities. It is not appropriate, in the present article, to debate the contentions put forward by the Inland Revenue as to why the present system of corporation tax and taxation treatment of dividends requires ACT to be dealt with in its present form[2]. However, it is manifestly obvious that it has caused considerable problems for many companies, particularly large companies with significant overseas interests, and there have been very powerful lobbies pressing for many years for the system to be mitigated in many ways. These have always met with resistance, possibly because the Government cannot afford to repay the surplus ACT that is currently "on loan" with the Government as advance payments of mainstream corporation tax that will never become chargeable.

ACT is a major factor in government finance. According to the recent Consultative Document, of the £16 billion of corporation tax raised in 1992/93 some £8.7 billion (roughly 55%) was represented by ACT. Following the Chancellor's undertaking in the 1992 Budget to look at the problem, there are to be some small alterations in the system to improve corporate cash flow, and a Consultative Document has been produced which contains the promise of a special regime for certain types of companies that are described as headquarters companies for co-ordinating activities or, possibly, it would seem on the basis of the Press Releases, companies that are established to co-ordinate joint venture operations.

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1 Reginald S Nock, Head of Corporate Tax Legal Services, Coopers & Lybrand, 1 Embankment, London WC2N 6NN.
Tel: (071) 583 5000 Fax: (071) 213 2481
Author of *Stamp Duty Planning for Corporate Transactions* and *Tax Planning on Reconstructions & Takeovers* both published by Key Haven Publications PLC.

Yvonne Metcalfe, Barrister, Tax Manager with Coopers & Lybrand as above.

2 See, for example, the "need to protect the Revenue" argument in the discussion document on the Reform of ACT published 19th March 1993.

However, whilst the proposals may ease the ACT problems for certain companies, it is far from obvious that they will solve the problem for all of the companies or even mitigate the burden to any significant extent, because of the problem of the probable adverse effect upon shareholder expectations arising by reason of the proposed changes. There may be a long term impact upon certain companies which could go a considerable way to reversing the cash flow benefits of the reduced ACT, if not cancelling them entirely, and adding to the absolute cost of dividends for many companies which hitherto have not been particularly affected by ACT issues. As will be shown later, the present year changes and the proposals for reform will reduce effective returns to many shareholders who may review their portfolios, and it is important for companies and investors to consider the effect that this will have upon dividend policy and share prices as the investment holdings of major institutional investors are changed to meet the new yields.

The significance of major institutional investors in ACT planning cannot be understated and on occasion such shareholders, to whom the gross return is of importance, have influenced the structure of ACT planning. For example, stock dividends are equivalent to a cash dividend for shareholders who pay basic or higher rate tax[3], although the latter may have to find the extra cash out of their own pockets rather than from cash dividends. However, because there is no ACT to the company[4] there is no recoverable or allowable tax credit or franked investment income ("FII"). Such arrangements are not so attractive to shareholders who do not bear basic rate tax or who might be entitled to recover such tax credit, such as charities and gross funds[5]. It is believed that when Trafalgar House plc proposed to mitigate its ACT problems (caused by double taxation reliefs) by means of stock dividend arrangements, institutional investors were prepared to support the arrangements only on the basis that they would apply for a limited time. Very recently, BAT plc have resorted to the arrangement of offering a choice between a cash dividend and a stock dividend, having a value equal to 150% of the cash dividend, in an attempt to obtain the support of institutional investors for stock dividends rather than cash[6]. It will be interesting to see the effective take-up rate and the proportion of such shares on-sold in due

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[3] See ICTA 1988 s.249.

[4] Because it is not a qualifying distribution.

[5] There may be other issues concerned with the calculation of the capital gains tax base cost for different types of shareholders.

[6] Attempts to provide a market for the shares organised by the company may themselves be distributions of the costs borne by the company. Section 151 Companies Act 1985 may also be in point.

course[7]. The analogy between stock dividends and the proposed foreign investment dividend ("FID") structure will emerge later in this article.

