INTM Guidance

Hybrid and Other Mismatches

The following guidance is provided to assist understanding of the application of the hybrid mismatch legislation, which came into effect on 1 January 2017. Many of the examples are based upon a selection of those contained within the OECD 'Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements', with additional examples dealing with hybrid transfers and permanent establishments.

These pages form part of the International Manual. They contain guidance prepared for HMRC staff and are published in accordance with the Freedom of Information Act 2000 and the HMRC Publication Scheme.

You should not assume that the guidance is comprehensive or that it will provide a definitive answer in every case. HMRC will use their own reasoning, based on their training and experience, when applying the guidance to the facts of particular cases.

This guidance is based on the law as it stood when it was published. HMRC will publish amended or supplementary guidance if there is a change in the law or in the department's interpretation of it. HMRC may give earlier notice of such changes through a Revenue and Customs brief or press release.

Subject to these qualifications you can assume the guidance normally applies, but where HMRC considers that there is, or may have been, avoidance of tax the guidance will not necessarily apply.

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INTM550000: Hybrids: Contents

This guidance aims to assist in understanding the application of the hybrid mismatch legislation (introduced by Finance Act 2016), which took effect from 1 January 2017.

The guidance largely follows the structure of the legislation. For each of the areas below the guidance gives a general overview of the legislation and how it is intended to apply, followed by more detailed analysis, and specific examples where appropriate.

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INTM550020: Hybrids: Chapter 1 - Introduction: What is a hybrid or other mismatch?

Part 6A of Taxation (International and Other Provisions) Act 2010 (TIOPA 2010) addresses arrangements that give rise to hybrid mismatch outcomes leading to a tax mismatch.

The legislation is based on the Organisation for Economic Co-operation and Development (OECD) recommendations in relation to Action 2 of the Base Erosion Profit Shifting (BEPS) project. The legislation is deliberately broader in scope than the OECD recommendations in some areas. Consequently, outcomes under this legislation may differ from those under the OECD recommendations.

For example, the UK's hybrid mismatch legislation includes:

- rules to deal with mismatches involving permanent establishments, and
- rules that counter hybrid mismatches where a hybrid entity is in a territory with no corporate income tax.

Mismatches can involve either double deductions for the same expense, or deductions for an expense without the corresponding receipt being fully taxed.

Hybrid mismatch outcomes can arise from hybrid financial instruments and hybrid entities, and from arrangements involving permanent establishments. They can also arise from hybrid transfers and dual resident companies.

The legislation aims to neutralise the tax mismatch created under these arrangements by altering the tax treatment of either the deduction or the receipt, depending on the circumstances. The rules are designed to work whether both the countries affected by a cross-border arrangement have introduced rules based on the OECD recommendations, or just the UK.

This legislation follows the OECD recommendations in providing alternative responses to mismatches which fall within the scope of the legislation. These are described as a 'primary response' and a 'secondary response'.

In the case of deduction/non-inclusion, the primary response is generally to deny a deduction to the payer. If this does not occur, the secondary defensive response is to bring the receipt into charge for the payee.

In the case of double deductions the primary response is to deny a deduction to the parent or investor company. If this does not occur (because the tax law in the country in which the parent or investor company is resident does not provide for this), the secondary response is to deny the deduction to the hybrid entity or permanent establishment, as appropriate.

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INTM550030: Hybrids: Chapter 1 - Introduction: Examples of hybrid mismatches

Hybrid financial instrument

An example of a hybrid financial instrument is an instrument giving rise to a payment which the law of the payer jurisdiction treats as deductible interest, by recognising the instrument as a debt instrument, but which the payee jurisdiction recognises as an exempt dividend in the hands of the payee since it sees the instrument as an equity instrument. This would result in the payer getting a deduction, without the recipient being taxed on a receipt.

Hybrid entity

An example of a hybrid entity is a UK limited liability partnership (LLP) which is treated as transparent by one jurisdiction (the UK), but treated as opaque by another jurisdiction. The effect is that one jurisdiction applies its tax rules to the partnership, whilst the other looks through the partnership and applies its tax rules to the partners. In the case where a payment is made to an LLP with overseas members from a payer company, the UK would consider the receipt to be taxable on the LLP's members in the overseas territory but the overseas territory might consider the receipt to be taxable in the UK as it considers the LLP to be an opaque entity, with the consequence that the receipt would be untaxed in both territories. Permanent establishments can be used in a similar way to generate mismatches.

Hybrid transfer

An example of a hybrid transfer is where a person sells shares to another party on condition that the shares will be returned 12 months later, during which time a dividend is paid in respect of those shares to the transferee. In form, the ownership of the shares has transferred and therefore the transferee is treated as the beneficial owner of the dividend. In substance, however, the transferor has not actually sold the shares and therefore may be treated as the beneficial owner of the dividend. This asymmetry presents opportunities for obtaining a deduction/ non-inclusion mismatch.

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INTM550040: Hybrids: Chapter 1 - Introduction: Scope of Part 6A, TIOPA 2010

Part 6A targets hybrid mismatches in the following circumstances:

Deduction/non-inclusion outcomes involving:

- Hybrid financial instruments
- Hybrid transfers
- Hybrid entity payers
- Hybrid entity payees
- Permanent establishments

Double deduction outcomes involving:

- Hybrid entities
- Dual resident companies
- Permanent establishments

The legislation also includes rules to deal with arrangements where a mismatch arises entirely outside the UK and is part of the same "over-arching arrangement" as a UK transaction: such arrangements are known as 'imported' mismatches. These additional rules are needed to ensure that the legislation cannot be by-passed by routing a mismatch via a third jurisdiction. The imported mismatch rules deal with double deduction or deduction/non-inclusion imported mismatch outcomes involving:

- Hybrid financial instruments
- Hybrid transfers
- Hybrid entity payees
- Hybrid entity payers
- Permanent establishments
- Dual resident companies

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INTM550050: Hybrids: Chapter 1 - Introduction: Why was new legislation introduced?

In 2013 the OECD and G20 countries adopted a 15-point Action Plan to address Base Erosion Profit Shifting (BEPS). The Action Plan aims to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created, and to counter aggressive tax planning aimed at base eroding a jurisdiction.

BEPS includes tax planning strategies that exploit gaps and mismatches in the tax rules of different countries, to

- make profits ‘disappear’ for tax purposes, or
- shift profits to locations where there is little or no real activity but where the tax rates are low, resulting in little or no overall corporate tax being paid.

In response to Action Point 2, the OECD and G20 countries agreed a set of rules designed to ensure that multinational entities can no longer derive a tax benefit from mismatch arrangements, including those arising from hybrid entities or hybrid financial instruments.

Part 6A of TIOPA 2010 is based on the recommendations of Action 2 of the BEPS project – OECD (2015), ‘Neutralising the Effects of Hybrid Mismatch Arrangements’ and OECD (2017), ‘Neutralising the Effects of Branch Mismatch Arrangements’ but with some variation.

The legislation includes rules to tackle hybrid mismatch arrangements which involve permanent establishments. Permanent establishments of companies are often used as an alternative to hybrid entities in tax planning arrangements as they provide for similar mismatch opportunities. The measure covers such arrangements to ensure that groups cannot simply sidestep the OECD recommendations by using permanent establishments.

The UK government announced its intention on 5 October 2014 to introduce domestic legislation to give effect to the recommendations of Action Point 2, and a consultation document was published at Autumn Statement 2014. This legislation has been informed by consideration of responses to the consultation, by further engagement with stakeholders, and by publication of the final OECD report.

Who is likely to be affected by this legislation?

Groups with a UK or overseas parent involved in cross-border or domestic transactions involving a mismatch in the tax treatment within the UK, or between the UK and another jurisdiction, which falls within the scope of the legislation.

Operative date

Part 6A applies to deductions arising or accruing on or after 1 January 2017 involving hybrid entities or instruments which give rise to a hybrid mismatch outcome. There are no grandfathering provisions, so deductions for payments or quasi-payments that arise or accrue after 1 January 2017 under instruments issued before that date are within the scope of Part 6A.

The commencement rules are set out at Part 3 of Schedule 10, Finance Act 2016, and include transitional rules for periods of account that begin before 1 January 2017 and end after that date (paragraph 24).

See INTM550070 for more details.

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INTM550060: Hybrids: Chapter 1 - Introduction: Overview of legislation

The hybrids legislation is at Part 6A of the Taxation (International and Other Provisions) Act 2010 (“TIOPA 10”).

Part 6A potentially applies to deduction/non-inclusion mismatches and double deduction mismatches involving –

- payments or quasi-payments in connection with financial instruments
- hybrid transfers
- hybrid entities
- companies with permanent establishments
- dual resident companies

The legislation targets specific types of mismatches, setting out the conditions to be satisfied in each instance, and what adjustments are to be made for corporation tax purposes to counteract the mismatch.

If the conditions applicable to a particular type of mismatch are satisfied, the mismatch is counteracted by disallowing the deduction claimed, or bringing an amount of income representing the mismatch amount within the charge to tax in the UK.

Part 6A contains 14 chapters –

- Chapter 1 is an overview
- Chapters 2 and 14 contain definitions and interpretations of key terms used throughout the legislation.
- Chapters 3 to 10 each target a specific type of hybrid or other mismatch.
- Chapter 11 counteracts imported mismatches in connection with payments or quasi-payments where the payer is within the charge to corporation tax.
- Chapter 12 contains provisions to make adjustments in certain circumstances where new information shows that counteraction of a mismatch was excessive.
- Chapter 13 contains an anti-avoidance provision.

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INTM550070: Hybrids: Chapter 1 - Introduction: When does the legislation take effect?

Part 6A of the Taxation (International and Other Provisions) Act 2010 was introduced by section 66/Schedule 10 of Finance Act 2016 (“FA 16”), and has effect from 1 January 2017.

The commencement provisions for chapters 3 to 11 are set out at paragraphs 18 to 22 of Schedule 10, FA 16.

Broadly speaking, the legislation applies from 1 January 2017 for –

- deduction/non-inclusion mismatches arising from deductions on or after that date
- deduction/non-inclusion mismatches arising from deductions in a payment period beginning on or after that date
- double deduction mismatches for accounting periods beginning on or after that date
- imported mismatch payments arising from deductions on or after that date
- imported mismatch payments arising from deductions in a payment period beginning on or after that date

There are transitional rules for payment periods and accounting periods that begin before 1 January 2017 and end after that date at paragraphs 23 and 24 of Schedule 10, FA 16.

In these cases the payment/accounting period is treated as 2 separate taxable periods -

- one ending on 31 December 2016, and
- the other beginning on 1 January 2017.

Amounts are apportioned to each of these periods on a time basis, unless that produces a result that is unjust or unreasonable. In those circumstances, the amounts should be apportioned on a just and reasonable basis.

For transactions between 16 March 2005 and 31 December 2016 involving hybrid mismatches the arbitrage rules set out at INTM590000 onwards may apply.

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INTM550080: Hybrids: Chapter 1 – Introduction: Interaction with other legislation

Counteraction under Part 6A TIOPA 2010 should be considered alongside the UK's other domestic rules. Examples of the type of rules that might be applicable are distribution exemption, transfer pricing, group mismatch legislation and unallowable purpose for loan relationships.

We would expect to apply the hybrid mismatch legislation in priority to the corporate interest restriction rules.

Although there is no statutory provision requiring it to be considered in priority, the distribution exemption provisions may also be considered before applying the hybrid mismatch rules – see INTM551170.

The hybrid mismatch rules do not contain a priority order for considering the application of other legislation. This means that customers will need to consider all relevant rules as part of their self-assessment. In general the hybrid rules will need to be considered whenever a mismatch within scope of Part 6A arises, unless the application of other rules removes the mismatch entirely.

Interaction with Transfer Pricing

The position set out previously continues to apply – that is, you cannot compare Part 4 and Part 6A and choose to apply one and not the other, nor can you choose to apply the two sets of rules in an order which produces a preferred result. Both sets of provisions must be considered in all cases. HMRC has however refined its view of the interaction of Part 4 and Part 6A. See INTM550085 and INTM550086.

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INTM550085: Hybrids: Chapter 1 – Introduction: Interaction with transfer pricing legislation

In many cases where the hybrid rules in Part 6A have a potential application, the transfer pricing rules in Part 4 will also be in point. How the two sets of provisions work together is explained below.

In essence, the transfer pricing rules should be applied taking the hybrid rules fully into account as part of the process to determine the correct transfer pricing position. That is, Part 6A should be considered for both the actual and the arm’s length provisions. Part 6A should then be considered in respect of the transfer pricing outcome to see if any further restriction is necessary.

It should be noted, you cannot compare Part 4 and Part 6A and choose to apply one and not the other, nor can you choose to apply the two sets of rules in an order which produces a preferred result.

INTM550086 includes a series of examples showing the outcomes of various scenarios where different chapters of Part 6A are in point.

Applying transfer pricing

When considering whether a transfer pricing adjustment is necessary, the taxable profits arising as a result of the making of each of the actual and arm’s length provisions must be computed assuming full effect is given to Part 6A as it applies to each provision. Accordingly, whether there is any potential advantage in accordance with s.155 will be determined taking account of the impact, if any, of Part 6A.

If a potential advantage results, s.147(3)/(5) will require the taxpayer’s computations to be restated as if the arm’s length provision had been made . Any counteraction under Part 6A applicable to the arm’s length provision must be taken into account when the resulting profits and losses are calculated.

In the absence of a corresponding adjustment claim, the transfer pricing rules only mandate adjustments to the tax computations of the potentially advantaged person, as defined. However, when considering the possibility and potential quantum of counteractions under Part 6A as part of the transfer pricing process, the counterparty or counterparties of the potentially advantaged person(s) under the contractual arrangement actually in place must be assumed to be party to the arm’s length provision and so paying or receiving the arm’s length amount. In relation to those chapters of Part 6A to which the ordinary income of payees is relevant, that assumption is necessary to test the potentially advantaged person’s tax outcome as if the arm’s length provision was imposed, as required by Part 4.

As an example, consider the simple case of an interest payment from a UK company to a hybrid payee. Suppose the actual interest payment is 100, but if the loan was on arm's length terms it would be 60. When applying Part 6A to the arm's length provision for the purposes of assessing whether there is a "potential advantage" within the meaning of s155 and, consequently whether a transfer pricing adjustment is appropriate (and then in due course when giving effect to that adjustment), the payee must be assumed to be receiving 60. In consequence the payee's amount of ordinary income for Part 6A purposes will be computed as if it had received a payment of 60.

In relation to Chapters 9 and 10, in computing the quantum of any double deduction, the payment made by the payer should be assumed to be reduced to the arm's length amount in both jurisdictions in determining whether an adjustment under Part 4 is necessary and, if it is, quantifying the amount of any Part 6A counteraction applicable in relation to the arm's length provision.

Related points under Part 4

The entitlement of a payee to claim a corresponding adjustment is unaffected by any hybrid counteraction. In any case where the actual provision conferred an advantage on the payer (so an adjustment under Part 4 has resulted), the payee is entitled by Chapter 4 of Part 4 to make a claim to prepare its own returns as if it had received a payment of the arm's length amount (a "corresponding adjustment claim"). Note however that where a corresponding adjustment claim is made, whether by a UK payee pursuant to Chapter 4 Part 4 or by an oversees payee under its own law or applicable treaty, that claim will reduce the amount of ordinary income received by that payee where relevant to the application of Part 6A.

Similarly, where the payment is one of interest, on the making of the relevant claim by the payee, s.187 provides that any withholding tax liability is computed by reference to the arm's length payment (so, ignoring any counteraction under the hybrid rules).

Finally, in the event that any part of the payment falls to be recharacterized as a distribution under s.187A, that amount is the excess over the arm's length amount with any hybrid counteraction irrelevant to the calculation.

Applying Part 6A

The possible application of Part 6A must also be considered independently notwithstanding the possibility that a hybrid counteraction may fall to be made via the transfer pricing process.

Part 6A Chapters 3-5 and 7-8

The overwhelming majority of cases where a hybrid counteraction is possible involve a UK resident payer.

In these cases, chapters 3-5 and 7-8 of Part 6A will seek to identify a “relevant deduction”, being the amount of the deduction which would be available to the payer if the hybrids rules were disregarded. This will then be compared to the ordinary income of the payee or payees under the arrangement in question. If the relevant deduction exceeds the total ordinary income, the difference is the basis of any counteraction.

In computing the “relevant deduction”, the transfer pricing legislation (and any other tax legislation) must be assumed to apply, but ignoring any possible hybrid counteractions to either the actual or arm’s length provision. The relevant deduction which is to be compared to the payees’ ordinary income will therefore be reduced to the arm’s length level if the actual payment exceeds that amount.

When the comparison is made with the ordinary income of the payee(s) under the relevant chapter of Part 6A, the payee(s) should be assumed to be receiving their actual payments (unless they are claiming corresponding adjustments). At this point, the mechanical provisions of Part 6A are being applied to compare the relevant deduction as already determined with the ordinary income. Any reduced level of assumed payment delivered by the notional application of transfer pricing in the computation of the relevant deduction should, in the absence of corresponding adjustments, not be applied to the computation of the ordinary income of the payee(s).

Counteractions are applied in the form of a limitation on the deduction that may be taken by the payer. They are not in the form of a disallowance (or restriction) of a set amount of deduction, to be imposed come what may.

(For example, see s.259CD: “the relevant deduction that may be deducted from the payer’s income for the payment period is reduced by an amount equal to the [mismatch]”.)

In a non-transfer pricing related case (i.e. a case in which either there is insufficient connection between the parties for Part 4 to be activated, or where the parties are as a matter of fact transacting on arm’s length terms), despite its strict form as described above, the counteraction is in effect a simple disallowance. The actual potential deduction available prior to consideration of the possible impact of Part 6A will inevitably be the same as the relevant deduction for Part 6A computational purposes. So the limitation on that deduction operates exactly as a simple disallowance would.

In a transfer pricing case, this will not be so. The actual potential deduction available in a case to which both sets of rules apply will be reduced to the extent needed to give effect to Part 6A via the transfer pricing adjustment, as set out above. When Part 6A is considered in its own right, the “relevant deduction” is not a real element in the tax computation process – it is no more than a computational step on the way to determining whether a counteraction is necessary. If a hybrid counteraction is to be appropriate, the “relevant deduction” will inevitably be larger than the deduction due to be claimed after application of the transfer pricing code.

In Part 4, the legislation specifically mandates the calculation of profits and losses on the basis of arm’s length payments, and so enables (and requires) the grant of a deduction at a lower level than would otherwise be the case. Part 6A does not operate in this way.

Part 6A merely says that as far as it is concerned, the total deduction cannot exceed a given amount. This is the amount of the deduction which would have been available absent the hybrids rules, less any counteraction. Where Part 4 has applied and Part 6A counteractions have been incorporated within its outcome, the resulting available deduction will inevitably be less than the limit imposed by Part 6A when it is considered in its own right. Part 6A will therefore have no impact beyond that taken into account in the Part 4 calculation. To reemphasise, there is nothing in Part 6A mandating the recalculation of profits and losses to deliver the relevant deduction and then adjust it: there is only a computational mechanic to determine the maximum available deduction in circumstances to which Part 6A applies.

Put another way: if the relevant deduction is not being sought because, when the rest of the legislation including Part 4 is applied, a lower amount is all that can be claimed, Part 6A cannot increase the available relief.

There is nothing in its language granting relief: it only operates to reduce relief that is otherwise available. This operation of the law is consistent with s.259A(5), which states that Part 6A counteracts mismatches *that would otherwise arise* by making certain adjustments for CT purposes. Where a transfer pricing adjustment taking account of Part 6A has been made, there is no mismatch otherwise arising to which a separate application of Part 6A should apply.

In any payer case where a transfer pricing adjustment and a hybrids counteraction are necessary, the hybrid counteraction delivered by the independent consideration of Part 6A will inevitably not limit the relief which can be claimed to a lower level than that already imposed via the transfer pricing adjustment. Part 6A will therefore have no additional effect over and above that which it has delivered as part of the application of the transfer pricing rules.

The proper application of the transfer pricing rules will therefore, where appropriate, give rise to a counteraction under the hybrids rules as part of the transfer pricing process.

Note:

For the reasons set out above, it is not the case that where the percentage disallowance under Part 6A is less than that under Part 4, it can be disregarded (or vice versa). The only exception to this will be in relation to a specific fact pattern to which Chapter 3 or Chapter 4 of Part 6A could apply (discussed below).

Part 6A Chapter 6

Part 4 will not have any impact on a counteraction under Chapter 6, since by its nature Chapter 6 only applies to value transfers between a permanent establishment and its "parent" in its jurisdiction of incorporation.

Part 6A Chapters 9 and 10

The interaction of Parts 4 and 6A is simpler in the context of Chapters 9 and 10 than in the cases of Chapters 3-5 and 7-8. In these Chapters, there is no need to assess a payee's ordinary income: the hybrid benefit targeted by the rules is a double deduction.

Both Chapters 9 and 10 require it to be reasonable to suppose that absent the operation of Chapter 9 or 10 as appropriate, a deduction will arise in respect of a payment or quasi-payment both the UK and another jurisdiction. If that is the case, counteraction follows in the form of the UK deduction being restricted to use against dual inclusion income.

The UK deduction to which a payment would give rise absent the operation of the relevant chapter of Part 6A will be the deduction post-adjustment under Part 4, ignoring Part 6A. Accordingly the counteraction under Part 6A will apply to the arm's length payment, where Part 4 has mandated the payer's profits and losses to be calculated on the arm's length basis. This will therefore create the same outcome as applying Part 4, which will have required counteractions under Part 6A to have been applied in determining the outcome of each of the actual and arm's length provisions.

When applying each of Part 4 and Part 6A, the assumption should be made that the arm's length payment is being made for the purposes of determining the overseas deduction as well as the UK one, as this is a necessary step in quantifying any double deduction.

Part 6A Chapter 11

The operation of Chapter 11 is different from that described above. This Chapter requires the identification of a "mismatch payment" between entities, which is funded by a payment made by a UK entity the deductibility of which is potentially subject to counteraction.

Under Chapter 11, the "relevant mismatch" must be determined, which is the difference between the relevant deduction and ordinary income of the parties to the relevant mismatch payment within the meaning of the appropriate chapter of Part 6A (or pursuant to s.259KB where the situation is analogous to a Chapter 10 case). While the definitions of relevant deduction and ordinary income must necessarily be taken from Part 6A, the quantum of the relevant mismatch must be determined according to the local law applicable to the payer of the mismatch payment.

If the other conditions of Chapter 11 are met, the amount of the relevant mismatch is applied as a counteraction restricting the deductibility of the payment made by the UK payer.

There is no provision in Chapter 11 providing for the amount of the relevant mismatch to be reduced to any extent where Part 4 has required the UK payer to calculate its profits and losses on the basis it is making a lower payment. Similarly, there is no provision in Part 4 permitting or requiring the arm's length terms deemed to be in place between the payer and its counterparty to be treated as impacting the counterparty's contractual position. Accordingly, in a Chapter 11 case where an adjustment under Part 4 is also required, the full amount of the relevant mismatch must be deducted from the payment deemed to have been made under the arm's length provision.

In a case where payments funding the mismatch payment are being made by a variety of entities in different jurisdictions, and the legislation requires a just and reasonable apportionment of the amount of the relevant mismatch by way of counteraction, the OECD principle that it will be necessary to ensure the full amount of the overseas mismatch must be counteracted should be followed, even if, due to inconsistencies of approach between jurisdictions, this means that the counteraction is not shared pro rata to the amounts of the funding payments.

Part 6A Chapters 3 and 4: Particular point to note

In the cases of Chapters 3 and 4, the imposition or otherwise of a hybrid counteraction turns on the nature of the provision between the parties, not the nature of the parties themselves. Accordingly, if the facts are such that it can be demonstrated that the actual provision was not at arm's length, and that the arm's length provision would not have contained the features which brought Chapter 3 or 4 into play, then the transfer pricing and hybrids rules will not apply cumulatively. Effectively, whichever would deliver the greater disallowance looked at in isolation will prevail. See example INTM550086: hybrid financial instrument background 3 and 4.

A series of examples to illustrate the above follows.

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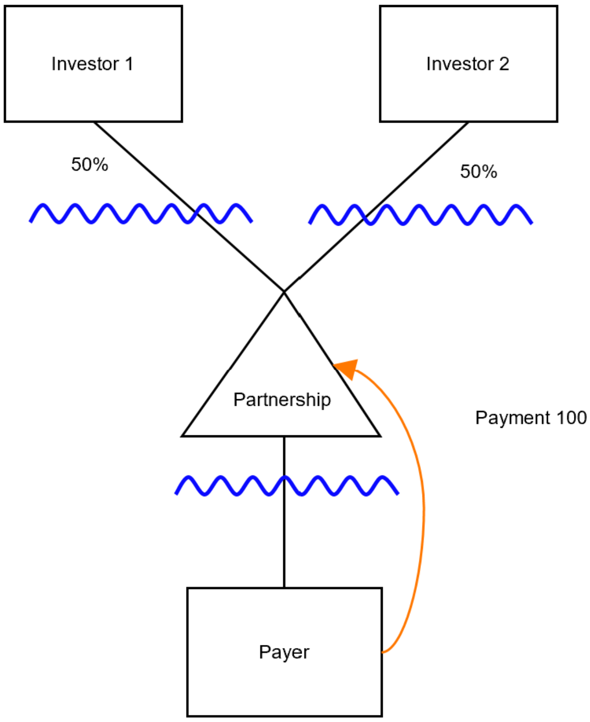
Hybrid financial instrument

These examples demonstrate how Part 6A and the Transfer Pricing rules apply in the case of a hybrid financial instrument. In considering chapter 4 the analysis would be the same in situations analogous to those discussed below.

The diagram is the same for all fact patterns.



Background 1

- There are no hybrid entities in this structure.
- Investor 1 sees the financial instrument as equity, and does not tax the return on it.
- Investor 2 sees the financial instrument as debt, and does tax the return it receives.
- The arm's length amount of the payment from Payer to Partnership would be 60.
- Note it is assumed in the analysis below that the terms of the partnership and the treatment of the partnership according to the

governing laws of Investor 1 and Investor 2 result in the two investors each being considered to own an indivisible 50% share in the hybrid security held by the partnership. In the event that this was not the case, and so the correct analysis was that two securities were deemed to be in issue, one held by each investor, the eventual result would be the same (but via a 100% counteraction on one security and no counteraction on the other, rather than via a 50% counteraction on the single security actually in issue).

Analysis

Applying Transfer Pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 3 would therefore be reduction of relevant deduction by 50. Total relief available to payer would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 60. This is the relevant deduction for Part 6A purposes. Total payee ordinary income would be 30. Counteraction under Chapter 3 would therefore be reduction of relevant deduction by 30. Total relief available to payer would therefore be 30.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50, but under the arm's length provision it would be 30. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 60. Deductibility of the payment is reduced by 30 due to counteraction under Chapter 3. Payer therefore claims deduction of 30.

To the extent relevant, corresponding adjustments would be available under s.174 as if the arm's length payment of 60 had been made.

Applying Part 6A (Chapter 3) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (ie relief available disregarding hybrids rules)

Payer makes payment of 100, which absent the hybrids rules would potentially be fully deductible. However, this exceeds the arm's length amount so transfer pricing would require recomputation of payer's tax position as if it was paying 60. Relevant deduction is therefore 60.

Step 2: Identify payees' total ordinary income

Only Investor 2 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch

The relevant deduction is 60 and the total ordinary income of payees is 50. There is therefore a hybrid or otherwise impermissible deduction/non-inclusion mismatch of 10.

Step 4: Apply counteraction

The relevant deduction (of 60) which may be deducted by the payer is reduced by the mismatch amount of 10. The maximum the payer may deduct is therefore 50.

However, since the application of the transfer pricing rules has led to a claimed deduction of only 30, the counteraction has no effect in practice.

Note that if a corresponding adjustment claim was made by Investor 2, Part 6A would have imposed a counteraction of 30 (as total payee ordinary income would have been reduced to 30), setting a maximum deduction of 30, leading to the same outcome as Part 4. Part 6A would therefore have had no effect in its own right.

Background 2

- There are no hybrid entities in this structure.
- Investor 1 sees the financial instrument as equity, and does not tax the return on it.
- Investor 2 sees the financial instrument as debt, and does tax the return it receives.
- The arm's length amount of the payment from Payer to Partnership would be 40.

- Note it is assumed in the analysis below that the terms of the partnership and the treatment of the partnership according to the governing laws of Investor 1 and Investor 2 result in the two investors each being considered to own an indivisible 50% share in the hybrid security held by the partnership. In the event that this was not the case, and so the correct analysis was that two securities were deemed to be in issue, one held by each investor, the eventual result would be the same (but via a 100% counteraction on one security and no counteraction on the other, rather than via a 50% counteraction on the single security actually in issue).

Analysis

Applying Transfer Pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 3 would therefore be reduction of relevant deduction by 50. Total relief available to payer would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 40. This is the relevant deduction for Part 6A purposes. Total payee ordinary income would be 20. Counteraction under Chapter 3 would therefore be reduction of relevant deduction by 20. Total relief available to payer would therefore be 20.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50, but under the arm's length provision it would be 20. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 40. Deductibility of the payment is reduced by 20 due to counteraction under Chapter 3. Payer therefore claims deduction of 20.

To the extent relevant, corresponding adjustments would be available under s.174 as if the arm's length payment of 40 had been made.

Applying Part 6A (Chapter 3) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (ie relief available disregarding hybrids rules)

Payer makes payment of 100, which absent the hybrids rules would potentially be fully deductible. However, this exceeds the arm's length amount so transfer pricing would require recomputation of payer's tax position as if it was paying 40. Relevant deduction is therefore 40.

Step 2: Identify payees' total ordinary income

Only Investor 2 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch

The relevant deduction is 40 and the total ordinary income of payees is 50. There is therefore no hybrid or otherwise impermissible deduction/non-inclusion mismatch.

Since there is no hybrid payee deduction/non-inclusion mismatch, there is no counteraction. Payer claims deduction of 20 in accordance with the outcome of applying the transfer pricing rules.

Note that if a corresponding adjustment claim was made by Investor 2, Part 6A would have imposed a counteraction of 20 (as total payee ordinary income would have been reduced to 20), setting a maximum deduction of 20, leading to the same outcome as Part 4. Part 6A would therefore have had no effect in its own right.

Background 3

- There are no hybrid entities in this structure.
- Investor 1 sees the financial instrument as equity, and does not tax the return on it.
- Investor 2 sees the financial instrument as debt, and does tax the return it receives.
- The arm's length amount of the payment from Payer to Partnership would be 60,
- But arm's length parties would have entered into a vanilla instrument which both Investor 1 and Investor 2 see as debt and tax the returns in full.

- Note it is assumed in the analysis below that the terms of the partnership and the treatment of the partnership according to the governing laws of Investor 1 and Investor 2 result in the two investors each being considered to own an indivisible 50% share in the hybrid security held by the partnership. In the event that this was not the case, and so the correct analysis was that two securities were deemed to be in issue, one held by each investor, the eventual result would be the same (but via a 100% counteraction on one security and no counteraction on the other, rather than via a 50% counteraction on the single security actually in issue).

Analysis

Applying Transfer Pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 3 would therefore be reduction of relevant deduction by 50. Total relief available to payer would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 60. Part 6A has no application, since under the arm's length provision both Investor 1 and Investor 2 receive interest which would be taxed as ordinary income.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50, but under the arm's length provision it would be 60. Payer is therefore not potentially advantaged. No transfer pricing adjustment falls to be made.

Applying Part 6A (Chapter 3) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (ie relief available disregarding hybrids rules)

Payer makes payment of 100, which absent the hybrids rules would potentially be fully deductible. However, this exceeds the arm's length amount so transfer pricing would require recomputation of payer's tax position as if it was paying 60. Relevant deduction is therefore 60.

Step 2: Identify payees' total ordinary income

Only Investor 2 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch

The relevant deduction is 60 and the total ordinary income of payees is 50. There is therefore a hybrid or otherwise impermissible deduction/non-inclusion mismatch of 10.

Step 4: Apply counteraction

The relevant deduction (of 60) which may be deducted by the payer is reduced by the mismatch amount of 10. The maximum the payer may deduct is therefore 50.

No corresponding adjustment is available (at least under UK domestic law) as the reduction in relief is effected solely by Part 6A (even though a notional transfer pricing exercise was conducted in order to quantify the counteraction under Chapter 3).

Background 4

- There are no hybrid entities in this structure.
- Investor 1 sees the financial instrument as equity, and does not tax the return on it.
- Investor 2 sees the financial instrument as debt, and does tax the return it receives.
- The arm’s length amount of the payment from Payer to Partnership would be 40,
- But arm’s length parties would have entered into a vanilla instrument which both Investor 1 and Investor 2 see as debt and tax the returns in full.

- Note it is assumed in the analysis below that the terms of the partnership and the treatment of the partnership according to the governing laws of Investor 1 and Investor 2 result in the two investors each being considered to own an indivisible 50% share in the hybrid security held by the partnership. In the event that this was not the case, and so the correct analysis was that two securities were deemed to be in issue, one held by each investor, the eventual result would be the same (but via a 100% counteraction on one security and no counteraction on the other, rather than via a 50% counteraction on the single security actually in issue).

Analysis

Applying Transfer Pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 3 would therefore be reduction of relevant deduction by 50. Total relief available to payer would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 40. Part 6A has no application, since under the arm's length provision both Investor 1 and Investor 2 receive interest which would be taxed as ordinary income.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50, but under the arm's length provision it would be 40. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 40, which is not subject to any hybrid counteraction. Payer therefore claims relief of 40.

To the extent relevant, corresponding adjustments would be available under s.174 as if the arm's length payment of 40 had been made.

Applying Part 6A (Chapter 3) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (i.e. relief available disregarding hybrids rules)

Payer makes payment of 100, which absent the hybrids rules would potentially be fully deductible. However, this exceeds the arm's length amount so transfer pricing would require recomputation of payer's tax position as if it was paying 40. Relevant deduction is therefore 40.

Step 2: Identify payees' total ordinary income

Only Investor 2 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch

The relevant deduction is 40 and the total ordinary income of payees is 50. There is therefore no hybrid or otherwise impermissible deduction/non-inclusion mismatch of 10. No counteraction therefore falls to be made.

Note that if a corresponding adjustment claim was made by Investor 2, Part 6A would have imposed a counteraction of 20 (as total payee ordinary income would have been reduced to 20), setting a maximum deduction of 20, leading to the same outcome as Part 4. Part 6A would therefore have had no effect in its own right.

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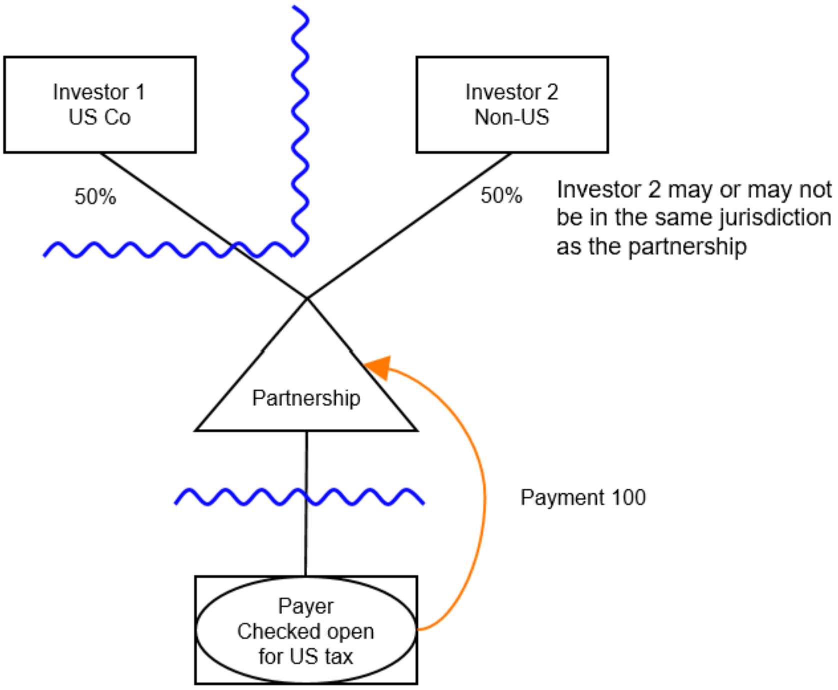
INTM550086 B: Hybrids: Chapter 1 – Introduction: Examples: Interaction with transfer pricing - Hybrid payer

These two examples demonstrate how Part 6A and the Transfer Pricing rules apply in the case of a hybrid payer. The diagram is the same for both fact patterns.



Background 1

- Investor 1 sees the payer as a transparent entity.
- Investor 2 sees the payer as an opaque entity.
- Both investors see the partnership as transparent.
- Under arm’s length terms, the value of the payment between Payer and Partnership would be 60, not 100.

Analysis

Applying transfer pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 5 would therefore be restriction of 50 of relevant deduction to apply against dual inclusion income only. Total relief available to payer for normal use would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 60. This is the relevant deduction for Part 6A purposes. Total payee ordinary income would be 30. Counteraction under Chapter 5 would therefore be restriction of 30 of relevant deduction to apply against dual inclusion income only. Total relief available to payer for normal use would therefore be 30.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50 available for general use and 50 available to set against dual inclusion income only. Under the arm's length provision it would 30 in each category. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 60. 30 of the resulting relief is restricted to use against dual inclusion income by Chapter 5. The remaining 30 is available for general use.

To the extent relevant, corresponding adjustments would be available under s.174 s if the arm's length payment of 60 had been made.

Applying Part 6A (Chapter 5) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (ie relief available disregarding hybrids rules)

Payer makes payment of 100. However, this exceeds the arm's length amount so transfer pricing would require recomputation of payer's tax position as if it was paying 60. Relevant deduction is therefore 60.

Step 2: Identify payees' total ordinary income

Only Investor 2 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid payer deduction/non-inclusion mismatch

The relevant deduction is 60 and the total ordinary income of payees is 50. There is therefore a hybrid payee deduction/non-inclusion mismatch of 10.

Step 4: Apply counteraction

An amount of the relevant deduction equal to the mismatch of 10 is restricted for use against dual inclusion income only. The maximum the payer may deduct generally is therefore 50. However, since the application of the transfer pricing rules has led to a greater restriction, with 30 of relief limited to use against dual inclusion income and only 30 of relief available for general use, the counteraction has no effect in practice.

Note that if a corresponding adjustment claim was made by Investor 2, Part 6A would have imposed a counteraction of 30 (as total payee ordinary income would have been reduced to 30), setting a maximum deduction for general use of 30, leading to the same outcome as Part 4. Part 6A would therefore have had no effect in its own right.

Background 2

- Investor 1 sees the payer as a transparent entity.
- Investor 2 sees the payer as an opaque entity.
- Both investors see the partnership as transparent.
- Under arm's length terms, the value of the payment between Payer and Partnership would be 40, not 100.

Analysis

Applying transfer pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 5 would therefore be restriction of 50 of relevant deduction to apply against dual inclusion income only. Total relief available to payer for normal use would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 40. This is the relevant deduction for Part 6A purposes. Total payee ordinary income would be 20. Counteraction under Chapter 5 would therefore be restriction of 20 of relevant deduction to apply against dual inclusion income only. Total relief available to payer for normal use would therefore be 20.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50 available for general use and 50 available to set against dual inclusion income only. Under the arm's length provision it would 20 in each category. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 40. 20 of the resulting deduction is restricted to use against dual inclusion income by Chapter 5. The remaining 20 is available for general use.

