Taxing investment income: lessons from the 20th century

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Structure of talk

- Look at history of investor taxation in the UK and the US
- Explore how tax systems can affect investors' ability to value investments correctly
  - Dividends, earnings, ratios, cash flow models
- Consider lessons for today

Taxing investment income in the US

- Taxing of corporations as separate entities
  - Introduced 1894, Federal Revenue Act 1913
  - Double taxation of dividends
- Capital gains in principle taxed as income
  - Land gains 'the main source' of large fortunes
- No difference between unearned and earned income
- Concern over retained earnings as tax shelter
  - Higher taxation of <u>un</u>distributed profits 1936-38
  - Classical tax system retained till today

Taxing investment income in the UK

- ‘Lifting the veil’ and deduction of income at source. A very efficient system which allowed for tax deduction of debt interest and quick payment:

  ‘*Firstly, the payment will reach the Revenue earlier than otherwise. Secondly, the payer has an interest in deducting tax, for by so doing, he gives himself the relief due to him on account of his payment.*’

- Higher income tax rate on unearned income from 1907 to 1984, graduated rates from 1909
  - Rentier, not corporation, seen as public enemy and ‘*direct cause of poverty*’, particularly the ‘*insatiable*’ bondholder

Tax emphasis on dividends

- No capital gains tax
  - Land and, later, bonds regarded as ‘res’ which could not change in value, so no capital gains
  - Primogeniture and the use of entail
  - 16% of national wealth held in trust in 1919.

- UK emphasis on penalising distributed profits to encourage reinvestment of profits
  - Peaked at 50% vs 10% 1951
  - Multiple changes of tax system, not just tax rates

Valuing dividends in the US

'A common stock is a bond which provides future payments indefinite in number and amount' (1938)

- **But US less wedded to dividends**
  - Unlike in the UK, US shareholders could not vote at AGM on the dividend which:

'fails to produce the stable dividend rate which is [management's] avowed purpose' (1934)

  - Lower dividend payout than in the UK
  - Could not issue shares below par. ('watered stock')

Valuing earnings in the US

- **And US more interested in earnings**
  - More detailed profit & loss statements e.g. US Steel
  - Earnings calculable *after* corporation tax, *before* income tax
  - Higher retained earnings and awareness of their compounding effect
  - Lawrence Smith, *Common Stocks as Long-Term Investment* (1924)

'Common stock values have come to depend exclusively on the earnings exhibit.' (1934)

'New and promising inventions explain high P/E ratios' (1930)

Valuing dividends in the UK

Company dividend policy unclear because of tax

Letters to secretary of Prudential by Mrs Gurney: *'Is there any chance of getting my pre-war dividend?'* (1919). *'I am told the difference on interest on shares is due to income tax.'* (1924)

'*numerous small investors, women mostly*' failed to claim income tax back. *'These people have no lawyers – never receive income tax papers, and would not know what to do with them if they did.'*

Dividends sometimes declared net – or 'free' - of tax, e.g. British Am Tob:

'A widespread impression … that a 'tax-free' dividend is really tax free- this, alas, is not so.' (1949)

Dividend rate vs yield

Dividend declared as % of nominal value not share price

- Capital issues were restricted post-WWII so no bonus shares
- Dividend controls to mirror wage controls from WWII till 1973 (bar 1958 to 1965). Some exemptions for overseas companies and takeover targets.
- A number of committees, Wrenbury 1918, Greene 1926, Cohen 1943, Gedge 1953 considered and rejected no par value shares

'Bentalls' nominal dividend payment rate was 80 per cent, but the real dividend yield was calculated as barely 5 per cent.' (1949)

'*post-war inflation … has led to misunderstandings, among them the impression that excessive dividends … have been and are being paid.'(*1954)

No long-term CGT payable till 1965

- Yet untaxed retained profits ignored by the market, *pace* e.g. Kaldor and Worswick
- More concerned with negative impact of profits taxes, capital expenditure and inflation on retained earnings called 'reserves' not 'surplus'.
- Lack of liquidity in stock market?