As will be indicated later, there is a tax credit for shareholders related to dividends which represents the recovery of something of the order of £3.6 billion but, of this, around two-thirds goes to institutional exempt investors and charities. The individual investors and the corporate investor dealing with franked investment income are, therefore, not major factors in the consideration of the treatment of the tax credit arising from ACT. This, as will be indicated later, could raise significant problems for companies in maintaining the dividend income in the hands of a major portion of their shareholders, with potential additional ACT complications and, certainly, probable cashflow burdens. Therefore, the current ingenuity that is being expended upon attempts to produce schemes to mitigate the hardship of ACT will continue, notwithstanding that one of these schemes is apparently struck down by the Budget[8].

The ACT Problem

The issues giving rise to ACT surpluses are many and complicated, and full discussions are probably out of place in the present context. However, the

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7 The choice of 150% is interesting. A cash dividend of £100 is worth £125 to a pension fund or charity (formerly £133.33); a stock dividend at £150 is worth £150, giving a strong incentive to take the stock alternative. For individuals not subject to tax the figures are the same; for higher rate tax payers the post tax figures are £75 for cash, and £112.50 for stock requiring funding of cash of £37.50 from other sources.

8 This involves the acquisition of a company with ACT capacity, i.e., the ability to carry back surplus ACT against previous years' mainstream corporation tax. It appears that the Finance Act 1993 will contain provisions restricting the carry back of surplus ACT where there has been a change of ownership, in the same way that there are provisions restricting the carry forward of ACT in similar circumstances (see ICTA 1988 s.245). The precise terms of this will need to be considered very carefully and there are the usual suggestions of a potential overkill since there may well be a change of ownership in relation to a company with ACT capacity where there is a change of control arising by reason of the establishment of a bona fide commercial joint venture, a reverse takeover, or where, for various reasons, a group is being assembled from family investments and one particular company is chosen as the prospective parent regardless of its ACT or franked investment income position, probably because it is the largest company and therefore offers the best prospect of saving stamp duty on the mergers. A further overkill potential exists in relation to the proposal to stop the sale of capital loss companies that was judicially approved in *Shepherd v Lyntress* [1989] STC 617, Ch D. Here the proposal is to ring fence accrued losses within the company that is being acquired. The losses can be used only against gains accruing in that company from assets that it owned at the time of the change of ownership. However, this overlooks the situation of a genuine merger where one of the companies involved does have accrued capital losses and which may never be in a position to use those losses against its trading activities because, for example, it is rationalised or divisionalised after the acquisition, or assets are extracted from it as part of the group planning such that the gains accrue from its former assets to other members of the group in due course.

potentially adverse effects of the Budget changes will not be limited to those companies with surplus ACT, as is considered later. Unfortunately, a brief understanding of the issues is required in order to identify those companies where the ACT surplus is likely to arise and whose dividend yield and share price may be affected by the new proposals, and in order to understand the context in which the present proposals fit.

Where a company, resident in the United Kingdom, pays a qualifying distribution[9], it is required to account for ACT within a short time after the payment of the dividend[10]. In theory such ACT is simply an advance payment of the corporation tax and can be used by the company to reduce the amount of mainstream corporation tax ("MCT") payable in due course[11]. Unfortunately, there are many situations where the company is not in a position to absorb the whole of the ACT against the current MCT. There is a specific statutory provision[12] which provides that the maximum amount of ACT that can be set off in any particular year is limited by the maximum taxable profits of the company for that year. In other words, the company cannot set off more ACT than would have arisen had it distributed the whole of its corporation taxable profits for the year. This may not appear to be much of a problem because of the restriction in company law[13] which limits a company to distributing by way of dividend only its realised profits and gains. However, this restriction overlooks many problems that can arise where a distribution can produce more ACT than can effectively be used. The situations are many but include:

(i) where there is a fall in profits and dividends are paid out of reserves;

(ii) where the profits available for distribution under company law exceed the taxable profits, such as where tax relief is available either directly or through group relief[14], or where there is a large scale capital investment

9 ICTA 1988 ss.209-211.

10 ICTA 1988 Sch 13.

11 ICTA 1988 s.239. This also ignores the possible recovery or set-off problems that are likely to occur under the transitional provisions concerned with the rate changes for institutional and similar investors. Although only one CT61 return is required for the period to 30th June 1993, two calculations will be required; one for the period 1st-5th April 1993 and another for the period 6th April 1993-30th June 1993. The effect of this now appears to be that FII received after 6th April 1993 cannot be used to recover ACT for periods ending prior to 6th April 1993. In certain situations, such as insufficient capacity to carry back or absorb the ACT arising, this may have to be carried forward as, effectively, a cost to the company.