To the extent relevant, corresponding adjustments would be available under s.174 as if the arm's length payment of 40 had been made.

Applying Part 6A (Chapter 5) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (ie relief available disregarding hybrids rules)

Payer makes payment of 100. However, this exceeds the arm's length amount so transfer pricing would require recomputation of payer's tax position as if it was paying 40. Relevant deduction is therefore 40.

Step 2: Identify payees' total ordinary income

Only Investor 2 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid payer deduction/non-inclusion mismatch

The relevant deduction is 40 and the total ordinary income of payees is 50. There is therefore no hybrid payee deduction/non-inclusion mismatch.

Since there is no hybrid payee deduction/non-inclusion mismatch, there is no counteraction.

Payer has an unrestricted deduction of 20, with a further 20 restricted to use against dual inclusion income, in accordance with the outcome of applying the transfer pricing rules.

Note that if a corresponding adjustment claim was made by Investor 2, Part 6A would have imposed a counteraction of 20 (as total payee ordinary income would have been reduced to 20), setting a maximum deduction for general use of 20, leading to the same outcome as Part 4. Part 6A would therefore have had no effect in its own right.

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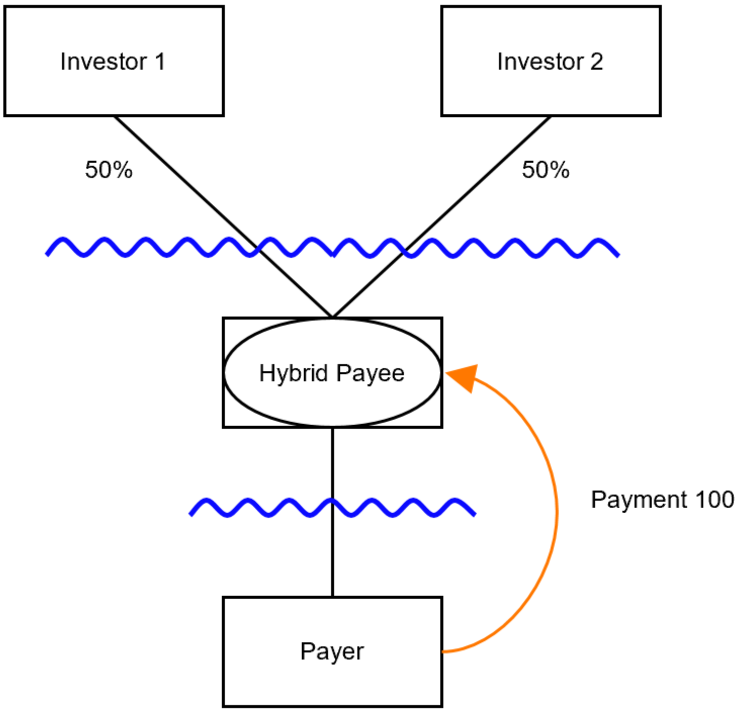
INTM550086 C: Hybrids: Chapter 1 – Introduction: Examples: Interaction with transfer pricing - Hybrid payee

These two examples demonstrate how Part 6A and the Transfer Pricing rules apply in the case of a hybrid payee. The diagram is the same for both fact patterns.



Background 1

- Investor 1 sees the Hybrid Payee as transparent.
- Investor 2 sees the Hybrid Payee as opaque.
- Under arm’s length terms, the payment from Payer to Hybrid Payee would be 60, not 100.

Analysis

Applying transfer pricing with Part 6A factored in

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 7 would therefore be reduction of relevant deduction by 50. Total relief available to payer would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 60. This is the relevant deduction for Part 6A purposes. Total payee ordinary income would be 30. Counteraction under Chapter 7 would therefore be reduction of relevant deduction by 30. Total relief available to payer would therefore be 30.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50, but under the arm's length provision it is 30. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 60. Deductibility of the payment is reduced by 30 due to counteraction under Chapter 7. Payer therefore claims deduction of 30.

To the extent relevant, corresponding adjustments would be available under s.174 as if the arm's length payment of 60 had been made.

Applying Part 6A (Chapter 7) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (i.e. relief available disregarding hybrids rules)

Payer makes payment of 100. However, this exceeds the arm's length amount so transfer pricing would require re-computation of payer's tax position as if it was paying 60. Relevant deduction is therefore 60.

Step 2: Identify payees' total ordinary income

Only Investor 1 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid payee deduction/non-inclusion mismatch

The relevant deduction is 60 and the total ordinary income of payees is 50. There is therefore a hybrid payee deduction/non-inclusion mismatch of 10.

Step 4: Apply counteraction

The relevant deduction (of 60) which may be deducted by the payer is reduced by the mismatch amount of 10. The maximum the payer may deduct is therefore 50. However, since the application of the transfer pricing rules has led to a claimed deduction of only 30, the counteraction has no effect in practice.

Note that if a corresponding adjustment claim was made by Investor 1, Part 6A would have imposed a counteraction of 30 (as total payee ordinary income would have been reduced to 30), setting a maximum deduction of 30, leading to the same outcome as Part 4. Part 6A would therefore have had no effect in its own right.

Background 2

- Investor 1 sees the Hybrid Payee as transparent.
- Investor 2 sees the Hybrid Payee as opaque.
- Under arm's length terms, the payment from Payer to Hybrid Payee would be 40, not 100.

Analysis

Applying transfer pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Total payee ordinary income is 50. Counteraction under Chapter 7 would therefore be reduction of relevant deduction by 50. Total relief available to payer would therefore be 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 40. This is the relevant deduction for Part 6A purposes. Total payee ordinary income would be 20. Counteraction under Chapter 7 would therefore be reduction of relevant deduction by 20. Total relief available to payer would therefore be 20.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 50, but under the arm's length provision it is 20. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 40. Deductibility of the payment is reduced by 20 due to counteraction under Chapter 7. Payer therefore claims deduction of 20.

To the extent relevant, corresponding adjustments would be available under s.174 as if the arm's length payment of 40 had been made.

Applying Part 6A (Chapter 7) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction (ie relief available disregarding hybrids rules)

Payer makes payment of 100. However, this exceeds the arm's length amount so transfer pricing would require re-computation of payer's tax position as if it was paying 40. Relevant deduction is therefore 40.

Step 2: Identify payees' total ordinary income

Only Investor 1 is recognising ordinary income. It receives 50. So the total ordinary income of all payees is 50.

Step 3: Test if there is a hybrid payee deduction/non-inclusion mismatch

The relevant deduction is 40 and the total ordinary income of payees is 50. There is therefore no hybrid payee deduction/non-inclusion mismatch.

Since there is no hybrid payee deduction/non-inclusion mismatch, there is no counteraction. Payer claims deduction of 20 in accordance with the outcome of applying the transfer pricing rules.

Note that if a corresponding adjustment claim was made by Investor 1, Part 6A would have imposed a counteraction of 20 (as total payee ordinary income would have been reduced to 20), setting a maximum deduction of 20, leading to the same outcome as Part 4. Part 6A would therefore have had no effect in its own right.

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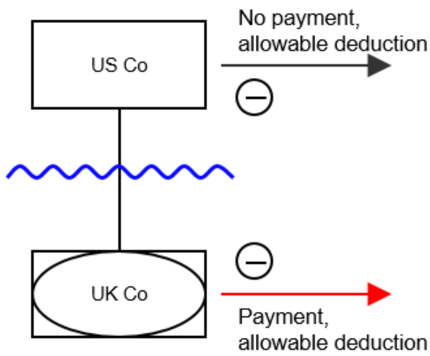
INTM550086 D: Hybrids: Chapter 1 – Introduction: Examples: Interaction with transfer pricing - Double deduction scenario

Background 1



- US Investor sees the payer as a transparent entity.
- Payer is opaque in the UK.
- Under arm's length terms, the value of the payment made by Payer would be 60.
- For Chapter 9 purposes dual inclusion income references would also apply to s.259ID income.

Analysis

Applying transfer pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the double deduction amount for Part 6A purposes. Counteraction under Chapter 9 would therefore be to restrict use of deduction of 100 to being set against dual inclusion income.

Step 2: Test outcome of arm's length provision

Payer makes payment of 60. For the purposes of Part 6A, the deduction in the US would also be computed on the basis that a payment of 60 was made, and is assumed in the example to be 60. This is the double deduction amount for Part 6A purposes. Counteraction under Chapter 9 would therefore be to restrict use of deduction of 60 to being set against dual inclusion income.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer's tax relief under the actual provision would be 100. Under the arm's length provision it would be 60. In each case that relief could only be set against dual inclusion income. Payer is therefore potentially advantaged.

Step 4: Recompute payer's tax position as if the arm's length provision was imposed

Payer is taxed as if it has made a payment of 60, which may only be set against dual inclusion income.

To the extent relevant, corresponding adjustments would be available under s.174 as if the arm's length payment of 60 had been made.

Applying Part 6A (Chapter 9) to consider whether a further counteraction is required.

Step 1: Identify double deduction amount

Payer makes payment of 100. However, this exceeds the arm's length amount so transfer pricing would require recomputation of payer's tax position as if it was paying 60. In identifying the double deduction amount, a payment of 60 would be assumed to be made for US purposes as well as for the UK and, as above, that is assumed in this example to give rise to a deduction in the US of 60. The double deduction amount is therefore 60.

Step 2: Apply counteraction

The double deduction amount of 60 is restricted to use against dual inclusion income. This is the same outcome as delivered by Part 4 and so the separate application of Part 6A has no consequence.

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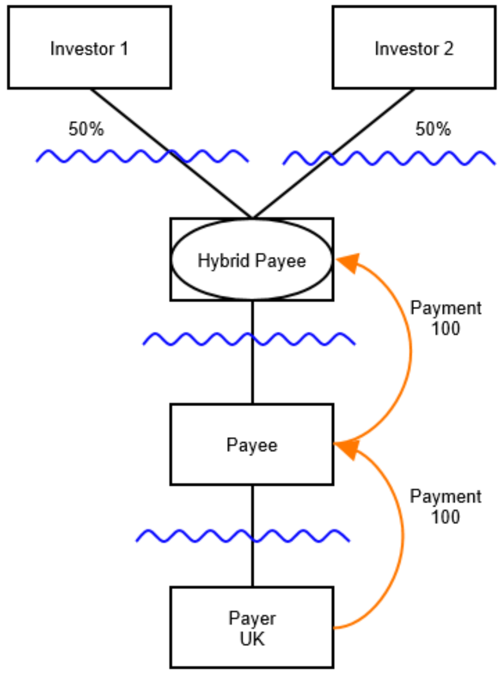
INTM550086 E: Hybrids: Chapter 1 – Introduction: Examples: Interaction with transfer pricing - Imported mismatch

Background 1



- Investor 1 sees Hybrid Payee as transparent.
- Investor 2 sees Hybrid Payee as opaque.
- All relevant jurisdictions see Payee and Payer as opaque.
- Under arm's length terms, the value of the payment made by Payer would be 60.

Analysis

Determine Relevant Mismatch

The payment of 100 between Payee and Hybrid Payee is the mismatch payment within the meaning of Condition D. It gives rise to a hybrid payee deduction/non-inclusion mismatch (i.e. it would be within the scope of Chapter 7 of Part 6A were Payee resident in the UK).

The relevant deduction in relation to the mismatch payment is 100 (assuming that no transfer pricing adjustment under the law of Payee's jurisdiction of residency falls to be made). The ordinary income of the payees is 50 (again assuming that local transfer pricing rules do not deem this to be a lesser amount). Accordingly the relevant mismatch is 50.

Applying transfer pricing with Part 6A factored in.

Step 1: Test outcome of actual provision, disregarding transfer pricing rules

Payer makes payment of 100. This is the relevant deduction for Part 6A purposes. Counteraction under Chapter 11 would therefore be to reduce the relevant deduction by the amount of the relevant mismatch, so limiting relief to 50.

Step 2: Test outcome of arm's length provision

Payer makes payment of 60. This is the relevant deduction for Part 6A purposes. Counteraction under Chapter 11 would therefore be to reduce the relevant deduction by the amount of the relevant mismatch, so limiting relief to 10. The amount of the relevant mismatch is not affected by the substitution of arm's length pricing at the level of Payer.

Step 3: Test if payer is a potentially advantaged person for transfer pricing purposes

Payer’s tax relief under the actual provision would be 50. Under the arm’s length provision it would be 10. Payer is therefore potentially advantaged.

Step 4: Recompute payer’s tax position as if the arm’s length provision was imposed

Payer is taxed as if it has made a payment of 10.

Corresponding adjustments will not be in point as Payee is not UK tax resident.

Applying Part 6A (Chapter 11) to consider whether a further counteraction is required.

Step 1: Identify relevant deduction

Payer makes payment of 100. However, this exceeds the arm’s length amount so transfer pricing would require recomputation of payer’s tax position as if it was paying 60. Relevant deduction is therefore 60.

Step 2: Apply counteraction

The relevant deduction of 60 is reduced by the relevant mismatch of 50. Accordingly, the counteraction reduces the available deduction to 10. Since this amount is not lower than the amount arrived at via applying Part 4, Part 6A has no further effect.

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INTM550090: Hybrids: Chapter 1– Introduction: Summary of Part 6A

Type	Mismatch Involving	Primary Response	Defensive Rule	Scope
D/NI	Chapter 3: Financial Instruments	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
D/NI	Chapter 4: Hybrid Transfers	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
D/NI	Chapter 5: Hybrid Payer	Deny payer deduction	Include as ordinary income	Control group and structured arrangements
D/NI	Chapter 6: Permanent Establishments	Deny deduction to UK PE		UK permanent establishments
D/NI	Chapter 7: Hybrid Payee	Deny payer deduction	Include as ordinary income of investor, then LLP	Control group and structured arrangements
D/NI	Chapter 8: Multinational Payee	Deny payer deduction		Control group and structured arrangements
DD	Chapter 9: Hybrid Entity	Deny investor deduction	Deny payer deduction	Related parties and structured arrangements
DD	Chapter 10: Dual Territory	Dual resident company: deny deduction Multinational company: deny parent jurisdiction deduction	Multinational company: deny deduction to UK PE	Dual resident and multinational companies
D/NI DD	Chapter 11: Imported Mismatches	Deny payer deduction		Control group and structured arrangements

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INTM550095: Hybrids: Chapter 1– Introduction: Legislative changes since 1 January 2017

FA (No. 2) 2017		
Chapter	**Section**	**Impact**
2	259B(3)	Clarification of scope of meaning of “foreign tax”
3	259CC(2)	Clarification of “permitted period” for purposes of the extent of the hybrid instrument deduction/non-inclusion mismatch
4	259DD(2)	Clarification of “permitted period” for purposes of the extent of the hybrid transfer deduction/non-inclusion mismatch
5	259EB (1A)	Deductions in respect of amortisation under s729 or s731 CTA 2009, or in respect of amortisation under an equivalent law of a territory outside the UK, are not hybrid payer deduction/non-inclusion mismatches.
6	259FA(4A)	A permanent establishment (PE) deduction for the purpose of Part 6A does not include deductions in respect of amortisation under s729 or s731 CTA 2009, or in respect of amortisation under an equivalent law of a territory outside the UK.
7	259GB(1A)	Deductions in respect of amortisation under s729 or s731 CTA 2009, or in respect of amortisation under an equivalent law of a territory outside the UK, are not hybrid payee deduction/non-inclusion mismatches.
8	259HB(1A)	Deductions in respect of amortisation under s729 or s731 CTA 2009, or in respect of amortisation under an equivalent law of a territory outside the UK, are not multinational payee deduction/non-inclusion mismatches.
11	259KB(3A)	An excessive PE deduction for the purpose of Chapter 11 of Part 6A does not include deductions in respect of amortisation under s729 or s731 CTA 2009, or in respect of amortisation under an equivalent law of a territory outside the UK.
FA 2018		
2	259B(3A)	Payment of withholding tax is to be ignored for the purposes of Part 6A
2	259B(5)	When a person is resident outside the UK and the law of the relevant territory has no provision for a person to be resident for tax purposes, references to a person’s residence for tax purposes in chapters 8-11 is to be taken as meaning their residence in the territory outside the UK.
2	259BC(3)	Meaning of “ordinary income”: amount of income not brought into account for purposes of calculating income or profits on which tax is charged to the extent it is charged to relevant tax at nil, or excluded by any exemption/exclusion/relief/credit that either applies generally to the income, or arises as a result of or in connection with a payment giving rise to the amount of income.

6	259FA(7A)	For the purpose of Condition C of Chapter 6 any increase in taxable profits or reduction in losses is to be ignored in any case where tax is charged at nil under the law of the parent jurisdiction.
7	259GB(3)	Inserted “at a higher rate than nil” after “where that payee is resident for the purposes of a tax charged”
11	259KB(4A)	For the purpose of establishing whether a PE deduction is “excessive” any increase in taxable profits or reduction in losses is to be ignored in any case where tax is charged at nil under the law of the parent jurisdiction.
2	259BD(12A) to (13)	Explanation of a qualifying CFC amount, and expand definition of “chargeable profits” to include any qualifying CFC amount within the given meaning.
3	259CC(7) to (12)	Inserted explanation and treatment of “a qualifying capital amount” for the purpose of Case 2.
4	259DB(7)	For purpose of s259DB(4) references to tax include any qualifying capital tax within the meaning of s259DB.
4	259DB (6) to (11)	Inserted explanation and treatment of “a qualifying capital amount” for the purpose of Case 2.
7	259GB(4A)	When a payee is a partnership, it is to be assumed that no amount of ordinary income arises to the payee by reason of the payment/quasi-payment if a partner in that partnership is entitled to the amount, and, having regard to the law of the territory where the partnership is established and that where the partner is resident/established, the payee would not be regarded as a hybrid entity.
8	259HB(2A)	Clarification of the counterfactual test: excess is to be taken to arise by reason of the payee being a multinational company so far as it would not arise if it was assumed that the company is not regarded under any territory as carrying on a business in the PE jurisdiction, and for tax purposes all amounts of ordinary income are regarded as arising to it in the parent jurisdiction.
9	259IC(4)	Restricted deduction may not be deducted from the hybrid entity’s income unless it is from dual inclusion income or section 259ID income for that period.
9	259ID	Section 259 ID income for the purposes of section 259 IC: application, conditions and amount of income of the hybrid entity that is 259ID income.
11	259K	Imported mismatches: dual inclusion income. S259KD inserted to provide for relief where an amount is deducted from dual inclusion income.
12	259LB	Adjustment in light of later treatment of accounting purposes section inserted to allow for such consequential adjustments as are just and reasonable in respect of reversal of a debit by a credit of the company after the end of the payment period.
FA 2019		
8	259HA(5)	Condition C expanded to include multinational companies that are UK resident for the payment period and under have a disregarded

		permanent establishment in the PE jurisdiction, with effect from 1 January 2020.
8	259HC	Counteraction of the multinational payee deduction/non-inclusion mismatch clarified to include the expanded Condition C at s259HA(5).
14	259N(3)	A financial instrument does not include “anything of a description specified in regulations made by the treasury”. Subsection (4) deleted.
The Hybrid and Other Mismatches (Financial Instrument: Exclusions) Regulations 2019		
These Regulations supplement the definition of “financial instrument” in section 259N of the Taxation (International and Other Provisions) Act 2010 (c. 8) which falls within Part 6A of that Act (hybrid and other mismatches). These regulations have effect form 1 January 2020 until 31 December 2022. Section 259N(1) defines “financial instrument”. Under section 259N(3), “financial instrument” does not include a hybrid transfer arrangement (within the meaning given by section 259DB) or anything of a description specified in regulations made by the Treasury. These Regulations specify other things which are not a “financial instrument”.		
The Taxation of Hybrid Capital Instruments (Amendment of Section 475C of the Corporation Tax Act 2009) Regulations 2019		
These Regulations amend section 475C of the Corporation Tax Act 2009 to ensure that the rules relating to hybrid capital instruments, introduced in Schedule 20 to the Finance Act 2019, work as intended. Specifically, these amendments ensure that where a takeover or change of control has taken place a conversion into shares of the new parent company will be a “conversion event” for the purposes of section 475C. These Regulations have effect from 1st January 2019, save in relation to stamp duty and stamp duty reserve tax for which they take effect from 12th February 2019. Paragraph 19(5) of Schedule 20 to the Finance Act 2019 enables these provisions to have retrospective effect.		

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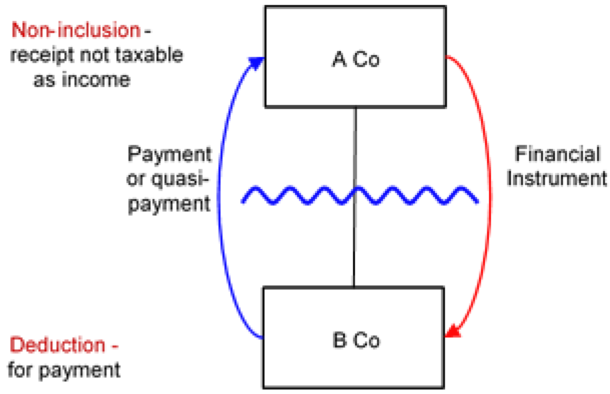
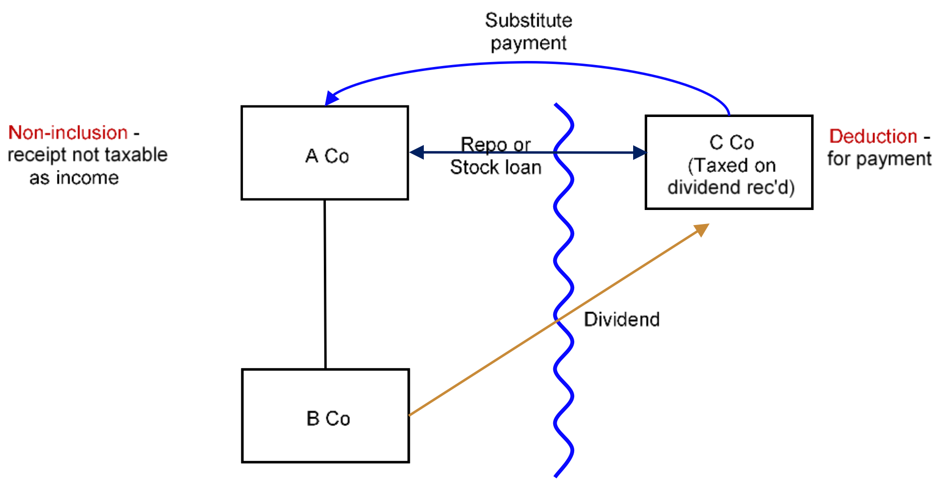
INTM550100: Hybrids: Chapter 1 - Introduction: Hybrid and other mismatch structures within Part 6A

To help in identifying the appropriate part of the hybrid mismatch legislation and guidance, the following diagrams provide illustrative and simplified examples of the main types of hybrid and other mismatch structures to which the rules in each of the main Chapters of the legislation apply.

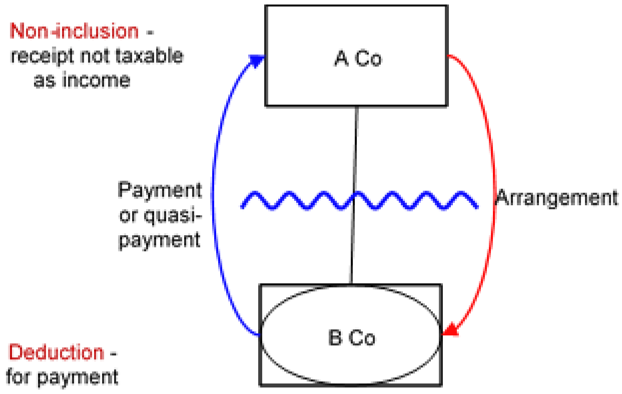
Chapter 3 – D/NI mismatch – Financial Instruments



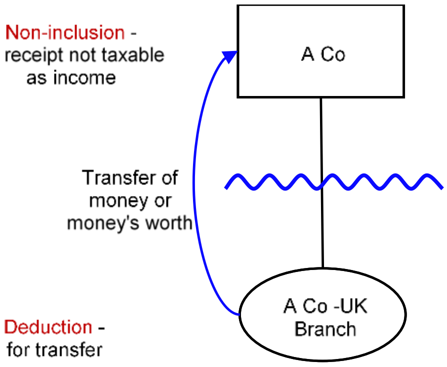
Chapter 4 – D/NI mismatch – Hybrid Transfers



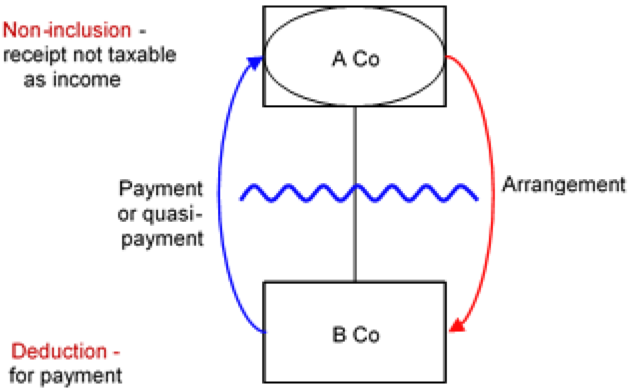
Chapter 5 – D/NI mismatch - Hybrid Payer



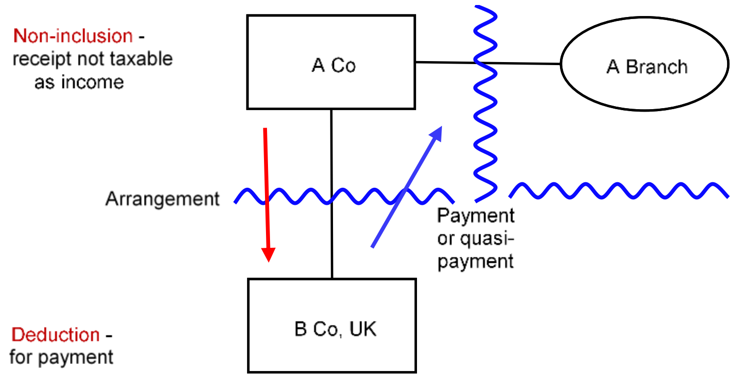
Chapter 6 – D/NI mismatch – UK PE of Multinational



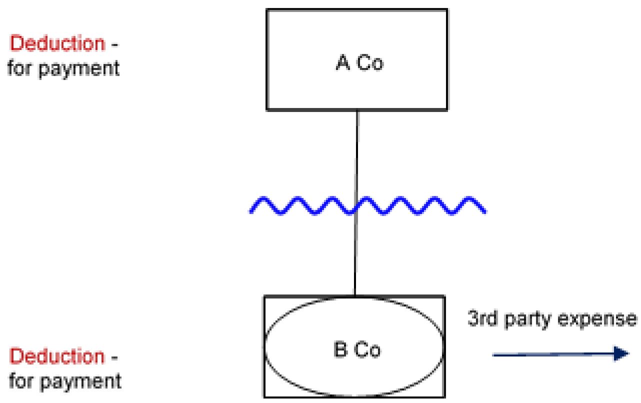
Chapter 7 – D/NI mismatch – Hybrid Payee



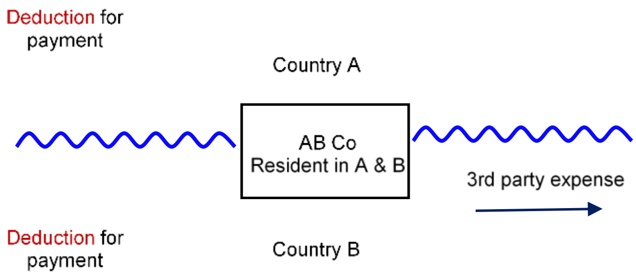
Chapter 8 – D/NI mismatch – Multinational Payee



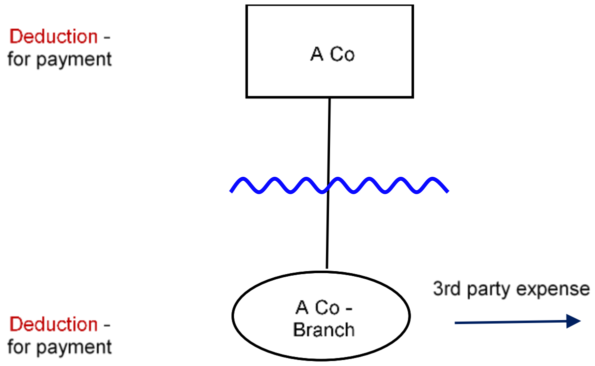
Chapter 9 – DD mismatch – Hybrid Entity



Chapter 10 – DD mismatch – Dual Territory



Chapter 10 – DD mismatch – Multinational



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INTM550500: Hybrids: Chapter 2 – Definition of key terms: Contents

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INTM550510: Hybrids: Chapter 2 – Definition of key terms: Arrangements within the scope of Part 6A

Part 6A of TIOPA 10 applies to mismatches involving –

- financial instruments as defined in s259N
- hybrid entities as defined in s259BE
- UK permanent establishments of multi-national companies as defined in s259BF
- multi-national companies as defined in s259HA(4)
- dual resident companies as defined in s259JA(3)
- hybrid payees as defined in s259GA(3)
- hybrid payers as defined in s259EA(3)
- hybrid transfer arrangements as defined in s259DB
- imported mismatch arrangements as defined in s259KA

Other key expressions for Part 6A of TIOPA 10 are defined in chapters 1, 2 and 14, and additional definitions are included within the chapters to which they apply.

An index of defined expressions is set out at Part 4A of Schedule 11, TIOPA 10 (as amended by paragraph 17 of Schedule 10, FA 16).

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INTM550520: Hybrids: Chapter 2 - Definition of key terms: Meaning of tax

S259B TIOPA 2010 defines tax for the purposes of Part 6A as -

- income tax
- the charge to corporation tax on income
- diverted profits tax
- the CFC charge
- foreign tax or
- a foreign CFC charge.

The definition of tax does not include -

- any tax on capital gains in the UK, whether CGT or corporation tax on capital gains
- any other UK capital taxes.

Foreign tax is defined as a tax chargeable on income under the law of a territory outside the UK that corresponds to the UK charge to income tax or the UK charge to corporation tax on income.

The legislation defines a foreign tax as a tax that corresponds to the UK income tax or UK charge to corporation tax on income.

For example, US Federal taxes on income correspond to the UK taxes, being imposed at national level, and so are regarded as foreign tax within Part 6A. US State taxes are not foreign tax within Part 6A - they do not correspond to UK taxes on income because they are not imposed at national level and there is another tax in the US that is.

Sales or turnover taxes are not foreign taxes that correspond to the UK income tax or charge to corporation tax on income in the UK.

Withholding taxes are specifically excluded from Part 6A (259B(3A)).

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INTM550530: Hybrids: Chapter 2 - Definition of key terms: Equivalent provision under the law of a territory outside the United Kingdom

Any provision of an overseas territory's law that is based on the OECD (2015) Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report published on 5 October 2015, or on any replacement or supplementary publication, will be equivalent to a corresponding provision of this legislation.

Existence of equivalent provisions will not be sufficient to prevent application of the targeted anti-avoidance rule at s.259M where the conditions set out in s.259M(1) are met and the obtaining of the relevant tax advantage cannot reasonably be regarded as consistent with the principles and policy objectives of this Part.

HMRC accepts that EU Council Directive 2017/952 of 29 May 2017 ("ATAD 2") meets the criteria to be an equivalent provision to Part 6A within the meaning of s.259BA TIOPA. Accordingly, HMRC also accepts that, where the legislation is considering the equivalence of Part 6A to an overseas hybrids regime as a whole, subject to the below, it will be reasonable to suppose that any EU member state which has enacted legislation implementing ATAD 2, in full, will have in place equivalent provisions to Part 6A, even if the outcome of applying those provisions is different to that which would have resulted from applying Part 6A to a similar fact pattern. However, in the event that any EU member state should be held by any of the EU Commission, the European Court of Justice or a court of competent jurisdiction in that Member State to have failed properly to implement ATAD 2 in any respect which is material to the UK tax analysis, HMRC will regard chapter 12 as applicable on the basis that the supposition as to the applicability of equivalent provisions which was reasonable at the time made has subsequently proved to be mistaken.

However, where Part 6A requires consideration of whether a specific provision within Part 6A has an overseas equivalent, it will be necessary to demonstrate that such a specific equivalent provision exists overseas. It will not be enough that the overseas regime as a whole can be regarded as equivalent.

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INTM550540: Hybrids: Chapter 2 - Definition of key terms: Payment and quasi-payment, Securitisation companies

Payment

A payment is any transfer of money or money's worth in relation to which an allowable deduction would arise in calculating the taxable profits of the payer for a taxable period, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The only exception is in respect of 259ID where payment takes its ordinary meaning.

Quasi-payment

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer for a taxable period, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- making the relevant assumptions, it is reasonable to expect that ordinary income would arise to one or more persons as a result of the circumstances giving rise to the deduction.

The relevant assumptions

The relevant assumptions are:

- any payee is assumed to be a distinct and separate person if it would be treated as such under the law of the payer jurisdiction,
- any payee or potential payee is assumed to have adopted the same accounting approach as the payer in respect of the circumstances giving rise to the deduction,
- any payee or potential payee is assumed to be resident for tax purposes in the payer jurisdiction, and
- any payee or potential payee is assumed to be carrying on a business in the payer jurisdiction and the circumstances giving rise to the payer's deduction arise in connection with that business.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments if the circumstances giving rise to the deduction do not involve the creation or amendment of economic rights existing between the payer and a payee.

In most instances a payment will also fall within the definition of a quasi-payment.

A simple example of a quasi-payment would be an interest free convertible loan note being treated as issued at a discount that qualifies for finance relief (see example at INTM551280). The deduction arises from the terms of the loan note, which creates economic rights between the payer and payee.

In contrast, a deduction granted by a territory for an amount of deemed interest on an interest free loan would not be a quasi-payment (see example at INTM551270). The deemed deduction does not arise from the terms of the existing loan nor from any amendment to it. It arises from the operation of the territory's tax rules.

Securitisation Companies

For the avoidance of doubt, payments or quasi-payments could arise to an entity which is charged to corporation tax under Regulation 14 of The Taxation of Securitisation Companies 2006 (SI 2006/3296). This could occur where transactions giving rise to the Retained Profit (on which the CT charge is calculated) represent an allowable deduction.

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INTM550550: Hybrids: Chapter 2 - Definition of key terms: Payer and payee

Payer

The payer is a person who would be able to deduct an amount in respect of a payment or quasi-payment when calculating their taxable profits, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

Payee

A payee is any person to whom

- a payment is made, or
- an amount of ordinary income arises as a result of a payment, or
- an amount of ordinary income arises as a result of a quasi-payment, or
- an amount of ordinary income could reasonably be expected to arise if the relevant assumptions are made. See INTM550540 for details of the relevant assumptions.

Payer is also payee

The payer can also be a payee where the entity is treated as the payer under UK law, but as a separate entity in the other jurisdiction.

For example, a payment made by a partnership to one of the partners has the same payer and payee from a UK perspective.

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INTM550560: Hybrids: Chapter 2 - Definition of key terms: Ordinary income

Ordinary income

Ordinary income is defined at s259BC as income that is brought into account when calculating taxable profits on which a relevant tax is charged. Entities such as charities and many pension funds may not have ordinary income where the income received falls wholly within relevant exemptions. This is because that income is not brought into account in calculating profits on which a relevant tax is charged.

A relevant tax is any tax within s259B(1) – see INTM550520 - other than CFC charges (259BC(9)).

Income is not brought into account as ordinary income for the purposes of Part 6A:

- if it is charged to the relevant tax at a nil rate, or
- if it is excluded, reduced or offset by any exemption, exclusion, relief or credit –
  1. that applies specifically to all or part of the amount of income (as opposed to ordinary income generally), or
  2. that arises as a result of, or otherwise in connection with, a payment or quasi-payment that gives rise to the amount of income.

Withholding taxes are excluded from scope.

A receipt may remain within the definition of ordinary income even where it has been characterised differently under the payee regime. For example, a finance return may be characterised as proceeds from a share sale by a share trader, but still be included within trading profits as income. In those circumstances the receipt is taxed at the same rate as a finance return would have been and so is ordinary income. See the example at INTM551380.

A full or partial refund of the relevant tax charged on profits will not prevent an amount from being treated as ordinary income if those refunds result from a "qualifying loss relief".

A qualifying loss relief is a loss that might be used to reduce the amount on which a person is liable to income tax or corporation tax on income in the UK, or a corresponding non-UK loss. This will include, for example, refunds arising from relief for or equivalent to

- UK group relief,

- UK loss carry back

- UK generic allowable expenditure incurred in earning the profits that exceeds the income received.

A full or partial refund of the relevant tax as a consequence of anything that is not a qualifying loss relief will result in the amounts being excluded from ordinary income. This may occur where it is a feature of the relevant jurisdiction's tax regime that the tax on income can be refunded, whether to the company or another person, without the application of a qualifying loss relief, but perhaps because it is income of a specified character.

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Controlled foreign companies regimes

S259BD extends the definition of ordinary income to include certain income subject to a charge under a controlled foreign company (CFC) regime.

See INTM550570 for a more detailed explanation.

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INTM550570: Hybrids: Chapter 2 - Definition of key terms: Ordinary income of controlled foreign companies

There are special rules in Part 6A to deal with income of controlled foreign companies (CFCs). Relevant income that has given rise to a charge under the UK's CFC regime or an equivalent CFC regime outside the UK may be treated as ordinary income of a relevant chargeable company, to the extent set out at s259BD.

A 'foreign CFC charge' means a charge which is similar to the UK CFC charge. The UK CFC regime may be characterised by;

- a charge, called the CFC charge, based upon the chargeable profits of the CFC directly or indirectly held by the water's edge company, and directly attributable to the water's edge company, on a single entity basis
- a CFC charge that is not be subject to further reductions, exemptions or repayments, and
- a CFC charge that does not allow cross entity or cross jurisdictional blending or netting off, whether between CFCs or non-CFCs, including for example, reliefs such as group relief or further reduction by aggregation or consolidation at group or shareholder level.

Relevant income

- is not ordinary income of the CFC, that is, the CFC does not bring the income into account in calculating the income or profits on which it is charged to tax (other than for a CFC charge), or
- is ordinary income of the CFC that arises from a payment or quasi-payment under, or in connection with, a financial instrument or a hybrid transfer arrangement, but is under taxed.

A relevant chargeable company is a company that holds at least a 25% interest in the CFC.

Amendments added Finance Act 2018 - 259BD (12A), (12B) & (12C) were added so that any amounts charged, including those on capital amounts, can be taken into account when determining to what extent amounts of income or profits have been charged to tax under foreign CFC rules.

259BD(12A) enables "a qualifying CFC amount" to be treated as an amount of relevant income of the CFC.

259BD(12B) defines "a qualifying CFC amount".

259BD(12C) disregards any amounts which benefit from exemptions or exclusions, or which relate to CFC charges which are refunded.

Calculating the amount of ordinary income

The amount treated as ordinary income of a relevant chargeable company is determined as follows -

Step 1

Determine the amount of relevant income included in the calculation of chargeable profits of the CFC for the purposes of a CFC charge.

If no relevant income is brought into account for the purposes of a CFC charge, no further action is necessary – there is nothing that could be treated as ordinary income of a relevant chargeable company

Step 2

For each CFC charge, determine the part of the CFC's chargeable profits apportioned to each chargeable company.