Valuing earnings in the UK

Couldn't calculate earnings as in the US.

- Instead, the emphasis was on dividends with income statement providing backdrop to distribution policy e.g. earnings cushion, dividend cover.

'The dividend yield on Rolls Royce is naturally low seeing that the Company earns nearly twice the amount of its dividend rate.' (1928)

Earnings declared net of income tax, dividends gross of income tax giving accounts 'piebald appearance'

- Different 'net profits' depending on dividend policy.

'Indeed, cases have been known where a chairman has complained that profits have fallen, whereas, in fact, if a true comparison is made, they have risen (1949)

Companies often ignored impact of profits tax when declaring earnings.

- Lack of transparency of tax payment in 'net profit'.

Changes in tax systems (1)

- **Classical tax system 1965 to 1973 to resemble the US**
  - Simplified income tax and profits tax into single corporation tax
  - The Labour Party was continuing its policy to '*reduce the incomes of the wealthy to encourage investment*'
  - Halcyon period for valuation
    - P/E ratios dominant: *'Holders of Jaguar 'A' shares can reflect on a P/E ratio of under 8, the best in the industry'*.

Changes in tax systems (2)

- **Imputation tax system 1973 to 1997 to be dividend neutral as in Europe**
  - Income tax deduction on dividend payments treated as advance payment (ACT) of the mainstream corporation tax (MCT) liability on UK taxable profits
  - Investors not liable to tax could claim ACT relief back from government, as with income tax
  - Happened as oil crisis and inflation led government to introduce 'stock relief' which, with existing depreciation allowances, meant that many companies ceased to be liable to MCT:

In effect, the Inland Revenue has given up collecting corporation tax from manufacturing industry while it thinks what to do next.' (1980)

Valuation issues with ACT

- Companies' 'nil', 'net' and 'full distribution' earnings made P/E ratios and dividend cover difficult to understand.
- Earnings after *notional* 52% corporation tax very different to earnings after *actual* tax.
  - US investors used actual tax, UK investors notional tax, so US investors bought UK blue chips as cheap on a P/E basis.
- Pension funds, now the major investor group in UK equities, could claim ACT relief – not dividend neutral at all
  - UK equities had highest dividend yields in the world (6% or more)
  - Acquisitions could be paid for by special dividends with ACT relief claimed by investors.

- *"No wonder that UK companies top the global dividend yield tables. The corporate tax system positively encourages pay-outs. The solution is to remove the refund for tax-exempt shareholders." (1997)*

Pension funds and ACT

- Dividend valuation model (DVM) calculates present value of future dividend payments discounted by appropriate discount rate
  - Pension funds used DVM to value equity assets and determine funding levels, unperturbed by 1987 crash
  - But difficult to choose the discount rate as CAPM affected by imputation
  - Highly sensitive model
- By using gross dividends, shares were worth more to pension funds than to anyone else.
  - 75% of UK DB portfolios in equities in 1991.
- Pension funds became valuable in their own right through tax advantages on income and capital gains

Comparisons

- US classical system
  - Offered continuity
  - Taxed unpopular corporations
  - Separation of corporate and personal taxation facilitated transparency and equity valuation tools
  - Tried briefly to reduce tax advantages on retained earnings
  - Offered some tax relief on double taxation of dividend income
- UK tax systems
  - Failed to offer continuity
  - Taxed unpopular rentiers on income but slow to introduce CGT
  - Deduction at source confused corporate and personal tax, making equity valuation difficult
  - Tried occasionally to encourage retained earnings through taxation
  - Offered over-generous tax relief on dividends under ACT

Conclusions

Valuation

Valuation affected by method of valuation
Eastern Electricity as an example
Method of valuation affected by tax system
dividend yield, dividend rate, P/E ratios, DVM
Tax system influenced by:

- efficiency of collection
- law and custom
- politics (corporate reinvestment, redistribution of wealth, Europe)

Unforeseen consequences

- Investor confusion
- Misvaluation
- Takeovers
- Distribution policies
- Pension fund valuation

Lessons to be learned for current debate is on redistribution of wealth?

THANK Y OU