12 see ICTA 1988 s.239(2).

13 Companies Act 1985 s.263, and following.

14 see, e.g., ICTA 1988 s.402.

programme producing capital allowances which reduce the tax profits without necessarily reducing distributable profits in quite the same way;

(iii) where the company may not have sufficient MCT because it derives substantial profits from overseas activities which attract tax in the local jurisdiction. Such tax will, under normal provisions of double taxation relief, attract some form of credit or benefit in the United Kingdom, reducing the company's MCT. In many cases, this has the effect of reducing the MCT payable below a level at which full ACT recovery can take place;

(iv) purchases of own shares can produce distributions bearing ACT[15].

Provision is made for some relief in respect of such surplus ACT, i.e., ACT arising in any particular year that cannot be offset against the current year's MCT. These provisions include:

(i) the ability to surrender the ACT to other members of the group who have the capacity to use it[16];

(ii) the ability to carry back the ACT against the preceding 6 years' profits, subject, however, to the maximum set-off described above as prescribed for each of those years[17]; and

(iii) the ability to carry forward the ACT against the MCT of future years, but again subject to the maximum prescribed amount described above in each of those subsequent years[18].

As indicated above, there are certain anti-avoidance provisions, including one in the current Budget, which have the effect of excluding the right to make use of surplus ACT in any of the above situations, particularly where there has been a

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15 see, e.g., ICTA 1988 s.209(2)(b). Following the case of *Scandinavian Bank Group* [1987] 2 All ER 70 it is now possible to have multiple currency share capitals and many companies have used the opportunity of issuing redeemable preference shares denominated in non-sterling currencies which are likely to be redeemed at a different rate of exchange. This has raised the issue of whether the transaction can be looked at solely in terms of the currency subscribed and repaid (i.e., no change in the amount of that currency) or whether there has to be some comparison of the sterling equivalents (see, e.g., *Bentley v Pike* [1981] STC 360 and *Capcount v Evans* [1993] STC 11) which may give rise to a distribution and an ACT liability.

16 ICTA 1988 s.240.

17 ICTA 1988 s.239(3).

18 ICTA 1988 s.239(4).

change of ownership[19]. The effect of this is that such surplus ACT becomes, effectively, irrecoverable and, far from being an advance payment of MCT, is a permanent donation to the Inland Revenue. It is hard to see the moral justification for some of the restrictions, notwithstanding that they are part of some anti-avoidance arrangements, because there has been a genuine payment of tax to the Government that is not due. The company, therefore, has an asset[20] of which it has been deprived.

The "standard shareholder" will receive his dividend "net of ACT"[21]. Hitherto, the rate of ACT has been linked to the basic rate of income tax. This means that individual shareholders (special rules apply to corporate shareholders) or trustees, who are subject to tax in addition to the basic rate, are liable to pay the difference. This is done by grossing up the amount of the dividend received by the tax credit, and calculating the relevant amount of higher rate tax payable, deducting therefrom the tax already charged by reason of ACT. The effect of the change is that on an net dividend of £75 a higher rate taxpayer will be £3.75 worse off (see Table 1).

Particular shareholders give rise to different problems. Individual shareholders who do not pay basic rate tax are entitled to recover the tax credit as are other shareholders such as exempt funds and charities who are not subject to income tax in respect of such income. Special rules apply to non-resident shareholders, who are prima facie not entitled to the benefit of the tax credit. However, limited reliefs[22] are available which are influenced by, and are dependent upon, the terms of any relevant double tax treaty.

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19 supra.

20 It may seem rather odd to describe a tax charge or right of set-off as an "asset" but this point was considered in *Charterhouse v Tempest* [1986] BCLC 1 where dealings in relation to such tax assets, in that case trading losses, were subject to scrutiny as potential unlawful financial assistance within s.151 of the Companies Act 1985. It may also be appropriate for the company to require payment for the surrender of its ACT; such payments are, subject to certain limits, ignored for tax purposes.