If there are no relevant chargeable companies in relation to the CFC charge, no further action is necessary - none of the relevant income of the CFC can be ordinary income of a relevant chargeable company.

Step 3

For each relevant chargeable company determine the appropriate proportion of relevant income brought into account in calculating profits chargeable under the CFC regime.

The appropriate proportion is the same as the proportion of chargeable profits to each relevant chargeable company under Step 2.

That amount may be treated as ordinary income of the relevant chargeable company.

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INTM550580: Hybrids: Chapter 2 - Definition of key terms: Hybrid entities, residence, investors and investor jurisdiction

Hybrid entity

An entity is hybrid if it meets conditions A and B at s259BE.

Condition A is that -

- the entity is treated as a person for tax purposes under the law of any territory.

Condition B is that -

- the entity's income or profits are treated by any territory wholly or partly as taxable income or profits of a different person, or

- the entity is treated as part of another entity in a territory different to that mentioned in condition A.

For example, a UK company which has elected to be disregarded for US tax purposes under the check the box regime will satisfy condition B.

Hybrid entities within Part 6A will include -

- those where applying the domestic law of two territories to the general characteristics of the entity leads to different outcomes as to whether the entity should be regarded as opaque or transparent for tax purposes.

- those where a territory's domestic law treats an entity of a specific type in a certain manner for tax purposes and that treatment is not followed under the domestic law of other territories.

  For example, the income and gains of a UK Limited Liability Partnership (LLP) that carries on a business are treated as transparent under UK tax law. Other territories may treat a UK LLP in line with its form, as a body corporate, and regard it a distinct taxable entity in its own right.

- those where a territory's domestic law allows certain entities to determine whether they are to be treated as opaque or transparent for tax purposes.

For example the US tax code allows entities to make an election to be treated as transparent or opaque for tax purposes under their check the box rules.

Residence

For the purposes of Chapters 8 and 11, residence in a territory is deemed to constitute tax residence where the relevant jurisdiction has no concept of tax residence 259B(5) with effect from 1 January 2018.

Investor and investor jurisdiction

The investor in a hybrid entity is determined by reference to which part of Condition B is satisfied -

- if the income and profits of the hybrid entity are treated as those of a different person, the different person is an investor in the hybrid entity.
- if the hybrid entity is regarded as part of a different entity for tax purposes, the latter entity is the investor in the hybrid entity.

The investor jurisdiction is the territory in which the investor is within charge to tax.

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INTM550590: Hybrids: Chapter 2 - Definition of key terms: Permanent establishment

The meaning of permanent establishment for Part 6A TIOPA 2010 is widely drawn. It includes anything that is a permanent establishment within the meaning of s1119 CTA 2010, or within the meaning of any similar concept outside the United Kingdom.

S259BF(2) specifically widens the definition of a permanent establishment by including any overseas concept of a permanent establishment not based on Article 5 of the Model Tax Convention on Income and Capital published by the Organisation for Economic Cooperation and Development.

A permanent establishment is not a hybrid entity under the definitions in Part 6A TIOPA 2010. Instead there are rules at Chapters 6, 8 and 10 that apply where certain mismatches involving a permanent establishment arise.

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INTM550600: Hybrids: Chapter 2 - Definition of key terms: Financial instruments and relevant investment funds

Financial instruments

Mismatches arising from payments or quasi-payments made under, or in connection with, financial instruments may be subject to counteraction under Chapter 3 of Part 6A TIOPA 2010.

Financial instruments for the purpose of Part 6A are defined in s259N as -

- arrangements where profits and deficits would fall within the loan relationship regime
- contracts where profits and losses would fall within the derivative contracts rules
- specific types of finance arrangements within Part 16 of CTA 2010
- issued shares
- arrangements providing economic benefits that correspond to those of an issued share
- a financial instrument as defined for UK generally accepted accounting practice ("GAAP").

The definition excludes anything that is a regulatory capital security as defined by:

- 1 January 2017 to 31 December 2018: Taxation of Regulatory Capital Securities Regulations 2013(SI 2013/3209) (see INTM551060).
- 1 January 2019 to 31 December 2019: Hybrid and other Mismatches (Financial Instrument: Exclusions) Regulations 2019 (SI 2019/1251).
- 1 January 2020 new regulations

An agreement for the transfer of a financial instrument is not expected to meet the definition of a financial instrument but may be a hybrid transfer falling within Chapter 4 (see INTM552000 onwards).

Relevant investment fund

The amount of any mismatch or undertaxed amount attributable to a relevant investment fund is disregarded when determining the amount of any mismatch arising from financial instruments or hybrid transfers.

A relevant investment fund is defined by s259NA as any of the following funds that meet the genuine diversity of ownership condition (whether or not a clearance has been given to that effect) -

- an open-ended investment company within the meaning of s613 of CTA 2010,
- an authorised unit trust within the meaning of s616 of that Act, or
- an offshore fund within the meaning of s354 of TIOPA 2010.

The genuine diversity of ownership condition is met where

- an offshore fund meets the conditions at regulation 75 of the Offshore Funds (Tax) Regulations 2006 (SI 2006/3001), and
- an open-ended investment company or an authorised unit trust meets the conditions at regulation 9A of the Authorised Investment Funds (Tax) Regulations 2006 (SI 2006/964).

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INTM550610: Hybrids: Chapter 2 - Definition of key terms: Control groups and related persons

Control groups

Control groups are defined by s259NB. A person (A) is in the same control group as another person (B) -

- throughout any period for which they are consolidated for accounting purposes, or
- on any day on which the participation condition is met in relation to them, or
- on any day on which the 50% investment condition is met in relation to them.

Consolidated for accounting purposes

A and B are consolidated for accounting purposes for a period if:

- their financial results for the period are required to be comprised in group accounts, or
- their financial results for the period would be required to be comprised in group accounts but for the application of an exemption, or
- their financial results for the period are in fact comprised in group accounts.

Group accounts means accounts prepared under s399 of the Companies Act 2006, or any corresponding provision of the law of a territory outside the United Kingdom.

Participation condition

The participation condition is met in relation to A and B (the relevant parties) on a day if, within the period of 6 months beginning with the day:

- one of the relevant parties directly or indirectly participates in the management, control or capital of the other, or
- the same person or persons directly or indirectly participate in the management, control or capital of each of the relevant parties.

The definition of participation in management, control or capital takes the same meaning as it does for transfer pricing (see INTM412060).

Investment condition

The 50% investment condition is met in relation to A and B if:

- A has a 50% investment in B, or
- a third person has a 50% investment in each of A and B.

Related persons

Two persons are related on any day that they are in the same control group, or that they meet the 25% investment condition.

The 25% investment condition is met in relation to a person A and another person B if:

- A has a 25% investment in B, or
- a third person has a 25% investment in each of A and B.

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INTM550620: Hybrids: Chapter 2 - Definition of key terms: 50% investment and 25% investment

The investment condition is relevant to both the control and related persons definitions, as required by the appropriate chapter. The same test is used to determine whether the investment condition is met, simply replacing X% with 25% or 50%, as appropriate. Defined at 259ND.

A person (P) has an X% investment in a company (C) if it is reasonable to suppose that -

- P possesses or is entitled to acquire X% or more of the share capital or issued share capital of C,
- P possesses or is entitled to acquire X% or more of the voting power in C, or
- if the whole of C's share capital were disposed of, P would receive (directly or indirectly and whether at the time of disposal or later) X% or more of the proceeds of the disposal.

Similarly, a person (P) has an X% investment in another person (Q) if it is reasonable to suppose that P would receive, directly or indirectly and whether at the time or later, X% or more of -

- the distributed amount if the whole of Q's income were distributed, or
- Q's assets which would be available for distribution in the event of a winding-up of Q or in any other circumstances.

References to a person receiving any proceeds, amount or assets also include references to the proceeds, amount or assets being applied, directly or indirectly, for that person's benefit.

Acting together

The percentage investment a person (P) has in another person (U) may be increased where P and a third person (T) are acting together. P will be treated as having all of T’s interest in U where -

- P and T are connected, or
- P can secure that T acts in accordance with P’s wishes in respect of U’s affairs, or vice versa, or
- T can reasonably be expected to act in accordance with P’s wishes in respect of U’s affairs, or vice versa, or

- P and T are party to an arrangement that it is reasonable to suppose will affect the value of T’s rights or interests in relation to U, or
- P and T are party to an arrangement that relates to exercise of T’s rights in U, or
- the same person manages some or all of P’s rights in U and some or all of T’s rights in U.

The members of a consortium will be considered to be acting together for the purpose of the related persons/control rules.

It is a matter of fact as to whether the conditions above are satisfied and so whether P and T are acting together. Take for example, a company (U) which has more than one loan, and the lenders (P and T) are unrelated. Each lender is likely to act in a way that protects its investment, which might also have the incidental effect of protecting the investment of the other lender. On its own, an alignment of separate interests of this sort will not generally be sufficient to show that P and T are acting together, whereas concerted action taken by P and T would be.

P and T are not treated as acting together in relation to U where the person managing their rights in U -

- is the operator of a collective investment scheme in relation to P’s rights,
- is the operator of a different collective investment scheme in relation to T’s rights, and
- the Commissioners are satisfied that the management of those schemes is not coordinated to influence U’s affairs.

Any cases to be considered by the Commissioners should be sent to the Base Protection Policy team, BAI -

- by email to: hybrids.mailbox@hmrc.gov.uk, or
- by post to:

HM Revenue & Customs
Base Protection Policy Team,
Business Assets & International
S0862, Floor 4 Rear
Central Mail Unit
Newcastle
NE98 1ZZ

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INTM550630: Hybrids: Chapter 2 - Definition of key terms: Partnership and partnership members

Partnerships

There is no definition of a partnership for the purposes of Part 6A TIOPA 2010, so the term will take its usual meaning in UK law, that is, the relation between persons carrying on a business in common with a view to profit.

259NE considers partnerships and the treatment of a person who is a member of a partnership.

A partnership is a person for the purposes of the hybrid mismatch rules.

A partnership is regarded as transparent for UK tax purposes, with the result that the partnership's income, profits etc. are treated as the income, profits etc. of its partners. However, some partnerships may be treated as opaque under the tax laws of other territories, leading to potential hybrid mismatches.

S259NE(4)(a) includes entities established under the law of a territory outside the UK that are of a similar character to a UK partnership. An entity regarded as transparent is not necessarily of a similar character to a UK partnership and must be considered on the full facts and characteristics. This subsection is intended to ensure that the treatment of non-UK partnerships, for Part 6A purposes, is consistent with the treatment of UK partnerships and not to extend the definition of a partnership.

Partners

s259NE sets out the treatment of a person who is a member of a partnership.

Any reference to income, profits or an amount of the person includes a reference to the person's share of the income, profits, or an amount of the partnership. A person's share of the income, profits or amount of a partnership is determined by apportioning between the partners on a just and reasonable basis.

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INTM550640: Hybrids: Chapter 2 - Definition of key terms: Reasonable to suppose

Many of the conditions in Part 6A include a test of whether it is “reasonable to suppose” something. There is no definition of this phrase in Part 6A, so it takes its ordinary meaning.

In general terms the test does not require knowledge of the actual outcome or position, but a rational, justifiable and credible view of the likely outcome or position. Whilst it will depend on context, this supposition should be based on facts and circumstances that are either already established, or which might reasonably be expected to be ascertained in considering the application of Part 6A.

The test is intended to facilitate the submission of a compliant tax return by persons to whom the hybrid mismatch rules may apply so that, for example, it is not necessary for the parties to await final resolution of the relevant tax return for a counterparty or to establish the final outcome of the application of tax law to a specific case in another jurisdiction.

Applying the test is straightforward when all the relevant facts are known. In other circumstances it may be reasonable to expect that further facts or information be obtained in order for a reasonable supposition to be made. For example, in order to meet the test it may be necessary to obtain information from other entities in the same control group or from other parties in a structured arrangement. Each instance will be fact dependant.

The application of Part 6A is part of the customer’s self-assessment, so in the first instance it will be for the customer to decide what it is reasonable to suppose in relation to the relevant facts and circumstances.

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INTM550650: Hybrids: Chapter 2 – Definition of key terms: Structured arrangements

Where there is a payment, quasi-payment, arrangement or transfer to which the hybrid mismatch rules would otherwise apply and the control/related persons tests are not met, one has to consider whether the payment, quasi-payment, arrangement or transfer is made under a structured arrangement.

The financial instrument, hybrid transfer arrangement, or arrangement is a structured arrangement if it is reasonable to suppose that:

- the financial instrument, hybrid transfer arrangement, or arrangement is designed to secure a hybrid or otherwise impermissible deduction/non-inclusion or double deduction mismatch, or
- the terms of the financial instrument, hybrid transfer arrangement, or arrangement share the economic benefit of the mismatch between the parties to the arrangement or otherwise reflect the fact that the mismatch is expected to arise.

The structured arrangement test is a fact dependent test. Further examples of this are included in INTM551115.

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INTM550660: Hybrids: Chapter 2 - Definition of key terms: Summary

This is a brief summary of where definitions can be found in Part 6A and in this guidance.

	Part 6A TIOPA 2010	INTM Guidance
Arrangement	259NF	
CFC and CFC charge	259B(4)	
The Commissioners	259NF	
Control group	259NB	550610
Dual resident company	259JA	558030
Equivalent provisions		550530
Financial instrument	259N	550600
Foreign CFC and foreign CFC charge	259B(4)	
Hybrid entity	259BE	550580
Hybrid transfer arrangement	259DB	552030
Imported mismatch	259KA	559210
Investment – 25% and 50%	259ND	550620
Investor	259BE(4)	550580
Investor jurisdiction	259BE(4)	550580
Multinational company	259HA	554030
Ordinary income	259BC 259BD	550560 550570
Partnership	259NE	550630
Payee in relation to a payment	259BB(6)	550550
Payee in relation to a quasi-payment	259BB(6)	550550

Payee jurisdiction	259BB(9)	
Payer in relation to a payment	259BB(1)	550550
Payer in relation to a quasi-payment	259BB(2)	550550
Payment	259BB(1)	550540
Payment period in relation to a payment	259BB(1)	
Payment period in relation to a quasi-payment	259BB(2)	
Permanent establishment	259BF	550590
Quasi-payment	259BB(2) – (5)	550540
Reasonable to suppose		550640
Related persons	259NC	550610
Relevant deduction in relation to a payment	259BB(1)	
Relevant deduction in relation to a quasi-payment	259BB(2)	
Relevant investment fund	259NA	550600
Structured arrangements		550650
Tax	259B	550520
Taxable period	259NF	
Taxable profits	259BC(2) 259BD(5)	

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INTM551000: Hybrids: Chapter 3 - Financial instruments: Contents

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INTM551010: Hybrids: Chapter 3 - Financial instruments: Overview: Contents

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INTM551020: Hybrids: Chapter 3 - Financial instruments: Overview

Chapter 3 of Part 6A, TIOPA 2010 counters deduction/non-inclusion mismatches (D/NI mismatches) involving financial instruments. These are mismatches that -

- result in an allowable deduction that is not matched by a fully taxable receipt – a D/NI mismatch, and
- arise from payments or quasi-payments (see INTM551080) made under, or in connection with, a financial instrument.

Financial instruments for the purpose of Part 6A TIOPA 2010 are defined at s259N. The definition includes –

- arrangements where profits and deficits would fall within the loan relationship regime
- contracts where profits and losses would fall within the derivative contracts rules
- specific types of finance arrangements within Part 16 of CTA 2010
- an issued share
- arrangements that provide a person with economic benefits corresponding to those attaching to an issued share
- a financial instrument as defined for UK generally accepted accounting practice ("GAAP").

The definition excludes anything that is a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209) (see INTM551060).

An agreement for the transfer of a financial instrument is not expected in itself to meet the definition of a financial instrument but may be a hybrid transfer falling within Chapter 4, see INTM552000 onwards.

Conditions to be satisfied

For a deduction/non-inclusion mismatch arising from a financial instrument to fall within Chapter 3, four conditions; Conditions A to D must be met.

Condition A

- there is a payment or quasi-payment involving a financial instrument

Condition B

- at least one of the parties to the financial instrument is within the charge to UK corporation tax

Condition C

- a mismatch would arise by reason of the terms or other specific features of the financial instrument or arrangements connected with the financial instrument (if that mismatch were not countered by this legislation or equivalent legislation outside the UK) and

Condition D

- the parties to the financial instrument are related, or it is reasonable to suppose the financial instrument is a structured arrangement.

Extent of the mismatch

The extent of the mismatch depends on whether it falls within Case 1 or Case 2.

Case 1 deals with mismatches where -

- the deduction exceeds the total amount of ordinary income arising to payees, and

- that excess is wholly or partly attributable to the terms or features of the financial instrument.

The amount of the mismatch is the excess.

Case 2 deals with mismatches where -

- the income is under-taxed (that is, it is brought into charge as ordinary income, but at a lower rate than the highest rate that could be charged on income from financial instruments), and

- the under-taxed amount is wholly or partly attributable to the terms or features of the financial instrument.

The amount of the mismatch is the under-taxed amount.

For an explanation of what is included as ordinary income see INTM550560 and INTM550570.

Counteraction

If all 4 conditions are met the mismatch is countered by -

- reducing the amount of the deduction claimed where the payer is within the charge to corporation tax in the UK, or
- treating the relevant amount as taxable income where the payee is within the charge to corporation tax in the UK.

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INTM551030: Hybrids: Chapter 3 - Financial instruments: Overview: Quasi-payments - foreign exchange losses of a UK company

Quasi-payments

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer for a taxable period, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons, were certain relevant assumptions to apply.

See INTM550540 for a fuller definition.

Foreign exchange losses

A foreign exchange loss that results from a change in the value of a financial instrument and is attributable solely to the relevant company's functional currency will not usually be a quasi-payment (see below).

A foreign exchange loss may be a quasi-payment where it arises because

- an instrument is a hybrid financial instrument, or
- the payer or the payee is a hybrid entity, or
- there is a mismatch involving either a multinational company (see INTM554030) or a dual resident company (see INTM558030).

Where there is reason to suspect that an arrangement involving foreign exchange losses is being used to avoid the application of Part 6A in circumstances in which Part 6A might otherwise apply, details should be forwarded to the Base Protection Policy Team, BAI to consider whether the targeted anti-avoidance rule applies (see INTM561200).

Debt instruments - exchange loss of a UK company

Relevant deduction

A simple debt instrument denominated in a particular currency will not give rise to an exchange difference if that currency is the same as the company's functional currency. For instance, a bond or loan denominated in euros will not give rise to an exchange difference in the accounts of a company where that company's functional currency is the euro. If, however, the company's functional currency were sterling, an exchange gain or loss may arise because of changes in the value of the euro relative to sterling.

An exchange loss on a debt denominated in a currency that is not the company's functional currency will normally give rise to a UK tax deduction under the loan relationships regime. This deduction is a "relevant deduction" within s259BB(2)(a).

It might be argued that if the exchange rate had changed in the opposite direction, there would have been an exchange gain and thus no relevant deduction. There is nothing in the definition of a quasi-payment that requires any consideration of alternative outcomes. The symmetry of treatment between an exchange gain and an exchange loss on a financial instrument under the loan relationship rules does not prevent an exchange loss being a relevant deduction under Part 6A TIOPA 2010.

Assumptions under s259BB(4)

If there is a relevant deduction, the next step is to consider whether, making the assumptions in s259BB(4), it would be reasonable to expect an amount of ordinary income to arise to one or more other persons as a result of the circumstances giving rise to the relevant deduction.

The assumptions to be made when considering whether it would be reasonable to expect ordinary income to arise are -

- the status of the payee as a separate entity is determined under the law of the payer jurisdiction (s259BB(4)(a)),

- the payee applies the same approach to accounting as the payer (s259BB(4)(b)),

- the payee is resident in the same tax jurisdiction as the payer and is carrying on business there (s259BB(4)(c)).

In the context of a foreign exchange loss on a financial instrument, the "payee" will be the corresponding debt creditor(s).

Accounting approach

Where a UK company is the debtor under a debt instrument and has a deduction in respect of an exchange loss in connection with that instrument, the assumptions require consideration of what ordinary income might be expected to arise to the creditor of that instrument if -

- the creditor were a UK company carrying on a business in the UK, and

- the creditor applied the same approach to accounting. For example, if the debtor applies UK GAAP standard FRS 102 or IFRS, it must be assumed that the creditor does the same.

The accounting condition will normally be met where the debtor and creditor companies have different functional currencies. This is because the application of the same approach to accounting will not necessarily result in the use of the same functional currency by both debtor and creditor entities. The functional currency is determined by applying the relevant accounting standard and taking into account its fact pattern. In essence, under both section 30 of FRS 102 and IAS 21, the functional currency of an entity is the currency of the primary economic environment in which the entity operates. That in turn requires consideration of the entirety of the entity's business and, in some cases, how independent its business is from that of its parent.

Consequently a debtor may have a sterling functional currency and the creditor a euro functional currency, despite adopting the same approach to accounting, because of their differing primary economic environment. In these circumstances, if the financial instrument is a euro-denominated debt, an exchange loss of the debtor will not necessarily be matched by an exchange gain for the creditor.

Ordinary income

There is no expectation that a deduction for a foreign exchange loss relating to a financial instrument would result in ordinary income for the creditor to that financial instrument, if the creditor were a UK company. This will also be the case where both debtor and creditor are UK companies (adopting the same approach to accounting).

For example, UK1 borrows externally in US dollars and then on-lends to a group company (UK2) which in turn invests equity in a US company. UK1 and UK2 might be expected to recognise the same exchange loss or gain if both have sterling as their functional currency. (Note that in these circumstances Regulation 3 of the Disregard Regulations may apply, so that the foreign exchange difference is not brought into account by UK2, if the liability is intended to hedge its investment in the US Company)

The unmatched deduction for any foreign exchange losses in this scenario is similar to the deemed deductions provided by some jurisdictions for interest free loans under s259BB(3), in that the circumstances giving rise to the deduction do not include economic rights existing between UK 1 and UK2.

Conclusion

Making the assumptions required by s259BB(4), where the debtor company suffers an exchange loss which is tax-deductible, it would not be reasonable to expect an amount of ordinary income to arise to another person. The requirements of s259BB(2)(b) are not met and the exchange loss of the debtor company does not give rise to a quasi-payment.

It follows that where a UK payer suffers an exchange loss, the deduction for that loss is neither a payment nor a quasi-payment. An actual mismatch will not be subject to counteraction because there cannot in these circumstances be a "hybrid or otherwise impermissible deduction/non-inclusion mismatch" in relation to a payment or quasi-payment.

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INTM551040: Hybrids: Chapter 3 - Financial instruments: Overview: Quasi-payments - foreign exchange losses of non-UK company

Debt instruments – exchange loss arising to a non-UK company

The UK tax regime for debt respects the functional currency of the company, but this is not necessarily the case in other jurisdictions. Another jurisdiction might require exchange differences to be measured by reference to that jurisdiction's legal currency, irrespective of the functional currency of the company.

If this were the case, the assumptions in s259BB(4) that the payee is a company both resident and carrying on business in the same jurisdiction of the company that has an exchange loss on a debt, may lead to the conclusion that an exchange gain taxable as ordinary income is expected to arise to the payee. In those circumstances the exchange loss would satisfy the definition of a quasi-payment.

In these circumstances it is necessary to consider whether Part 6A could apply. For example, the hybrids rules may apply where –

- the UK company payee does not have an exchange gain nor loss (because the loan is denominated in sterling), and

- the non-UK payer suffers a tax-deductible exchange loss in a jurisdiction that requires exchange differences to be computed by reference to the official currency, irrespective of functional currency.

See the example at INTM551340 (in which, based on the particular facts in that example, no counteraction would arise under s259CE).

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INTM551050: Hybrids: Chapter 3 - Financial instruments: Overview: Quasi-payments - derivatives

Derivatives

The position as regards exchange losses on derivatives and fair value losses on derivatives more generally is different. This is because the fair value of a derivative will respond to changes in value of its underlying subject matter, irrespective of the functional currency of a company: a comparison of the value of this subject matter with some fixed price or other variable will always be a feature of the terms of the derivative. In an option or forward the comparison is with a fixed amount. Other simple derivatives will have two legs each exposed to a different variable.

A very simple example of a derivative is a currency swap. A company would have a "short" euro position on a currency swap if it agreed to pay €100m in three years' time, paying a 6-month euro LIBOR on €100m every 6 months, in return for receiving £90m in three years' time and receiving a 6-month sterling LIBOR on £90m every 6 months (£90m is assumed to be the spot rate equivalent of €100m on entry into the swap). This is similar to making a three year loan of £90m and borrowing €100m from the same counterparty, but the credit risks are offset. The swap is primarily exposed to two variables, the value of €100m and the value of £90m.

If the euro strengthens against sterling the company will make an exchange loss, as the in-substance €100m loan it effectively exchanged for the £90m loan will be a relatively heavier burden. This is not dependent on the functional currency of the company because the sterling leg is built into the swap and the movement in value of the euro relative to sterling inevitably changes the fair value of the swap. The change in value results from the comparison of one leg of the swap with another, rather than, say, between the single leg of a euro-denominated debt security and a company's sterling functional currency. Regardless of the functional currency the company will have a liability that is now considered more expensive, effectively exchanging euros for sterling.

Derivatives including currency swaps will normally be accounted for on a fair value basis whether under IFRS (IFRS 10) or FRS 102 (section 12). For the swap considered here, the fair value movement is almost entirely driven by the euro/ sterling exchange rate. (There will be some "noise" because of the effect of changes in interest rates between the 6-monthly resets of the LIBOR rates.). If a UK company with a short euro position on the swap made a fair value loss on the derivative, this would give rise to a "relevant deduction" within s259BB(2)(a). If the assumptions in s259BB(4) are made as regards the swap counterparty, it would be expected to have a corresponding gain irrespective of its functional currency, which would be subject to corporation tax and so treated as ordinary income . Accordingly, the condition in s259BB(2)(b) would be satisfied.

Thus the UK company's fair value loss on the derivative gives rise to a quasi-payment. This will generally be the case for fair value losses on derivatives.

Whether a counteraction arises depends on whether the other conditions in s259CA are satisfied.

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INTM551060: Hybrids: Chapter 3 - Financial instruments: Overview: Regulatory capital securities

The definition of financial instruments at s259N is intended to exclude anything that is a regulatory capital security.

Regulated financial businesses are required to fund a proportion of their activities through loss-absorbent forms of capital called regulatory capital. This applies to banking and insurance businesses, and to some regulated financial firms.

The UK's regulatory framework for banks, building societies and investment firms gives effect to the Capital Requirements Directive IV (CRD IV). This Directive, effective in UK law, is derived from Basel III (the international regulatory framework). CRD IV, which requires these firms to hold certain amounts of regulatory capital, as prescribed within its texts.

The rules for insurers are under Solvency II, which requires insurers to issue financial instruments to meet their Tier 1 and Tier 2 capital requirements.

The issuance of instruments for regulatory capital purposes reflects the fact that ordinary share capital is expensive, so regulators allow banks and insurers to meet a proportion of their capital requirements by issuing these instruments. AT1 has certain characteristics of both equity and debt as they pay a regular coupon but are perpetual and can be converted to equity in a time of stress and, as such, are hybrid capital instruments.

These financial instruments may be treated differently under different countries' tax systems and, as a result, can give rise to hybrid mismatch outcomes. Without the exemption these instruments could be caught by the hybrid rules even though they are issued to satisfy mandatory regulatory requirements. This would disadvantage regulated financial institutions that operate cross-border.

Exemption for Regulatory Capital from 1 January 2017 to 31 December 2018

s259N specifically excludes anything that is a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209) as amended by SI 2015/2056.

Exemption for Regulatory Capital from 1 January 2019 to 31 December 2019

The 2013 Regulatory Capital Security Regulations (SI 2013/3209) were revoked with effect from 31 December 2018.

From 1 January 2019, the exemption for regulatory capital provided by Section 259N applies by reference to the Hybrid and other Mismatches (Financial Instrument: Exclusions) Regulations 2019 (SI 2019/1251).

These Regulations are designed to exempt all regulatory capital instruments that previously fell within the scope of the 2013 RCS Regulations. In addition, the 2019 Regulations also cover other instruments which could be used to meet Bank of England MREL requirements. The instruments covered by the exemption are set out in paragraph 3 of the Regulations, as follows –

Exclusions from the meaning of "financial instrument"

3. The following are specified exclusions from the meaning of "financial instrument" for the purposes of section 259N(3)(b) of the Taxation (International and Other Provisions) Act 2010—
(a) Additional Tier 1 instruments,
(b) Tier 2 instruments,
(c) an item listed in point (a)(iii) or (b) of Article 69 of CDR which is a Tier 1 item under—
(i) Article 69 or 79 of CDR, or
(ii) rule 4.1 in the Annex to the Transitional Instrument,
(d) an item listed in point (a)(iii) or (b) of Article 72 of CDR which is a Tier 2 item under—
(i) Article 72 or 79 of CDR, or
(ii) rule 4.2 in the Annex to the Transitional Instrument, or (e) own funds and eligible liabilities which are not excluded under article 123(4) of the Bank Recovery and Resolution (No. 2) Order 2014(9).

The Regulations have effect in relation to payments made on or after 1 January 2019, and quasi-payments where the payment period begins on or after that date.

These Regulations are revoked with effect from 1 January 2020, and replaced with new regulations which provide an exemption for regulatory capital which meets the detailed requirements of the EU Anti-Tax Avoidance Directive ("ATAD") see next section at INTM551065.

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INTM551065: Hybrids: Chapter 3 - Financial instruments: ATAD compliant Hybrid Regulatory Capital Exemption with effect from 1 January 2020

The EU Anti-Tax Avoidance Directive ("ATAD") (EU Directive 2016/1164) sets out minimum standards for various anti-avoidance measures. ATAD was amended by EU Directive 2017/952 ("ATAD 2") which set out more detailed rules concerning hybrid mismatches.

From 1 January 2020, any exemption for hybrid regulatory capital has to meet the conditions set out in Article 9(4)(b) of ATAD ("the Directive"). From 1 January 2020, the exemption for regulatory capital is provided by Statutory Instrument 2019/1345 – which are referred to as "the Regulations" below.

The Regulations provide an exemption from the hybrid and other mismatch rules in Part 6A TIOPA 2010 for those financial instruments which meet the detailed conditions of the Directive. These Regulations will come into force on 1 January 2020.

This exemption replaces the existing exemption provided by Statutory Instrument 2019/1251, which in itself replaced the previous exemption which was based upon the 2013 Regulatory Capital Security Regulations (SI 2013/3209).

As with the previous exemptions, these Regulations work by excluding certain instruments from the definition of "financial instruments" within Section 259N, Part 6A TIOPA 2010. However, whilst the previous exemptions applied to specified types of financial instrument, the new exemption will apply by reference to a number of detailed conditions set out in the Directive.

The Regulations operate by a simple cross-reference to the detailed conditions set out in Article 9(4)(b) of the Directive. This approach was considered to be more straightforward than transposing those conditions into UK law. The relevant text of the Directive is as follows -

Article 9

(4). A Member State may exclude from the scope of:

(a) .....

(b)..... hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise where:

(i) the financial instrument has conversion, bail-in or write down features;

(ii)the financial instrument has been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector and the financial instrument is recognised as such in the taxpayer's loss absorbing capacity requirements;

(iii)the financial instrument has been issued

—in connection with financial instruments with conversion, bail-in or write down features at the level of a parent undertaking,

—at a level necessary to satisfy applicable loss absorbing capacity requirements,

— not as part of a structured arrangement; and

(iv)the overall net deduction for the consolidated group under the arrangement does not exceed the amount that it would have been had the taxpayer issued such financial instrument directly to the market.

Point (b) shall apply until 31 December 2022.

This guidance therefore provides a brief explanation of those conditions, and sets out how HMRC's proposed interpretation of those conditions, to enable taxpayers to consider whether the exemption will apply.

Hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise.

The Regulations refer to payments and quasi-payments, as defined in the Hybrid and other Mismatch rules in Part 6A TIOPA. They do not provide a definition of interest. Given the nature of regulatory capital financial instruments, and the payments made under those instruments, it was not considered necessary to provide any further definition on this point. However, in order for any hybridity mismatch to arise, any such payments or quasi-payments would have to be treated as deductible payments in one jurisdiction, and non-taxable receipts in the other jurisdiction.

The Regulations adopt the definition of an associated enterprise provided by Article 2(4) of ATAD, which provides that, in relation to hybrid financial instruments, an *associated enterprise* is one where

(a) An entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more or is entitled to received 25% or more of the profits of the taxpayer;
(b) An individual or entity which holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25% or more or is entitled to receive 25% or more of the profits of the taxpayer ;
If an individual or entity holds directly or indirectly a participation of 25% or more in a taxpayer and one or more entities, all the entities concerned, including the taxpayer, shall also be regarded as associated enterprises.

The financial instrument has conversion, bail-in or write down features.

This condition is a matter of fact in each case, but the expectation is that a range of regulatory capital will have one of these features – it is noted that the features listed are alternatives. So, for example, Additional Tier 1 instruments, as defined by section 3(1) of the Banking Act 2009, will meet this condition, as would other internal instruments issued in order to meet minimum requirements for own funds and eligible liabilities (MREL) as set by the Bank of England.

The financial instrument has been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector

We consider that this condition will be met by financial instruments which have been issued in order to meet regulatory capital requirements. We do not consider that the fact that capital has a general function of supporting the business activities of a bank alters the analysis of the essential purpose of such instruments.

We do not consider that this condition requires financial instruments to be issued in response to specific regulatory capital requirements imposed on individual banks. In practice, the expectation is that such instruments will have been issued in order to ensure that regulatory requirements will be met, rather than being issued in response to such requirements.

With regard to the quantum of regulatory capital issued by a bank, it is accepted as a matter of practicality that banks will hold more regulatory capital than the minimum level set by the relevant regulatory authorities. However, we do not consider that holding a buffer over and above the minimum requirement will alter the analysis in terms of the purpose of issuing such instruments.

We anticipate that banks will be able to support any exemption claimed by reference to the actual regulatory requirements imposed upon them.

The Directive does not provide a definition of the banking sector. HMRC consider that, in accordance with the Prudential Regulatory Authority (PRA) Rulebook, the banking sector can be defined for the purposes of these Regulations as UK banks, building societies and investment firms that are currently subject to the EU Capital Requirements Regulation.

The Bank of England has responsibility for setting minimum standards in relation total loss absorbing capacity requirements for banking entities, in line with the approach set out by the Financial Stability Board (FSB). The Bank of England's approach can be summarised as follows –

The Bank will set MREL (Minimum Requirement for own funds and Eligible Liabilities) on a firm-specific basis, informed by the resolution strategy for that firm.

The Bank of England 2018 policy statement in relation to MREL can be found here.

The financial instrument is recognised as being taken into account in relation to the taxpayer's loss absorbing capacity requirements

This condition simply requires that the financial instrument is accepted as appropriate regulatory capital that is taken into account by the Bank of England when assessing whether the minimum loss absorbing capacity requirements have been met. Specifically, the Prudential Regulatory Authority (PRA) reporting requirements in relation to MREL would be an appropriate starting point for taxpayers seeking to confirm that particular financial instruments have been taken into account in relation to their loss absorbing capacity requirements.

The financial instrument has been issued in connection with financial instruments with conversion, bail-in or write-down features at the level of a parent undertaking.

This condition is intended to ensure that any internal (intra-group) financial instruments can be linked with similar regulatory capital instruments that have been issued higher up the group structure. HMRC consider that this is primarily a measure of quantum, which tests whether sufficient regulatory capital has been issued at the level of a parent to match or exceed the amount of regulatory capital issued in the UK.

So to take a simplified example, if a UK subsidiary of a US parent bank issues internal financial instruments of £100m, this condition requires that the US parent has issued financial instruments with appropriate features of at least £100m.

There is no specific requirement that the instruments issued by a parent undertaking need to have been issued externally. Nor is there any requirement that the parent undertaking is the ultimate parent of the group.

The Directive does not include a definition of "parent undertaking". For the purposes of these Regulations, HMRC consider that any entity of which the relevant UK bank is at least a 51% subsidiary will qualify as a parent undertaking.

We do not consider that this condition requires the instruments to have been issued in a particular order – the condition does not specify, for example, that the first instrument has to be issued in advance of the issue of similar instruments at the level of the parent undertaking. We consider that this condition can be met so long as there is some link between the internal issuance and the issuance by the parent undertaking.

The financial instrument has been issued at a level necessary to satisfy applicable loss absorbing capacity requirements

We consider that this condition refers to the structural level within the group at which the relevant instruments have been issued, rather than any measure of quantum. Therefore taxpayers will need to demonstrate that the instruments can be taken into account in meeting regulatory requirements, on the basis that they have been issued at the appropriate level within the group structure.

This condition is clearly closely linked to the requirement that the instruments have been issued to satisfy loss absorbing capacity requirements. Evidence that an instrument has been so issued should be sufficient to indicate that the requirement for instruments to have been issued at the right level will also have been met.

The financial instrument has not been issued as part of a structured arrangement

The Directive defines a "structured arrangement" in Article 2 as

"*an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch*"

(Article 2 of ATAD as amended by ATAD 2 (EU Directive 2017/952))

Whilst it will be a matter of fact in relation to each relevant instrument, we consider that it would be unusual for regulatory capital to be issued as part of a structured arrangement designed to seek a mismatch, or that any mismatch will have been specifically priced into the arrangement, notwithstanding that the effect of such instruments may be that there is a hybrid mismatch outcome.

With regard to whether an arrangement has been designed to achieve a mismatch outcome, it may be relevant that in order to meet the purpose condition considered above, the primary purpose of the relevant financial instrument will already have been considered.

The overall net deduction for the consolidated group under the arrangement does not exceed the amount that it would have been had the taxpayer issued such financial instrument directly to the market

The Directive does not provide a definition of “arrangement”. HMRC’s view is that the arrangement to be considered must be limited to the issuing of relevant internal financial instruments to associated enterprises, rather than any wider arrangement which also takes into account any external issuance. So we do not consider, for example, that any connected issue by a parent undertaking is relevant to this condition.

This condition requires a consideration of whether the tax deductions which arise as a result of the issuance of relevant financial instruments exceed the deductions that would have arisen if those instruments had been issued externally to the market. This will be a matter of fact in each case.

The exemption will apply until 31 December 2022.

The Directive requires that the detailed requirements in order for exemption to apply, as set out in Article 9(4)(b), will apply from 1 January 2020. The Directive also provides that any exemption cannot apply after 31 December 2022.

This point is dealt with in the Regulations, which specify both a commencement date (1 January 2020) and an end date (31 December 2022), and provide straddling period rules for accounting periods that run across those two dates.

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INTM551070: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied

The conditions applicable for Chapter 3 of Part 6A TIOPA 2010 are set out at s259CA.

[INTM551080: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition A]

[INTM551090: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition B]

[INTM551100: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition C]

[INTM551110: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition D]

[INTM551115: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition D – Structured arrangements]

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INTM551080: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition A

Condition A of s259CA TIOPA 2010 requires a payment or quasi-payment to be made under, or in connection with, a financial instrument.

Financial instrument

A financial instrument is defined at s259N - see INTM551020. It is likely that where the definition of financial instrument is satisfied by one party to the agreement, it will also be satisfied for the counterparty. However, this is not always the case and it may be that this condition is only satisfied in respect of one of the parties to the transaction (see the example at INTM551370).

