The Offshore Taxation Review

THE ABOLITION OF ACT

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The purpose of this article is to consider two of the three relevant aspects of the abolition of ACT. At the time of writing the shadow ACT regulations have not been published, and clearly many will be focusing on those and the generosity or otherwise of the shadow ACT system in the weeks to come. The purpose of this article is to look at the other two main aspects of the abolition of ACT. First it is worth looking at the slightly piecemeal way in which the overall changes to the distribution system have been introduced, because that history certainly accounts for some of the oddities that remain in the system. Secondly, the aim is to look at other general implications of the abolition of ACT, ignoring shadow ACT.

The course of the changes, and the oddities and anomalies

The abolition of ACT was really triggered, rather inadvertently, by the denial to pension funds of the cash repayments previously available in respect of all UK franked dividends. It was that denial of credits that made pension funds indifferent to receiving a foreign income dividend as against a conventional franked dividend; it was that indifference that thus removed the pressure on companies to gross up their FID dividends from 80 to 100 (to provide pension funds with an equivalent benefit) as against ordinary dividends of 80; and it was thus the abolition of repayments of tax credits that instantly made FID dividends of enormous, rather than mere theoretical appeal, to ACT surplus groups. Such groups were able, by initiating FID dividends in subsidiaries with only foreign income, or by matching their FID dividends against the profits of such subsidiaries to reserve whatever mainstream profits they had for offset of past surplus ACT. Thus groups could solve their current ACT surplus

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This article was first published in *The Corporate Tax Review*, Volume 1, Issue 2, at page 195.

problem, and eat into the past surplus, by paying FID dividends, without any further shareholder objection.

The Revenue anticipated this, and therefore put a two year limit on the ability to pay FID dividends. That initially left a glowering question mark over what would happen in relation to ACT surplus problems from 1999 onwards. Not only would companies be deprived of the ability to pay further FIDs, but the surplus ACT problem would then be dramatically more serious than before the 2nd July. For pension funds would no longer be recovering the ACT that companies would be paying and companies would not even have the ability to pay FIDs, even if they had been prepared to gross them up to the higher level.

It was really the inability to revert to this sort of system that forced the Government's hand. They either had to make all dividend payments by UK companies FIDs, or they had to abolish ACT. There is not an enormous difference between those two possibilities, save that, rather refreshingly, the abolition of ACT means that the Government has plugged the hole in its cash flow by requiring corporation tax to be paid in advance by instalments. This means that the cash flow cost to the corporate sector is borne substantially by the companies with larger tax liabilities (the big mainstream payers) rather than by the companies (the ACT surplus companies) that used to bear an unduly onerous, and potentially indefinite, cash flow cost in paying ACT.

Tax credits

Although ACT is to be abolished from 6th April 1999, we are still left with the vestiges of an imputation tax system, and the rather curious feature of a credit attaching to dividends of 10%. The lower rate of credit is matched by lower rates of tax and a top rate of tax of only 32.5% for individuals in relation to UK dividends. The intention of this is that individuals will be taxed, on getting reduced credits with UK dividends, at exactly the same level, on account of the matching reductions in the rate of tax.

Explaining this situation in the future to clients and more particularly bewildered foreign clients is going to be something of a challenge, and it is worth observing why we have reached this somewhat extraordinary position.

The driving force to reducing the theoretical rate of credit is to deprive foreign "treaty" shareholders from 1999 onwards of the repayment of tax that some shareholders presently remain entitled to. The motive for doing this is entirely understandable. When the imputation system was introduced, the rate of corporation tax was increased to 52%, and partial repayments of ACT to foreign shareholders were realistically the equivalent of capping a withholding tax at a treaty rate rather than leaving it at the full domestic rate. With the UK corporation tax reduced however to 31% and 30%, the idea of repaying part of that tax to treaty shareholders had really become slightly anomalous. Thus we adopted a device for seeing that that was no longer done, halving the tax credit so that on a mathematical basis the amount of ACT actually paid back to treaty shareholders was not worth claiming. This end result was an entirely understandable objective.

This could have been achieved by scrapping the credit altogether and simply saying that the top rate of tax on a cash dividend from a UK company was 20%, with no credit, which would produce exactly the same result as the old 40% rate with a 20% credit. The problem with this however was that the limitation of US withholding tax, under the US/UK treaty on dividends flowing in the other direction, is itself dependent on US residents being theoretically entitled to the benefit of a tax credit attaching to UK dividends, and preserving this benefit is apparently why we have our rather extraordinary system of a credit at 10% and the adjusted rates of tax on UK dividends.