21 The question of whether a dividend is a set percentage plus tax credit (i.e., with a fixed net amount but a variable gross depending upon the rate of ACT) or is expressed to be a gross sum subject to the deduction of ACT (i.e., a fixed gross sum with a variable net) can be of crucial importance in determining whether the shares in question are ordinary share capital. It seems that the Inland Revenue incline to the view that only the former are fixed rate preference shares. See discussions in *Sime Darby London Limited v Sime Darby Holdings Limited and Others* [1975] 51 TC 178, Ch D, and *Tilcon Ltd v Holland* [1981] 15 TC 464, Ch D.

22 This usually takes the form of a "half tax credit".

A United Kingdom resident corporate shareholder is not subject to corporation tax upon any dividend received[23]. It receives a dividend "net" of tax which constitutes FII, which can be used by such a corporate shareholder in one of two ways:

(i) it can use the tax credit in the dividend received as a reduction in the amount of ACT that arises upon any dividends that it pays to its shareholders[24]; or

(ii) where it has more franked investment income than is necessary to frank its own dividends it can, subject to certain conditions, make temporary use of the surplus franked investment income against trading losses, permitting a temporary recovery on the tax credit[25].

A potential issue arises with regard to the utilisation of FII, in either of the above ways, in the context of a company receiving a dividend, which includes a dividend from a subsidiary to a parent paid outside the group income election, which the receiving company, in turn, pays on to its shareholders. As a consequence of the changes, the initial payer company will account for ACT at 22½%, as will the intermediate company when passing the dividend on to its shareholders. Although the Press Release is silent on this point, the Inland Revenue have indicated that, in such a scenario, the intermediate company will be entitled to a credit of 22½% when calculating the ACT due upon its dividends although this will **not** apply where it is proposed to use a surplus of FII for s.242 purposes, when the 20% limit will apply.

The Current Changes

The immediate changes in ACT are aimed primarily at easing the position of the paying company with surplus ACT problems. It must not, however, be overlooked when reviewing investments, that it is not only those companies with actual or imminent surplus ACT problems which are likely to be affected. Such companies are likely to be most involved in the economic issues arising from the choices involved if the proposed FID structure is adopted. Other companies with significant institutional and overseas shareholders will inevitably have to consider their dividend position and policy because of the reduction in the rate of tax credit contained in the Budget. Such companies will either have to increase their

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[23] ICTA 1988 s.208.

[24] ICTA 1988 s.241.

[25] see ICTA 1988 s.242.

dividends, thereby affecting retained profits[26], or face institutional shareholder discontent and a number of members voting with their feet. As will be seen, increased dividends (unlike ACT at higher rates) is an absolute cost to such companies which have no surplus ACT problems; for companies with surplus ACT the cash flow position is effectively unchanged.

The basic change is that for 1993/94 the rate of ACT for which the company is liable to account is reduced from 25% to 22½%, reducing further to 20% for 1994/95. This means that the amount of ACT for which the company is liable and the cash required to be laid out to the Government as advance MCT will be reduced where the dividend remains the same. The table below shows that the company can make the same net payment to the shareholder and reduce its total cash outlay because an individual basic rate shareholder, receiving a dividend of £75 in 1994/95, could receive the same net payment of £75 but this would require an ACT payment of £18.75 by the company rather than the £25 hitherto. For 1993/94 the same dividend of £75 would require ACT of £21.77.

However, from the shareholder's point of view, whilst receiving the same initial net dividend, his overall position may be worsened. It is to be provided in the Finance Act 1993 that the tax credit attaching to the dividend is to be reduced from 25% to 20%. The shareholder's "gross return" is therefore reduced. Those shareholders who are liable to higher rate tax will continue to bear that higher rate tax with the benefit of only a credit of 20% against the 40% or other rate.