Payment or quasi-payment

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

As the relationship of the payment to the financial instrument is merely that it be made under or in connection with it, this will include payments to either alter the terms of the instrument (e.g. see INTM551290 for an example of where a payment is made to reduce the interest rate due, or INTM551350 where a payment is made to cancel a loan) or allow the release from all or some of its terms (see the example at INTM551300).

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and

- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons if certain assumptions were to apply.

Relevant assumptions

The relevant assumptions are –

- if there is any question of whether an entity is separate from the payer, that is to be determined by the law of the payer jurisdiction, (this will address situations where the payee jurisdiction does not recognise the payee as a separate entity, for example, where it is the permanent establishment of a head office)

- any payee or potential payee is assumed to have adopted the same accounting approach to those circumstances as the payer,

- any payee or potential payee is assumed to be resident for tax purposes in the payer jurisdiction, and

- any payee or potential payee is assumed to be carrying on a business in the payer jurisdiction and the circumstances giving rise to the payer's deduction arise in connection with that business.

See INTM551260 for an example of how the relevant assumptions are applied.

Payer, payer jurisdiction and payee

The payer is the person who makes the transfer.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

A payee is any person to whom:

- a transfer of money or money's worth is made, or

- an amount of ordinary income arises.

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INTM551090: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition B

Condition B of s259CA TIOPA 2010 requires

- the payer to be within the charge to UK corporation tax for a relevant payment period, or
- a payee to be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period.

The relevant payment period is the taxable period of the payer in which an amount may be deducted, in relation to the payment or quasi-payment.

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INTM551100: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition C

Condition C of s259CA TIOPA 2010 requires an objective judgement: is it reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a relevant deduction/non-inclusion mismatch in relation to the payment or quasi-payment?

The test here is whether a relevant deduction/non-inclusion mismatch would arise if Chapter 3 and Chapters 5 to 10 of Part 6A TIOPA 10 (or any equivalent non-UK legislation) did not apply. For example, if Chapter 5 can also apply to the arrangement at issue, then Chapter 3 has priority, because counteraction under Chapter 3 is given priority over all other chapters except Chapter 4 (S259A(20)(b)).

In determining whether Condition C is satisfied, it is necessary to apply the rules in s259CB to determine whether there is a relevant mismatch (see INTM551230) and to determine its amount. If there is a mismatch, it will only be subject to counteraction if all four conditions are satisfied.

Reasonable to suppose
There is no definition of the term "reasonable to suppose" in Part 6A. The phrase will take its ordinary meaning. It does not require either party to know how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it would be reasonable to conclude that a mismatch may or may not arise.

The inclusion of this phrase is intended to assist in the application of Condition C (whether it is reasonable to suppose that there would be a hybrid or otherwise impermissible deduction/non-inclusion mismatch). Parties to the transaction should take all reasonable actions to establish whether a mismatch is likely to arise, taking account of the relevant tax laws of the territories involved. It is not necessary for the parties to await final resolution of the relevant tax returns, nor do the parties need to make disproportionate enquiries.

Other conditions not satisfied
Where it is clear that one of the conditions will not be satisfied, for example, because the financial instrument is not a hybrid financial instrument and is between unrelated parties, it should not be necessary to make enquiries to establish whether there may be a mismatch. On the other hand, it may be necessary to make enquiries if the same financial instrument is part of an over-arching arrangement within Chapter 11.

No mismatch possible
In other cases, it may be clear that the terms or other features of a financial instrument could not lead to a hybrid mismatch. In these cases, the parties to

the financial instrument may conclude that it is reasonable to suppose that no mismatch could arise, and that it is unnecessary to provide full details of their corporate structure and financing arrangements to test this.

Group transactions

Where the parties to a financial instrument are related because they are in the same group, it is reasonable to expect that relevant information would be shared between the parties to establish if a mismatch arises.

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INTM551110: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition D

Condition D is satisfied where one of the following applies –

- a quasi-payment is made where the payer is also the payee, or
- the payer and a payee are related at any time from when the arrangement in connection with the financial instrument is made, to the last day of the payment period, or
- the financial instrument or an arrangement connected with it is a structured arrangement.

A payer may also be a payee in respect of a quasi-payment where the payee

- is an entity that is not considered to be a separate person from the payer, for example the branch of a company, and
- is an entity that is a separate person from the payer for tax purposes in the payer's jurisdiction, and
- it would be reasonable to expect that entity to have an amount of ordinary income arising as a result of the circumstances giving rise to the quasi-payment.

Related persons

Related persons are defined at s259NC. More detailed guidance on related persons is at INTM550610, but in broad terms a payer and a payee are related on any day that they are

- in the same control group (as defined at s259NB), or
- one holds a 25% investment in the other, or
- a third person holds a 25% investment in both entities.

See INTM559230 where previously unrelated parties become related solely as a consequence of the financial instrument.

Structured arrangements

A financial instrument or arrangement connected with it is a structured arrangement if –

- it is designed to secure a relevant mismatch within Case 1 or Case 2, or

- under the terms of the instrument or arrangement the economic benefit of the mismatch is shared between the parties to that instrument or arrangement, or

- the terms of the instrument or arrangement otherwise reflect that the mismatch was expected to arise.

It is likely, but not essential, that all parties would be aware that the instrument or arrangement may create a relevant mismatch whether by virtue of its structure, terms, conditions or simply that the price reflects that benefit.

Where it is designed to achieve the mismatch it is irrelevant whether it has also been designed to achieve commercial or other objectives.

Where it can be shown that the pricing resulting in any tax saving was derived from factors unconnected to the possible mismatch then there will not be a structured arrangement, unless it is reasonable to suppose that it was still designed to secure it, irrespective of whether both parties intended to share in that saving.

If a product is targeted at a subset of taxpayers who are likely to benefit from such a mismatch, then irrespective of whether the product is also more widely available to other taxpayers, who would not benefit from the mismatch, the arrangement or instrument would be caught.

For further examples of structured arrangements, see INTM551115.

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INTM551115: Hybrids: Chapter 3 - Financial instruments: Conditions to be satisfied: Condition D – Structured arrangements

Whilst the question of whether arrangements are structured arrangements will depend on the specific facts and circumstances, the following scenarios are provided as examples of arrangements which we would not generally see as structured arrangements for the purposes of the hybrid mismatch legislation. The aim in providing these examples is to minimise any additional due diligence in relation to compliance with the hybrid mismatch rules.

These examples are intended to illustrate that, in appropriate cases, the existence of a range of prices for similar transactions, and the fact that a UK broker dealer, prime broker or agent lender has some understanding of the tax position of the underlying principals/counterparties, do not necessarily or automatically lead to the conclusion that the UK broker dealer, prime broker or lending agent is party to a structured arrangement for the purposes of Part 6A.

Stock loan pricing

- A UK broker dealer, prime broker or agent lender operates under standard market agreements with a wide range of third party lenders and borrowers.

- A stock loan of shares issued by a French company, crossing the dividend date, would have a real gross dividend of EUR 100 which is subject to a statutory rate of EUR 30 French withholding tax at source, leaving a net French dividend equal to EUR 70.

- Lender 1: a pension fund in Country A, exempt from tax within its jurisdiction on all income, but under a double tax treaty is subject to a French withholding tax treaty rate of 15% on its French source dividend received, agrees a dividend payment rate of EUR 70 plus EUR 15 equaling a total of EUR 85, thereby putting the pension fund in the same economic position as if it had not lent the securities. In addition to agreeing its dividend pricing with the borrower, the pension fund would also agree a fee for its loan of the French equities based upon an agreed percentage value of the gross dividend value. The fee represents a cost to the borrower and it would be pro-rated over the term of the trade into a basis point value. From its stock loan fee income, the pension fund would pay a fee to either its prime broker or its agent lender calculated on an agreed revenue share basis that would not be reflective at all of the fact that the pension fund has a tax exempt status within its home jurisdiction.

- Lender 2: an investment fund such as a non-French qualifying UCITS, entitled to a 0% French withholding tax rate on French source dividend income, ought to agree its French manufactured payment value at a rate of 100% of the gross dividend because the pricing ought to reflect what the UCITS fund will receive with regard to its real French source dividend income. As with Lender 1, the non-French UCITS fund would receive an agreed fee from the borrower for lending its French equities (the percentage rate charged would fluctuate in this instance) and would, in turn, pay either its prime broker or agent lender a fee for arranging the loan. Again, as with Lender 1, the fee which the non-French UCITS would pay to either its prime broker or its lending agent would not be reflective of the fact that it has an exempt status within its home jurisdiction.

- Lender 3: an insurance company, resident for tax purposes within a jurisdiction which has not concluded an income and capital treaty with France, would become subject to a 30% French withholding tax on its French source dividend income. The insurance company would probably lend its French stock with a dividend rate of 70 (100 – 30% French withholding tax). The insurance company may be able to elect to have its foreign source income in the form of a real or manufactured dividend income which is not subject to local corporation tax. Once again, as with the previous examples, the fee which the non-treaty insurance company would pay to either its prime broker or agent lender would not be reflective of the fact that it has a tax exempt status on the income within its home jurisdiction.

The above varying substitute payment rates are consistent with the market range of pricing for substitute payments. Furthermore, the fees charged by the lender to the borrower are subject to many variables such as the attractiveness of the stock, the lender's treaty or non-treaty withholding tax rate and whether the stock is difficult to source. In addition, the fees paid by the lender to either its prime broker or lending agent for arranging the loan are normally agreed based upon a revenue sharing agreement, that revenue being the initial fee charged by the lender to the borrower for the borrower's temporary use of the stock. The fee does not therefore reflect any deliberate intention to share in the benefit of any D/NI mismatch between the parties, even if the stock lending desk has some awareness of the expected tax position of (some of) its counterparties.

Ordinary course derivative

- A multinational enterprise (MNE) wishes to hedge certain exposures arising from its employee share scheme.

- The MNE enters into a cash settled share option, linked to the value of the MNE's shares, with a third party UK bank.

- On maturity, the UK bank pays the settlement amount to the MNE, as the MNE's shares have risen in value. The UK bank obtains a tax deduction in the course of computing its financial trading profit.

- The MNE is exempt from tax on the return from the option, for example because it is linked to shares or because it is linked to a transaction in its own shares.

- At the time of entering into the transaction, the UK bank expects (due to a general awareness of the tax position of its counterparties) that the MNE would be exempt from tax on any return on the option, but there is no reason to suppose that this is a relevant consideration in the pricing of the transaction.

- The UK bank's pricing of the option reflects its usual approach to pricing share options, taking account of a range of commercial factors including characteristics specific to the MNE's shares (such as share price and volatility) and which might include the size of the transaction.

On the basis that the transaction is a normal commercial transaction that has not been designed by the parties to obtain a D/NI mismatch, and has not been priced to share the benefit of any mismatch or to reflect that a mismatch is expected, it is reasonable to suppose that this is not a structured arrangement for the purposes of the hybrid mismatch legislation. It follows that the UK bank would not need to carry out any additional due diligence review.

Securities issued to customers

Not all securities issued to customers which aim to deliver a particular tax treatment for the customer will give rise to arrangements within the definition of structured arrangements.

For example, Excluded Indexed Securities ("EIS") within the terms of s433 ITTOIA 2005 are not usually considered to be structured arrangements. These can be debt securities which provide a return linked to an underlying asset or index – such as the FTSE 100. The securities are designed to meet the requirements of the UK's EIS rules, so that a UK resident individual is subject to capital gains tax on their return from investing in the security – entirely in line with the policy objective of the EIS regime. The payments a bank makes under such securities will be deductible from financial trading profits.

In addition, there is an expectation that instruments such as UK EIS -

- are priced in the same way as other similar instruments entered into with third parties; and,
- there is no certainty the instrument will produce a gain for the investor.

The issue of securities that meet the conditions of s433 ITTOIA 2005 will not give rise to structured arrangements where

- they are designed with an intention of meeting those conditions in order to deliver the policy aim underlying the introduction of the EIS legislation, and

- they are issued in the normal course of commercial banking business.

Directly comparable securities issued in other jurisdictions, and which would satisfy the conditions set out in the preceding paragraph had they been subject to s433 ITTOIA 2005, will be treated in the same way.

We take the same approach in relation to ISAs and similar statutory financial products.

In considering this guidance, it may be helpful to also consider the anti-avoidance provisions in Chapter 13 of the legislation [see INTM561200].

Hedge accounting

A third-party client may enter into a transaction with a bank if the client has a specific intention that it will obtain a hedging accounting treatment. For example, a corporate group issues a convertible bond to investors. If the corporate group wishes to hedge the associated risk of conversion, it may enter into an equity derivative with a bank. Obtaining hedging accounting may mean that the corporate group requires specific features in the derivative, which the bank would take care to provide. A consequence of hedging accounting treatment may be a hedging tax treatment, which may result in a situation where any deduction for the bank is not matched by an inclusion for the client.

Where the underlying instrument does not result in a hybrid mismatch, then any associated hedging would not be considered to be a structured arrangement, on the basis that the arrangement is not designed to secure a tax mismatch and the pricing is not affected by the tax treatment of the parties.

Where, however, the hedging instrument may itself be a hybrid financial instrument, it would be necessary to consider all of the facts to determine whether there is a structured arrangement.

Islamic financing

Islamic finance transactions may involve sales and purchases of assets, such as commodities (for example, a gold purchase), and may not be taxed on the same basis as in the UK. Income/expenditure arising in overseas jurisdictions may therefore not correspond to that brought into account for tax purposes in the UK, perhaps because the transaction is on capital account or because income/expenditure is considered to arise at maturity. These transactions are designed to achieve a particular characterisation for the purposes of the relevant Islamic GAAP or financing requirements, which in turn may have tax consequences.

For example, in a UK bank, the fee income and interest on a loan/gold purchase would be accounted for across the period of the loan under IFRS, whereas under an Islamic GAAP system, interest is not allowed and would be rolled up into the loan. This would create either non-inclusion or a timing mismatch between the UK deduction and the taxable period for the counterparty in the Islamic country. The Islamic counterparty usually has no influence on the accounting treatment.

Such sharia compliant financing instruments are not usually considered to be structured arrangements as -

- the arrangement is not designed to secure a tax mismatch, and
- the arrangement is priced in the same way as other similar instruments entered into with third parties.

However, if the parties use such instruments to produce a mismatch outcome that is not intended by the legislation and is contrary to the policy intention, the possibility that the financing arrangements are structured arrangements would need to be considered.

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INTM551120: Hybrids: Chapter 3 - Financial instruments: Extent of the mismatch

If conditions A to D of s259CA TIOPA 2010 are satisfied, the next step is to establish the extent of any hybrid or other mismatch.

S259CB determines the extent of the hybrid or other mismatch in respect of a payment or quasi-payment if either or both of case1 or 2 applies.

Case 1 – see INTM551130, or

Case 2 – see INTM551140, or

both Case 1 and Case 2.

It is necessary to apply S259CB to determine whether there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch, which in turn determines whether condition C is satisfied – see INTM551100.

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INTM551130: Hybrids: Chapter 3 - Financial instruments: Extent of the mismatch: Case 1

Case 1 deals with deductions arising from a payment or quasi-payment under or in connection with a financial instrument where

- the deduction exceeds the total amount of ordinary income arising to payees, and
- all or part of that excess arises by reason of the terms or features of the financial instrument.

Reason for the excess - terms

The legislation requires a consideration of whether any excess of the deduction above the ordinary income would have been less if the terms or any other feature of the financial instrument had been different. If so then, to that extent, it is a hybrid or otherwise impermissible deduction/non-inclusion mismatch.

Where Case 1 applies the impermissible mismatch is the amount of that excess which is attributable to the terms, or any feature, of the financial instrument.

There may be circumstances where only part of the excess is so attributable, with the balance arising for different reasons, and in that case only the part so attributed will satisfy this condition - see the example at INTM551380 where part of the mismatch is attributable to differences over the characterisation of a finance return but the balance is attributable to one of the parties being a share trader (and the mismatch would have arisen regardless of the instrument's attributes).

Reason for the excess - any other feature

The addition of the phrase 'or any other feature' to s259CB(2) widens the scope of Case 1, bringing within it, for example, mismatches that arise by reason of the financial instrument being treated in a more beneficial manner because of the relationship between the relevant parties (see the examples at INTM551210, INTM551250, and INTM551300).

Exclusion for specified loan relationship debt relief provisions

There is an exclusion to the extent the excess arises by reason of a relevant debt relief provision, as defined in s259CC(3), which generally respects loan relationship provisions specifically introduced to permit mismatches. These are limited to circumstances such as genuine distress situations, where the object is not to burden further a debtor that is already genuinely struggling financially or to discourage rescue situations. See CFM35370 for more specific details.

Exclusion for excess attributable to a relevant investment fund

The legislation excludes any element of the excess which arises as a result of the payee being a relevant investment fund, which is defined in s259NA. This includes certain open-ended investment companies, authorised unit trusts and certain offshore funds.

What if the mismatch arises for several reasons?

Where the mismatch arises for several reasons it will be treated as arising by reason of the terms, or any other feature, of the financial instrument if it would have arisen as a result those terms or features.

However if a mismatch arises solely because of the combination of the terms, or any other feature, with a particular fact pattern of the counterparty, and would not have arisen with any other counterparty then the mismatch cannot be attributed to specific terms or feature of the instrument.

Relevant assumptions

A hybrid mismatch within Case 1 arises where the mismatch is attributable wholly or in part to the terms or other features of the financial instrument.

S259CB(5) sets out the relevant assumptions that test whether the mismatch arises for reasons other than hybridity of the financial instrument. If there is no mismatch on making the relevant assumptions, then any actual mismatch does not result from hybridity of the financial instrument. In these circumstances the actual mismatch is not a Case 1 mismatch, and falls outside the scope of Chapter 3.

The relevant assumptions are:

- If the payee is not within the charge to tax as it benefits from an exclusion, exemption, immunity or relief assume that the exclusion, exemption, immunity or relief does not apply.

  This assumption deals with mismatches that arise solely because the entities do not have ordinary income as a result of specific reliefs or exemptions. This will include exempted charitable corporations, certain pension funds or companies benefitting from sovereign exclusion.

- If the payment or quasi-payment is not made in connection with a business carried on by the payee in the relevant jurisdiction, then assume it is made in connection with such a business.

  This assumption tests whether the mismatch is attributable to a territorial tax regime. An entity within a territorial tax regime is typically charged to tax only on receipts arising from a business carried on in that jurisdiction.

  If the payee is not within the charge to tax in any territory, either as a resident or through a permanent establishment, then assume it is UK tax resident and that the payment or quasi-payment is made in connection with a business carried on in the UK. This assumption tests whether the mismatch arises because the payee is resident in a territory that has no equivalent to UK income tax or corporation tax on income.

Differences in valuation

If the mismatch is not attributable to the terms, or any other feature, of the financial instrument then it will not be within the scope of Chapter 3.

This could occur, for example, where the mismatch arises due to a difference of opinion on the value of shares to be received on the maturity of a convertible loan note. This contrasts with the situation where the mismatch arises as a result of attributing different valuations to an equity element created by inserting an option to convert before maturity (see the example at INTM551280).

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INTM551140: Hybrids: Chapter 3 - Financial instruments: Extent of the mismatch: Case 2

Case 2 deals with ordinary income arising from a payment or quasi-payment under or in connection with a financial instrument where

- the income is under-taxed, and
- the under-taxed amount is wholly or partly attributable to the terms or features of the financial instrument.

A similar exclusion in relation to excesses attributable to a relevant investment fund applies as for Case 1, and is outlined in INTM551130. Likewise, INTM551130 also considers the interpretation of the term 'or any other feature'.

If there is more than one reason why an amount is under-taxed, and one of those reasons includes the effect of the terms or any other feature of the financial instrument, then the amount will be treated as under-taxed by reason of the terms, or any other feature, of the financial instrument.

Where Case 2 applies, the amount of the impermissible mismatch is calculated by applying the following formula to each under-taxed amount –

$$\frac{(UTA \times (FMR - R))}{FMR}$$

Where -

- UTA is the under-taxed amount
- FMR is the payee's full marginal tax rate for the permitted taxable period, as a %
- R is the highest rate at which tax is charged on the profits that are under-taxed, as a %, taking into account the effect of any credit for underlying tax on a just and reasonable basis.

For the purposes of establishing the under-taxed amount ignore withholding tax.

The full marginal tax rate is the highest rate that could be charged on the taxable profits of that payee on finance related income. It does not include a higher tax rate that may be imposed under the Diverted Profits Tax.

The 'under-taxed amount' is the relevant proportion of ordinary income that is subject to tax at a rate lower than the 'full marginal tax rate'.

The highest rate at which tax is charged recognises income and capital taxes corresponding to the charge that would be imposed under the UK's income tax, capital gains tax or corporation tax regime.

Illustration of calculation

Consider a payee that would ordinarily be subject to tax at 40% on their finance income but who treats the relevant receipt as proceeds from a capital asset, which is eligible for a lower tax rate and other relief. After taking into account the relevant deductions and reliefs, available to be offset under that capital gains taxation regime (including, where relevant, taper, indexation or other such reliefs), they are effectively subject to tax at a rate of 10%, then:

- 'UTA' is the relevant gross proceeds amount
- 'FMR' is 40%, and
- 'R' is 10%

Effectively only 25% of the receipt has been fully included as ordinary income, and 75% is therefore treated by the rules as not-included.

There are examples illustrating this point further at INTM551220, INTM551310 and INTM551380.

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INTM551150: Hybrids: Chapter 3 - Financial instruments: Timing – permitted taxable period

Mismatches within case 1 or case 2 are calculated by reference to the ordinary income arising to each payee for the permitted taxable period. The permitted taxable period is defined at s259CC(2) TIOPA 2010.

A permitted taxable period of a payee is a period that begins before the end of 12 months after the end of the payment period. A later period may be permitted if it is just and reasonable for the amount of ordinary income to arise in the later period. The payment period is the payer's taxable period that includes a deduction for the payment or quasi-payment from which the payee's ordinary income arises.

For example, X Co has a deduction in respect of a payment in its accounts for the year ended 31 December 2017. Ordinary income arises to Z Co as a result of this payment. The payment period is the year ended 31 December 2017. The permitted taxable period will include Z Co's accounting periods that begin before 31 December 2018.

The 12 month period recognises that the payer and payee may not have identical taxable periods, and that there may be a short timing delay between when the payer recognises a payment or quasi-payment and when the payee recognises ordinary income in relation to that payment or quasi-payment.

Where ordinary income arises to a payee in a period that begins after the 12 month period, the permitted taxable period is only extended if it is 'just and reasonable' that ordinary income arises in that later period.

Just and reasonable is not a defined term and therefore takes its ordinary meaning. It asks what is fair, sensible and appropriate depending on the facts, circumstances and the non-tax commercial drivers.

There is unlikely to be a just and reasonable basis for extending the period beyond the 12 month period where the deferral in income recognition results from circumstances, decisions or choices which have the effect of side-stepping the policy intent of the legislation, or which do not reflect commercial arrangements that would be made at arm's length in these circumstances.

If an amount of ordinary income relating to the payment or quasi-payment does not arise in the permitted taxable period, the payer will be denied a deduction under the counteractions below for the period in which the payment or quasi-payment is made. If ordinary income is brought into account at a later date (outside the permitted taxable period) S259LA allows the payer to deduct all or part of the denied deduction in a later period (see INTM561130).

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INTM551160: Hybrids: Chapter 3 - Financial instruments: Counteraction

Action to counter the hybrid or other impermissible mismatch (arising from either case 1 or case 2) depends on whether the payer, payee or both are within the charge to corporation tax in the UK.

Primary response

If the payer is within the charge to corporation tax in the UK for the payment period, s259CD applies to reduce the payer's claim for a deduction from income by an amount equal to the mismatch.

A payment period is the taxable period of the payer in which the deduction for the payment or quasi-payment is made.

Secondary response

If a payee is within the charge to corporation tax in the UK, s259CE may apply to treat a relevant amount of the mismatch as income of the payee in the counteraction period.

The counteraction at s259CE applies where it is reasonable to suppose that -

- s259CD or an equivalent non-UK provision does not apply, or
- an equivalent non-UK provision to s259CD applies but it does not fully counteract the mismatch,

The relevant amount of the mismatch to be included as income of the payee is an amount equal to the hybrid or impermissible mismatch where s259CD or a non-UK equivalent provision do not apply.

The relevant amount of the mismatch to be included as income of the payee where a non-UK provision equivalent to s259CD applies but does not fully counteract the mismatch is the lesser of -

- the amount by which the mismatch exceeds the deduction allowed, and
- the amount of the deduction the payer may deduct after any counteraction outside the UK.

If there is more than one payee, the relevant amount is apportioned on a just and reasonable basis, taking into account

- any profit sharing arrangements between some or all of the payees,
- payees to whom any under-taxed amounts arise, and

- payees who would have been expected to have ordinary income as a result of the payment or quasi-payment, but did not have that ordinary income.

The counteraction period is

- an accounting period of the payee that coincides with the payment period, or, failing that,
- the first accounting period of the payee falling wholly or partly in the payment period.

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INTM551170: Hybrids: Chapter 3 - Financial instruments: Counteraction and distribution exemption rules

The hybrid mismatch rules do not contain a priority order for considering the application of other legislation. In general the hybrid rules will need to be considered whenever a mismatch within scope of Part 6A arises, unless the application of other rules removes the mismatch entirely (see INTM550080).

Where a payment or quasi-payment is made under, or in connection with, a financial instrument for which a deduction is claimed by the payer but the payment is treated as a distribution under the law of the payee jurisdiction, there is overlap between the hybrid mismatch rules and the UK's distribution exemption rules in Part 9A of the Corporation Tax Act 2009 (and equivalent rules in overseas jurisdictions). Therefore, although there is no statutory provision requiring it to be considered in priority, the distribution exemption provisions may be considered before applying the hybrid mismatch rules.

Primary response

The primary counteraction in relation to a hybrid mismatch under a financial instrument is that if the payer is within the charge to corporation tax in the UK for the payment period, s259CD applies to reduce the payer's claim for a deduction from income by an amount equal to the mismatch.

An exception to this is where the overseas territory has rules equivalent to the UK's distribution exemption rules in Part 9A of Corporation Tax Act 2009 (specifically the UK's rules at s931B(c) and s931D(c) CTA 2009), removing the distribution's exemption where a deduction is allowed to a resident of any territory in respect of that distribution. Where a distribution is brought back into charge through such a provision in another jurisdiction, the UK will not usually deny the deduction to the payer.

All such cases should be referred to Base Protection Policy Team, BAI for consideration.

Secondary response

The secondary counteraction in relation to a hybrid mismatch under a financial instrument is that if a payee is within the charge to corporation tax in the UK, s259CE may apply to treat a relevant amount of the mismatch as income of the payee in the counteraction period.

However, if the payment is treated as a distribution within the terms of Part 9A CTA 2009 and a deduction is allowed in respect of the payment, the UK will usually apply the Part 9A rules and bring the distribution into charge rather than apply the counteraction in s259CE.

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INTM551180: Hybrids: Chapter 3 - Financial instruments: Examples: Contents

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INTM551190: Hybrids: Chapter 3 - Financial instruments: Examples – general comment

Several of the following examples correspond to examples included in the Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements published by the Organisation for Economic Cooperation and Development ("OECD") on 5 October 2015. These illustrate scenarios that could include a mismatch where a financial instrument issued by a company in one tax jurisdiction is held by a company in another, but which might not necessarily give rise to a mismatch where one of the jurisdictions is the UK.

Nevertheless, these examples are included to demonstrate the principles underlying the relevant parts of the hybrid and other mismatch legislation.

Additional examples reflecting more common commercial use of financial instruments in the UK may be considered for inclusion in later versions of this guidance.

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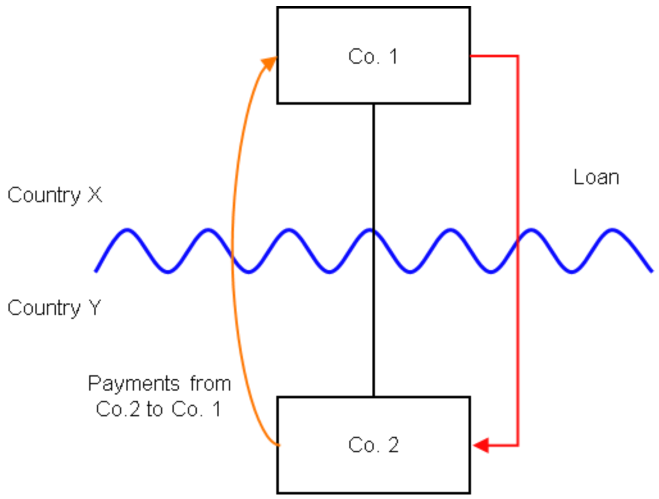
INTM551200: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment - debt/equity hybrid

This example looks at situations where a company issues a loan to a related company and it is treated as debt in one country and equity in the other. The interest payments are deductible and dividend receipts are exempt from tax.

The example considers whether the interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Counteraction in the UK is likely to be limited to the primary response as the UK's distribution exemption rules are expected to apply so that no mismatch arises where the UK is the payee jurisdiction (see INTM551170).



Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X and owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan').
- The terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.
- Under the laws of Country Y the Loan is treated as a debt instrument, and the payments of interest under the Loan are deductible in calculating Co. 2's profits for a taxable period.

- Under the laws of Country X the Loan is treated as an equity instrument (i.e. shares), and the payments of interest under the Loan are treated as dividends.

- Country X exempts dividends received from a foreign company where the recipient controls the payer. If the instrument had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts.

- The payee is not a relevant investment fund as defined in s259NA.

- The Loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid or other mismatches arising from financial instruments rules?

Condition A: Are the payments of interest made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and is therefore within the definition of a financial instrument in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co.1, Co.2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co.1 nor Co.2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to these payments?

The background suggests it is reasonable to suppose that Country Y will allow Co. 2 a deduction (the relevant deduction) for the payment of interest against its ordinary income. It is also reasonable to suppose that, by reason of the terms of the Loan, Country X will not require Co. 1 to bring the corresponding receipt into tax as ordinary income.

This creates a case 1 mismatch, as defined in s259CB(2), as

- the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arises to the payee in the permitted taxable period, and

- all or part of that excess arises by reason of the terms of the financial instrument.

Condition C is satisfied.

Note: If Country X is the UK or, like the UK, has adopted distribution exemption rules, you will need to consider how those rules treat the distribution received by Co.1.

If the UK is in the position of Country X, the rules at s931B(c) and s931D(c) CTA 2009 apply. Those provisions deny or restrict the distributions exemption for Co.1 where the dividends have been allowed as a deduction of a company outside the UK - see INTM650000 for more details.

This changes the amount of ordinary income arising to Co.1, and the calculation of whether any mismatch arises. Where the provisions at s931B(c) and s931D(c) CTA09 (or a non-UK equivalent provision) apply and result in the dividend receipt being treated as taxable income of Co.1, the receipt will also be ordinary income of Co. 1.

The result is that if the UK is Country X, then the application of the distributions exemption rules will result in ordinary income matching the deduction allowed in Country Y. Condition C will not be satisfied.

Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, the relevant counteractions should be considered.

Counteraction

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary Response
Where the UK is in the position of Country Y (the payer jurisdiction) s259CD will apply. Co. 2’s allowable deductions in relation to the payments of interest must be reduced to the extent that the deduction is a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’.

In this example Country X exempts the receipt from tax, therefore the excess is the entire amount and none of the deduction will be allowed.

If Country X had subjected the receipt to a rate of taxation lower than the full marginal rate for interest income , then the deduction will be disallowed by an amount as quantified under s259CB(9) TIOPA 2010.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Note: The following will only apply where, exceptionally, the dividend receipt by Co.1 is not treated as ordinary income (as detailed under Condition C above).

Secondary Response
Where the UK is Country X (the payee jurisdiction) and the mismatch has been fully counteracted in the payer jurisdiction by s259CD or an equivalent provision, no further action will be taken by the UK.

If the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted, s259CE TIOPA 2010 applies. The UK will counteract the remaining ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ by treating that amount as taxable income of the payee arising in the counteraction period.

Note: If, exceptionally, the UK is in the position of both Country X and Country Y (i.e. the transaction is not cross-border but wholly domestic, and UK law results in a mismatch), counteraction is applied to the payer. S259CD takes priority over s259CE by virtue of s259CE(1)(b)(i).

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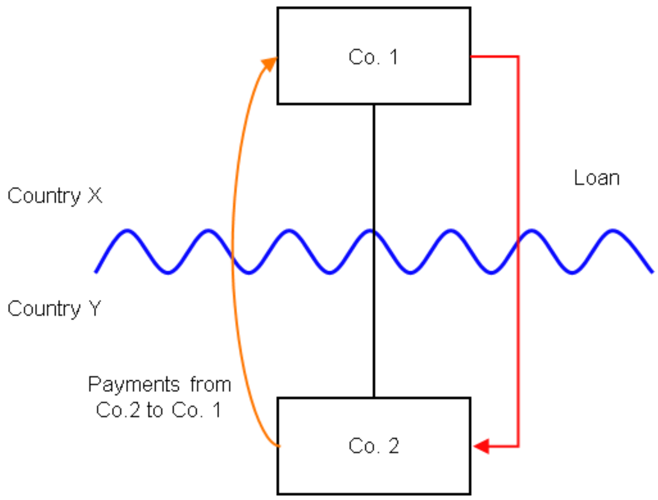
INTM551210: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment - partial exemption

This example looks at situations where a company issues a loan to a related company and it is treated as debt in one country and equity in the other. The interest payments are deductible and the dividend receipts are partially exempt from tax (partial distribution exemption will not be applicable in the UK).

The example considers whether the interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Counteraction in the UK is likely to be limited to the primary response as the UK's distribution exemption rules are expected to apply so that no mismatch arises where the UK is the payee jurisdiction (see INTM551170).



Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.
- Under the laws of Country Y the Loan is treated as a debt instrument, and the payments of interest under the Loan are deductible in calculating Co. 2's taxable profit for a taxable period.

- Under the law of Country X the Loan is treated as an equity instrument (i.e. shares), and so the sums received under the Loan are treated as dividends.
- Country X partially exempts dividends received from foreign companies where the recipient controls the payer. The exemption applies to 90% of the dividend received.
- If the Loan had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts.
- The payee is not a relevant investment fund as defined in s259NA.
- The Loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid or other mismatches arising from financial instruments rules?

Condition A: Are the payments of interest made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co .2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?

The background, suggests it is reasonable to suppose that Country Y will allow Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income. It is also reasonable to suppose that, by reason of the terms of the Loan, Country X will not require Co. 1 to bring the entire corresponding receipt into tax as ordinary income as the payment is treated as a partially exempt equity receipt.

This creates a Case 1 mismatch, as defined in s259CB(2), as

- the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and

- all or part of that excess arises by reason of the terms of the financial instrument – being the interaction of the terms of the loan and the recognition of the relationship between Co. 1 and Co. 2 in Country X.

Condition C is satisfied.

This is a mismatch of amounts (Case 1) rather than an under-taxed mismatch (Case 2).

If Country X had brought the entire amount into charge as ordinary income but subjected it to a preferential tax rate (that is, a rate lower than that which would have been imposed if it had been treated as finance income), Case 2 would apply (see example at INTM551220).

Note: If Country X is the UK or, like the UK, has adopted distribution exemption rules, you will need to consider how those rules treat the distribution received by Co. 1.

If the UK is in the position of Country X, the rules at s931B(c) and s931D(c) CTA 2009 may apply. Those provisions deny or restrict the distributions exemption for Co. 1 where the dividends have been allowed as a deduction of a company outside the UK - see INTM650000 for more details.

This changes the amount of ordinary income arising to Co. 1, and the calculation of whether any mismatch arises. Where the provisions at s931B(c) and s931D(c) CTA09 (or a non-UK equivalent provision) apply and result in the entire dividend receipt being treated as taxable income of Co. 1, the receipt will also be ordinary income of Co. 1.

The result is that if the UK is Country X, then the application of the distributions exemption rules will result in ordinary income matching the deduction allowed in Country Y. Condition C will not be satisfied.

Where the UK is in the position of Country X then the UK distributions exemption legislation should operate to make the distribution receipt either wholly taxable or wholly exempt – it would not treat it as partially exempt.

Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, the relevant counteractions need to be considered.

Counteraction

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary Response
Where the UK is in the position of Country Y (the payer jurisdiction) then s259CD will apply. Co. 2’s allowable deduction in relation to the payments of interest must be reduced by the amount of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’. In this case, the dividend received by Co. 1 is treated by Country X as 90% exempt and 10% taxable at the full marginal rate in Country X. Counteraction under s259CD will limit the allowable deduction of Co. 2 to the amount taxed in Co. 1 in Country Y (equal to 10% of the dividend received). Therefore only 10% of the deduction is allowable in Co. 2 and the remaining 90% will be disallowed.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Note: The following will only apply where, exceptionally, the dividend receipt by Co.1 is not treated as ordinary income (as detailed under Condition C above).

Secondary Response
Where the UK is Country X (the payee jurisdiction) and the mismatch has been fully counteracted by s259CD or an equivalent provision, no further action will be taken by the UK.

As stated above, if the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted, the UK will generally apply the rules at s931B(c) and s931D(c) CTA 2009. Those provisions deny the distributions exemption for Co. 1 where the dividends have been allowed as a deduction for a company outside the UK - see INTM650000 for more details.

If s931B(c) or s931D(c) do not apply, s259CE TIOPA 2010 applies. The UK will counteract the remaining ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ by treating that amount as taxable income of the payee arising in the counteraction period.

Note: If, exceptionally, the UK is in the position of both Country X and Country Y (i.e. the transaction is not cross-border but wholly domestic, and UK law results in a mismatch) counteraction is applied to the payer. S259CD takes priority over s259CE by virtue of s259CE(1)(b)(i).

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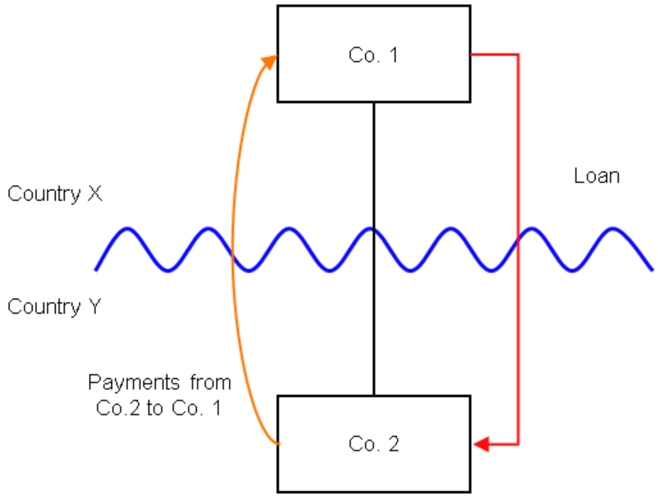
INTM551220: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment – payee is under-taxed

This example looks at situations where a company issues a loan to a related company and it is treated as debt in one country and equity in the other. The company paying interest gets a deduction and the dividend receipt is taxed on the company making the loan but at a lower rate than applies to interest receipts.

The example considers whether the under-taxed interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Counteraction in the UK is likely to be limited to the primary response (disallowing part of the deduction). Where the UK is the payee jurisdiction, the UK's distribution exemption rules are expected to apply so that no mismatch arises (see INTM551170).



Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.

- Under the laws of Country Y the Loan is treated as a debt instrument, and the payments of interest under the Loan are deductible in calculating Co. 2's taxable profit for a taxable period.

- Under the law of Country X the Loan is treated as an equity instrument (i.e. as shares), and so the payments of interest under the Loan are treated as dividends.

- Country X taxes dividends from wholly owned subsidiaries at a lower rate than it taxes interest.

- If the instrument had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts at the normal rate applicable to interest income.

- The payee is not a relevant investment fund as defined in s259NA.

- The loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions and thus fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are the payments of interest made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income. It is also reasonable to suppose that Co. 1 will treat the receipt as dividend income of Co. 1, chargeable to tax at the lower rate for dividends.

This reduced rate is less than the highest rate applicable to income arising from a financial instrument (the full marginal rate).

This creates a Case 2 mismatch, as defined in s259CB(7), as

- there is an amount of ordinary income that arises, by reason of the payment, to the payee for a permitted taxable period, and

- the income is under taxed by reason of the terms or other features of the financial instrument – being a combination of the terms of the loan and the recognition of the relationship between Co. 1 and Co. 2 in Country X

Note: If Country X is the UK or, like the UK, has adopted distribution exemption rules, you will need to consider how those rules treat the distribution received by Co. 1.

If the UK is in the position of Country X, the rules at s931B(c) and s931D(c) CTA 2009 apply. Those provisions deny the distributions exemption for Co. 1 where the dividends have been allowed as a deduction for a company outside the UK - see INTM650000 for more details.

This changes the amount of ordinary income arising to Co. 1, and the calculation of whether any mismatch arises. Where the provisions at s931B(c) and s931D(c) CTA09 (or a non-UK equivalent provision) apply and result in the entire dividend receipt being treated as taxable income of Co. 1, the receipt will also be ordinary income of Co. 1.

The result is that if the UK is Country X, then the application of the distributions exemption rules will result in ordinary income matching the deduction allowed in Country Y. Condition C will not be satisfied.

Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

All the conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, and the relevant counteractions need to be considered.

Extent of the mismatch

As there is a Case 2 mismatch, the amount of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ is calculated by means of the formula in s259CB(8)-

$$\frac{UTA\ \times (FMR - R)}{FMR}$$

Where:

- UTA is the under-taxed amount. This is the amount of dividend charged at a reduced rate in Country X

- FMR is the payee’s full marginal rate (expressed as a %) for the permitted taxable period in which the under-taxed amount is included in taxable profit. This is the highest rate which would have been charged on income from a financial instrument in Country X

- R is the rate (expressed as a %) at which the relevant tax is charged on the ordinary income in which the under taxed amount is included. This is the lower rate being applied to the dividend income.

Counteraction

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response
Where the UK is in the position of Country Y (the payer jurisdiction), s259CD will apply. Co. 2’s allowable deduction in relation to the payments of interest must be reduced to the extent that the deduction is a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’.

The ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ is calculated using the formula above. This amount is the amount disallowed in Co. 2 by s259CD.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Note: The following will only apply where, exceptionally, the dividend receipt by Co.1 is not treated as ordinary income (as detailed under Condition C above).

Secondary Response
Where the UK is Country X (the payee jurisdiction) and the mismatch has been fully counteracted by s259CD or an equivalent provision, no further action will be taken by the UK.

if the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted, the UK will generally apply the rules at s931B(c) and s931D(c) CTA 2009. Those provisions deny the distributions exemption for Co. 1 where the dividends have been allowed as a deduction for a company outside the UK - see INTM650000 for more details.

If for whatever reason s931B(c) or s931D(c) do not apply, s259CE TIOPA 2010 applies. The UK will counteract the remaining ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ by treating that amount as taxable income of the payee arising in the counteraction period. The ‘hybrid or otherwise impermissible deduction/non-inclusion mismatch’ is calculated using the formula shown above.

Note: If, exceptionally, the UK is in the position of both Country X and Country Y (i.e. the transaction is not cross-border but wholly domestic, and UK law results in a mismatch) counteraction is applied to the payer. S259CD takes priority over s259CE by virtue of s259CE(1)(b)(i).

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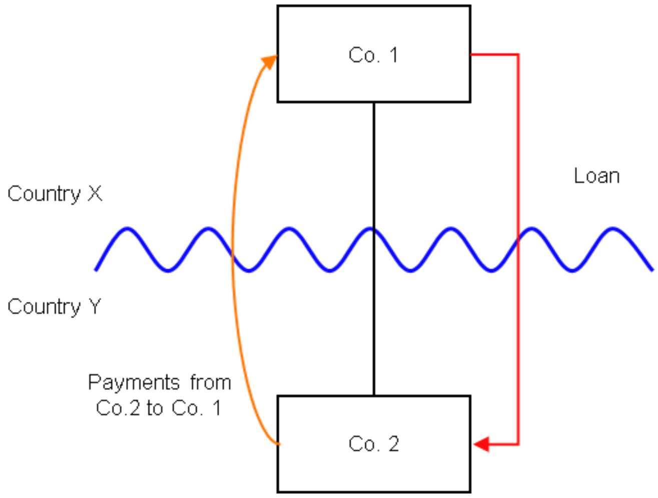
INTM551230: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment under a hybrid financial instrument – payee has no tax jurisdiction

This example looks at situations where a company which does not have a tax jurisdiction issues a loan to a related company. The company paying interest gets a deduction for the payment but the sum received is not taxable (as the recipient jurisdiction does not charge income, profits or gains to tax), and even if it did, the sum would be treated as an exempt distribution.

The example considers whether the deemed interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms ('the Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.
- Under the law of Country Y, the Loan is treated as a debt instrument, and payments of interest under the Loan are deductible in calculating Co. 2's ordinary income for a taxable period.
- Country X does not tax income, profits or gains and Co. 1 does not have a taxable presence in any other jurisdiction.

- Co. 1's receipt of the interest payment is not subject to tax as income, profit or gains.

- If Co. 1 were resident in Country Y, the terms of the instrument would lead to be it being characterised as an equity instrument in the hands of the holder.

- The payee is not a relevant investment fund as defined in s259NA.

- The loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Note: Under UK corporate tax law, a mismatch of this type should not arise. However, for the purposes of this example, the relevant sections of Part 6A are applied on the assumption that the UK is Country Y.

Condition A: Are the payments of interest made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and is therefore within the definition of a financial instrument in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

The background above suggests the UK cannot be Country X, as the UK taxes income, profits and gains.

As this example is presented for illustrative purposes only, it is assumed that the UK is Country Y, and that Co. 2 is the payer and within the charge to corporation tax.

Condition B is satisfied.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

The background suggests it is reasonable to suppose Country Y will permit Co. 2 a deduction (a relevant deduction) for the payment of interest. As Country X does not tax income, profits or gains, it is also reasonable to suppose that Co. 1 is not required to bring the interest receipt into account for tax purposes.

There is a potential Case 1 mismatch - as defined in s259CB(2) – as the relevant deduction exceeds the ordinary income that, by reason of the payment, arises to the payee in the permitted taxable period. The mismatch will be within Case 1 only if all or part of it arises by reason of the terms or any other feature of the financial instrument.

This is tested by applying the relevant assumptions at s259CB(5). As Co. 1 is not within the charge to a tax under the law of any territory, either as a resident or through a permanent establishment, s259CB(5)(c) applies to test whether the mismatch would still have arisen after making the assumption that Co. 1 is a company that is resident in Country Y (the UK) for tax purposes, and carries on a business here in connection with which the payment is made. If a mismatch would still have arisen, then it is to be treated as arising by reason of the terms, or any other feature, of the Loan.

For the purposes of this example it is assumed that if Co. 1 were resident in Country Y the receipt would have been treated as a distribution (and the return on it non-taxable) by reason of a term or feature of the Loan, and a mismatch would have arisen. The rules therefore recognise that there is hybridity in the financial instrument which is targeted by the legislation.

Condition C is satisfied.

Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, the relevant counteractions need to be considered.

Counteraction

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response
In this hypothetical scenario, where the UK is in the position of Country Y (the payer jurisdiction), s259CD TIOPA 2010 will apply and Co. 2’s allowable deduction in relation to the payments of interest must be reduced by the amount of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’. In this case, that is equal to the amount that is not chargeable to tax as a result of Country X not charging tax on income, profits or gains.

On the facts given counteraction under these provisions will apply only where the UK is in the position of the payer jurisdiction. The UK cannot be in the position of Country X.

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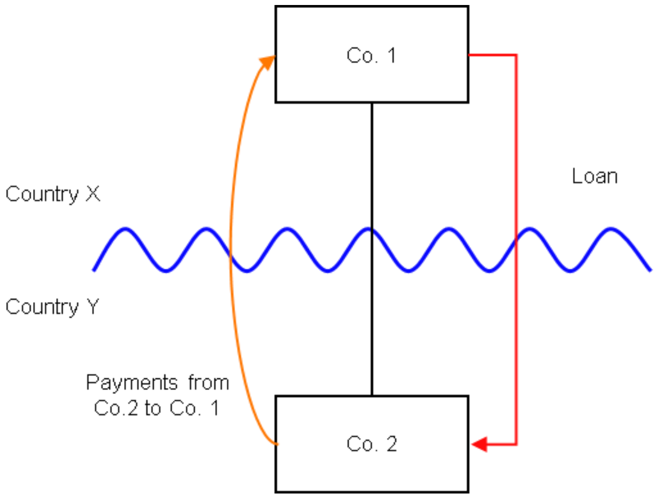
INTM551240: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment – payee in territorial tax regime

This example illustrates the principle that the payment of interest to a payee in a territorial tax regime resulting in a mismatch may not be a hybrid mismatch (depending on the facts) as it may not arise from the terms or any other feature of the financial instrument but from the nature of the territorial tax regime.



Background

- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
- Co. 2 is a company resident in Country Y
- Co. 1 lends money to Co. 2 on arm's length terms.
- Under the laws of Country Y, the Loan is treated as a debt instrument, and payment of interest under the Loan is deductible in calculating Co. 2's profits.
- Country X has a territorial tax system and does not tax income unless it has a domestic source.
- Co. 1's receipt of the interest payment is not subject to tax as income, profit or gains in Country X because it does not have a domestic source from Country X's perspective. If the interest were received from a source in Country X it would be taxable at the full rate of tax in Country X.

- The payee is not a relevant investment fund as defined in s259NA.
- The loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are the payments of interest made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and is therefore within the definition of a financial instrument in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The UK cannot be Country X, as it does not operate a pure territorial tax system.

Where the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B is satisfied only where the UK is the payer jurisdiction.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest.

However, as Country X operates a pure territorial system and does not tax foreign source income, profits or gains, the interest payment received by Co. 1 is not taxable, (irrespective of whether the financial instrument is classified as debt or equity). It is reasonable to suppose that Co. 1 is not required to bring the corresponding receipt into tax as ordinary income.

There is a potential Case 1 mismatch - as defined in s259CB(2) - as the relevant deduction exceeds the ordinary income that, by reason of the payment, arises to the payee in the permitted taxable period. The mismatch will be within Case 1 only if all or part of it arises by reason of the terms or any other feature of the financial instrument. This is tested by applying the relevant assumptions at s259CB(5).

Applying the assumption at s259CB(5)(b), we need to test whether the mismatch would still have arisen if the payment were received in connection with a business carried on by Co.1 in Country X. If a mismatch would still have arisen, then it is to be treated as arising by reason of the terms, or any other feature, of the Loan.

On the facts given there would be no mismatch if the interest payment were received by Co. 1 from a source in Country X. The mismatch does not arise from the terms or any other feature of the financial instrument but from the nature of the tax regime in Co. 1's territory of residence.

Condition C is not satisfied. There is no need to consider the other conditions.

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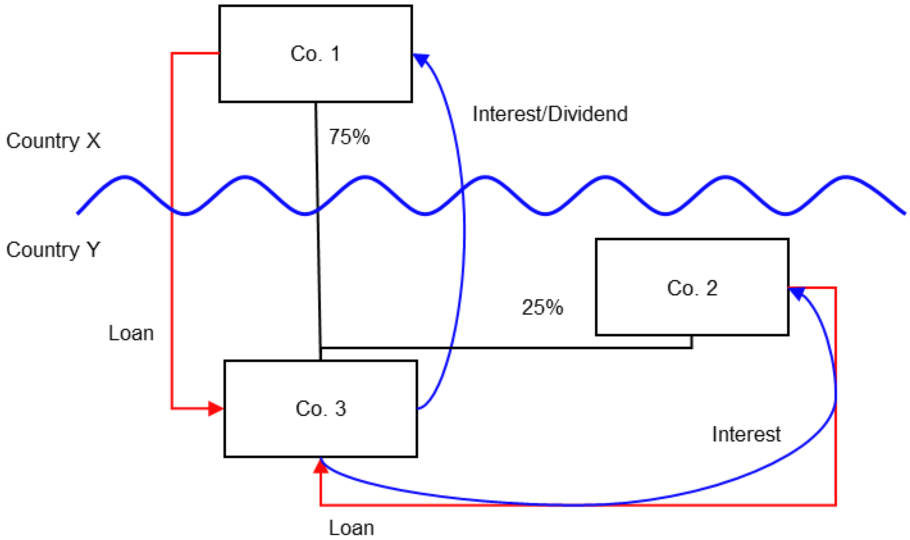
INTM551250: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment – debt re-characterised as equity

In this example, under existing UK corporate tax law, a mismatch should not arise where Country X is the UK because of the impact of other domestic law. This example is included to illustrate how Part 6A would apply in this hypothetical scenario.



Background

- Co. 3 is resident in Country Y
- Co. 2 owns 25% of the equity in Co. 3, and is also resident in Country Y
- Co. 1 owns 75% of the equity in Co. 3, but is resident in Country X
- Co. 3 needs additional debt financing, and Co. 1 and Co. 2 agree to fund this in proportion to their shareholding in Co. 3 (‘the Loans’).
- Country Y treats both Loans as debt instruments, and allows Co. 3 to claim a deduction for the relevant interest payments. Co. 2 is liable to tax on the interest payments it receives.
- Country X regards the Loans as equity, as they are established by reference to equity held.
- Co. 1 does not pay tax on the interest receipt as the payment is treated as a dividend in Country X and this income is exempt.
- The payees are not relevant investment funds as defined in s259NA.

- The Loans are not regulatory capital securities for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are the payments of interest made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loans. The Loans are defined as financial instruments for the purposes of UK GAAP, and are therefore within the definition of a financial instrument in s259N.

Condition A is satisfied.

Condition B: Is Co. 1 or are Co. 2 and Co. 3 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to these payments?

The background suggests it is reasonable to suppose that Country Y will allow Co. 3 a deduction (the relevant deduction) for the payment of interest on each of the Loans.

Country Y will also require Co. 2 to bring the interest receipt into account in calculating its taxable income. No mismatch arises in respect of this Loan.

It is also reasonable to suppose that, by reason of a feature of the Loans (the relationship and proportionality to the relevant shareholding interests), Country X will not require Co. 1 to bring the interest receipt on its Loan into account as income for tax purposes.

This creates a Case 1 mismatch in respect of the Loan from Co. 1, as defined in s259CB(2).

Note: If the UK is Country X then the rules at s931B(c) and s931D(c) CTA09 will apply to deny an exemption to Co.1. This is because the interest, the receipt of which is treated as a dividend, has been allowed as a deduction to a resident company of any territory outside the UK under the law of that territory. See INTM650000 for more details.

Where the distribution exemption is denied in these circumstances and the receipt becomes ordinary income of Co. 1, no mismatch will arise.

The result is that if the UK is Country X, then UK legislation should mean that Condition C is not satisfied. If the UK is Country Y, Condition C is satisfied.

Condition D: Are the two companies related or are the Loans, or any arrangement connected with them, structured arrangements?

Although neither Co. 1 nor Co. 2 owns all the shares in Co. 3, the companies are related as each of Co. 1 and Co. 2 satisfies the 25% investment condition at s259NC in relation to Co. 3.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, the relevant counteractions need to be considered.

Counteraction

The appropriate counteraction to counteract this mismatch will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response
According to the background, the payment of the interest from Co. 3 to Co. 2 (all within Country Y) does not give rise to a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ as an interest payment is matched with corresponding ordinary income.

With regard to the payment of interest between Co. 3 and Co. 1, since Country X treats the payment received by Co. 1 as a dividend, it is reasonable to suppose a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ will arise to the extent of the relevant payment.

Where the UK is Country Y (the payer jurisdiction), then s259CD will apply. Co. 3’s allowable deduction in relation to the payments of interest will be restricted in proportion to the amounts payable to Co. 1. From the background this is likely to result in a denial of 75% of the relevant deduction, representing the full amount of the payment to Co. 1.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Note: The following will only apply where, exceptionally, the restrictions in relation to distribution exemption, as detailed under condition C above, do not apply.

Secondary response
Where the UK is Country X (a payee jurisdiction) it is assumed that the receipt is regarded as an equity dividend in nature and that, but for Part 6A, the dividend would be exempted from tax, creating a mismatch.

If the mismatch has been fully counteracted in the payer jurisdiction under s259CD or an equivalent provision, no further action is required in the UK.

If the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted, however, the UK will generally apply the rules at s931B(c) and s931D(c) CTA 2009. Those provisions deny the distributions exemption for Co. 1 where the dividends have been allowed as a deduction for a company outside the UK - see INTM650000 for more details.

If for whatever reason s931B(c) or s931D(c) do not apply, s259CE TIOPA 2010 applies. The UK will counteract the remaining ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ by treating that amount as taxable income of the payee arising in the counteraction period.

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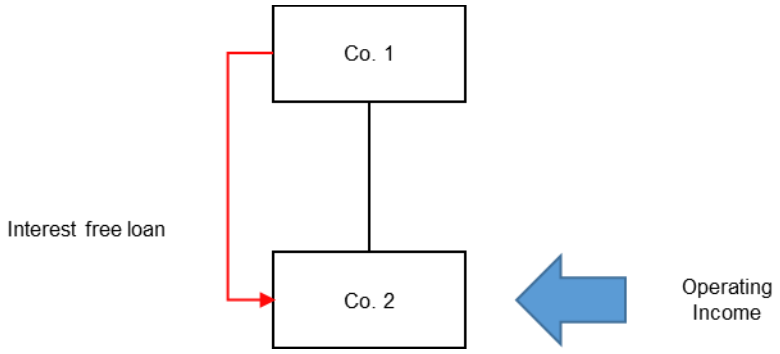
INTM551260: Hybrids: Chapter 3 - Financial instruments: Example: Interest free loan – deemed discount

This example looks at situations where a company issues an interest free loan to a related company. The two companies use different accounting treatment for the deemed discount on the loan.

The example considers whether the deemed interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Note - the accounting and tax treatment shown here is hypothetical, designed to illustrate the principles underlying the legislation



Background

- Co. 1 is a company resident in the UK
- Co. 1 establishes a subsidiary, Co. 2, also in the UK
- Co. 1 provides Co. 2 with capital of 40, which consists of 5 share capital and 35 interest-free loan (the ‘Loan’)
- The Loan is repayable in full at the end of the five years
- The Loan is treated as a debt instrument under the laws of the UK
- For the purposes of the example, it is assumed that applying local GAAP, which is assumed to be respected for tax, Co. 2 is required to split an interest free loan from its parent company (Co. 1) into two separate components:
  - a loan of principal amount 35, which Co. 2 is treated as having issued to Co. 1 at a discount of 10, such that is initial carrying value is 25, and
  - a deemed equity contribution equal to the amount of that discount (10).

- The amount that Co. 2 treats as due for the interest free loan is based on an arm's length valuation.

- The payee is not a relevant investment fund as defined in s259NA.

Table 1

Co. 2 – Assets, Liabilities and Equity	
Assets – Fixed assets	40
Liabilities – Shareholder loan	(25)
Equity: Share capital Other equity	 5 10

As is detailed in Table 1 above, Co. 2 has treated the interest free sum of 35 as an equity contribution of 10 and a loan whose initial carrying value is 25. In each accounting period Co. 2 will be required to accrue a portion of the deemed discount on the loan as an expense for accounting purposes and to treat this expense as funded out of Co. 1's deemed equity contribution.

Table 2 below provides a simplified illustration of how Co. 2 might account for the accrued liability under the shareholder loan as at the end of Year 1.

Table 2

Co. 2 – Assets, Liabilities & Equity			**Co. 2 – Income**	
Asset		**45**	**Income Tax Cash**	
Current assets (cash)	5		Operating income	5
Fixed assets	40		**Expenditure**	
Liabilities		**27**	Accrued liability on shareholder loan	(2)
Shareholder loan	27		**Net return**	**3**
Equity:				
Share Capital	5			
Other Equity	13			

In this case Co. 2 treats the deemed discount as accruing at the implied internal rate of return of 8.0%, so at the end of Year 1 the shareholder Loan is recorded on the balance sheet as 27 (an increase of 2).

‘Other equity’ has subsequently been reduced by the 2, taken to the shareholder loan as the interest expense, and then increased by the 5, being the operating income received during the period.

For the purposes of this example, it is assumed that UK tax law permits this deemed increase in liabilities to be treated as a current expense in Year 1 so that, as Co. 2 has operating income of 5 in that year, its accounts show a net return of only 3 (that is, the income of 5 less the deemed increase in liabilities of 2 treated as a current expense).

Applying the same accounting treatment in each of the following years will permit the entire discount to be expensed over the life of the Loan so that, at maturity, the shareholder Loan will be recorded on the company’s balance sheet at its face value (35).

Co. 1 adopts different accounting standards from Co. 2 and under those standards it is not required to bifurcate the interest free Loan into equity and debt components.

Accordingly the accrued liability recorded in Co. 2’s accounts in each year is not recognised as income by Co. 1.

On repayment of the loan the entire amount paid by Co. 2 is simply treated as a non-taxable return of loan principal.

Analysis - Applying the test in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?

The Loan would be defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N TIOPA 2010.

Co. 2 may claim a deduction against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it adopted the same accounting approach as Co. 2 – an assumption required by s259BB(4)(b). Therefore the accrued expense satisfies the definition of a quasi-payment within s259BB (2) TIOPA 2010.

Condition A is satisfied.

Condition B: Is Co. 1 or Co. 2 within the charge to corporation tax?

The charge to corporation tax is the charge to corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this quasi-payment?

Given the background and assumed tax treatment above, it is reasonable to suppose the UK will permit Co. 2 a deduction (relevant deduction) for the accrued obligation under the loan against its ordinary income. It is also reasonable to suppose that the UK will not require Co. 1 to bring the corresponding amount into tax as ordinary income.

Therefore Case 1, as defined in s259CB (2), applies to characterise the quasi-payment as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the quasi-payment, arise to Co. 1 in the permitted taxable period, and all or part of that excess arises by reason of the terms or any other feature of the financial instrument – the mismatch arises because of the loan being interest free and between related parties.

Note: It is likely in this case that the Group Mismatch Scheme rules will also apply to address the mismatch (CFM77500 refers), and that the unallowable purpose loan relationship rules or even possibly the transfer pricing rules would apply to deny the deduction in question.

Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?

As Co. 1 owns all the shares in Co. 2 the companies are related as the conditions within s259NC TIOPA 2010 are satisfied.

Condition D is satisfied. There is no need to consider whether there is a structured arrangement.

Conclusion

All the conditions are satisfied to characterise the arrangement involving the accruals of interest under the Loan as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', and the relevant counteractions need to be considered.

Counteraction

Ordinarily, the counteraction applied will depend on whether the legislation is being applied to Co. 1 or Co. 2: in this case, however, since both companies are in the UK, the following applies:

Counteraction to Co. 2 (the payer) (under s259CD TIOPA 2010)

Primary Response
The deductions claimed would be disallowed in Co. 2.

Counteraction to Co. 1 (the payee) (under s259CE TIOPA 2010)

Secondary Response
As both companies are UK resident, both payer and payee are UK resident and therefore the primary counteraction under s259CD TIOPA 2010 would always apply, with the result that the mismatch would be counteracted in Co. 2.

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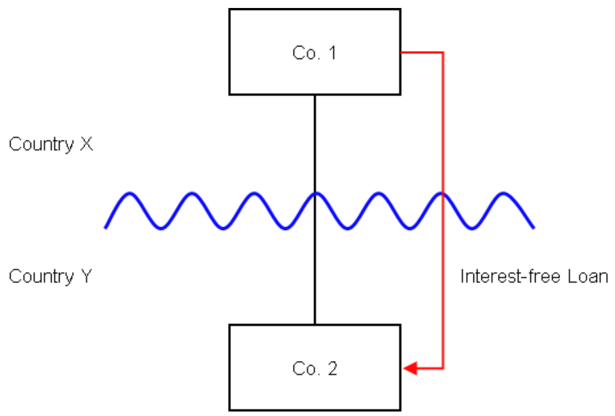
INTM551270: Hybrids: Chapter 3 - Financial instruments: Example: Interest-free loan – deemed interest

This example looks at situations where a company issues an interest free loan to a related company and it is treated as debt in one country and equity in the other. The loan recipient gets a deduction for deemed interest and there is no deemed interest receipt.

The example considers whether the deemed interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 1 is resident in Country X
- Co. 1 owns 100% of the equity in Co. 2
- Co. 2 is resident in Country Y
- Co. 1 provides Co. 2 with an interest free loan (the ‘Loan’), which is repayable in full at the end of the five years.
- The law of Country Y allows Co. 2 to claim a deduction for tax purposes for the deemed interest it would have paid to Co. 1 at a market rate. It does not re-characterise the Loan to treat an element of it as relating to a discount.
- Under the law of Country X, due to the relationship between the relevant parties, the Loan is treated as an equity instrument and there is no corresponding interest imputed in that country. The entire value of the Loan on repayment is treated as a return of capital.

- The payee is not a relevant investment fund as defined in s259NA.

- The loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Apply the tests in s259CA

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrids and other mismatches from financial instruments rules?

Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?

The Loan satisfies the definition of a financial instrument for the purposes of UK GAAP, so falls within the definition of a financial instrument provided in s259N.

As the deduction allowed for interest is deemed, it does not fall within the definition of a payment at s259BB(1). Therefore, we must consider whether the deemed interest is a quasi-payment under s259BB(2).

Co. 2 may claim a deduction for the deemed interest in Country Y. Making the assumptions at s259BB it may be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it been resident in Country Y and carrying on a business there.

However, we need to consider whether the deemed deduction falls within s259BB(3), in order to determine whether there is a quasi-payment. . In this situation there is no value transfer as a consequence of the Loan and the circumstances giving rise to the deduction do not include the creation or amendment of any economic rights in relation to interest between Co. 1 and Co. 2. In these circumstances we consider the deemed deduction is within s259BB(3) and is not a quasi-payment

Condition A is not satisfied, and so no further analysis is required.

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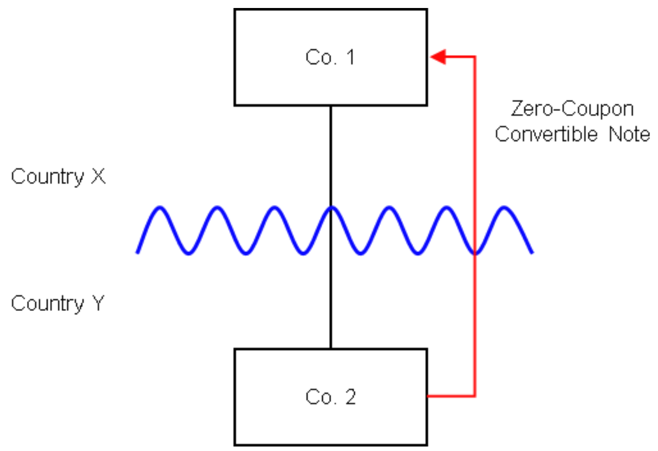
INTM551280: Hybrids: Chapter 3 - Financial instruments: Example: Convertible note – valuation of discount

This example looks at situations where a company issues a zero-coupon convertible note to a related company. The option to convert has both a finance and an equity element and the two countries give a different valuation to the discount.

The example considers whether the valuation of the discount to modify the loan is within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 1 is resident in Country X and owns all the shares in Co. 2
- Co. 2 is resident in Country Y
- Co. 1 subscribes for a five year zero-coupon convertible note (the ‘Note’) with a principal amount of 100
- The Note can be converted into shares of Co. 2 at the option of Co. 1.
- Under the laws of both Country X and Country Y, the Note is bifurcated for tax purposes, treating it as being issued at a discount. This discount is deductible by Co. 2 and is included in ordinary income by Co. 1.
- Country Y treats Co. 1 as having paid 80 for the Note and 20 for the share option, which may be accrued as a deduction for tax purposes over the term of the Note.

- Country X adopts the same tax treatment but treats Co. 1 as having paid 90 for the Note and 10 for the share option, which it brings in as ordinary income spread over the term of the Note.

- The payee is not a relevant investment fund as defined in s259NA.

- The Note is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest accruals satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?

The Note is defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N.

There is no actual payment of interest in the intervening years until maturity, and no payment within the definition at s259BB(1). Therefore, we must consider whether the interest is a quasi-payment under s259BB(2).

Although there are no actual payments of interest in the intervening years until maturity, Co. 2 may claim a deduction in respect of accrued interest in calculating its taxable profits. It would be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it adopted the same accounting approach (which in this case it actually has).

While the deduction is deemed to arise to Co. 2 for tax purposes, the accrued interest arises from the existence of economic rights between Co. 1 and Co. 2. S259BB(3) does not apply in these circumstances.

The accrued expense satisfies the definition of a quasi-payment within s259BB(2).

Condition A is satisfied.

Condition B: Is either Co. 2 or Co. 1 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will allow Co.2 a deduction (the relevant deduction) of 20 for the accrued obligation under the Note against its ordinary income. It is also reasonable to suppose that Country X will not require Co.1 to bring more than 10 into tax as ordinary income. The deductions of 20 therefore exceed the 10 included as a receipt, and there is a mismatch.

The different valuation applied to the share option by Country X and Country Y determines the characterisation of the difference between 10 and 20 (or 90 and 80). This difference is debt from the perspective of Country Y, but equity from the perspective of Country X.

In this example, where the option to convert does create both a finance and an equity element, the split between them is being measured differently by each jurisdiction. This directly determines the character of 10 of the quasi-payment made by Co. 2.

There is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch in that the relevant deduction exceeds the sum of the amounts of ordinary income that arises to each payee in the permitted taxable period by reason of the quasi-payment, and all or part of that excess arises by reason of the terms of the financial instrument. Therefore, Case 1 in s259CB(2)) applies.

Condition C is satisfied.

Condition D: Are the two companies related, or is the Note or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', the relevant counteractions need to be considered.

Counteractions

The counteraction applicable will depend on whether the UK is in the position of Country X and Country Y (or both).

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response
Where the UK is Country Y (the payer jurisdiction), s259CD applies to counteract the mismatch to the extent of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ allocated to each period. This will be the case for each of the 5 years of the Note, provided it is not converted.

Co. 2’s deductions will be restricted by an amount equal to the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in each accounting period until maturity if

Co. 2 accrues the discount over the 5 years,

the payment period coincides with their accounting period, and the Note is not converted.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Secondary response
Where the mismatch has been fully counteracted in Country Y under s259CD or an equivalent provision, no further action will be taken by the UK.

If the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted in Country Y, s259CE applies to counteract the remaining mismatch by including that amount as income arising to Co. 1 for the counteraction period.

This will be computed in a similar manner to that outlined in the counteraction at s259CD above if Co. 1 also recognises the discount on a straight line basis over the 5 years, that the payment period coincides with their accounting period and that the Note is not converted

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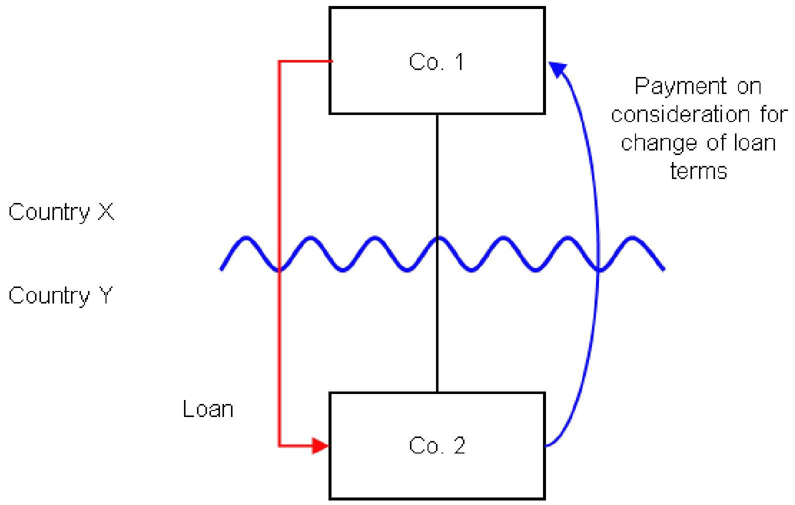
INTM551290: Hybrids: Chapter 3 - Financial instruments: Example: Payment to modify a debt instrument

This example looks at situations where the parent company makes a loan to an overseas subsidiary and the subsidiary makes a payment to modify the terms of the loan. The subsidiary gets a deduction for the payment but the receipt is not taxed.

The example considers whether the payment to modify the loan is within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 1 is resident in Country X
- Co. 2 is resident in Country Y
- Co. 2 borrows money from its immediate parent Co. 1 (the ‘Loan’)
- The Loan has a 5 year term and pays a high fixed rate of interest (but not in excess of an arm’s length rate at the time the loan was advanced)
- Co. 2 makes a one off arm’s length payment to Co. 1 in consideration for Co. 1 agreeing to lower the interest rate on the Loan
- Country Y allows Co. 2 a deduction for this payment (either when made or spread over the remaining life of the loan)

- Co. 1 is not required to bring the receipt in as Ordinary Income as Country X does not subject to tax amounts attributable to a surrender of rights

- The payee is not a relevant investment fund as defined in s259NA.

- The Loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest accruals satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are there payments made under, or in connection with, a financial instrument?

The one off payment is a payment as defined at s259BB(1), being a transfer of money in relation to which an amount (relevant deduction) may be deducted in calculating Co. 2's ordinary income for a taxable period.

The payment is made in connection with the Loan, which is defined as a financial instrument for the purposes of the definitions provided in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2, within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will allow Co.2 a deduction (the relevant deduction) for the one-off payment against its ordinary income. It is also reasonable to suppose that Country X will not require Co.1 to bring the corresponding receipt into account for tax purposes (as ordinary income).

This creates a potential Case 1 mismatch - as defined in s259CB(2) – as the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms of the financial instrument - in this case the Loan.

It is by reason of the adjustment to the terms of the Loan that Country X characterises the payment differently. If either the terms had not been adjusted, or the provisions within the Loan did not allow for such an adjustment, then it would not be characterised as a surrender of rights and the mismatch would not have arisen.

Condition C is satisfied.

Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ the relevant counteractions need to be considered.

Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y (or both).

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response
Where the UK is Country Y (the payer jurisdiction), s259CD applies to restrict the deduction for Co. 2 by the amount of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’. In this case the entire amount will be disallowed (spread between periods, if appropriate, to reflect its accounting treatment).

Note: If Co. 1 were required to bring some or all of the receipt into account for tax at the end of the Loan term, the counteraction may not be appropriate if the delay is deemed just and reasonable.

If the delay in recognising ordinary income is not just and reasonable, s259CD will apply to deny the deduction, but relief may be available in a later period under s259LA.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Secondary response
Where the UK is Country X (the payee jurisdiction) and the mismatch has been fully counteracted by s259CD or an equivalent provision, no further action will be taken by the UK.

Where the 'hybrid or otherwise impermissible deduction/non-inclusion mismatch' has not been fully counteracted then s259CE applies to counteract the remaining mismatch by including that amount as income arising to Co. 1 for the counteraction period.

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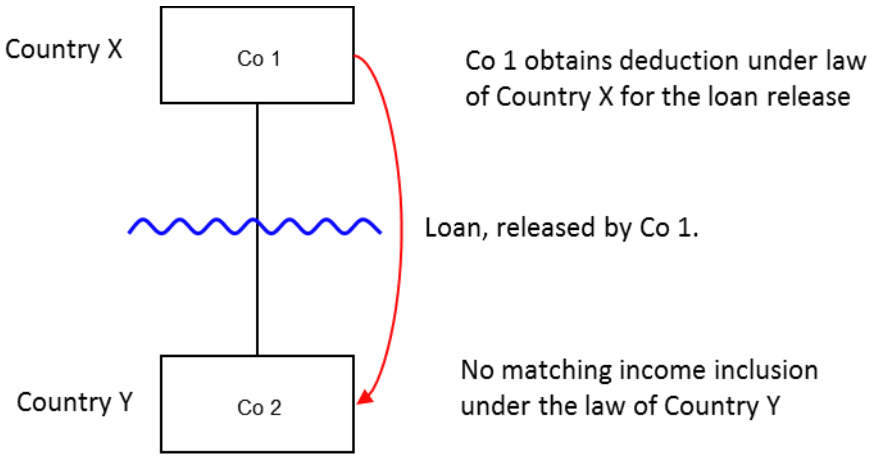
INTM551300: Hybrids: Chapter 3 - Financial Instruments: Example: Release of debt obligation

This example looks at situations where the parent company makes a loan to an overseas subsidiary and then releases the company from meeting its obligations under the loan. The parent gets a deduction for the amount of the loan which is forgiven and the release of the debt is not treated as taxable income of the subsidiary.

The example considers whether the release of the debt obligation is within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 1 is resident in Country X.
- Co. 2 is resident in Country Y.
- Co. 2 borrows money from its immediate parent Co. 1 (the ‘Loan’).
- The Loan has a 5 year term and pays a normal rate of interest.
- Co. 2 gets into financial difficulties and is unable to make payments of interest and principal of the Loan.
- Co. 1 agrees to forgive the Loan and releases Co. 2 from the obligation to make further payments of principal and accrued interest. Country X permits Co. 1 a deduction for the reduction in value of this asset.
- Due to the relationship between Co. 1 and Co. 2, Country Y recognises the release as an equity contribution.

- The amount of debt forgiven is treated as deductible under Country X law but is not treated as income under Country Y law.

Analysis – Applying the tests in s259CA TIOPA 2010

Do the payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Is there a payment or quasi-payment made under, or in connection with, a financial instrument?

The release of the Loan is a payment under s259BB(1), as a transfer of money's worth directly from Co. 1 (the payer) to Co. 2 in relation to which an amount (relevant deduction) may be deducted in calculating Co. 1's ordinary income for a taxable period.

This release also satisfies the definition of a quasi-payment at s259BB(2) as Co. 1 may claim a deduction and it would be reasonable to expect Co. 2 to bring in a corresponding receipt if it were also resident in Country X and adopted the same approach to accounting as Co. 1. (It would be unusual for a country to allow such a mismatch in domestic transactions).

The payment is made in connection with the Loan, which is within the definition of a financial instrument at s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2, within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Note: if Co. 1 and Co. 2 were both within the charge to corporation tax it would be unusual for the UK loan relationship legislation to allow such a domestic mismatch. The group mismatch scheme rules in s938A CTA 2010 would also apply.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

The background suggests it is reasonable to suppose that Country X will allow Co. 1 a deduction (the relevant deduction) for the release of the Loan. It is also reasonable to suppose that, by reason of the terms or feature of the Loan, Country Y will not require Co. 2 to bring in the corresponding receipt into account as income for tax purposes (ordinary income).

