EXPLANATORY MEMORANDUM TO

THE INCOME TAX (MANUFACTURED OVERSEAS DIVIDENDS) (AMENDMENT) REGULATIONS 2011

2011 No. 1787

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

2. Purpose of the instrument

2.1 This instrument amends the Income Tax (Manufactured Overseas Dividends) Regulations 1993 (S.I. 1993/2004) ("the principal Regulations"). It makes regulations relating to manufactured overseas dividends consistent with changes made to primary legislation as part of the reform of the taxation of foreign permanent establishments. It will allow manufactured overseas dividends paid and received by permanent establishments outside the United Kingdom to be treated in a similar way to those paid and received by foreign companies which do not carry on a trade in the United Kingdom.

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

3.1 None

4. Legislative Context

4.1 Amendments to primary legislation made by the Finance Act 2011 allow a UK resident company to make an election to exclude the profit or loss attributable to a foreign permanent establishment from its profits chargeable to corporation tax. Sections 922 and 923 Income Tax Act 2007 provide for tax to be deducted where manufactured overseas dividends are paid depending on the residence status of the payer or recipient. These sections are being amended so that, where the election has been made, a foreign permanent establishment is treated for tax purposes in a similar way to a foreign company which does not carry on a trade in the United Kingdom.

4.2 Sections 922 and 923 Income Tax Act 2007 are supplemented and their application amended by the principal Regulations. It is necessary to amend these regulations in order to be consistent with the changes in the primary legislation. The intention to do so was stated by the Exchequer Secretary to the Treasury in a letter to the Finance Bill Committee on 9 May 2011.

5. Territorial Extent and Application

5.1 This instrument applies to all of 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 A manufactured overseas dividend (MOD) is a payment made following certain transfers of shares in foreign companies, usually under a stock loan or a repo. It compensates the original holder of the shares if that person does not receive the dividend paid by the foreign company.

7.2 Tax will often be deducted from a dividend paid by a foreign company. Sections 922 and 923 Income Tax Act 2007 and the principal Regulations provide for tax to be deducted from a MOD so that a UK recipient of the MOD is in the same position as if it had received the real dividend.

7.3 Whether tax needs to be deducted and whether it is the payer or the recipient of the MOD who is responsible for accounting for this tax depends on the residence status of the payer and the recipient. Changes in the Finance Act 2011 allow an election to be made to exclude the profit or loss attributable to a foreign permanent establishment from a company's profits chargeable to corporation tax.

7.4 Where such an election is made, the treatment under the principal Regulations of MODs paid ("foreign permanent establishment payments") in the course of a trade carried on though a foreign permanent establishment and MODs received ("foreign permanent establishment receipts") for the purposes of a trade carried on through a foreign permanent establishment will be changed. Foreign permanent establishment payments and foreign permanent establishment receipts will be treated in the same way as MODs paid or received by a non-UK resident other than in the course of or for the purposes of a trade which the non-UK resident carries on in the UK.

7.5 A payer does not deduct tax if it pays a MOD to a non-UK resident or as part of a chain of payments which ends in a payment to a non UK resident, as long as the non UK resident does not carry on a trade in the UK. This is being extended so that where a MOD is a foreign permanent establishment receipt or part of a chain of payments which ends with a foreign permanent establishment receipt, the payer does not deduct tax.

7.6 The chain of payments and the similar chain ending in a payment to a pension scheme, which are subject to special treatment under the regulations, will exclude foreign permanent establishment payments.

7.7 An exemption from a charge on a MOD received on behalf of a non-UK resident will be extended to include a situation where a MOD is received on behalf of a company for which it would be a foreign permanent establishment receipt. The exemption is removed where the non-UK resident would receive the MOD in the course of a trade carried on in the UK.

7.8 The principal Regulations allow tax deducted from real dividends and MODs received to be set against liabilities to account for tax deducted from MODs paid by a process of matching and offsetting. As part of the changes being made to the treatment of foreign permanent establishments, credit relief is not available for foreign tax paid on profits which are excluded from the profits chargeable to corporation tax following an election. It would be inconsistent to allow such tax to be offset against tax deducted from MODs paid. Foreign permanent establishment payments and foreign permanent establishment receipts will therefore be excluded from the matching and offsetting process.

8. Consultation outcome

8.1 The technical note on foreign branch exemption published on 20 December 2010 asked whether anything further was required in respect of manufactured overseas dividends other than the changes to the primary legislation which had been published in draft on 9 December 2010. Responses were received from two accountancy firms and a financial industry body which pointed out the need to amend the principal Regulations.

8.2 There has been no consultation concerning this measure as it proposes minor technical changes consequential on other changes. In addition, the time needed for consultation would leave a period after the changes have been made to the primary legislation where it might be possible for inconsistencies between the primary and secondary legislation to be exploited.

9. Guidance

9.1 HMRC’s published guidance on manufactured overseas dividends will be updated to reflect the changes made by this measure.

10. Impact

10.1 The reform to the taxation of foreign permanent establishments is expected to impact on no more than 150 companies owned by large UK multinational groups, plus a small number of companies owned by non-UK multinational groups. Only a small proportion of these, mainly in the banking sector, can be expected to pay or receive manufactured overseas dividends as part of trades carried on through foreign permanent establishments. It will increase the freedom of such companies to operate through foreign permanent establishments rather than foreign subsidiaries. This may make them more competitive. There is no impact on charities or voluntary bodies.

10.2 There is no impact on the public sector.

10.3 A Tax Information and Impact Note covering this instrument will be published on the HMRC website at http://www.hmrc.gov.uk/thelibrary/tiins.htm.

11. Regulating small business

11.1 The exemption regime for foreign permanent establishments is available to any company but, in practice, is considered unlikely to affect small firms.

12. Monitoring & review

12.1 There are no plans for monitoring or review of this measure.

13. Contact

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