One of the further perverse results of this fiddling with the rates of credit and tax is that the rate of tax charged on individuals on foreign source dividends has also been reduced to 32.5%. This is strange because the rate of tax on UK dividends was only reduced to preserve the previous effective rate of tax on the basis of the old credit. The Government presumably felt bound to reduce the rate of tax on foreign dividends commensurably, so as not to appear to be discriminating against foreign dividends, and also to try to substantiate that the rate of tax on UK dividends was a real rate of tax rather than just an artificial way of getting to 40%.

Attributes and implications of the abolition of ACT

1. As already noted the total abolition of ACT means that the potential ACT trap of streaming foreign profits through a UK company disappears. The Government recovers the cash flow benefit of ACT by accelerated payments of corporation tax that impose most of the cost of this on the mainstream payers rather than the companies paying little corporation tax on high taxed foreign profits.

2. The old ACT surplus companies will probably not rejoice unreservedly. Once we are able to consider the details of the shadow ACT system, one rather supposes that that system will be less generous than the current intermediate FID system operating between 1997 and 1999. As already noted, companies can stream their FID dividends out of foreign profits, preserving their mainstream profits for offset of carry-forward ACT, so that in a sense in the intermediate two year period the Government is repaying the ACT paid in earlier years notwithstanding that a particular group's ratio of UK income to foreign income might remain constant. Under the shadow ACT system one presumes that a company in this position will not find it so easy to recover its past ACT.

Although ACT is to be abolished it appears that the whole of the distribution code, defining whether payments by a company rank as distributions, or return of capital, will remain in place. This is an extremely complex code, and with bonus issues, issues of shares at different times for different prices, issues of shares on a merger accounting basis, capitalisation of premium, etc., the determination of what might rank as a distribution, and what as return of capital, can be difficult.

It seems strange to persist with all this complication when the distinction will now have no significance to the company itself; little or no significance to gross fund shareholders; and generally little significance to corporate shareholders. And so far as individual shareholders are concerned, there appears to be a bit of a toss up as to whether distribution treatment will be more or less advantageous than capital gains treatment.

3. The next rather startling implication of the abolition of ACT is that there might emerge a fairly major planning temptation for substantial individual shareholders selling shares in a private company to do this not by selling shares on a capital gains basis but by procuring a massive reduction of capital by the company. If the company pays out all its profits as dividend, then without worrying about whether the profits have been taxed, or whether ACT can be carried back to the year in which the tax was paid, the implication of there being a distribution will be that shareholders will pay tax at only 20%, whereas they might have paid tax at 40%, with taper relief, on a conventional capital gains sale.

Shareholders would appear to be able to go a step further than this. They could procure that the company realised all its unrealised profits by making artificial sales to a subsidiary so that dividends could be paid. In other words the same steps could be undertaken as used to be undertaken in the corporate sector prior to the introduction of the value shifting provisions contained in sections 30-34 TCG Act. And shareholders could procure a full distribution of the realised, and artificially realised profits of the company so as to diminish the rate of tax down to 20%. The value shifting sections would appear to be irrelevant because the shareholders' dividend taxed at 20% would not be "a tax-free benefit" for the purposes of section 30.

Much the same thinking has been adopted for a number of years now, by shareholders in private companies who have sought to achieve the same result by artificially procuring that the company declared colossal scrip dividends, caught by section 249 TA 1988, so that again without paying ACT, shareholders would be taxed at 20% and would secure an uplifted base cost. The significance of the abolition of ACT is that this basic thinking can now be pursued without the complication of having to worry about the artificial scrip dividend, and avoiding the ACT.

There appears a possibility thus that the tables may have been wholly turned, and that the tax effective way of achieving a liquidation may be to distribute the maximum amount possible as dividend before the liquidation, and only distribute the residue during the course of the winding up. Equally, sales and purchases of private companies may (subject to possible *Furniss* sensitivities) come to be implemented as repayments of capital, coupled with re-issues of shares rather than straight sales.

4. Another implication of the abolition of ACT is that scrip dividend schemes, albeit never terribly popular, could well disappear altogether. No category of shareholder has had a tax incentive in recent years to take a scrip dividend rather than a cash dividend. The company offering scrip might have enjoyed an advantage by saving ACT if it was in an ACT surplus position, and a company worrying about its shadow ACT payments may still have a motive to continue to offer scrip. That apart however the abolition of ACT probably leaves companies observing that they were generally unattracted to scrip since it put more shares in issue, and generated more dividends to be serviced in the future, so that with nobody having any tax motive for scrip to be offered, scrip dividends will presumably die out. Instead companies may offer arrangements where under they will re-invest cash dividends paid to shareholders who wish to re-invest by buying shares in the market. This achieves the shareholders' objective and does not increase the shares in issue.