This creates a Case 1 mismatch (as defined in s259CB(2)) as the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms or any other feature of the financial instrument. In this case the relationship between Co. 1 and Co. 2 is a feature of the financial instrument that results in Co. 2 recognising the Loan release as an equity contribution.

Condition C is satisfied.

Note: this scenario makes the assumption that the mismatch does not arise by reason of one of the relevant debt relief provisions listed in s259CC(3). If the excess did arise by reason of a relevant debt relief provision, then s259CB(3) would deem the excess not to have arisen by reason of the terms, or any other feature, of the financial instrument and Condition C would not be satisfied.

Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' the relevant counteractions need to be considered.

Counteraction

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y (or both).

Counteraction where the UK is in the position of Country X (the payer jurisdiction)

Primary response
Where the UK is Country X (the payer jurisdiction),s259CD applies to reduce the deduction claimed by Co. 1 for release of the Loan by the amount of the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'. On the facts given in this case the entire deduction will be disallowed.

Counteraction where the UK is in the position of Country Y (the payee jurisdiction)

Secondary response
Where the UK is Country Y (the payee jurisdiction) and the deduction has been fully counteracted under s259CD or an equivalent provision, no further action will be taken by the UK.

Where the 'hybrid or otherwise impermissible deduction/non-inclusion mismatch' has not been fully counteracted then s259CE applies to counteract the remaining mismatch by including that amount as income arising to Co. 2 for the counteraction period.

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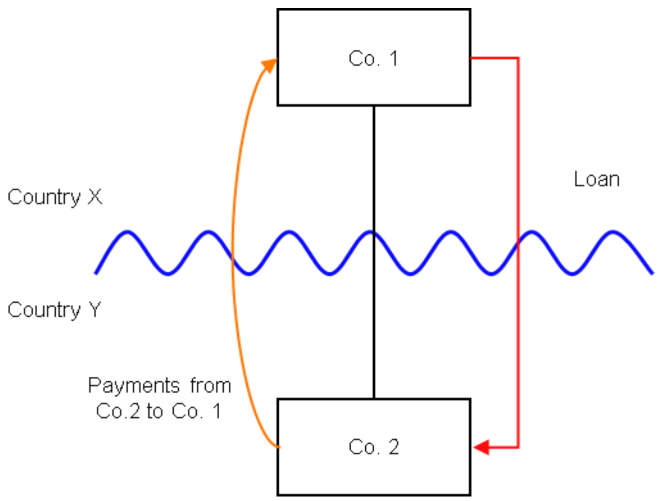
INTM551310: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment with underlying foreign tax credit

This example looks at situations where a company issues a loan to a related company and it is treated as debt in one country and equity in the other. The interest payment is deductible and the dividend receipts are also taxable but attract an underlying foreign tax credit.

The example considers whether the dividend receipts are undertaxed within the hybrid and other mismatches from financial instruments rules and to what extent.



Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X and owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements
- Under the laws of Country Y the Loan is treated as a debt instrument, and the payments of interest under the Loan are deductible in calculating Co. 2's ordinary income for a taxable period
- Under the law of Country X the Loan is treated as an equity instrument (i.e. shares), and payments under the Loan are treated as dividends. Country X taxes dividends at the same rate as any other income received from a financial instrument but allows a foreign tax credit to

reflect the underlying foreign tax suffered on profits from which a dividend is paid

- If the Loan had been treated as a debt instrument in Country X, Co. 1 would be taxable on those receipts at the full marginal rate for ordinary income, without the benefit of a foreign tax credit for underlying tax.
- The payee is not a relevant investment fund as defined in s259NA.
- The Loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209)

Analysis - Applying the tests in s259CA TIOPA 2010:

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches for financial instruments rules?

Condition A: Are the payments made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and is therefore within the definition of a financial instrument in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Note: if Co.1 and Co.2 were both within the charge to corporation tax it would be unusual for UK legislation to allow such a domestic mismatch. The group mismatch schemes rules in s938A CTA 2010 would also be likely to apply.

Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will allow Co. 2 a deduction (relevant deduction) for the payment of interest. It is also reasonable to assume that, by reason of the terms of the Loan, Co. 1 will treat the receipt as dividend income chargeable to tax at the full marginal rate, but with the benefit of a foreign tax credit for underlying tax.

The tax credit, which applies specifically to the receipt of dividend income, reduces the effective tax suffered on the amount of ordinary income received so that that effective tax falls below that which would be payable at the full marginal rate applicable to ordinary income. This creates a potential Case 2 mismatch as defined at s259CB(7).

The Loan is treated as equity in Country X because of the relationship between the parties and the fact that the debt is subordinated. The under-taxed amount is therefore attributable to the terms or any other feature of the financial instrument, and a Case 2 mismatch arises.

(Note that there is no Case 1 mismatch because the entirety of the dividend receipt is included within Co. 1’s ordinary income).

Condition C is satisfied.

Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

All the conditions are satisfied to characterise the arrangement involving the payment of interest under the Loan as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ and the relevant counteractions need to be considered.

Counteractions

Extent of the mismatch

The extent of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ is calculated by means of the formula in s259CB(11), which is as follows:

$$\frac{UTA \times (FMR - R)}{FMR}$$

Where:

- UTA is the under-taxed amount. This is the amount of dividend benefitting from the underlying foreign tax credit.

- FMR is the payee’s full marginal rate (expressed as a %) for the permitted taxable period in which the under-taxed amount arises. This is the highest rate which would have been charged on taxable profits of the payee which include ordinary income that arises from, or in connection with, a financial instrument. Under the background of this example it would equate to the rate that would be applied to the dividend in the absence of any foreign tax credit.

- R is the highest rate (expressed as %) at which tax is charged on the taxable profits in which the under-taxed amount is included, taking into account the effect of any credit for underlying tax.

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

If the dividend received by Co. 1 was 100, the tax rate in Country X for ordinary income (including dividend income) was 40% (and thus Co. 1’s full marginal rate was 40%), and the amount of underlying tax on the profits taxed in Country Y out of which the dividend was paid was 10, then the highest rate at which tax would be paid by Co. 1 (R) would be 30%. Using the formula above, the amount of the impermissible deduction/non-inclusion mismatch would be 25.

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response

Where the UK is Country Y (the payer jurisdiction) s259CD applies to reduce the allowable deduction by an amount equal to the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, calculated according to the equation above.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Secondary response

Where the UK is Country X (the payee jurisdiction) and the deduction has been fully counteracted under s259CD or an equivalent provision, no further action will be taken by the UK.

If the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted, s259CE applies to counteract the remaining mismatch by including that amount as income arising to Co. 1 for the counteraction period.

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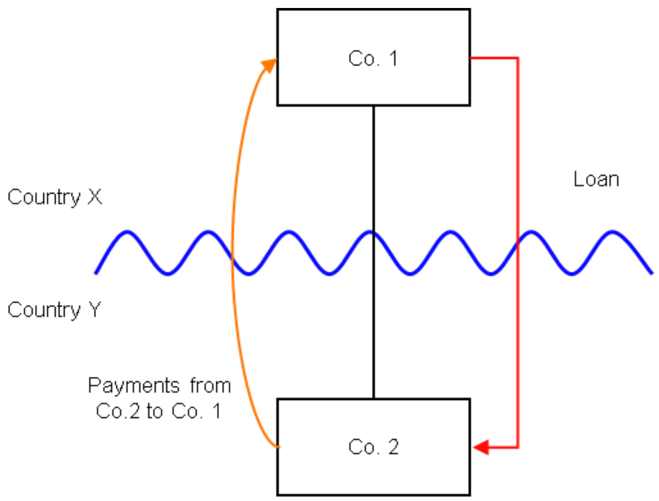
INTM551320: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment to a charity

This example looks at situations where a company which is a registered charity issues a loan to a related company and it is treated as debt in one country and equity in the other. The interest payment is deductible but the interest receipt is not taxed because the charity has exempt status.

The example considers whether the interest receipt is ordinary income within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 2 is a company resident in Country Y.
- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2.
- Co. 1 is a registered charity in Country X.
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.
- Under the laws of both Country X and Y, the Loan is treated as a financial instrument.
- Under the laws of Country Y the payments of interest under the Loan are deductible in calculating Co. 2's ordinary income for a taxable period.

- Under the laws of Country X Co. 1 is exempt from tax generally by reason of being a registered charity.
- In the absence of that exemption Co. 1 would still not be taxable upon the receipts as the Loan would be treated as an equity instrument (i.e. shares), and as such the payments of interest under the Loan are treated as dividends. Country X usually exempts dividends received from a foreign company where the recipient controls the payer.
- If the Loan had been treated as a debt instrument in Country X then ordinarily a non-charity would be taxable on those receipts.
- The payee is not a relevant investment fund as defined in s259NA.
- The Loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis - Applying the tests in s259CA TIOPA 2010:

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are the payments made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and is therefore within the definition of a financial instrument in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to these payments?

The background suggests it is reasonable to suppose that Country Y will permit Co. 2 a deduction (the relevant deduction) for the payment of interest. It is also reasonable to suppose that Country X will not require Co. 1 to bring the corresponding receipt into account as ordinary income for tax purposes.

This creates a potential Case 1 mismatch (as defined in s259CB (2)) as the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period.

The mismatch apparently arises because Co. 1 is not within the charge to a tax under the law of any territory because it benefits from an exemption by reason of being a registered charity. Applying the relevant assumption at s259CB(5)(a), we need to test whether the mismatch would still have arisen if Co. 1 did not benefit from such an exemption. If a mismatch would still have arisen, then it is to be treated as arising by reason of the terms, or any other feature, of the Loan.

The background states that if Co. 1 had not benefitted from the registered charity exemption, the receipt would not have been included as ordinary income. The receipt would have been treated as a distribution by reason of a combination of the term of the Loan and the relationship between the parties. A mismatch (in this case, the full amount of the deduction) would still have arisen. The rules recognise that there is hybridity in the financial instrument, and the mismatch is brought within the scope of the hybrid and other mismatches rules.

Condition C is satisfied.

(Note that if Country X treated the Loan as a debt instrument (rather than an equity instrument as outlined above), Co. 1 would include the interest receipt in its ordinary income if the relevant assumption at s259CB(5)(a) was made that Co. 1 did not benefit from the registered charity exemption, and there would not be a mismatch. Accordingly, the mismatch arises only because of the registered charity exemption, and not from the terms or any other feature of the financial instrument. Condition C would not then be satisfied).

Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, the relevant counteractions need to be considered.

Counteraction

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response
Where the UK is Country Y (the payer jurisdiction), s259CD applies to reduce the allowable deduction by the amount of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’. In this case, the impermissible deduction/non-inclusion mismatch is equal to the full amount of the deductions.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Secondary response
Where the UK is Country X (the payee jurisdiction), it is unlikely that there will be a counteraction. Although the counteraction requires a receipt to be included in ordinary income of the payee, this will not override the relief provided to registered charities where their income is exempted from taxation.

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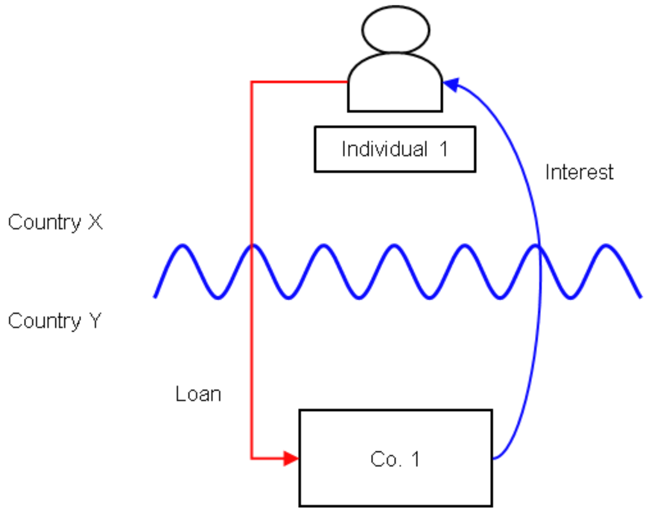
INTM551330: Hybrids: Chapter 3 - Financial instruments: Example: Interest payment to a person holding instrument through tax exempt accounts (e.g. ISAs)

This example looks at situations where an individual receives interest from a company. The interest payment is deductible but the interest receipt is not taxed because it is held in a tax exempt account.

The example considers whether the interest receipt is ordinary income within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 1 is resident in Country Y.
- Individual 1 is resident in Country X and, except as specified below, there is no other relationship between the parties.
- Individual 1 subscribes for a bond issued by Co. 1 that pays regular interest.
- The bond is treated as a debt instrument under the laws of Countries X and Y.
- Under the law of Country Y Co. 1 is allowed a deduction for the interest payments.
- Under the law of Country X the interest receipts would usually be treated as ordinary income of the recipient.

- In this case, the bond is held by Individual 1 through a tax exempt personal savings account that entitles the individual to an exemption on any income and gains in respect of qualifying investments held in the account. To be eligible as a ‘qualifying investment’ they must be stocks and shares listed or traded on a recognised stock exchange, akin to a UK ISA.

- The savings account is available to individuals only, and there are limits on the amounts that can be put into the account.

Analysis – Applying the test in s259CA TIOPA 2010:

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Note: Individuals are not subject to these rules, so the counteraction at s259CE is not applicable.

Condition A: Are the payments made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the bond. The bond is defined as a financial instrument for the purposes of UK GAAP, and is therefore within the definition of a financial instrument in s259N.

Condition A is satisfied.

Condition B: Is either Co. 1 or Individual 1 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country Y, then Co. 1 will be within the charge to corporation tax. Condition B will be satisfied.

If the UK is Country X, then condition B will not be satisfied as Individual 1 is not within the charge to corporation tax.

Condition B will be satisfied only if the UK is in the position of Country Y.

Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will allow Co. 1 a deduction (relevant deduction) for the regular interest payments under the bond. It is also reasonable to suppose that Country X will not require Individual 1 to bring the interest receipt into account as ordinary income for tax purposes.

This creates a potential Case 1 mismatch as defined at s259CB(2). Applying the relevant assumption at s259CB(4)(a) the mismatch does not arise by reason of the terms or any other feature of the financial instrument, but because of unilateral relief granted by Country X to Individual 1 for investments that are held within a specified account.

Condition C is not satisfied. No further analysis is needed

Application to similar circumstances

The analysis provided above in respect of tax exempt accounts would also be applicable in relation to other mismatches where the mismatch arises from a unilateral relief granted by Country Y.

For example, Excluded Indexed Securities (EIS) which are designed to meet the requirements of section 433 ITTOIA 2005 and produce a capital return for individual investors.

An impermissible mismatch occurs only if either Case 1 at s259CB(2) or Case 2 at s259CB(7) apply. Case 2 is not relevant, as there is no under-taxed amount. Case 1 is not satisfied because, when considering the relevant assumptions at s259CB(5), there would not be a mismatch if the issuance did not meet the EIS requirements of s433 ITTOIA 2005.

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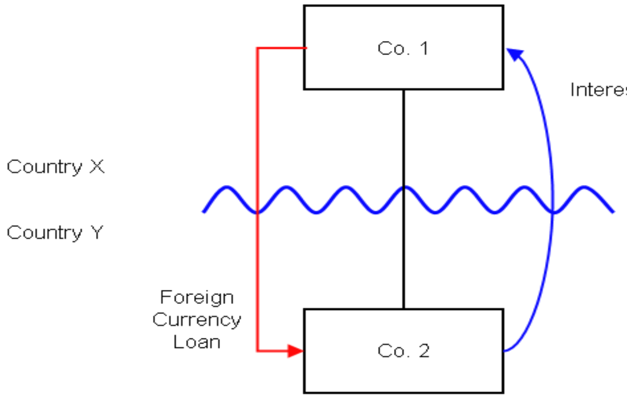
INTM551340: Hybrids: Chapter 3 - Financial instruments: Example: Foreign exchange differences on a debt instrument



Background

- Co. 1 is resident in Country X.
- Co. 1 owns all the shares in Co. 2, which is resident in Country Y.
- Co. 1's functional currency for accounting purposes is the official currency in its country of residence, Currency X.
- Co. 2's functional currency for accounting purposes is the official currency in its country of residence, Currency Y.
- Co. 1 provides Co. 2 with a loan on normal commercial terms (the 'Loan'). Interest is payable every year in arrears at the market rate and the principal is payable at maturity.
- The loan is treated as a debt instrument under the laws of both Country X and Country Y. The interest payable on the Loan is deductible in Country Y and included in ordinary income under the laws of Country X.
- The interest and principal under the Loan are payable in Currency X.
- The value of Currency X strengthens in relation to Currency Y while the Loan is still outstanding. The accounts of Co. 2 reflect an increase in the principal amount outstanding under the Loan, as expressed in Currency Y, and consequently recognise an exchange loss for the period.

- Under the law of Country Y, Co. 2 is entitled to a deduction for this exchange loss.

- There is no similar adjustment required under Country X law and neither exchange gain nor loss is recognised in profit or loss in Co. 1's accounts, as its functional currency is the same as that of the Loan - Currency X.

Analysis:

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and is therefore within the definition of a financial instrument in s259N.

Condition A is satisfied in respect of the interest payments.

While the deduction for the exchange loss arises from the terms of the Loan, it is not a payment, so we need to consider if it is a quasi-payment. This will depend on whether, making the assumptions at s259BB(4) as necessary, it is reasonable to expect an amount of ordinary income to arise to Co. 1.

Where Country Y is the UK, the exchange loss is not considered to be a quasi-payment – see INTM551030

Whether an exchange gain or loss arises depends on the functional currency of the company. Even if two companies adopt the same approach to accounting, the functional currency of a company is fact-dependent and usually determined by the currency of the primary economic environment in which the entity operates.

The UK allows companies to prepare their accounts in their functional currency and therefore were Co. 1 resident in the UK it would still be permitted to prepare its accounts in Currency X, and no foreign exchange gain would arise.

Where Country X is the UK, it may be reasonable to expect that ordinary income would arise to Co. 1 if it were resident in Country Y and if Country Y required exchange differences to be computed by reference to its official currency, and always took into account exchange differences on loans.

In those circumstances there would be a quasi-payment – see INTM551040.

Condition A may be satisfied in respect of the exchange losses only where the UK is in the position of Country X.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X or Country Y, Condition B is satisfied, as either Co. 1 or Co. 2 is within the charge to corporation tax.

If the UK was in the position of both Country X and Country Y then Condition B would also be satisfied. In relation to the deduction for a foreign exchange loss this situation will occur only if one of the companies prepares their accounts in a currency other than UK Sterling. If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Is it reasonable to assume that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

No mismatch arises in respect of the interest payment, so condition C is not satisfied as regards interest.

Although Country X does not require Co. 1 to bring within income a corresponding amount characterised as a 'foreign exchange movement' in respect of this movement in the value of the principal, it does require Co. 1 to recognise the amount by virtue of bringing into account the value of the principal in the stronger currency.

If we assume that when the Loan was entered into, it was quantified as X10 (10 in currency X) and Y20 (20 in currency Y), then if during the period the value of currency Y falls such that the equivalent of X10 now becomes Y25 the value of the Loan principal is still X10, independently of which currency you translate it to. In absolute terms there is no mismatch.

Gains and losses that result from converting foreign exchange into local or functional currency are attributable to the way jurisdictions measure the value of money rather than the value of the payment.

The legislation requires there to be a comparison between the relevant deduction and the amount included in ordinary income. In this case whether we quantify the deduction and income in Currency X or Currency Y, than they are equal. There is no requirement to quantify the relevant amounts in a specific currency.

Therefore the foreign exchange movement will not give rise to a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' provided the proportion of the interest and principal payable under the Loan is the same under the laws of both jurisdiction.

Condition C is not satisfied, and no further analysis is required.

Conclusion

There is no hybrid or otherwise impermissible deduction/non-inclusion mismatch to counteract.

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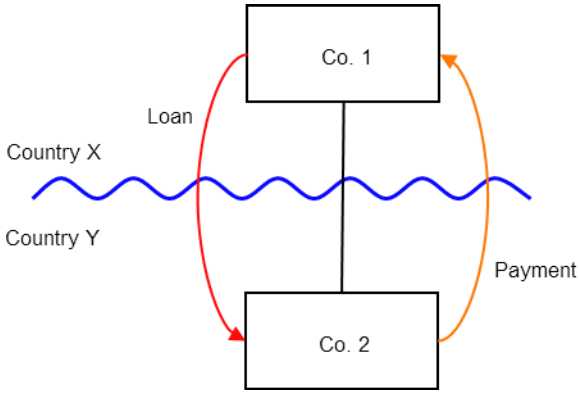
INTM551350: Hybrids: Chapter 3 - Financial instruments: Example: Payment for cancellation of a financial instrument

This example looks at situations where a company pays a premium to cancel a loan from a related company in exchange for payment. The payment is deductible and the premium is taxed as a capital gain.

The example considers whether capital gain is ordinary income within the hybrid and other mismatches from financial instruments rules and how it should be treated.



Background

- Co. 1 is resident in Country X.
- Co. 1 owns 100% of the equity of Co. 2, which is resident in Country Y.
- Co. 2 has borrowed money from Co. 1 (the ‘Loan’), but now acquires that Loan at a premium, effectively cancelling the Loan.
- Under the law of Country Y, Co. 2 treats the premium as deductible expenditure.
- The receipt of the premium received by Co. 1 in Country X is treated as a gain on the disposal of the Loan.
- The payee is not a relevant investment fund as defined in s259NA.
- The Loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

Analysis – Applying the tests in s259CA TIOPA 2010

Does the payment satisfy the relevant conditions to fall within the scope of the hybrid or other mismatches arising from financial instruments rules?

Condition A: Is the payment of the premium made under, or in connection with, a financial instrument?

There is a payment representing the acquisition cost of a financial instrument that has the effect of cancelling Co.2's indebtedness under that instrument. The payment is considered to be made in connection with a financial instrument as it discharges Co. 2's obligations under the Loan. The Loan falls within the definition of a financial instrument for the purposes of UK GAAP, and so is a financial instrument within the meaning of s259N.

The transfer of the financial instrument is not a hybrid transfer arrangement within the meaning given by s259DB and so is dealt with under the financial instrument provisions (s259N(3)(a)).

Condition A is satisfied.

Condition B: Is Co. 2 or Co. 1 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Note: The loan relationship legislation (at s307 CTA 2009) would usually apply where the UK is in the position of Country X to ensure that the amounts are brought into account. Where the Loan satisfies the definition of a financial instrument for the purposes of UK GAAP but does not fall within the definition of a loan relationship or related transaction within CTA09/Part 5, then there may be a mismatch as reflected here.

Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will permit Co. 2 a deduction (relevant deduction) equal to the payment of the premium. If Country X treats the receipt as a gain on the disposal of the loan, there will be a mismatch if either none of the receipt will be taxed as ordinary income or it will be taxed at lower rate (i.e. under-taxed).

If Country X subjects the receipt to tax on capital then it will not be treated as included in ordinary income of the payee. However, credit for the tax suffered may be given when determining whether the income is under-taxed.

In either of these circumstances, Condition C is satisfied.

The quantum of the hybrid or otherwise impermissible deduction/non-inclusion mismatch is determined under the provisions of s259CB(2)(b) where Case 1 applies (that is, where the relevant deduction exceeds the sum of the amounts of ordinary income arising to each payee, and all or part of that excess arises by reason of the terms, or any other feature, of the financial instrument). Case 2 applies where there is an amount of ordinary income which arises by reason of the payment or quasi-payment and is under-taxed by reason of the terms, or any other feature, of the financial instrument, and the amount of the Case 2 hybrid or otherwise impermissible deduction/non-inclusion mismatch is determined under s259CB(11).

Condition D: Are the two companies related or is there a structured arrangement?

As Co. 1 owns 100% of the equity in Co. 2, the companies are related within the definition at s259NC.

Condition D is satisfied.

Conclusion

As Conditions A to D are satisfied, there is a ‘hybrid or otherwise impermissible deduction/non-inclusion mismatch’.

Counteraction

The appropriate response to counteract this mismatch will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Primary response
If the UK is Country Y, s259CD will apply and the UK will deny the deduction for the premium paid by Co. 2 to the relevant extent necessary to address the mismatch.

Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Secondary response
If the UK is Country X, the counteraction will depend on whether or not the deduction has been fully counteracted under a provision equivalent to s259CD in Country Y. If so, no further action will be taken by the UK.

If however, under the law of Country Y, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully counteracted, then s259CE will apply and the UK will counteract the remaining mismatch by including that amount as income arising for the counteraction period.

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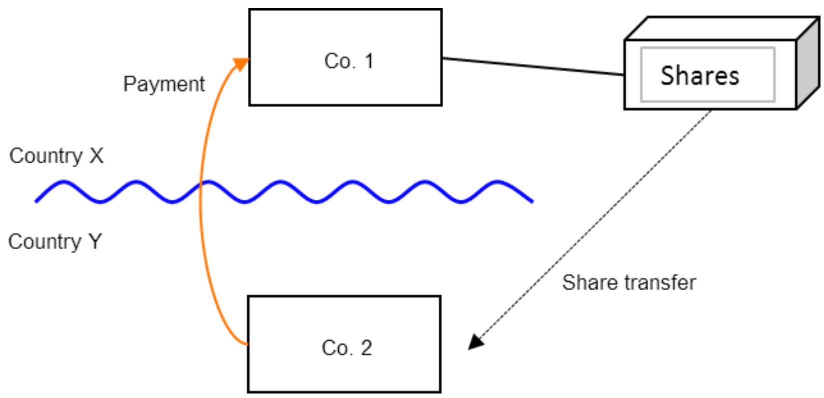
INTM551360: Hybrids: Chapter 3 - Financial instruments: Example: Consideration for the purchase of a trading asset

This example looks at situations where a company acquires shares on trading account from a related company in exchange for payment. This payment is deferred and interest is applied to the unpaid amount.

The example considers whether the asset sale agreement falls within the hybrid and other mismatches from financial instruments rules.



Background

- Co. 1 is resident in Country X.
- Co. 2 is resident in Country Y.
- Co. 1 transfers shares to Co. 2, who pays fair market value for the shares.
- The share transfer occurs on the same day as the payment.
- Co. 2 acquires the shares as part of its activities as a trader and will be able to include the purchase price as expenditure when calculating any taxable gains/loss on the disposal of the shares.

Analysis – Applying the rules in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are the payments or quasi-payments made under, or in connection with, a financial instrument?

The asset sale agreement is not a financial instrument as it does not fall within any of the definitions provided in s259N.

Although shares are included, an agreement to acquire them will only be a financial instrument if it satisfies one of the tests in s259N, for instance that amounts are brought into account in respect of it under Part 6 CTA 2010 – see s259N(1)(b). That is not the case here.

Condition A is not satisfied, and no further analysis is required.

Conclusion

There is no hybrid or otherwise impermissible deduction/non-inclusion mismatch to counteract.

Note that if a substitute payment is made in connection with the transfer, Chapter 4 dealing with hybrid transfers may apply.

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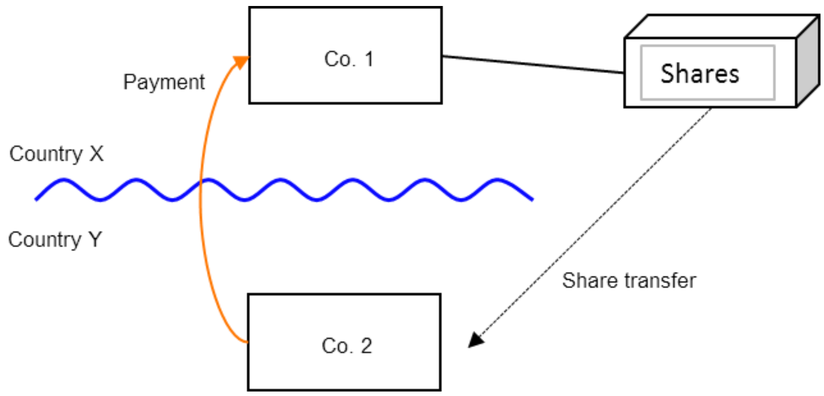
INTM551370: Hybrids: Chapter 3 - Financial instruments: Example: Interest component of the purchase price of shares

This example looks at situations where a company transfers shares to a related company in exchange for payment. This payment is deferred and interest is applied to the unpaid amount.

The example considers whether the interest element of the payment falls within the hybrid and other mismatches from financial instruments rules, and how it should be treated.



Background

- Co. 1 is a company resident in Country X.
- Co. 2 is a related company, resident in Country Y.
- Co. 1 transfers shares to Co. 2, which pays the market value for the shares (subject to a price adjustment for the consideration being deferred).
- The payment of consideration for the shares is deferred for a year. The purchase price is the fair market value on the date of the agreement plus an amount equal to a market rate of interest on the unpaid purchase price.
- Under the laws of Country Y, Co. 2 is allowed to treat the interest portion of the purchase price as a separate deductible expense for tax purposes.
- Under the laws of Country X, Co. 1 treats the entire purchase price (including the interest element) as consideration for the transfer of the

asset. This is not a trading asset of Co. 1 and so Co. 1 does not include the receipt as ordinary income.

- The payee is not a relevant investment fund as defined in s259NA.

Analysis – Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Are the payments or quasi-payments made under, or in connection with, a financial instrument?

The underlying shares may satisfy the definition to be considered a financial instrument but Chapter 3 can only be applied where a payment or quasi-payment is made under or in connection with a financial instrument. The payment to purchase the shares is made in connection with the transfer agreement, not in connection with the shares. Consequently, there is no payment or quasi-payment in connection with the shares.

There may be a payment or quasi-payment in connection with the transfer agreement. This will occur where the transfer agreement is treated as a financial instrument. This will be in the following circumstances -

- the transfer agreement is treated as a financial instrument under UK GAAP per s259N(2); or

- if it is assumed that a party to the transfer agreement is subject to corporation tax, then the resulting profits or losses would be taken into account under Part 6 CTA 2009 per s259N(1)(b).

Other subsections of s259N are unlikely to apply.

Where Country X is the UK, it is likely that s480 CTA 2009 would apply and that the UK would tax the in-substance interest under Part 6 CTA 2009. If that were the case, the transfer agreement would be a financial instrument, but note that this does not fit the fact pattern described above.

Where Country X is the UK (but s480 is not in point and the UK does not otherwise tax the in-substance interest), Condition A is only satisfied if the transfer agreement is accounted for as a financial instrument and Country Y allows a tax deduction for the payment representing the in-substance interest. In these circumstances, the transfer agreement is unlikely to be regarded as a financial instrument unless it falls within the relevant definition in UK GAAP.

Condition A may be satisfied where the UK is Country Y, the transfer agreement is a financial instrument under UK GAAP and the UK gives a tax deduction for the in-substance interest.

Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

In the event the UK is country X, Co. 1 is the payee and is within the charge to corporation tax.

In the event the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B is satisfied providing either of the above is satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax, then Condition B would be satisfied since both the payer and the payee companies were within the charge to corporation tax.

Condition C: Is it reasonable to suppose that there is, or will be, a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?

Co. 2 receives an allowable deduction for the interest expense, while Co. 1 does not include the corresponding receipt as ordinary income. There is a Case 1 mismatch as defined in s259CB(2), all or part of which arises by reason of the terms or other feature of the financial instrument.

Condition C is satisfied.

Condition D: Are Co. 1 and Co. 2 related or is the financial instrument, or any arrangement connected with it, a structured arrangement?

Co. 1 and Co. 2 are related within the definition at s259NC, and so Condition D is satisfied.

Conclusion

Where the UK is in the position of Country Y all the conditions are satisfied to characterise the arrangement involving the payment of interest as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ and the relevant responses therefore need to be considered.

Counteractions

The response will only apply where the UK is in the position of Country Y (for the reasons explained in the above analysis of Condition A).

Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

Where the UK is in the position of Country Y (the payer jurisdiction) then s259CD will apply and Co. 2's allowable deductions in relation to the payments of interest must be reduced to the extent that the deduction is a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.

In this example Country X does not tax the receipt as it is treated as part of the sale receipt from the transfer of the shares. Therefore, none of the finance related deduction is allowed.

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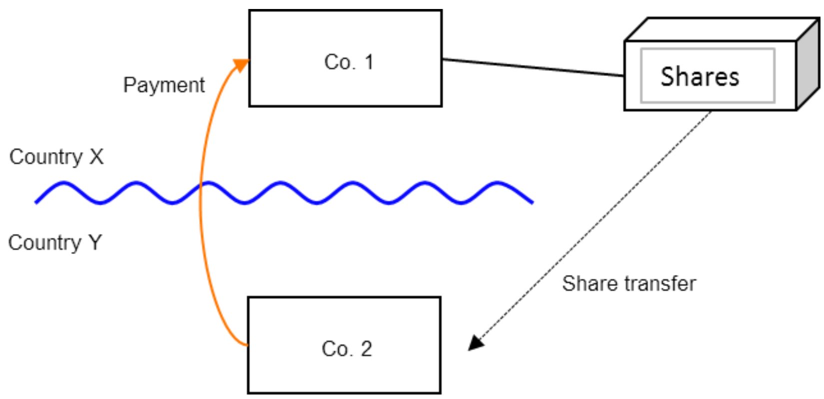
INTM551380: Hybrids: Chapter 3 - Financial instruments: Example: Interest paid on the purchase of shares from a share trader

This example looks at situations where a company transfers shares to a related company in exchange for payment. The company selling the shares is a share trader. The payment is deferred and interest is applied to the unpaid amount.

The example shows both that the cost price of the shares should be included in ordinary income in computing the share trader's profits and that if the interest receipt is brought into charge at the full marginal rate, albeit in a different character, there will be no hybrid mismatch to be counteracted under the hybrid and other mismatches from financial instruments rules.



Background

- Co. 1 is a share trader and resident in Country X.
- Co. 2 is resident in Country Y and is related to Co. 1.
- Co. 1 transfers shares to Co. 2, which pays market value for the shares (subject to a price adjustment for the consideration being deferred).
- The consideration given for the shares is deferred for a year. The purchase price is fair market value on the date of the agreement plus an amount equal to a market rate of interest on the unpaid purchase price.
- Under the laws of Country Y, Co. 2 is allowed to treat the in-substance interest portion of the purchase price as a separate deductible expense for tax purposes. Co. 2 is not a share trader and is therefore not able to claim a deduction for the cost of the shares acquired.

- Under the laws of Country X, Co. 1 treats the entire purchase price (including the interest element) as consideration for the transfer of the asset. However, as it is a share trader, Co. 1 is required to bring the entire amount of the payment into account as ordinary income when computing its taxable profits.

Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

Condition A: Is there a payment made under, or in connection with, a financial instrument?

The definition of a 'financial instrument' within s259N TIOPA 2010 includes anything else that 'has the meaning that it has for UK generally accepted accounting practice'. Therefore if the UK is in the position of Country X then it can usually be supposed that UK GAAP has determined the agreement to be merely a transfer of the asset, and therefore not a financial instrument.

By contrast, where the UK is in the position of Country Y, the transfer agreement includes a finance element and is therefore a financial instrument under UK GAAP.

Condition A is satisfied only if the UK is in the position of Country Y.

Condition B: Is the payer or payee within the charge to corporation tax for a relevant payment period?

In the event the UK is in the position of Country X, Co. 1 is the payee and is within the charge to corporation tax.

In the event the UK is in the position of Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B will therefore be satisfied providing either of the above is satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax, then condition B would be satisfied since both payer and payee companies were within the charge to corporation tax.

Condition C: Is it reasonable to assume that there is, or will be, a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?

The payment is made up of two distinct and separable elements: the payment for the shares and the payment of interest.

The separate and identifiable payment for the shares will not result in a hybrid or otherwise impermissible deduction/ non-inclusion mismatch as Country Y will not permit a deduction for the cost of the shares in calculating Co. 2's trading profits (because it is not a share trader).

The interest payment also does not result in a hybrid mismatch because the relevant deduction does not exceed the amounts of ordinary income arising to each payee for the permitted taxable period. Co. 2 has benefitted from a deduction in Country Y, but it is reasonable to assume that the corresponding receipt has been taxed in Country X as ordinary income – it is income that has been brought into charge by Country X under a tax corresponding to the UK's charge to corporation tax on income.

Co. 1's receipt is not accounted for as finance income, but that does not prevent the amount being recognised as ordinary Income under the definition at s259BC.

As the rate charged on that element of ordinary Income is not lower than that charged in Country X on all ordinary income arising from financial instruments, it is not under-taxed for the purpose of case 2.

Condition C is not satisfied, and no further analysis is required.

Conclusion

There is no hybrid or otherwise impermissible deduction/non-inclusion mismatch to counteract.

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INTM552000: Hybrids: Chapter 4 - Hybrid transfers: Contents

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INTM552010: Hybrids: Chapter 4 - Hybrid transfers: Overview

Chapter 4 of Part 6A TIOPA 2010 counters deduction/non-inclusion mismatches that arise from payments or quasi-payments (INTM550540) involving hybrid transfers. A hybrid transfer arrangement is an arrangement for the transfer of a financial instrument. The definition of a hybrid transfer arrangement specifically includes repos and stock lending arrangements.

Conditions to be satisfied

Chapter 4 applies where the five conditions (A to E) set out in s259DA are met. These conditions are:

Condition A

Is there a hybrid transfer arrangement in relation to an underlying instrument?

Condition B

Is a payment or quasi-payment made under or in connection with either the hybrid transfer arrangement or the underlying instrument?

Condition C

Is either the payer or one of the payees within the charge to UK corporation tax?

Condition D

Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch if it were not countered by this legislation or equivalent legislation outside the UK?

Condition E

Are the relevant counterparties related, or is the hybrid transfer arrangement a structured arrangement?

Counteraction

If all five conditions are met, then the hybrid transfer deduction/non-inclusion mismatch is counteracted by altering the corporation tax treatment of either the UK payer or UK payee.

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INTM552020: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied

S259DA TIOPA 2010 sets out the five conditions (A, B, C, D and E) that must be met for Chapter 4 to apply.

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INTM552030: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition A

Condition A is met where there is a hybrid transfer arrangement in relation to an underlying financial instrument. The definition of financial instrument in s259N is wide, and includes shares.

A hybrid transfer arrangement in relation to an underlying instrument includes

- a repo,
- a stock lending arrangement, and
- any other arrangement

that provides for, or relates to, the transfer of a financial instrument where either the dual treatment condition is satisfied or a substitute payment could be made.

The terms repo (see INTM552040) and stock lending arrangement (see INTM552050) are not defined, so take their normal commercial meanings.

An arrangement for the transfer of a financial instrument that would not ordinarily be regarded as a repo or a stock loan may still fall within the definition of a hybrid transfer arrangement. Where that arrangement may result in a deduction/non-inclusion mismatch it is within the definition of a hybrid transfer arrangement if either the dual treatment condition is met, or substitute payments could arise.

Dual treatment condition

The dual treatment condition (INTM552060) is met in relation to an arrangement where –

- the tax treatment of a person who is party to a transaction follows the economic substance of the agreement, that is, as if it were an agreement for the borrowing of money, and
- the tax treatment of another party to that transaction does not follow the same approach,

Substitute payments

A substitute payment may be made where there is an arrangement for the transfer and transfer back of a security, or a delay in its transfer under contractual arrangements (INTM552070). The actual recipient of a dividend or interest payment in respect of the financial instrument may be required to make a payment to the other party to the transfer, in effect to compensate that party for not receiving that dividend or interest payment.