Table 1

1992/93 - 25%		1994/95 - 20%
Net dividend	75	75
Tax credit	25	18.75
Notional receipts	100	93.75
Tax due at 40%	40	37.50
Higher rate	15	18.75
Net receipt	60	56.25

[26] Some commentators, however, believe in a 100% distribution policy leaving decisions on investment to the shareholders rather than enabling management to have retained earnings as a source of cheap money to fund new programmes or enterprises producing low yields - see, e.g., Rubner: "The Ensnared Shareholder".

Discretionary trustees, it seems, will have an additional cashflow problem. Under the new regime they will be liable for tax at the 35% rate (including the additional rate) but will be entitled to a tax credit of only 20%. The additional rate payout will, therefore, increase from 10% to 15%. Other shareholders, who are not liable to tax, such as institutional investors and charities will, prima facie, suffer a real reduction in their gross return unless a higher net payment is made.

Table 2

	25% 1992/93	20% 1994/95 OR	20% 1994/95
Net Dividend	75	75	80
Tax credit	25	18.75	20
Gross return	100	93.75	100

To cope with this, special transitional arrangements are to be introduced for charities.

Charities receiving dividends from UK companies are normally entitled to claim payment of the accompanying tax credit by virtue of their exemption from tax on this income. For a transitional period of four years from 1993-94, charities will also be able to claim additional payments, designed to ease the transition to the new reduced value of the tax credit. These payments will be public expenditure and will be calculated on a sliding scale. They will be one-fifteenth of the dividend for 1993-94, one-twentieth for 1994-95, one-thirtieth for 1995-96 and one-sixtieth for 1996-97. (Broadly, this will represent the difference between the tax credit (payable on the basis of the lower rate of 20%) and the amount of the tax credit which would be payable if the appropriate rate of tax were 24% (in the case of dividends paid in 1993-94), 23% (1994-95), 22% (1995-96) or 21% (1996-97)).

As previously stated, the bulk of shareholders affected by the tax credit in gross terms are institutional investors, representing some 66%. These are clearly, therefore, a major constituent in a company's consideration of its dividend policy. Given the size of the investments held by pension funds and others in major companies, there could be a potential adverse effect upon the share price because the gross yield (which for these shareholders is the same as the net yield) will diminish. There being a lower rate of return, the amount of capital that is appropriate to invest may also reduce, pulling down share prices. Therefore, as companies are not particularly anxious to see their share prices fall, particularly where this might make them vulnerable to predators who can then afford to take them over, they may wish to, or may be forced to, increase their dividends in order to provide the same effective return to a significant part of their shareholders. As has been indicated above, ACT mitigation arrangements have not always found favour because they represent an effective reduction of income to major shareholders because of the lack of a recoverable tax credit, unless the company is prepared to bear the cost of an increased payout. Since schemes have been rejected or restricted on this basis or, as with Trafalgar House plc, subject to a time limit in order to persuade such investors to participate in this scheme, it is not unlikely that companies may find themselves under pressure to maintain the gross return by higher net payments. This will, of course, go some way to removing the cashflow benefit of the reduced ACT payment, thereby producing effectively more ACT, albeit at a lower rate, with the consequent problems of offsetting this against MCT in due course[27]. This could produce a situation where, instead of as indicated above, the company now maintaining the same net payment of £75 but having a reduced gross outlay (e.g., £93.75 for 1994/95 instead of having to pay out £100) will, in order to maintain the gross payout of £100, be required to pay £80 net dividend and £20 ACT for 1994/95 and later years. It would seem that by focusing more upon the net position than the need for maintaining the gross position, the Chancellor of the Exchequer has merely shifted the cashflow problem from ACT to dividend maintenance in order to sustain share prices and credibility in the market, and has for many companies turned the ACT cashflow into a permanent cost of £5.

Another body of shareholders who represent a particular problem will be non-resident shareholders. As indicated above, the issues relating to these are complicated and turn upon double tax treaties. What follows is merely a very simple illustration of how these non-resident shareholders are likely to suffer as a result of this change. Under most double tax treaties and other arrangements, there will be withholding tax and provision for a partial repayment of the tax credit. Non-resident shareholders are not entitled to full tax credit and the table below highlights their worsened position consequent upon the Budget changes.

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[27] see Table 2 (above).