5. Some odd points arise in relation to the rate of tax on dividends, and the feature that UK dividends suffer no withholding. The potential charge to corporation tax on capital gain, and the difficulty in computing foreign tax credits will greatly complicate the following simplistic example, but nevertheless the example is worth noting.

Suppose that UK individuals own all of the shares in a Dutch company whose profits, at some underlying level, have suffered tax at a rate at least equal to 30%.
If the Dutch company pays dividends to the individual shareholders, there is a 15% withholding tax, but more relevantly the shareholders pay tax at 32.5%.

If the shareholders drop the Dutch shares into a UK company, the European Directive presumably eliminates the Dutch withholding tax; credit relief eliminates any UK corporation tax; the UK company pays dividends without any withholding; and the shareholders pay tax at effectively 20% on the dividends from the UK company.

Two other factors are worth noting. As the UK dividend is not the subject of any withholding, non-treaty investors in a Dutch company might equally observe that if they put income producing shares without capital appreciation potential into a UK holding company, and filter the dividends through the UK holding company, unless the protection of the European Directive is forfeited, the foreign shareholders effectively avoid all withholding taxes.

Another even more perverse point appears to arise. Prior to the changes in the rate of credit attaching to UK dividends, most foreign treaty shareholders obtained a credit for the whole of the ACT, and were able to recover a small portion of it in cash, and obtain a credit for the rest of the ACT against their local tax liability. The following proposition is of course dependent on the terms of treaties, and foreign tax law, but it would appear that when certain treaty foreign shareholders receive UK dividends they will not only receive them free of withholding, but find that they have attaching to them a 10% credit that may eliminate part of their local tax. It must be possible to find a set of facts thus where, say, Dutch shareholders might pay less tax on underlying Dutch income by filtering it through a UK holding company, than if they received the Dutch dividends directly.

Having regard to the feature that for the last 20 years filtering high taxed foreign income through UK companies has been regarded as highly problematic, this sort of example does strike one as rather novel.

6. UK companies' problems with paying ACT and occasioning a mountain of surplus ACT led to a considerable number of dividend access shares, where for instance UK companies might have sought to pay dividends direct to certain foreign shareholders out of the profits of foreign subsidiaries. Often the advantage was not just the avoidance of ACT, but the conferring of imputation tax credits on shareholders in a particular jurisdiction when dividends were paid out of a local subsidiary. Equally in the reverse direction dividend access shares were periodically designed to flow UK income to UK shareholders in a foreign group, by taking the dividends from a UK subsidiary.

The abolition of ACT will minimise the need for some dividend access structures. Now that we are so conversant with the technique however, and since some situations will continue to make access structures attractive, some will remain and more may be created.

There can be difficult questions as to how one now fairly contrasts UK and foreign dividends in access structures, and indeed also in dual listed company structures (such as Unilever and RTZ/CRA) now that the UK tax system effectively deals differently with different categories of shareholder. In the old days with individuals, pension funds, etc., all treating a dividend of 80 from a UK company as worth 100, it was common to equalise a UK dividend at 80 with a foreign dividend of 100 even if the foreign dividend was paid subject to withholding. Whether one now says that the UK dividend should be pitched at 90 (because of the technical credit available to individual shareholders) or 100 (because gross funds, the major constituency of shareholders, derive no added benefit in the form of a repayment any longer with a UK dividend) is quite a difficult issue to decide. It is however worth observing that if dividends are to be equalised on the basis of a UK dividend being pitched at 100, to match a foreign dividend of 100, then when the UK dividend suffers no withholding whoever it is paid to, and it carries a tax credit for certain UK and indeed non-UK shareholders that may diminish their taxes, the post-tax value of the UK dividend pitched at 100 might be more than the foreign dividend to a considerable number of categories of shareholder. Even gross funds will presumably be content with the 90 since it will be more than the value of most foreign dividends if they suffer a 15% withholding.

Conclusion

Whilst the 1999 dividend system has removed the unfair ACT excess charge on the UK distribution of high taxed foreign profits, we do appear to be left with a system with a number of oddities. Whether the system remains substantially unchanged until we have an EC system for the co-ordinated European taxation of company distributions remains to be seen.