A substitute payment may result in a deduction/non-inclusion mismatch where, for instance, the tax jurisdiction of the recipient of the substitute payment taxes it in an advantageous way (or not at all) as if it were the real dividend but the other jurisdiction allows a deduction for the substitute payment made.

Novations and other indirect transfers

S259DB(6) extends the definition of a transfer for arrangements other than repos and stock loans. This includes (but is not restricted to) novations of a financial asset or liability. A novation is a legal term describing contractual arrangements where a new obligation is substituted for the one that previously existed.

For example, where there is a transfer from P to Q, even if the original financial instrument held by P ceases to exist, so long as Q comes to have substantially the same rights or obligations in respect of a financial instrument as P had under the original instrument, this would be treated as a transfer.

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INTM552040: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition A: What are repos?

A repo is a type of in-substance lending (see CFM46100). In its simplest form, the in-substance borrower transfers a security (the underlying financial instrument) to an in-substance lender at a price, say £100. The in-substance borrower agrees to repurchase the same security (or an identical security) on a fixed future date at an agreed higher price, say £101. Economically this is equivalent to a loan of £100 secured on the transferred securities, bearing an interest-like funding cost of £1.

There are many variations on the theme. For instance -

- the prices could be set in any currency (but the same currency for both sale and repurchase).

- there may be flexibility as to the relevant dates and the repurchase price may be fixed by a formula, essentially the accretion of interest over time on the original transfer price.

- the nature of the securities to be redelivered may be the actual securities delivered or there may be flexibility for the in-substance lender to deliver securities similar, but not necessarily identical, to the original securities, with the same value as the securities originally transferred.

Adjustments may need to be made if interest or dividends become payable on the underlying securities in the interim. The in-substance lender may be required to make a substitute payment (see INTM552070) to recompense the in-substance borrower for the actual dividend received, or the repurchase price may be reduced.

Example

- Securities are transferred from Co. 1 (the in-substance borrower) to Co. 2 (the in-substance lender) for £100, under an arrangement such that Co. 1 will repurchase them for £101 in 4 months' time.

- During this period Co. 2 becomes entitled to a dividend payment of £4 on the underlying securities.

- Co. 2 may be obliged either to make a substitute payment of £4 to Co. 1 or to reduce the repurchase price payable by Co. 1 at the end of the period from £101 to £97.

If Co. 1's jurisdiction treats this arrangement as secured borrowing, Co. 1 (the in-substance borrower) is likely to be treated as receiving the dividend of £4 on the underlying financial instrument and as having incurred a funding cost of

£1 on the repo. The receipt of £4 may be non-taxable under a portfolio dividend exemption.

If Co. 2's jurisdiction also treats this arrangement according to its economic substance, Co. 2 (the in-substance lender) is likely to be taxed on an in-substance interest amount of £1, with the transfer and retransfer of the securities and the receipt of the dividend of £4 being ignored. No tax mismatch would arise in these circumstances.

But, if Co 2's jurisdiction taxes the arrangement purely on the legal form of the transaction, Co 2 is likely to be regarded as having made a capital loss of £3 (cost £100, sales proceeds £97). If the actual dividend actually received by Co. 2 is non-taxable, then a mismatch arises.

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INTM552050: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition A: What are stock lending arrangements?

In a commercial stock lending transaction (see CFM74100) there is normally a party that has a need of securities (for example, in order to deliver securities to satisfy a sales contract it has previously entered into). The original holder of the securities transfers them to the stock borrower, but no price is specified. However, the stock borrower is obliged to transfer back those securities (or identical securities) at a later date.

In the interim, the stock borrower lodges collateral with the stock lender and will normally pay a fee to the stock lender, sometimes by allowing the stock lender to retain part of the return on the collateral (a collateral rebate). For example, where the collateral is a security the stock lender may be allowed to retain any interest payments in the interim.

If there is no collateral, this may be a sign of an uncommercial arrangement that is possibly tax-driven.

Where the collateral is cash, a stock loan can be very similar to a repo in its economic effects. The stock lender transfers securities and gets them back at a later date. When it transfers the securities, the stock lender gets the cash collateral, which it can use in its business. It pays over an interest return on the cash collateral and returns the cash principle at the end. In this example, the stock lender is in the same position as the in-substance borrower in a repo.

This type of arrangement is unlikely to satisfy the dual treatment condition, as the amount paid over in respect of the cash collateral is interest and is less likely than the price differential on a repo to give rise to a mismatch.

In stock lending, as with repos, a transaction may extend over a dividend or interest record date. The stock borrower will typically be obliged to make a substitute payment to the stock lender. A payment may also arise from the lender to the borrower on the securities posted as collateral. The stock lender would normally pay this over to the stock borrower, so substitute payments could flow in both directions, although they could be netted.

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INTM552060: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition A: Dual treatment condition

The dual condition treatment is satisfied if the arrangement involves a transfer of a financial instrument, and –

- gives rise to a financing expense in the jurisdiction of the company that incurs the funding cost (the in-substance borrower), but

- the tax jurisdiction of the counterparty (the in-substance lender) does not recognise it as a lending transaction.

Such transactions tend to be built around the concept of a “repo” arrangement. This involves the transfer of a financial instrument for a price. The instrument is then transferred back later at a predetermined or pre-determinable higher price. The price differential is the funding cost to the transferor and will be higher for a longer term repo that a shorter term one. The financial instrument transferred may be plain shares, with no inherent hybridity characteristics.

Repo transactions are very common in the financial markets and play a vital role in maintaining liquidity. The great majority of transactions do not create deduction/non-inclusion mismatches, as they are treated for tax purposes as financing or financial trading transactions from the perspective of both parties.

There can be mismatches, however, where

- the transferor treats the transaction in line with its substance, as equivalent to a transaction for the lending of money, and

- the transferee treats that transaction in line with its form, as an acquisition and subsequent disposal.

Where the transferee jurisdiction taxes capital transactions in a more favourable manner than finance transactions then this will create a mismatch.

There are examples of transactions at INTM552490, INTM552500 and INTM552510 demonstrating how the dual treatment condition applies.

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INTM552070: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition A: Substitute payments

A substitute payment is defined in s259DB(5) as a payment or quasi-payment that -

- consists of or involves an amount paid or a benefit given,
- is representative of a return arising on, or in connection with, the underlying financial instrument, and
- is paid or given to someone other than the person to whom the return on the underlying instrument arises.

Payment or benefit

Normally a substitute payment is an actual payment. However, there might be a benefit rather than an actual payment if amounts are netted off or where there are less obvious or more contrived arrangements for transferring value, such as by means of a loan waiver.

A substitute payment may become payable where an economic owner of securities is deprived of a dividend or interest payment that would be expected to arise to it as economic owner of the asset. This may arise because the economic owner has lent the security under a repo or stock loan arrangement and expects the security to be transferred back at a later date, and during this period an amount of interest or a dividend is paid.

If a repo (see INTM552040) or stock loan (see INTM552050) extends over the record date (the date which determines to whom the dividend or interest on the underlying instrument will be paid) the registered holder (the transferee) of the securities on that date is entitled to the interest or dividend. Commonly, under the terms of the stock lending or repo arrangement, the transferee will be required to compensate the original transferor by means of a substitute payment.

Substitute payments are very common in the financial markets. There may be a chain of substitute payments, for instance if shares are lent to an intermediary, and then on-lent to a further party who sells into the market intending to repurchase similar shares in the market at a later date.

Representative return

The amount must be representative of a return of any kind on the underlying instrument. Accordingly, it need not be the same as a gross dividend or interest payment, because withholding tax effects, etc. may have an impact.

For example, if a dividend of 100, payable to the original holder of the shares, would normally be paid subject to a withholding tax of 15% (depending on the jurisdiction of residence of the issuer of the security), the substitute payment might be reduced to 85.

A stock lending or repo transaction might be used to position securities over the record date, with a view to reducing or eliminating the withholding tax levied on an actual dividend or interest payment by the issuer's jurisdiction. In these circumstances, the substitute payment might be some amount in-between 85 and 100, sharing the benefit of the reduced withholding tax between the parties.

This form of tax arbitrage is not within the scope of the hybrid mismatch rules. To the extent that such withholding tax arbitrage impacts on pricing, this is not taken into account in determining whether there is a "structured arrangement" for the purpose of the hybrid mismatch regime.

Substitute payments and failed delivery

Substitute payments are not limited to those made in stock lending and repo arrangements. For example, a company might enter into a contract to sell securities cum dividend (i.e. including the right to the dividend) but for some reason, perhaps because of a delay in delivery resulting from a failed trade, title to the securities might not pass until after the record date for the dividend or interest in question; the securities are thus delivered ex-dividend. Typically the sales contract will require the vendor to make a substitute payment (which might be described as compensation) to the purchaser in such circumstances – thus the substitute payment is made in reverse by the transferor to the transferee.

A failed delivery that gives rise to a substitute payment, whether unintended or deliberate, falls within s259DB(2)(c) as an example of any other arrangement.

Substitute payments and condition A

The question of whether a substitute payment could be made is determined by the actual contractual arrangements. There is no need to consider whether there could have been alternative arrangements with similar economic characteristics under which a substitute payment could have arisen. If a substitute payment is possible, condition A is satisfied even if no substitute payment is made.

Note that although condition A is satisfied where a substitute payment could be made, a mismatch cannot arise if a substitute payment is not actually made.

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INTM552080: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition B

Condition B is met if a payment or quasi-payment is made under or in connection with the hybrid transfer arrangement itself, or the underlying instrument.

Payment

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

Payer and payee

The payer is the person who makes the transfer. A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

Quasi-payment

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply.

See INTM550540 for more detail on payments and quasi-payments.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments where the circumstances giving rise to the deduction do not involve economic rights between the payer and a payee.

Where the dual treatment condition is satisfied in respect of funding expense mismatches (see INTM552060) the mismatch will normally concern a quasi-payment and the mismatch will be the amount of the relevant deduction (see INTM550540) for the funding cost under the hybrid transfer arrangement.

The quasi-payment may reflect the effects of a number of payments, for example the sale and repurchase costs of the security and any interest, dividend and substitute payments received, paid, or forgone.

Example

- An in-substance lender, Co 1, sells securities for £100m to Co 2, its counterparty, and agrees to buy back the securities in 4 months' time for £101m.

- Co 2 is permitted to retain any dividend or interest payment received while it holds the security. This amount is deducted from the repurchase price.

- A dividend of £4m is received by the counterparty, Co 2, and so the repurchase price is reduced to £97m.

- Co 1's jurisdiction follows economic substance and allows a deduction of £1m for the funding cost under the repo and taxes (or exempts) the payment on the underlying security as if the security had not been transferred.

If Co 2's jurisdiction mirrors this treatment, by taxing a financing return of £1m and ignoring the dividend or interest on the security, the dual treatment condition is not satisfied.

But, if Co 2's jurisdiction follows legal form, for instance by recognising a capital loss of £3m (purchase price £100m, sale price £97m) and treating the actual payment as if it were income of Co 2 (for example, a dividend benefitting from a portfolio dividend exemption), the dual treatment condition is satisfied in respect of a quasi-payment of £1m, being Co 1's funding cost under the arrangement.

The above example is similar to the example at INTM552510.

There may be a question as to whether fully taxed ordinary income arises to the counterparty that corresponds to the funding expense deducted. In the case of such funding arrangements, once the funding cost is identified, it is not necessary to further test the individual components of the overall transfer arrangements.

In the case of mismatches arising from substitute payments (see INTM552070), the amount in point is normally a payment being the substitute payment. Exceptionally, there may be a quasi-payment where, as described above, some other non-cash benefit is given in respect of a substitute payment.

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INTM552090: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition C

Condition C at s259DA(4) requires that either -

- the payer must be within the charge to UK corporation tax for a relevant payment period, or

- a payee must be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period.

The relevant payment period is the taxable period of the payer in which an amount may be deducted for a payment or quasi-payment.

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INTM552100: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition D

Condition D at s259DA(5) asks whether it would be reasonable to suppose that a hybrid transfer deduction/non-inclusion mismatch would arise, if Part 6A (or equivalent non-UK legislation) did not apply.

There are two types of hybrid transfer deduction/non-inclusion mismatches:

- Case 1 (s259DC(2)) applies where deductions exceed ordinary income
- Case 2 (s259DC(5)) applies where ordinary income arises, but is under-taxed.

In broad terms, ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is in s259BC and the concept is discussed further at INTM550560.

The definition was expanded by Finance (No.2) Act 2017 to include a qualifying capital amount as ordinary income 259DD(6)-(11).

Any excess is disregarded if it arises because of the financial trader exclusion (see INTM552170) or because the payee is a relevant investment fund (see INTM552210).

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INTM552110: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition D - Case 1

Case 1 – deductions exceed ordinary income

For case 1 the requirements are that the relevant deduction exceeds the total amounts of ordinary income arising by virtue of payments or quasi-payments for a permitted taxable period and all or part of that excess arises (s259DC(7) TIOPA 2010) because either:

- the dual treatment condition is satisfied in respect of an arrangement under which a payment or quasi-payment is made, or

- the payment or quasi-payment is a substitute payment.

Where the mismatch arises for several reasons it will be treated as arising by reason of the dual treatment condition being satisfied or the payment/quasi-payment being a substitute payment, if it could arise for either of those reasons.

It does not matter if the excess could also have arisen for some other reason as well.

Where there is more than one payee, the case 1 mismatch is calculated by reference to the ordinary income arising to each payee, making the relevant assumptions (see below) as regards each payee.

The relevant assumptions

The assumptions are –

- if the payee is not within the charge to tax in a payee jurisdiction because of an exclusion, immunity, exemption or relief under that law, the exclusion, etc. is assumed not to apply.

- if a payment or quasi-payment is not chargeable to tax in a “payee jurisdiction” because it is not made in connection with the payee’s business in that jurisdiction, it is assumed that it is made in connection with such a business.

- if the payee is not resident in any territory which imposes a tax charge or there is no territory where the payee is chargeable to tax as a result of carrying on business through a permanent establishment, then assume the payee is UK resident, and carries on a business in the UK.

A payee jurisdiction is one in which the payee is resident for tax purposes, or has a permanent establishment – s259BB(9).

Where you are assuming that a payee is UK resident, and carrying on a business in the UK, the following UK tax provisions are disregarded for the purpose of s259DB(3)(b) –

- transfer pricing (Part 4 TIOPA 2010),
- the hybrid and other mismatch rules (Part 6A TIOPA 2010),
- the worldwide debt cap (Part 7 TIOPA 2010), and
- the loan relationships unallowable purposes rules (s441 CTA 2009).

Permitted taxable period

The permitted taxable period (in which ordinary income arises to a payee) is defined in s259DD(2). It includes any period that begins before the end of 12 months after the end of the payer's taxable period. This will include a coincident period or an earlier period.

Further, if it is just and reasonable that ordinary income might arise in a later period rather than earlier, the permitted taxable period will include that later period.

This is intended to ensure that mismatches attributable entirely to timing or accounting differences are not brought within the scope of the hybrid and other mismatch rules. There is further comment on the permitted taxable period in the context of financial instruments at INTM551150.

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INTM552120: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition D: Case 2

Case 2 - Under-taxed amounts

In case 2 mismatches, ordinary income does arise to the payee in respect of a hybrid transfer, but the income in question represents an under-taxed amount for a permitted taxable period.

As with Case 1, the amount must be under-taxed for one of the reasons set out in s259DC(7), that is, because:

- the dual treatment condition is satisfied in respect of an arrangement under which a payment or quasi-payment is made, or
- the payment or quasi-payment is a substitute payment.

If the amount of relevant under-taxed income would have been reduced had the arrangement not contained those relevant characteristics, then it will satisfy the requirements for a hybrid transfer deduction/non-inclusion mismatch.

Ordinary income is under-taxed if the highest rate at which the payee is taxed on such income is less than the payee’s full marginal rate, taking into account (on a just and reasonable basis) any credit for underlying tax on profits used wholly or partly to fund the payment.

This full marginal rate is the highest rate at which the taxpayer would be taxed on ordinary income arising from a financial instrument (s259DD(4)).

The “highest rate” of tax referred to is the effective rate after taking into account underlying tax credit relief, assuming no other reliefs are also applied to that income.

For example, under a complex repo arrangement, the temporary holder of the share receives a taxable dividend payment in respect of which underlying tax credit relief can be claimed. That dividend, or rather the quasi-payment reflecting the financing return on the repo, of which the dividend forms a part, will be an under-taxed amount due to the underlying tax credit.

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INTM552130: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition D: Foreign exchange differences

A foreign exchange loss does not give rise to a Case 1 or Case 2 hybrid transfer deduction/non-inclusion mismatch. It is not within the scope of the rules.

An example of a transaction to which the dual treatment condition in s259DA(4) TIOPA 2010 might apply is a repo (see INTM552040).

It is quite possible that the in-substance borrower on a repo is a UK company with a sterling functional currency, but the sale and repurchase price are denominated in some other currency.

For example, a UK company with a sterling functional currency enters into a euro-denominated repo with a related party. Absent the hybrid and other mismatch legislation, the UK company would have been entitled (under s551 CTA 2009) to a deduction for both in-substance interest and an exchange loss on a debtor repo denominated in euros. The counterparty is not taxed either on deemed interest or any exchange difference. In this example the counteraction will deny the deemed interest deduction, but not the exchange loss.

The key point as regards the exchange loss is that it should not give rise to a quasi-payment within s259BB(2) TIOPA 2010.

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INTM552140: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition E

There are three circumstances in which Condition E would be satisfied. These are:-

- the payer is also the payee,
- the payer and payee are related, or
- the hybrid transfer arrangement is a structured arrangement.

The payer is also the payee

From a UK tax perspective this circumstance could happen (if at all) when the transaction takes place within a single entity.

The UK branch of a non-UK company enters into a repo transaction with its head office. The UK is assumed to respect the arrangement as an internal financing arrangement in attributing profits to the branch and therefore allows a tax deduction for the funding cost under the repo, giving rise to a quasi-payment.

Whilst it could be argued that there is not an actual transfer of securities, from the perspective of the foreign jurisdiction, the head office and branch are different entities and therefore there is a transfer within s259DB(3) enabling condition E to be satisfied. Further the branch and head office might hold securities through different nominees, in which case there is an actual transfer. Alternatively branch and head office might have separate accounts with a central securities depository (for instance Euroclear, Clearstream or SIX SIS Ltd.) which could reflect a change in ownership by means of book entries. This would be regarded by the markets as a transfer.

The branch is the payer and the head office is the payee, but the head office is not regarded as a distinct and separate person from the branch for the purposes of UK corporation tax. Both are parts of a single taxable company, even though the UK taxes only profits attributable to the UK permanent establishment (the branch).

If the head office jurisdiction takes a different approach and for tax purposes treats the UK branch as if it were a separate entity and the transaction as a sale and repurchase of securities even though it takes place within a single entity (the scenario imagined in s259BB(7)) and the foreign jurisdiction does not treat the scenario as a financing arrangement and taxes the corresponding financing income as ordinary income, then the counteraction may apply.

The payer and payee are related

This circumstance is satisfied where the payer and payee are related at any time in the period beginning with entry into the hybrid transfer arrangement and ending on the last day in the payment period. This is the last day of the tax period in the payer's tax jurisdiction in which the payer gets a tax deduction giving rise to a quasi-payment (or makes a payment).

The meaning of related party is set out in s259NB, see INTM550610.

Where the payer of a substitute payment is a financial trader, entitled to a tax deduction for the payment in computing trading profits, the related party circumstance on its own is insufficient to lead to counteraction, see INTM552170.

The hybrid transfer is a structured arrangement

The definition of a structured arrangement is found in s259DA(7). See INTM552150 for further details.

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INTM552150: Hybrids: Chapter 4 - Hybrid transfers: Conditions to be satisfied: Condition E - Structured arrangements

The concept of a structured arrangement is relevant in two contexts.

It determines whether there is sufficient connection to satisfy Condition E for Chapter 4 to apply, and in the case of a substitute payment made by a financial trader, the financial trader exemption will not apply in the case of a structured arrangement, see INTM552170.

An arrangement is a structured arrangement if it is reasonable to suppose that

- it is designed to secure a hybrid payer deduction/non-inclusion mismatch,
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or
- the terms of the arrangement otherwise reflect an expected mismatch.

An arrangement may be designed to secure a commercial or other objective, and yet also still secure a hybrid payer deduction/ non-inclusion mismatch. When considering this issue the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch.

See INTM551110 for further commentary on structured arrangements as they apply to financial instruments.

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INTM552160: Hybrids: Chapter 4 - Hybrid transfers: The extent of the mismatch

Case 1 mismatch

Where case 1 applies, the extent of the mismatch is the excess of the deductions over the amounts treated as ordinary income by the payees, making all the relevant assumptions, as necessary.

Case 2 mismatch

Where case 2 applies the calculation of under-taxed amounts has two stages. First it is necessary to identify the under-taxed amounts. Then for each amount a simple formula is applied to each under-taxed amount:

$$\frac{(\mathrm{UTA}\ \times (\mathrm{FMR} - \mathrm{R}))}{\mathrm{FMR}}$$

Where -

- UTA is the under-taxed amount

- FMR is the payee's full marginal tax rate for the permitted taxable period, as a %

- R is the highest rate at which tax is charged on the profits that are under-taxed, as a %, taking into account the effect of any credit for underlying tax on a just and reasonable basis.

For the purposes of the establishing the undertaxed amount, withholding tax is disregarded.

The full marginal tax rate is the highest rate that could be charged on the taxable profits of that payee on finance related income. It does not include a higher tax rate that may be imposed under the Diverted Profits Tax.

The under-taxed amount is the relevant proportion of ordinary income that is subject to tax at a rate lower than the full marginal tax rate.

The highest rate at which tax is charged (R) recognises both income and capital taxes corresponding to the charge that would be imposed under the UK's income tax, capital gains tax or corporation tax regime.

Example
The non-UK party to a repo (under which the UK party is the in-substance borrower) is subject to tax on the return on the repo, but as a capital gain subject to less than the non-UK payee's full marginal rate on ordinary income.

The UK company is entitled to a deduction for deemed interest of 80.

In this example, the normal corporate income tax rate (the full marginal rate) is 30% but capital gains are taxed at 18% (ignoring indexation or any other computational adjustments of the gain).

Applying the formula

$$\frac{(\mathrm{UTA} \times (\mathrm{FMR} - \mathrm{R}))}{\mathrm{FMR}}$$

- UTA is 80, the under-taxed amount
- R is 18%, the rate actually suffered on the amount
- FMR is 30%, being the full marginal rate

The deduction denied would be:

80 x (30% -18%) ÷ 30% = 32.

The UK company's deduction for deemed interest would be restricted by 32: from 80 to 48.

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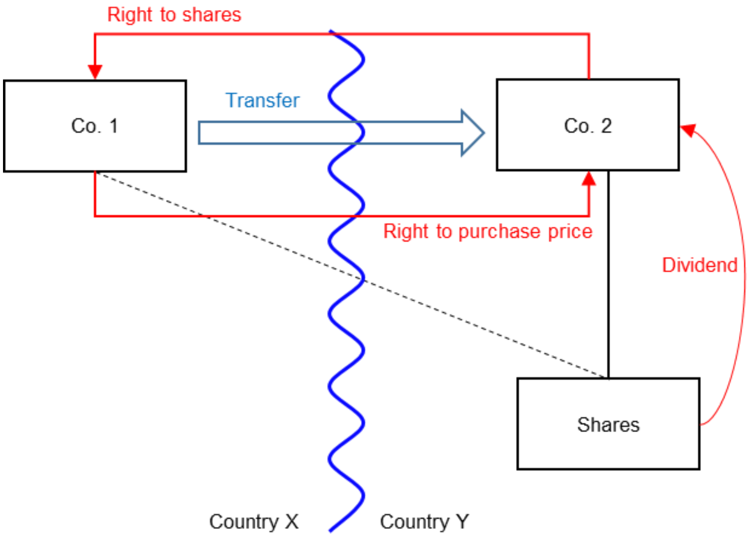
INTM552165: Hybrids: Chapter 4 - Hybrid transfers: The extent of the mismatch: Example

Example illustrating under-taxed amount: Repo, UK payer, dual treatment condition satisfied, counterparty entitled to underlying tax credit relief

This example is similar to that at INTM552510, except that here the dividend is not exempted by Country Y; instead it is taxed, but underlying tax credit is given. It should be noted that this not a straightforward repo: it is a rather unusual transaction which would probably have been specifically designed to achieve the tax arbitrage.



- A UK payer (Co. 1) sells shares to a counterparty (Co. 2) under a repo.
- Co. 1 gets a deduction for a financing cost of 80 under the repo, which is equal to a dividend retained by the repo counterparty (a net-paying repo).
- The sale and repurchase prices are equal once the dividend retained by the counterparty (Co. 2) is deducted from the purchase price (i.e. the finance cost = the expected distribution).
- It is also assumed that the dividend is paid out of profits which have suffered tax in the share issuer's source jurisdiction of 20%.
- The normal rate of tax on financing income on Co. 2 would be 30%. But it is able to treat the dividend retained as gross income of 100. Its gross tax liability would be 30, but this is reduced by credit for underlying tax of 20, leaving net tax of 10 payable. (It is assumed that no withholding tax arises.)

- As there is only the one payer the under-taxed amount is 80, which is an amount equal to Co. 1's tax deduction.

Position of counterparty Co. 2:

- Co. 2's financing income from the hybrid transfer is 80 (the ordinary income that would be expected to be received under the repo is equal to the cash dividend received).

- The maximum rate of tax on that income (or at least the cash dividend) is 10/80 = 12.5%. This compares with a normal rate of tax (and FMR in the formula) on financing income of 30%. So R equals 12.5%.

The tax saved by Co. 2 as compared with the return on a conventional loan to Co. 1 is 80x (30%-12.5%) = 14. This is reconciled as 24 tax at 30%, on normal loan interest of 80, less 10, the net tax under the net-paying repo.

Applying the formula, the amount of the deduction/non-inclusion mismatch is:

$$\frac{(\mathrm{UTA} \times (\mathrm{FMR} - \mathrm{R}))}{\mathrm{FMR}}$$

Where -

- UTA is 80, the under-taxed amount

- R is 12.5%, as determined above

- FMR is 30%, being the payee's full marginal rate

The deduction denied would be 46.67, calculated as below

$$\frac{80 \times (30\% - 12.5\%)}{30\%}$$

This is the tax saving to Co. 2 of 14, divided by its full marginal rate of tax, 30%, to give the measure of a notional non-inclusion that would provide the same tax-saving.

The primary counteraction, see INTM552220, is to deny the UK payer (Co. 1) a deduction of the same amount, 46.67.

Co. 1 is therefore only able to deduct 33.33 of its repo interest expense of 80.

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INTM552170: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Overview

The financial trader exclusion (FTE), in s259DE, relates solely to hybrid transfer deduction/non-inclusion mismatches arising from a payment or quasi-payment that is a substitute payment.

Substitute payments are very commonly made in commercial financial transactions. It is common for there to be chains of substitute payments, some between related parties, and if a transaction under which a substitute payment is made is looked at narrowly, a deduction non-inclusion mismatch arises. However, if the entirety of the chain of transactions giving rise to the payment is considered, there is usually no mismatch.

At the beginning of the chain of transactions there is a real non-deductible dividend and at the end a substitute payment treated as a tax exempt dividend. Providing the financial trader brings all expenses and receipts into account in trading taxable profits, for example by being subject to tax on a dividend or substitute payment received, the financial trader gains no tax benefit. Consequently, there is a special rule (the financial trader exclusion) in Chapter 4, which applies to deduction/non-inclusion mismatches that arise because a financial trader can deduct the cost of the substitute payment in computing profits. This means that a related-party transaction in the chain of transactions does not of itself lead to counteraction; counteraction will only occur where the related party transaction is itself a “structured arrangement” see INTM552150.

The purpose of the financial trader inclusion is two-fold:

- to prevent inappropriate counteraction of mismatches, and
- to ease the compliance burden imposed on financial traders.

As a result of this exclusion, excesses of deductions over inclusions, or under-taxed amounts, which fall within the terms of this exclusion are not taken into account in computing the extent of a hybrid transfer deduction/non-inclusion mismatch under s259DC (see INTM552100).

The financial trader exclusion does not apply to the class of transactions where the dual treatment condition is satisfied (that is, in-substance lending mismatches, see INTM552060).

For instance, there might be there is a repo or repo-like related party transaction in which a financial trader is the in-substance borrower and a related party is the in-substance lender. The financial trader has a tax-deductible financing expense, a quasi-payment. If the related party’s tax jurisdiction does not regard the transaction as an in substance lending and does not tax an amount corresponding to the quasi-payment as ordinary income, the dual treatment condition is satisfied. Whether the financing expense deduction is generally available or arises from the financial trader status of the in-substance borrower, the mismatch in respect of the quasi-payment is an arrangement that is capable of counteraction. There is no special feature which justifies application of an exclusion for financial traders.

It is also conceivable, albeit unlikely, that a dual treatment mismatch might arise where a substitute payment is a part of the mechanism for delivering a dual treatment mismatch. One jurisdiction may allow a tax deduction for accruing interest-like finance expense (a quasi-payment) but the other jurisdiction does not tax the return as an interest like financing return. In such a transaction a mismatch does not directly relate to the substitute payment itself. The financial trader exclusion does not apply in such circumstances. Note, however, it would be more likely that a real dividend, as against a substitute payment, would be incorporated in the mechanics of such a repo-like transaction as in the example at INTM552510.

The example below shows that in circumstances where the deduction is claimed by a financial trader, there is no actual deduction/non-inclusion mismatch when the relevant transactions are seen together.

Example – bank acts as stock lending intermediary

- An investment entity (not a financial trader) which is a member of a group wishes to earn a stock lending fee by lending shares in the market. Its sister company, a UK bank, has many clients that may wish to borrow the shares and acts as an intermediary - on-lending the shares to its client.

- The stock loan extends over the record date for payment of a dividend. Accordingly the client makes a substitute payment to the bank which in turn makes a substitute payment to its sister investment company.

Looking at the overall transaction, the issuer of the underlying instrument (the shares) makes a dividend payment which is not tax-deductible.

The 3rd party client receives a dividend which is not taxable (for example because of participation exemption) and makes a non-deductible substitute payment to the UK bank which is tax neutral for the client.

The UK bank receives a substitute payment, which is taken into account in computing its tax liability.

The UK bank makes a deductible substitute payment to its sister investment company, which is not taxed on it as the payment is treated as a real tax-exempt dividend.

Overall there are:

- two non-deductible payments, by the issuer and the client,

- two non-taxable receipts, to the client and the investment company,

- and additionally one taxable receipt and one tax deductible payment to the UK bank.

Therefore it is tax-neutral. It would not be appropriate for a mismatch to be countered in such circumstances and the effect of the financial trader should be to prevent this happening.

Two entities may benefit from a participation exemption relating to the same dividend, but providing the client does not get a tax deduction for its substitute payment the position is neutral. Counteraction would apply to that transaction, which is not between related parties, only if it were a structured arrangement.

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INTM552175: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Conditions to be satisfied

The financial trader exclusion applies if all three conditions (A to C) at S259DE are satisfied.

[INTM552180: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition A]

[INTM552190: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition B]

[INTM552200: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition C]

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INTM552180: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition A

Condition A at s259DE(3) is that:

- a mismatch arises from a payment or quasi-payment that is a substitute payment. In the illustration in INTM552170 the substitute payment is made to the sister investment entity.

- the payment is treated by a person in a manner that reflects the facts that the substitute payment is representative of the underlying return (the underlying shares). In the illustration in INTM552170 the person is the stock loan counterparty. This is the case because the substitute payment received is treated for taxable purposes in the same manner as a real dividend on the stock-lent shares.

- the substitute payment is brought into account in computing the taxable profits of a financial trader. In the illustration in INTM552170 this is the UK bank who is the financial trader.

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INTM552190: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition B

Condition B at s259DE(4) and (5) is met where the financial trader brings associated payments into account.

These are payments that are received by, or made by, the financial trader and relate to the underlying instrument or an arrangement that relates to the underlying instrument.

In the illustration in INTM552170, the dividend on the shares borrowed, if actually received by the UK bank, would be an associated return, as would the UK bank's return on some other transaction it enters into relating to the shares borrowed. Here, the UK bank is trading for tax purposes and the value of the dividend received forms part of its taxable trading income but it is also allowed as a deduction the substitute payment made to the investment company who is the lending the shares.

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INTM552200: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition C

Condition C is set out at s259DE(6). The condition is satisfied if both of the following apply:

- the return on the underlying security must not be one to which Chapter 3 of the UK hybrid and other mismatches provisions, nor an equivalent foreign provision, would apply. This counters the use of hybrid transfers as a means to avoid counteraction on the underlying instrument.

- the hybrid transfer arrangement giving rise to the substitute payment is not a structured arrangement (see INTM552150).

Part 6A and Equivalent Foreign Provision

The example in INTM552550 looks at the situation where equivalent foreign provisions to the UK hybrid and other mismatches provisions deny the financial trader exclusion. In this case we have L Co which is resident in country L which holds shares in I Co which is resident in country I. L Co lends the stock in I Co to U Co which is resident in the UK. U Co is a financial trader and it uses the borrowed stock as part of its trade to sell these shares short. (The repurchase price is expected to be less than the sale price allowing a profit on the transaction.)

In this example U Co, L Co and I Co are related parties. Country I allows a deduction for dividends paid. However it also has equivalent hybrid and other mismatches provisions. These provisions act to deny a deduction for dividends paid in country I if the payment is made to a related party. This means that if a dividend were paid direct from I Co to L Co then the deduction in I Co would be denied.

In the example the dividend is paid from I Co to U Co followed by a substitute payment to L Co. Here the deduction from I Co is allowed. However because the direct payment of the underlying return from I Co to L Co would trigger the equivalent foreign hybrids and mismatches provisions in Country I then under condition C the financial trader exclusion is not allowed. As shown in this example this satisfies the conditions for there to be a hybrid transfer deduction/non-inclusion mismatch and a counteraction is required.

Structured arrangements

The example in INTM552540 shows condition C is failed because the hybrid transfer arrangement giving rise to the substitute payment is a structured arrangement. This is because the transaction was structured giving rise to taxable benefits both to L Co and U Co and both the deductibility of the substitute payment paid by U Co and the non-taxation of the receipt of the substitute payment to L Co are critical to the design of the arrangement.

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INTM552210: Hybrids: Chapter 4 - Hybrid transfers: Payments to relevant investment funds

S259DC(9) provides that a hybrid transfer deduction/non-inclusion mismatch is disregarded if, or to the extent that, it arises as a result of the payee being a relevant investment fund.

The definition of a relevant investment fund is found in s259NA (see INTM550600), and includes OEICs, authorised unit trusts and offshore funds that meet the genuine diversity of ownership condition. These entities are in substance transparent, as income is taxed (or not taxed in the case of an exempt investor) at the level of the investor.

Unlike the financial trader exclusion this exclusion applies both to substitute payments and to the return on funding transactions on which the dual treatment condition is satisfied, see INTM552060.

Neither is the exclusion limited to payments and quasi-payments made by financial traders. Where a payment of quasi-payment is to such an investor then, to the extent the excess is attributable to the payee being a relevant investment fund, compliance is simplified because it is not necessary to consider whether there is a related party transaction or whether, for example, the quantum of a substitute payment might be an indicator that there is a structured transaction. A counteraction will not arise.

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INTM552220: Hybrids: Chapter 4 - Hybrid transfers: Counteraction - UK payer

Where the payer is within the charge to UK tax and conditions A to E in s259DA are met, the mismatch is counteracted under s259DF by denying the payer a deduction or the deduction/non-inclusion mismatch (computed as at INTM552160).

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INTM552230: Hybrids: Chapter 4 - Hybrid transfers: Counteraction - UK payee

Counteraction in relation to a UK payee is dealt with in s259DG and occurs only if it is reasonable to suppose that the corresponding payer is not denied a deduction under the UK hybrid mismatch legislation (see INTM552220), or an equivalent provision under of another territory, or where the payer counteraction is only partial.

A counteraction is a partial counteraction if some of the hybrid transfer deduction/non-inclusion mismatch, as computed under the UK legislation at s259DC (see INTM552160), remains deductible even after the equivalent provision has been applied.

If there is only one payee, the entire relevant amount is treated as taxable income of the UK payee for the counteraction period. The relevant amount is the hybrid transfer deduction/non-inclusion mismatch deduction that is not counteracted, or the part of the deduction that is not counteracted.

If there is more than one payee, this amount is apportioned between payees on a just and reasonable basis. This basis takes into account profit sharing arrangements that may exist between payees, to whom amounts that are not taxed as ordinary income arise and to whom under-taxed amounts arise.

The counteraction period in which the income should be included is the accounting period of the payee that coincides with the chargeable period of the payer (under its applicable tax law) or, if there is no such period, the payee’s first accounting period that is wholly or partly contained within the payer’s chargeable period.

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INTM552400: Hybrids: Chapter 4 - Hybrid transfers: Examples: Contents

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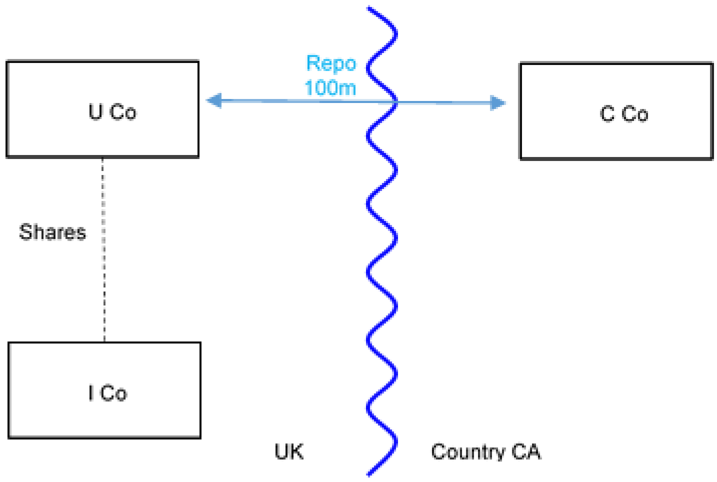
INTM552490: Hybrids: Chapter 4 - Hybrid transfers: Examples: Simple repo transaction - no mismatch

This example illustrates a straightforward repo transaction between related parties, in which both parties are treated as entering into a financing transaction for tax purposes. U Co benefits from a tax deduction for the funding cost on the in-substance secured loan and C Co is taxed on a corresponding amount of income.



Background

- U Co is resident in the UK.
- U Co holds a portfolio shareholding in I Co.
- U Co sells its shares in I Co to a related company, C Co, for £100m, subject to an agreement (the Repo) that U Co will repurchase the shareholding after 3 months for £101m.
- C Co is resident in Country CA.
- No dividends are paid or payable on the I Co shares during this 3 month period.
- U Co accounts for the transactions as a borrowing of £100m, secured on the shares in I Co, recognising a financing cost of £1m (being the excess of the repurchase cost of the shares). Under UK tax law U Co may deduct that £1m from its income for tax purposes.

- The borrowing cost for U Co is at an effective annual rate of approximately 4% and is accepted as an arm's length cost.

- C Co also treats the repo as secured lending for tax purposes, and the in-substance interest of £1m is ordinary income of C Co in Country CA.