Table 3

	Pre 6th April 1993 £	Post 5th April 1994 £
Dividend	75	75
Tax credit 1/3 1/4	25	18.75
One half tax credit refund	12.50	9.38
Withholding tax 5% x (75 + 12.5) 5% x (75 + 9.38)	(4.38)	(4.22)
Net tax credit refund	£8.12	£5.16

Again, it remains to be seen how companies will be forced to tackle the situation in relation to significant bodies of overseas shareholders.

Headquarters Companies

One particular type of company may achieve a reasonable position in relation to non-resident shareholders. For many years, there has been a disincentive as regards the use of the United Kingdom as a location for holding companies or consortium arrangements. Where non-resident shareholders wish to co-ordinate their activities in, say, Europe or wish to enter into some form of cross-border joint venture, then the fact that the dividends that have to flow into the United Kingdom attract ACT (with limited benefits from the tax credit) on their onward movement to shareholders and consortium members abroad, has discouraged people from basing joint venture companies in the United Kingdom. Considerable skill has been used in attempting to deal with these problems, such as stapled stock and income access shares as well as parallel holdings[28].

[28] See variations on this theme, such as Smith Kline Beecham; Arjo Wiggins Teape; the recent joint venture between Reed and Elsver; and the Waterford and Wedgeford merger. The idea behind these arrangements to provide for non-resident shareholders to have direct access to dividends declared in order to avoid the multiple taxation and ACT issues arising as dividends flow from abroad into the United Kingdom and back to residents in the local jurisdiction where the profits arose, does not always find favour with the United Kingdom Inland Revenue; see for example, the amazingly rapid response of the Inland Revenue to the attempt by BP to "stapled stock" in relation to certain of its oil interests for a few years ago.

There will be provisions in the Finance Bill 1994 dealing with headquarters companies that are based in the United Kingdom. If these provisions are appropriately drafted, this may ease some of these economic issues and political squabbles about the location and place of residence of holding and consortium companies. The current proposal is that the Finance Bill 1994, following the second Budget this year, will, in any event, contain some proposal for allowing headquarters companies to pay dividends out of non-UK source income without accounting for ACT. Prima facie, this mechanism is to be linked to the FID procedures and proposals considered later in this article, but, if these proposals are altered or amended or rejected, then some other proposal will be put in place to avoid the ACT problems for such companies.

The difficulty is, of course, planning ahead in the absence of any definitions in this area, particularly as there are no indications of what activities will be appropriate. The indications are that such a headquarters company will have to have a substantial part of its share capital ultimately held by shareholders who are not resident in the United Kingdom. The proposals in paragraph 89 of the Consultative Document indicate something of the order of 80% of the share capital must be owned by non-residents which, of course, casts serious doubt upon many joint venture companies operating a 50/50 or 33% basis[29]. There will also be problems as to the number of shareholders since it is suggested that it should be limited to five. No doubt, with the usual Inland Revenue over-enthusiasm for anti-avoidance legislation, there will be heavy restrictions upon the nature of the activities that such companies can undertake and, presumably, they will be limited to holding company activities[30]. Prima facie, the concept of a headquarters company may overcome some of the difficulties for non-resident shareholders under the revised ACT rules considered above but just how far this will be beneficial must depend upon the terms of the legislation and it is unlikely to be of any great benefit to existing companies with ordinary portfolios of non-resident investors overseas where clearly the concept of a headquarters company will be totally inappropriate.

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[29] There was also the question as to whether and how far there will be "look-through" provisions in these shareholdings since certain of the definitions of group and consortium arrangements raise problems where foreign companies are involved, subject to the fate of *ICI v Colmer* [1992] STC 51, in the Court of Appeal.

[30] Subject to all the problems with Customs and Excise and VAT that the *Polysar* decision has apparently created ,although it seems that the Customs and Excise view on the effect of this decision is not widely accepted outside Customs and Excise and is apparently being reviewed.

