EXPLANATORY MEMORANDUM TO

THE INCOME TAX (MANUFACTURED OVERSEAS DIVIDENDS) (AMENDMENT) REGULATIONS 2009

2009 No. 2811

THE MANUFACTURED INTEREST (TAX) (AMENDMENT) REGULATIONS 2009

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1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instruments

2.1 The Income Tax (Manufactured Overseas Dividends) (Amendment) Regulations 2009 omit paragraphs (3A) to (3E) of regulation 7 of the Income Tax (Manufactured Overseas Dividends) Regulations 1993 (S.I.1993/2004) ("the Principal MOD Regulations"). The amendment will ensure that the recipient of a manufactured overseas dividend (MOD) to which those paragraphs applied will in future be taxable on the manufactured overseas dividend received without relief for any foreign tax suffered on the real overseas dividend.

2.2 The Manufactured Interest (Tax) (Amendment) Regulations 2009 repeal the Manufactured Interest (Tax) Regulations 2007 (S.I. 2007/2488) ("the Principal MI Regulations").

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

3.1 Both of these instruments 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 instruments form part of a wider anti-avoidance package announced by the Financial Secretary to the Treasury on 21 October 2009. Unless the instruments come into force as soon as possible, there is a danger that participants in the schemes that the instruments aim to block will accelerate payments so as to fall into the period between the laying of the instruments and 21 days after that date, thus escaping the application of the Regulations resulting in a significant loss of tax to the Exchequer.

4. Legislative Context

4.1 These Regulations are being made because disclosures under Part 7 of the Finance Act 2004 (disclosure of tax avoidance schemes) have shown that the Principal MOD Regulations leave open the possibility of avoidance of UK corporation tax. Similar avoidance is possible using the Principal MI Regulations.

5. Territorial Extent and Application

5.1 These instruments apply to all of the United Kingdom.

6. European Convention on Human Rights

As these instruments are subject to negative resolution procedure and do not amend primary legislation, no statements are required.

7. Policy background

- ***What is being done and why***

7.1 MODs are payments which arise under an agreement for the transfer of overseas securities such as shares and which represent dividends payable in respect of the securities. They commonly arise under repo or stocklending arrangements where securities are temporarily transferred by their original owner to a temporary holder.

7.2 Where a MOD is received by a UK recipient from a non-resident dividend manufacturer that received the real dividend, then paragraphs (3A) to (3E) of regulation 7 of the Principal MOD Regulations treat the UK recipient of the MOD as entitled to double taxation relief in respect of the smaller of:

- The overseas tax suffered by the dividend manufacturer in respect of the real overseas dividend, and

- The excess of the gross amount of the real overseas dividend received by the dividend manufacturer over the amount of the MOD representing that dividend paid the overseas dividend manufacturer.

7.3 Accordingly, the UK recipient of the MOD would be entitled to claim double taxation relief for overseas tax deducted from the real dividend even though that tax was deducted on account of the liability of a person other than the UK recipient.

7.4 A disclosure made to HMRC under the disclosure of tax avoidance schemes rules shows that regulation 7 of the Principal MOD Regulations could be used to circumvent the operation of the controlled foreign company legislation. The notified scheme could be restructured in various ways to use this provision to give rise to unwarranted tax advantages.

7.5 Manufactured interest arises where under an arrangement for the transfer of UK debt securities such as gilts one party is required to pay to the other an amount representative of interest on those securities. Manufactured interest is commonly payable under repo or stocklending arrangements where securities are temporarily transferred by their original owner to a temporary holder.

7.6 Where the temporary holder is a non-UK person then the real interest may be paid under deduction of UK tax even though the UK resident original owner would have received the interest gross. In such a case it is possible that the amount of manufactured interest paid by the overseas recipient may be similarly reduced so that the UK recipient will receive a smaller amount than if the interest had been paid directly to it.

7.7 The Principal MI Regulations were intended to provide that in this case the UK recipient of the manufactured interest would be entitled to claim tax credit relief for the UK tax deducted.

7.8 As with the Principal MOD Regulations, HMRC has received a notification under the disclosure of tax avoidance schemes rules of a scheme that seeks to exploit the Principal MI Regulations to circumvent the operation of the controlled foreign company legislation. The notified scheme could be restructured in various ways to produce unwarranted tax advantages.

7.9 The Government considers that it is wrong in principle that the UK recipient of the MOD should be able to benefit from the tax that has been deducted on account of the liability of the recipient of the real overseas dividend or that a recipient of manufactured interest should be able to benefit from the tax deducted on account of the liability of the recipient of the real interest.

7.10 Accordingly, paragraphs (3A) to (3E) of regulation 7 of the Principal MOD Regulations are repealed in relation to MODs received or treated as received on or after 21 October 2009. Thereafter the recipient will be taxed on the MOD income without relief for overseas tax deducted from the real dividend. The Principal MI Regulations are repealed in relation to manufactured interest received or treated as received on or after 21 October 2009. Thereafter the recipient will be taxed on the basis of their accounting result without relief for tax deducted from the real interest.

- ***Consolidation***

7.11 HMRC has no plans to consolidate the Principal Regulations.

8. Consultation outcome

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

9. Guidance

9.1 Guidance on these regulations will be included in HMRC Guidance before returns for the periods to which the regulations apply are filed.

10. Impact

10.1 An Impact Assessment has not been produced for these instruments as they have no impact on business, charities or voluntary bodies.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 The outcome will be subject to internal review to ensure that the projected revenue protection is achieved.

13. Contact

Richard Rogers at the HM Revenue and Customs, Tel: 020 7147 2625 or email: Richard.rogers@hmrc.gsi.gov.uk can answer any queries regarding the instrument.