EXPLANATORY MEMORANDUM TO

THE AUTHORISED INVESTMENT FUNDS (TAX) (AMENDMENT) REGULATIONS 2006

2006 No. 3239

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before Parliament by Command of Her Majesty. This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

These Regulations insert a new regulation 52A into the Authorised Investment Funds (Tax) Regulations 2006 (S.I. 2006/964) ("the principal Regulations"). Regulation 52A applies only to banks and other financial traders which receive a dividend distribution from an authorised investment fund ("AIF") - an authorised unit trust or open-ended investment company - which is paid out of income of the AIF which has borne foreign tax. The new regulation 52A ensures that in the hands of the bank etc. part of the UK income tax which the bank is deemed to suffer on the distribution is treated as foreign tax for the purposes of the rules restricting the bank's entitlement to double taxation relief, so that those restrictions apply to such distributions out of foreign income in the same way as they apply to foreign dividends directly received.

3. Matters of special interest to the Select Committee on Statutory Instruments

These Regulations come into force less than 21 days after the date on which they were made. The Department regrets that compliance with the 21-day rule is not possible in this case. These Regulations form part of a significant anti-avoidance package announced by the Chancellor of the Exchequer in the Pre-Budget Report on 6 December 2006. Unless the Regulations come into force as soon as possible, there is a risk that participants in AIFs to which the Regulations are intended to apply will arrange their affairs to bring forward distribution dates to fall into the period between the laying of the Regulations and 21 days after that date, thus escaping the application of the Regulations.

4. Legislative Background

These Regulations are being made because disclosures under Part 7 of the Finance Act 2004 (disclosure of tax avoidance schemes) have shown that one aspect of the principal Regulations leaves open the possibility that a bank or similar financial concern which uses an AIF as a vehicle for holding its portfolio of foreign equities could avoid the restrictions on the amount of foreign tax suffered on dividends applying to such banks and financial traders in section 798A of the Income and Corporation Taxes Act 1988 ("ICTA").

5. Extent

These Regulations apply throughout the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy Background

7.1 The provisions setting out the principles for the taxation of AIFs are sections 468 and 468A ICTA. But the detailed code of taxation of the funds and of participant in the funds is to be found in the principal Regulations, made under section 17(3) and 18 of the Finance (No. 2) Act 2005. This was done among other things to provide the flexibility to make future amendments to enable, or in response to, developments in this fast-moving industry.

7.2 Part 4 of the principal Regulations provides that the recipients of dividend distributions of an AIF (AIFs can also make interest distributions) which are subject to corporation tax ("CT") must treat the distribution as divided into a "franked" part (treated in the same way as a distribution for a UK resident company) and an "unfranked" part. The unfranked part is treated for tax purposes as an "annual payment" from which income tax at 20% is treated as deducted.

7.3 Regulation 52 of the principal Regulations recognises that the AIF may have received dividends and other income from overseas and may have set foreign tax against its own liability to CT. Foreign tax is not repayable in any circumstances: but UK income tax may be repaid if the amount suffered by a company exceeds its liability to CT. Regulation 52 provides that any part of the deemed income tax representing, among other things, foreign tax suffered by the AIF is not repayable.

7.4 The whole of the deemed income tax suffered is however capable of being set against CT charged on the participant generally, without restriction. However by virtue of sections 798A and 803C of ICTA, certain financial traders are liable to have the amount of double taxation relief on foreign dividends restricted. Neither regulation 52 nor any other provision embodies any of these restrictions, and as the deemed tax suffered is UK tax, the restrictions relating to foreign tax do not apply.

7.5 There has been no consultation with the industry on these Regulations because of the need to prevent forestalling.

7.6 It is not appropriate to charge tax otherwise than by legislation, so no other way of achieving the Government's objectives have been considered.

7.7 Guidance on the regulations will be included in HMRC's Guidance Manuals before returns for periods to which the regulations apply are filed.

8. Impact

No RIA has been prepared because no impact on the private or voluntary sector is foreseen. The Regulations should prevent a potential loss of tax of £200 million.

9. Contact

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