Foreign Income Dividends (FID)

As indicated above, one of the major sources of surplus ACT is companies with substantial overseas earnings attracting foreign tax which have the effect of reducing the MCT bill in the United Kingdom below the level at which effective recovery of the ACT can be achieved. Currently, the plan to deal with this particular problem merely takes the form of a Discussion or Consultative Document. The problem is, however, that the same sort of distortions between exempt and other investors is likely to arise with the result that, as the scheme is optional, companies may find it better to opt out of the system and maintain the ACT problem, seeking to alleviate it by other means and schemes rather than have the problems of higher dividends with related ACT problems and the complex administration procedures that are required to deal with the FID situation. The response of certain types of shareholders can be predicted since the FID proposals are very similar to the taxation rules relating to stock dividends[31] which, as indicated above, have not been particularly popular with shareholders to whom the "gross return" is important. For these classes of shareholders, the cash paid will also be the gross return.

Under the proposals, the system is operated at the choice of the company. The broad structure of the proposals is that the company could elect that certain of its dividends will be declared as FIDs. This gives it the option of declaring several dividends within the year, some of which might be FIDs, others of which would be ordinary dividends. The idea is that a FID will be identified with foreign source income and, where ACT is not recoverable in the normal way because of foreign tax credits, the surplus ACT so arising will be recoverable. However, since it may not be possible to identify that income or the amount thereof, or the foreign tax in respect thereof at the time the dividend is declared or paid, it seems that it will have to account for ACT in the normal way. Special rules will detail how the repayable surplus ACT in respect of foreign source income is to be calculated. The company will then be able to recover the lower of its actual surplus ACT for the period, or the surplus ACT, irrespective of the FID, which is attributable to foreign source profits. Where the full amount of the surplus ACT attributable to FIDs cannot be recovered in any period, it can be carried forward to later periods.

From the shareholder perspective a FID will have no tax credit. As the company has not paid ACT, and the tax borne by the FID has been paid to a foreign government this absence of recovery seems reasonable, and basic rate and higher rate taxpayers will be in the same position as if receiving an ordinary dividend, i.e., the shareholder who receives a FID is deemed to have received a dividend which has borne tax at the 20% rate. However, this is not a tax credit in the strict sense and is irrecoverable.

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31 see ICTA 1988 s.249.

A person who is liable to the higher rate of tax will be liable for the tax in excess of the notional 20% income tax rate. The amount received will be treated as a dividend, net of 20% rate tax, grossed up and then the higher rate tax calculated, currently requiring a further payment of the 20% rate. Trustees of discretionary trusts receiving a FID will, on this basis, be treated as receiving net income at the lower rate of 20% and be liable to the tax at 35% with the liability at the additional rate. They will, therefore, be required to find a 5% tax payment in addition to the current 10% charge. However, the 20% tax notionally borne will not be available to set off against the trustees' liability in respect of discretionary payments to beneficiaries[32]. Similarly, there will be no repayment of tax to any person who is not liable to income tax. Since the company can recover any surplus ACT arising in respect of a FID, there is no tax credit in the recoverable sense for a shareholder. Therefore, the value of the dividend received, if paid in the same net terms, will be significantly less to taxpayers who do not bear tax because of lack of income, or are within some exemption such as pension funds and charities. Similarly, non-resident shareholders will not be entitled to any benefits of the tax credit in respect of a FID.

There will, therefore, as with the reduction in the tax credit considered earlier in this article, be an effective reduction of income in the hands of many shareholders save that, in this case, the problem will be more acute. Where a company declares a FID of £75 this will be the gross payment for many shareholders, an effective reduction of £18.75 in their income at the 20% rate. This may well have a depressing effect upon the value of the shares as these investors switch from their existing holdings into holdings where foreign income is not such a problem. The Inland Revenue appear to think that the reduction in the ACT cost will swell the company's resources sufficiently to counteract the possible fall in the share price. This is, of course, only verifiable by empirical testing after the system has been in place for some time, by which time any long term damage may have been done.

The Inland Revenue fear that companies will somehow organise their dividends, and their share capital structure, so that ordinary dividends are diverted towards exempt shareholders who are entitled to recover the tax credit, and FIDs are paid to other shareholders who are not prejudiced by the nature of this dividend.

