EXPLANATORY MEMORANDUM TO

THE INCOME TAX (MANUFACTURED OVERSEAS DIVIDENDS) (AMENDMENT No. 2) REGULATIONS 2011

2011 No. 2503

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 to provide that where a stock loan of foreign shares is made via a central counterparty, manufactured overseas dividends (which compensate the lender for not receiving the real dividend) can be treated as though they had been paid directly by the stock borrower to the stock lender. This will allow the tax treatment of such transactions to follow their economic substance.

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

3.1 None

4. Legislative Context

4.1 The context for the instrument is the manufactured overseas dividends tax rules, and representations made by the stock lending industry that the application of the current rules to a central counterparty ("CCP") creates tax distortions which inhibit the development of CCPs as a means of settling stock loans of shares in foreign companies. The instrument is being made to remove these distortions and facilitate the lending of foreign shares via central counterparties. This is explained in more detail in Policy Background.

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 Stock lending is an important feature of the UK and worldwide financial system. It involves the temporary transfer of securities from a lender to a borrower. Where the securities are shares in foreign companies and a dividend is paid during the period of the stock loan, the borrower makes a payment known as a manufactured overseas dividend ("MOD") to the lender, to compensate the lender for not receiving the real dividend.

7.2 Sections 922 and 923 of the 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. They also provide that MODs paid to non-UK residents are paid without deduction of tax.

7.3 Central counterparties are used to settle a range of financial market transactions. Where, for instance, a sale of securities is settled by a CCP, the seller sells the securities to the CCP and the CCP sells them to the end purchaser. Because CCPs increase market efficiency and reduce risk, their use is becoming more widespread in financial markets.

7.4 The current tax rules relating to MODs generally apply by reference to the person who is the legal recipient or payer of the MOD, even if that person is, for instance, a CCP which has little or no economic interest in it. Under the current rules, for instance, in a loan of overseas equities made directly by a non-UK lender to a UK borrower, a MOD is paid without deduction of tax. However, if such a loan were settled via a CCP, tax would have to be deducted if the CCP were UK resident.

7.5 Representations have been made by the stock lending industry that tax distortions of the type described in the preceding paragraph are a factor inhibiting the development of CCPs as a means of settling stock loans of shares in foreign companies.

7.6 The Government agrees that the development of CCPs should not be inhibited by such tax distortions. The instrument is being made to remove these distortions and facilitate the lending of foreign shares via CCPs.

7.7 HMRC currently has no intention to consolidate the relevant legislation.

8. Consultation outcome

8.1 There have been two rounds of consultation on the draft instrument, the second of which was announced on the HMRC website on 26 July 2011. The periods of the consultations were three weeks for the first and four weeks for the second. The normal 12 week period was not considered appropriate or necessary because the instrument concerns a technical change which has been requested by the stock lending industry, because the audience for the consultation is a closely defined one (the trade body for the stock lending industry and industry participants), and because discussions with the industry were already taking place before the consultation was launched.

8.2 The outcome of the first round of consultation was a request that the instrument should make provision for anonymous trading, i.e. where the original lender and end borrower do not know each other's identities, as this was likely to be a feature of some CCP trading models. The draft instrument was revised to accommodate this and other minor changes that were requested, such as to definitions of terms used.

8.3 The outcome of the second consultation was some minor queries on the revised draft instrument. Following discussion with those concerned it was not considered necessary to revise the instrument further, and that matters could be dealt with in HMRC guidance. The instrument thus reflects the views of participants in the stock lending industry.

9. Guidance

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

10. Impact

10.1 The instrument will have a beneficial impact on businesses that engage in stock lending and borrowing – predominantly companies in banking groups and other institutions in the financial sector – to the extent that the development of CCPs as a means of settling stock loans of shares in foreign companies is facilitated by the measure's removal of tax distortions, and that the use of CCPs improves market efficiency and reduces risk. 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 manufactured overseas dividends rules apply to all businesses but as only large companies and institutions engage in stock lending and borrowing, the instrument is considered unlikely in practice to affect small firms.

12. Monitoring & review

12.1 The changes introduced by the instrument will be monitored and reviewed as part of HMRC's normal assurance process.

13. Contact

Geoff Heaton (020 7147 2577 or e-mail: geoff.heaton@hmrc.gsi.gov.uk) or Robin Blades (020 7438 6453 or e-mail: robin.blades@hmrc.gsi.gov.uk) at HM Revenue and Customs can answer any queries regarding the instrument.