32 This is somewhat ambiguous. It is thought that the trustees will pay the sum received less only the extra 15% to the beneficiaries who can recover only the 15% in whole or in part as appropriate, i.e., the trustees receive a payment of £80 (equivalent to £100) and pay the additional £15. They pay £65 to a beneficiary who can recover a maximum of £15. It is, however, possible to interpret the words as meaning that the trustees receive a payment of £80 and are liable for 35% of £80 (i.e., the dividend paid is the grossed up amount without any tax credit). The trustees are taxed £28 so that the higher rate beneficiaries will receive only £52. Alternatively, it could mean that the trustees are treated as receiving £100 and pay the additional 15%, but when making the payment of £80 to the beneficiary are required to deduct 35%, i.e., £28, of which the part equivalent to basic rate must be paid over to the Inland Revenue. It is thought that these latter two interpretations are not intended but it indicates that the precise wording of the legislation will require careful scrutiny.

Again, given the overkill attitude of the Inland Revenue towards anti-avoidance, it will be of great significance to see how these issues are dealt. Attempts at anti-avoidance legislation may hit at existing bona fide share structures. For example, there may be problems in relation to certain types of preference shares where the rights have already been laid down by the Articles of Association as to their dividend participation and may not, in their existing form, be amenable to FIDs. Annual general meetings may be required to consider not only the dividend, but also alteration to share rights in order to cope with possible problems in relation to fixed rate preference shares and other shares which are favoured by institutional investors because of the relative certainty of the yield.

On the basis of very broad proposals without the detailed draft legislation, it is difficult to deal with many of the important issues concerned with a possible FID scheme. However, the mere fact that it is expressed to be optional on a dividend by dividend basis suggests that the Inland Revenue are aware of the potentially adverse effect upon a wide body of shareholders. The difficulties have to be overcome, not by drafting, but by opting out of the scheme and living with the present mess. As paragraph 43 of the Consultative Document states, it is for the companies "to make a judgement about what was in the best interests of their shareholders, since it is accepted that some shareholders would find a FID unattractive and would prefer to receive an ordinary dividend". This is scarcely a very satisfactory way of attempting to resolve a problem that will produce tensions between the company's need for cash and to avoid ACT problems, and shareholders' legitimate expectation that the yield that they anticipated when purchasing their shares will be maintained without an adverse effect on the capital value. It will be a very difficult job for boards of directors of major companies, with substantial overseas interests, to find some reasonable way of resolving this tension and conflict of interests in the best interest of all of the parties.

Unfortunately, there will be some winners and some losers and it is not really very satisfactory, having had at least a year to think about the problem and many years of having been faced with the problem, for the Inland Revenue to say that shareholders "might be concerned about the extent to which a company would make use of the option, which could have an unsettling effect on the market value of the shares. A quoted company might want to declare a policy about whether some or all of its future dividends would be FIDs so that potential shareholders could decide whether they wanted to hold the shares". Unfortunately, this fails to add the words "and so that existing actual shareholders could decide whether they want to continue to hold shares". Taking a very relaxed view about the decision of people in the future whether to invest in a particular company or not depending upon its potential FID attitude is not a very happy way of dealing with the situation of people who have already invested and because of the "unsettling effect" may not find it the most advantageous time at which to sell.

Conclusion

The overall conclusion is that the Inland Revenue recognise that there are some fundamental strategic problems for companies and their shareholders embodied in the new ACT proposals at all levels, but fail to take account of the fact that the vast majority of present shareholders are not UK individuals, subject to tax at the higher rate, who are probably the only people who are not adversely affected by the present arrangement. This means that, subject to the detailed drafting of the legislation, institutional shareholders, exempt funds, charities and similar investors will be required to reconsider their investment strategy by reference to whether the company is prepared to change its dividend policy to produce the same effective yield, notwithstanding the ACT and tax credit adjustments. In particular, a very important factor is the extent to which the company has ACT problems arising by reason of its foreign income and double tax credits and how it feels it is appropriate to use the new scheme. There will be, therefore, much effort required over the next year or so, for major companies in deciding their dividend strategy to consider various models of UK to foreign income ratios and the percentage of institutional shareholders who may be influenced by the presence or absence of a recoverable tax credit.