Analysis – Applying the tests in s259DA TIOPA 2010

Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?

The agreement to sell I Co shares for £100m and repurchase them after 3 months for £101m is a repo in the ordinary sense of the term as used in the context of financial transactions. The Repo is a hybrid transfer arrangement as defined at s259DB(2) only if it provides for, or relates to, the transfer of a financial instrument and

- the dual treatment condition is met, or

- a substitute payment could be made.

The I Co shares are a financial instrument, as defined at s259N. The Repo is, therefore, an arrangement providing for the transfer of a financial instrument.

The dual treatment condition is met if, for tax purposes -

- one person regards the arrangement as equivalent to a transaction for the lending of money at interest, and a payment or quasi-payment made under or in connection with that arrangement is treated accordingly, and

- another person does not treat that payment or quasi-payment as equivalent to a transaction for the lending of money at interest.

On the facts given above, the dual treatment condition is not met because both U Co and C Co treat the payment of £1m under the Repo as a transaction under an arrangement that is equivalent to the lending of money at interest.

No dividends are paid or payable to C Co during the 3 months it holds the shares. Assuming that the Repo does not contain any provision to make a substitute payment (for example, because the period covered does not include a record date for I Co shares), no substitute payment could be made by C Co to U Co.

Condition A is not satisfied, as the dual treatment condition is not met and there cannot be a substitute payment. It is not necessary to consider the remaining conditions at s259DB.

Conclusion

The conditions at s259DB(2) are not satisfied, so there is no hybrid transfer arrangement and there can be no counteraction under Chapter 4.

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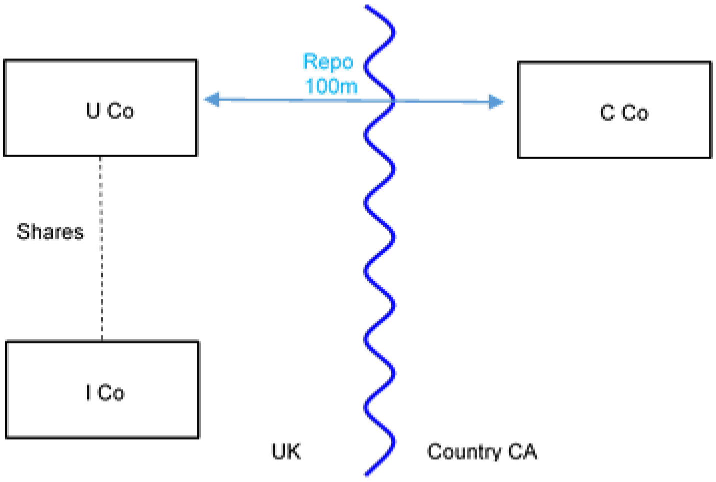
INTM552500: Hybrids: Chapter 4 - Hybrid transfers: Examples: Simple repo transaction – case 1 mismatch

This example illustrates a straightforward repo transaction, between related parties, in which one party is treated as entering into a financing transaction for tax purposes. U Co benefits from a tax deduction for the funding cost of the in-substance secured loan but C Co is not taxed on a corresponding amount of income.



Background

- U Co is resident in the UK.
- U Co holds a portfolio shareholding in I Co.
- U Co sells its shares in I Co to a related company, C Co, for £100m, subject to an agreement (the Repo) that it will repurchase the shareholding after 3 months for £101m.
- C Co is resident in Country CA
- No dividends are paid or payable in respect of the I Co shares during this 3 month period.
- U Co accounts for the transactions as a borrowing of £100m, secured on the I Co shares, recognising a financing cost of £1m (being the excess of the repurchase cost of the shares. Under UK law U Co may deduct that £1m from its income for tax purposes.
- The effective annual rate of approximately 4% represents an arm's length borrowing cost for U Co.

- Under the tax laws of Country CA, C Co treats the receipt of £1m (that is, the proceeds of £101m less the costs of £100m) as a capital gain, which is non-taxable.

Analysis – Applying the tests in s259DA TIOPA 2010

Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?

The agreement to sell I Co shares for £100m and repurchase them after 3 months for £101m is a repo in the ordinary sense of the term as used in the context of financial transactions. The Repo is a hybrid transfer arrangement as defined at s259DB(2) only if it provides for, or relates to, the transfer of a financial instrument and

- the dual treatment condition is met, or
- a substitute payment could be made.

The I Co shares are a financial instrument, as defined at s259N. The Repo is, therefore, an arrangement providing for the transfer of a financial instrument.

Dual treatment condition
The dual treatment condition is met if, for tax purposes -

- one person regards the arrangement as equivalent to a transaction for the lending of money at interest, and a payment or quasi-payment made under or in connection with that arrangement is treated accordingly, and
- another person does not treat that payment or quasi-payment as equivalent to a transaction for the lending of money at interest.

On the facts given above, the dual treatment condition is met because

- U Co treats the Repo as an arrangement that is equivalent to the lending of money at interest and is entitled to a UK tax deduction for the financing cost and
- C Co does not treat its return under the Repo as an arrangement that is equivalent to the lending of money at interest.

Condition A is satisfied because the dual treatment condition is met. It is not necessary to consider whether a substitute payment could arise.

Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?

Under the terms of the Repo, U Co transfers money of £101m to C Co, in relation to which £1m may be deducted from U Co's income for the purposes of calculating its taxable profits. The UK tax deduction of £1m, the relevant deduction, will fall within s259BB whether it is a payment or a quasi-payment.

Condition B is met.

Condition C: Is the payer or the payee within the charge to corporation tax for a relevant payment period?

U Co is the payer of the in-substance interest accrual and is within the charge to corporation tax in the UK.

Condition C is satisfied.

Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the payment or quasi-payment?

Given the background above it is reasonable to suppose that, but for the hybrid mismatch provisions, U Co would be entitled to a deduction of £1m (the relevant deduction) in computing its liability to corporation tax, for the in-substance interest accrual.

It is also reasonable to suppose that C Co will not treat any amount of the receipt of £1m as ordinary income, because Country CA does not regard the Repo as an arrangement for the lending of money at interest.

Condition D is satisfied.

Note: most jurisdictions would tax a repo in according with its economic substance, as at INTM552490, so the treatment described here would be unusual.

Condition E: Are U Co and C Co related, or is the arrangement a structured arrangement?

U Co and C Co are related parties. It is not necessary to consider whether the Repo is a structured arrangement.

Condition E is satisfied.

Conclusion

All the conditions are satisfied so there is a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the relevant deduction, £1m.

Counteraction

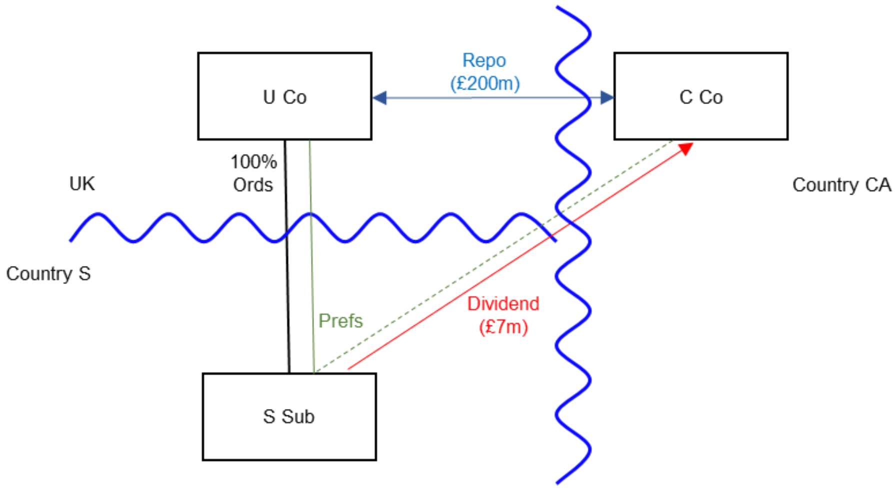
As the UK is in the position of the payer, the relevant counteraction is at s259DF. U Co is denied a deduction for the entire mismatch of £1m.Return to contents

INTM552510: Hybrids: Chapter 4 - Hybrid transfers: Examples: In-substance loan to UK company - case 1 mismatch

This arrangement is an unusual variation of a repo in which a financing return on an in-substance loan from C Co to U Co is delivered by arranging for C Co to retain the dividend on repo-ed shares.

This is not a typical market transaction: a repo of shares in a subsidiary is unlikely, because the shares might not represent reliable security for the in-substance lender and the arrangement appears to be designed to ensure that the sale and repurchase price are the same. Such a highly structured repo is more likely to be designed to deliver a cross-border tax arbitrage.

In this example, U Co accounts for the repo as a loan and is taxed on this basis. C Co's jurisdiction treats the sale and repurchase as on capital account and as the sale and repurchase price are the same, no gain nor loss is taken into account for tax purposes. The dividend received by C Co is not taxed.



Background

- U Co is resident in the UK.
- U Co has a 100% subsidiary (S sub), which is incorporated and resident in Country S.
- S Sub has issued to U Co 3.5% fixed rate preference shares carrying 10% of the voting rights (the Prefs).
- U Co sells the entire holding in Prefs for £200m to an unrelated company, C Co, resident in Country CA. This is subject to an agreement (the Repo) that U Co will repurchase the Prefs for £200m 12 months later.

- S Sub pays a dividend of £7m to C Co while C Co holds the Prefs. C Co is not required to make a substitute payment to U Co under the terms of the Repo.

- S Sub is not entitled to a tax deduction in Country S in respect of this dividend.

- U Co accounts for the transactions as a borrowing of £200m, secured on the Prefs in S Sub, recognising a financing cost of £7m (being the dividend foregone) as accruing over the 12 month term of the Repo. Under UK tax law U Co deducts the £7m from its income when calculating its profits for tax purposes.

- The expected arm's length borrowing cost for U Co on a secured loan, commercially similar to the Repo, would be 4.0%.

- Under Country CA tax law, C Co treats the Repo as an acquisition and sale of shares for £200m, giving rise to no profit or loss. The dividend received by C Co. is exempted from tax.

Analysis – Applying the tests in s259DA TIOPA 2010

Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?

The transaction has abnormal features that depart from those of a typical market repo; most notably the engineering of the arrangements such that the repurchase and sale prices are identical. This is done by ensuring that the retention of the real dividend by C Co, without obligation to make a substitute payment to U Co provides it with a return from the transaction which is approximately commensurate with the interest that might be expected on a one year loan from C Co. to U Co.

It is unclear whether the Repo is a repo in the ordinary sense of the term as used in the context of financial transactions. It is an arrangement within the meaning at s259NF that provides for the transfer of a financial instrument (the Prefs) and is a hybrid transfer arrangement as defined at s259DB(2) if it provides for, or relates to, the transfer of a financial instrument and

- the dual treatment condition is met, or

- a substitute payment could be made.

The dual treatment condition is met if, for tax purposes -

- one person regards the arrangement as equivalent to a transaction for the lending of money at interest, and a payment or quasi-payment made under or in connection with that arrangement is treated accordingly, and

- another person does not treat that payment or quasi-payment as equivalent to a transaction for the lending of money at interest.

On the facts given above, the dual treatment condition is met because

- U Co has a deduction of £7m for tax purposes. That deduction is a payment or quasi-payment (as defined at s259BB) that arises because the UK treats the Repo as an arrangement equivalent to the lending of money at interest, and

- C Co does not treat its return (the dividend of £7m received on the repo-ed shares) as a transaction under an arrangement equivalent to the lending of money at interest.

Condition A is satisfied because the dual treatment condition is met. It is not necessary to consider whether a substitute payment could arise.

Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?

U Co may claim a deduction for the interest accrual against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to C Co had it adopted the same accounting approach and been within the charge to tax in the UK.

The accrued interest expense satisfies the definition of a quasi-payment within s259BB(2).

Condition B is met.

Condition C: Is the payer or a payee within the charge to corporation tax for a relevant payment period?

U Co is the payer of the accrued interest expense, and is within the charge to corporation tax in the UK.

Condition C is satisfied.

Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the payment or quasi-payment?

Given the background above it is reasonable to suppose that, but for the hybrid mismatch provisions, U Co would be entitled to a deduction of £7m (the relevant deduction) for the in-substance interest accrual when computing its profits for corporation tax purposes.

It is also reasonable to suppose that C Co will not treat any amount of the £7m dividend received as ordinary income, because in Country CA the Repo is not treated as an arrangement for the lending of money at interest, and the dividend is not taxable.

Condition D is satisfied.

Condition E: Are U Co and C Co related, or is the arrangement a structured arrangement?

U Co and C Co are not related in this example, so it is necessary to consider whether the Repo is a structured arrangement.

The Repo is a structured arrangement as defined at s259DA(7) if it is reasonable to suppose that

- it is designed to secure a hybrid transfer deduction/non-inclusion mismatch, or
- the terms of the Repo share the economic benefit of the mismatch between the parties to the arrangement, or otherwise reflect the fact that the mismatch is expected to arise.

In this example the features of the design (for instance its elaborate nature which contrasts with a normal market repo and in particular, the contrived equality of sale and repurchase price) suggest that the transaction was designed to create a mismatch. In a real scenario other factors such as a reorganisation of the share capital of S Sub to facilitate the transaction would reinforce this.

Further the tax mismatch benefit appears to be priced into the transaction. U Co is able to raise funding at 3.5% (£7m cost on a loan of £200m) a lower rate than under conventional funding at 4%; C Co appears to get a lower return than under a conventional loan, but that return is not taxable (unlike a more conventional return on lending).

Condition E is satisfied.

Conclusion

All the conditions are satisfied so there is a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the relevant deduction.

Counteraction

As the conditions are all satisfied, the mismatch is subject to counteraction in the UK under s259DF. U Co is denied a deduction for the entire in-substance interest accrual of £7m.

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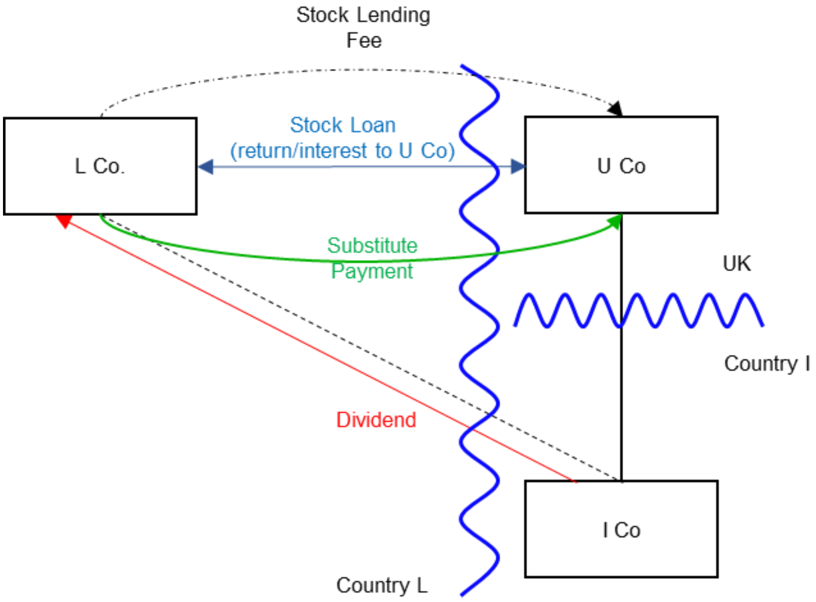
INTM552520: Hybrids: Chapter 4 - Hybrid transfers: Examples: Stock loan – UK company lends shares

An example of a stock loan that may result in a hybrid transfer mismatch. U Co transfers I Co shares to L Co under a stock lending agreement, and receives collateral and a stock lending fee. L Co receives dividends in respect of the shares, and makes a substitute payment to U Co. L Co later transfers the I Co shares to U Co, and U Co returns the collateral to L Co, with interest.



Background

- U Co is incorporated and resident in the UK.
- U Co holds shares in I Co, a company incorporated and resident in Country I.
- L Co is incorporated and resident in Country L.
- I Co is not a related party of either U Co or L Co at any time as these transactions are carried out.
- U Co enters into a stock lending transaction with L Co. Under the stock lending agreement U Co transfers the I Co shares to L Co. The agreement provides that L Co is required to transfer the same or identical shares to U Co 24 days later. L Co provides collateral (cash or high grade securities) to U Co, and this is transferred back to L Co when the shares are returned to U Co. U Co is also required to pay L Co any profit made while it held

the collateral, for example, any return on securities, or to pay interest due on cash.

- L Co pays a stock lending fee to U Co. In this instance the fee is larger than would be expected for a simple commercial stock lending transaction.

- The record date for the I Co shares falls during the 24 day period, so L Co holds the stock on the record date and receives the actual dividend for the I Co shares. L Co is not taxed on the dividend received.

- Under the terms of the stock lending agreement L Co is required to make a substitute payment (manufactured dividend) to U Co. The amount of the substitute payment is related to the amount of the dividend received in respect of the I Co shares but not necessarily the same amount.

- Under Country L law, L Co is allowed a deduction when calculating its profits chargeable to tax for the substitute payment made to U Co.

- Under s814D(2) CTA 2010 the substitute payment received by U Co is treated as a dividend.

Analysis – Applying the tests in s259DA TIOPA 2010

Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?

This is a stock lending arrangement that may be a hybrid transfer arrangement if it is an arrangement that provides for, or relates to, the transfer of a financial instrument and

- the dual treatment condition is met, or

- a substitute payment could be made.

The I Co shares are a financial instrument, as defined at s259N. The stock loan is, therefore, an arrangement providing for the transfer of a financial instrument.

Dual treatment condition
The dual treatment condition is met if, for tax purposes -

- one person regards the arrangement as equivalent to a transaction for the lending of money at interest, and a payment or quasi-payment made under or in connection with that arrangement is treated accordingly, and

- another person does not treat that payment or quasi-payment as equivalent to a transaction for the lending of money at interest.

On the facts given above, it is not clear whether the dual treatment condition is met, so the substitute payment position must be considered.

Substitute payment
A payment or quasi-payment is a substitute payment if

- it consists of or involves an amount being paid or a benefit being given,
- the amount or value of the benefit is representative of a return of any kind arising on, or in connection with, the underlying financial instrument, and
- the amount is paid, or the benefit is given, to a person other than the recipient of the return on the underlying financial instrument.

In this case the stock lending arrangement requires L Co to make a substitute payment to U Co when L Co receives the dividend from I Co. L Co receives the return on the underlying financial instrument when the dividend is paid in respect of the I Co shares. U Co receives an amount (from L Co) that is representative of that dividend and the payment to U Co is a payment made to a person who did not receive the dividend.

The payment to U Co by L Co in respect of the dividend from I Co is a substitute payment within the definition in s259DB(5).

Condition A is satisfied as a substitute payment could be made (and is, in fact, made) under the terms of the stock lending agreement.

Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement or the underlying instrument?

There are several payments made under or in connection with the stock lending arrangement in relation to which an amount may be deducted from the payer's income. These include –

- payment of the stock lending fee
- payment of the substitute payment.

Condition B is satisfied.

Condition C: Is the payer or a payee within the charge to corporation tax for a relevant payment period?

U Co is within the charge to corporation tax in the UK, and is a payee in respect of the substitute payment and the stock lending fee

Condition C is satisfied.

Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to a payment or quasi-payment?

There is no apparent mismatch in respect of the stock lending fee, so this is not considered further.

The facts set out above indicate that L Co is allowed a deduction for the substitute payment in Country L. In the UK the receipt of the substitute payment is treated as receipt of a dividend by U Co (s814D, CTA 2010). There may be a mismatch if U Co’s receipt of the substitute payment is not taxable in the UK.

Where the substitute payment is treated as a distribution within the terms of Part 9A CTA 2009 and a deduction is allowed to a non-UK resident in respect of that payment, the UK will usually apply the Part 9A rules and bring the distribution into charge. In most circumstances this means there will be no mismatch to consider, and condition D will not be satisfied.

If the substitute payment is treated as an exempt distribution in the UK, there will be a hybrid transfer deduction/non-inclusion mismatch, and condition D will be satisfied.

Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?

U Co and L Co are related. There is no need to consider whether the arrangement is also a structured arrangement.

Condition E is satisfied.

Conclusion

Where all the conditions are satisfied and there is a hybrid transfer deduction/non-inclusion mismatch, the extent of that mismatch is the full amount of the substitute payment received by U Co.

Where condition D is not satisfied, there is no hybrid transfer arrangement and Chapter 4 will not apply.

Counteraction

Where all the conditions are satisfied, the hybrid transfer deduction/non-inclusion mismatch is counteracted in the UK under s259DG. The amount of substitute payment is treated as income arising to U Co.

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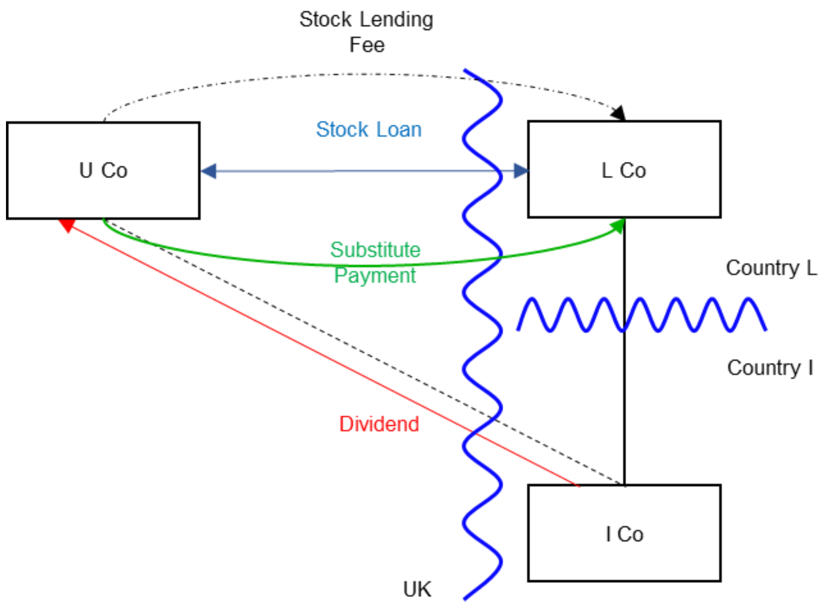
INTM552530: Hybrids: Chapter 4 - Hybrid transfers: Examples: Stock loan – UK financial trader borrows shares

In this stock lending arrangement U Co is a financial trader and is a related party of L Co.



Background

- U Co is resident in the UK. It is a financial trader and all transactions in this arrangement are within its financial trade.
- L Co is incorporated and resident in Country L.
- L Co holds shares in I Co
- I Co is incorporated and resident in Country I. I Co is not related to either U Co or L Co.
- U Co and L Co are in the same worldwide group and are related parties.
- L Co enters into a stock lending transaction with U Co. Under the stock lending agreement L Co transfers its I Co shares to U Co. The agreement provides that U Co will transfer the same or identical shares to L Co after 24 days. U Co provides collateral (cash or high grade securities). L Co will return the collateral to U Co, along with any return made on the securities or interest due on cash when the I Co shares are transferred to L Co.

- Under the stock lending agreement U Co pays a stock lending fee to L Co.

- The stock lending transaction facilitates U Co selling the I Co shares short. (U Co is expecting the price of the shares to fall. Accordingly it hopes to make a profit by purchasing shares in the market to redeliver to L Co at the end of the stock loan for an amount lower than the proceeds from the earlier sale of the borrowed shares.)

- The record date for the I Co shares falls during the 24 day period.

- On the record date U Co still holds the shares and has not sold them yet. U Co receives the dividend, and makes a substitute payment (manufactured dividend) to L Co as set out in the terms of the stock lending agreement.

- In the UK U Co brings the dividend into account when calculating its taxable profits, as the dividend is income received in the course of its financial trade.

- U Co is allowed a deduction for the substitute payment made to L Co, as it is brought into account in calculating the profits of its financial trade (s814C(3), CTA 2010).

- Under the tax law of Country L the substitute payment received by L Co is treated as a non-taxable dividend.

- It is accepted for the purposes of this example that the transactions are not a structured arrangement.

Analysis – Applying the tests in s259DA TIOPA 2010

Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?

This is a stock lending arrangement that may be a hybrid transfer arrangement if it is an arrangement that provides for, or relates to, the transfer of a financial instrument and

- the dual treatment condition is met, or

- a substitute payment could be made.

The I Co shares are a financial instrument, as defined at s259N. The stock loan is, therefore, an arrangement providing for the transfer of a financial instrument.

Dual treatment condition
The dual treatment condition is met if, for tax purposes -

- one person regards the arrangement as equivalent to a transaction for the lending of money at interest, and a payment or quasi-payment made under or in connection with that arrangement is treated accordingly, and

- another person does not treat that payment or quasi-payment as equivalent to a transaction for the lending of money at interest.

On the facts given above, there is no reason to expect either party to treat the stock loan as a funding transaction, so the substitute payment position must be considered.

Substitute payment
A payment or quasi-payment is a substitute payment if

- it consists of or involves an amount being paid or a benefit being given,

- the amount or value of the benefit is representative of a return of any kind arising on, or in connection with, the underlying financial instrument, and

- the amount is paid, or the benefit is given, to a person other than the recipient of the return on the underlying financial instrument.

In this case the stock lending arrangement requires U Co to make a substitute payment to L Co when U Co receives the dividend from I Co. U Co receives a return (the dividend) on the underlying financial instrument (the I Co shares). L Co receives an amount (from U Co) that is representative of that dividend and the payment to L Co is a payment made to a person who did not receive the dividend.

The payment to L Co by U Co in respect of the dividend from I Co is a substitute payment within the definition in s259DB(5).

Condition A is satisfied as a substitute payment could be made (and is, in fact, made) under the terms of the stock lending agreement.

Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?

There are several payments made under or in connection with the stock lending arrangement in relation to which an amount may be deducted from the payer's income. These include –

- payment of the stock lending fee

- payment of the substitute payment.

Condition B is satisfied.

Condition C: Is the payer or a payee within the charge to corporation tax for a relevant payment period?

U Co is within the charge to corporation tax in the UK, and is the payer of the stock lending fee and the substitute payment.

Condition C is satisfied.

Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to a payment or quasi-payment?

There is no apparent mismatch in respect of the stock lending fee, so this is not considered further.

The facts given above state that U Co is allowed a deduction for the substitute payment in the UK but the receipt of the substitute payment is treated as a non-taxable dividend by L Co in Country L. This appears to result in a case 1 excess, because the relevant deduction by U Co exceeds the ordinary income brought into account by L Co. However, U Co is a financial trading company so the financial trader exclusion must also be considered.

Financial trader exclusion
Under s259DC(9) any part of the excess to which the financial trader exclusion applies is to be disregarded.

The financial trader exclusion applies where conditions A, B and C, set out at s259DE, are satisfied.

- Condition A is met where one person treats a substitute payment as a return on the underlying instrument for tax purposes, and another person (the financial trader) brings that amount into account in calculating the profits of a trade.

- Condition B is met where the financial trader also brings any associated payments into account as trading income or expenses.

- Condition C is met if there would be no mismatch within Chapter 3 of the hybrids legislation (assuming the return on the underlying instrument arose and was paid direct to the payee) and the hybrid transfer arrangement is not a structured arrangement.

In this case, L Co treats the substitute payment as a return on the underlying instrument, that is, as a dividend. U Co is a financial trader and brings the substitute payment into account when calculating the profits of that trade. Condition A is met.

U Co also brings the dividend received from I Co into account when calculating trading profits, so condition B is met.

There is nothing to suggest that a non-UK provision equivalent to Chapter 3 of Part 6A would apply if the dividend payment were made directly from I Co to L Co. The facts also make clear that this is not a structured arrangement. Condition C is met.

As all the conditions are met, the financial trader exclusion applies, and the excess arising under s259DC(2) is reduced accordingly. In this example the financial trader exclusion applies to the entire excess, so the remaining excess under s259DC(2) is nil.

Condition D is not satisfied, as the entire mismatch is disregarded under the financial trader exclusion. It is not necessary to consider the other conditions.

Conclusion

The conditions are not all satisfied, so no hybrid transfer deduction/non-inclusion mismatch arises under Chapter 4 and there is no counteraction under Chapter 4.

Note 1: U Co sells shares cum-dividend and buys equivalent shares ex-dividend

The background given states that U Co held the I Co shares on the record date. However, as U Co is trading in these shares it may not hold the I Co shares on the record date. Assume that -

- U Co delivers the shares, cum dividend (before the record date) to a third party in a normal market sale. It is not known what happens to the shares after that sale.

- Later, and after the record date, U Co buys equivalent shares from a third party in the market, ex-dividend (after the record date) and delivers these shares to L Co as a repayment of the stock loan.

As part of the stock loan agreement U Co still has to make a substitute payment to a related party, L Co. The analysis for Chapter 4 is therefore unchanged. Condition D in s259DA(5) is again not satisfied as a result of the financial trader exclusion in s259DC(9) and s259DE.

The key point is that the deduction arises only because of U Co's financial trader status. It is not dependent on matching the tax treatment of U Co on the dividend received and the substitute payment made. U Co is unlikely to be aware of who received the actual dividend on the shares sold and the shares later purchased in the market or how the dividends are taxed. U Co is taxed on its commercial profits from the trading. Whether shares were bought cum-dividend and purchased ex-dividend will already be recognised in the valuation of the shares and be reflected in the profits of the transaction.

Note 2: Withholding tax benefits priced into the arrangement

This example can present issues where there are different withholding tax rates on dividends paid from Country I to Country L and from Country I to the UK. For example

- if L Co received the dividend directly from I Co, a withholding tax rate of 30% would apply.
- on the dividend payment date, U Co is the registered holder of the I Co shares, and the Country I dividend withholding tax is 15% to the UK.
- under UK tax law U Co is not required to withhold UK income tax from the overseas manufactured dividend.

Therefore there is a potential benefit in routing the dividend through the UK to Country L as this would allow less withholding tax on the dividend.

It is then assumed that the amount of the substitute payment is such that the withholding tax benefit is split between the parties and on a gross dividend of 100, the substitute payment is, say, 77, more than the 70 that L Co would have received in respect of a direct dividend, but less than the 85 received by U Co.

The analysis for Chapter 4 remains essentially the same as in the main example above. There is no structured arrangement. Although the economic benefit relating to the withholding tax treatment is reflected in the amount of the substitute payment, that economic benefit does not arise from the deduction/non-inclusion mismatch. This type of tax rate arbitrage is outside the scope of the hybrid and other mismatches provisions.

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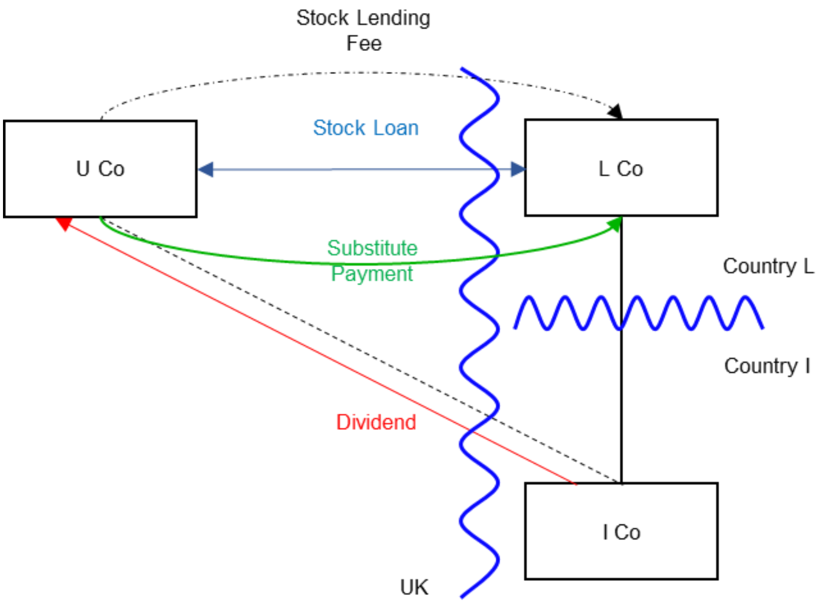
INTM552540: Hybrids: Chapter 4 - Hybrid transfers: Examples: Stock loan - UK financial trader and structured arrangement

In this stock lending transaction U Co is a financial trading company and is a related party of L Co. The substitute payment made by U Co is part of a structured arrangement.



Background

- U Co is resident in the UK. It is a financial trader and all transactions in this arrangement are within its financial trade.
- L Co is incorporated and resident in Country L.
- L Co holds shares in I Co.
- I Co is incorporated and resident in Country I. I Co is not related to either U Co or L Co.
- U Co and L Co are in the same worldwide group, and are related parties.
- L Co enters into a stock lending transaction with U Co. Under the stock lending agreement, L Co transfers its I Co shares to U Co. The agreement provides that U Co will transfer the same or similar shares to L Co after 24 days. U Co provides collateral (cash or high grade securities). L Co will

return the collateral to U Co, along with any return made on the securities or interest due on cash, when the I Co shares are transferred to L Co.

- The stock lending transaction might, in other circumstances, facilitate U Co selling these borrowed shares short or facilitate a stock loan or repo to a customer who might intend to sell short. However, in this instance, U Co holds the shares until they are due for redelivery to L Co.

- Under the stock lending agreement U Co pays a stock lending fee to L Co.

- During the 24 day period the record date falls for the I Co shares.

- On the record date U Co holds the shares, and so receives the dividend. Under the terms of the stock lending agreement U Co is required to make a substitute payment (manufactured dividend) to L Co. The amount of the substitute payment is related to the amount of the dividend received in respect of the I Co shares but not necessarily the same.

- In the UK U Co takes the dividend received into account when computing the taxable profits of its financial trade. The substitute payment made by U Co is also taken into account in computing the taxable profits of its financial trade.

- Under the tax laws of country L, L Co would not normally be taxed on dividends. However, under a specific tax rule (not in any way related to hybridity) the dividend on the I Co shares would have been taxable if actually received by L Co.

- Under the tax law of Country L the substitute payment received by L Co in lieu of the dividend is not taxable.

- The transactions in this case are part of a structured arrangement as the hybrid transfer arrangement is designed to secure a hybrid transfer deduction/non-inclusion mismatch. U Co has no particular need for the shares, but L Co benefits by receiving a tax-free substitute payment in lieu of a taxable dividend. U Co is neutral; it gets a tax deduction for the substitute payment but is taxed on the dividend received, because it is a financial trader. It is critical to the design of the arrangements that U Co is able to obtain a tax deduction for the substitute payment, and that L Co is not taxed upon the receipt of the substitute payment.

Analysis – Applying the tests in s259DA TIOPA 2010

Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?

This is a stock lending arrangement that may be a hybrid transfer arrangement if it is an arrangement that provides for, or relates to, the transfer of a financial instrument and

- the dual treatment condition is met, or
- a substitute payment could be made.

The I Co shares are a financial instrument, as defined at s259N. The stock loan is, therefore, an arrangement providing for the transfer of a financial instrument.

Dual treatment condition
The dual treatment condition is met if, for tax purposes -

- one person regards the arrangement as equivalent to a transaction for the lending of money at interest, and a payment or quasi-payment made under or in connection with that arrangement is treated accordingly, and
- another person does not treat that payment or quasi-payment as equivalent to a transaction for the lending of money at interest.

On the facts given above, it does not appear that the dual treatment condition is met, so the substitute payment position must be considered.

Substitute payment
A payment or quasi-payment is a substitute payment if

- it consists of or involves an amount being paid or a benefit being given,
- the amount or value of the benefit is representative of a return of any kind arising on, or in connection with, the underlying financial instrument, and
- the amount is paid, or the benefit is given, to a person other than the recipient of the return on the underlying financial instrument.

In this case the stock lending arrangement requires U Co to make a substitute payment to L Co when U Co receives the dividend from I Co. U Co receives a return (the dividend) on the underlying financial instrument (the I Co shares). L Co receives an amount (from U Co) that is representative of that dividend and the payment to L Co is a payment made to a person who did not receive the dividend.

The payment to L Co by U Co in respect of the dividend from I Co is a substitute payment within the definition in s259DB(5).

Condition A is satisfied as a substitute payment could be made (and is, in fact, made) under the terms of the stock lending agreement.

Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?

There are several payments made under or in connection with the stock lending arrangement in relation to which an amount may be deducted from the payer's income. These include –

- payment of the stock lending fee
- payment of the substitute payment.

Condition B is satisfied.

Condition C: Is the payer or a payee within the charge to corporation tax for a relevant payment period?

U Co is within the charge to corporation tax in the UK, and is the payer of the stock lending fee and the substitute payment.

Condition C is satisfied.

Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to a payment or quasi-payment?

There is no apparent mismatch in respect of the stock lending fee, so this is not considered further.

U Co is allowed a deduction for the substitute payment in the UK but the receipt of the substitute payment is treated as a non-taxable dividend in country L. This appears to result in a case 1 excess, because the relevant deduction by U Co exceeds the ordinary income brought into account by L Co. However, U Co is a financial trading company so the financial trader exclusion must also be considered.

Financial trader exclusion

Under s259DC(9) any part of excess to which the financial trader exclusion applies is to be disregarded.

The financial trader exclusion applies where conditions A, B and C set out at s259DE are satisfied.

- Condition A is met where one person treats a substitute payment as a return on the underlying instrument for tax purposes, and another person (the financial trader) brings that amount into account in calculating the profits of a trade.
- Condition B is met where the financial trader also brings any associated payments into account as trading income or expenses.

- Condition C is met if there would be no mismatch within Chapter 3 of the hybrids legislation (assuming the return on the underlying instrument arose and was paid direct to the payee) and the hybrid transfer arrangement is not a structured arrangement.

In this case, L Co treats the receipt of the substitute payment as a return on the underlying instrument, that is, as a dividend. U Co is a financial trader and brings the substitute payment into account as an expense when calculating the profits of that trade. Condition A is met.

U Co also brings the dividend receipt from I Co into account when calculating its trading profits, so condition B is met.

There is nothing to suggest that a non-UK provision equivalent to Chapter 3 of Part 6A would apply if the dividend payment were made directly from I Co to L Co. However, it is critical to the success of these arrangements that a hybrid transfer deduction/non-inclusion mismatch is secured in respect of the substitute payment. The facts make clear that this is a structured arrangement, so condition C of the financial trader exclusion is not met.

The statutory question is whether the hybrid transfer arrangement was "designed" to result in a hybrid transfer deduction/non-inclusion mismatch. This implies some active participation by U Co but it would be surprising if this were not the case where the parties are related. In this particular case, U Co works with L Co to secure a benefit for L Co in relation to the treatment of a substitute payment, and the mismatch is essential to the design of the arrangements. If, for example, entry into such a tax beneficial transaction could increase the bonuses of the U Co employees concerned, this would be a clear marker of a structured arrangement.

If L Co were replaced by an unrelated third party to the transaction and U Co received no economic benefit from the arrangements, then it is less likely that the arrangement is a structured arrangement. If, however, U Co were to actively market such a transaction to third parties, seeking to benefit from an increased volume of transactions, it would then be party to the design and there would be a structured arrangement. In that event, the financial trader exclusion would not apply.

In this example, the financial trader exclusion does not apply, so condition D is satisfied.

Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?

U Co and L Co are related. There is no need to consider whether the arrangement is also a structured arrangement.

Condition E is satisfied.

Conclusion

All the conditions are satisfied and there is a hybrid transfer deduction/non-inclusion mismatch, the extent of which is the full amount of the deduction for the substitute payment.

Counteraction

As the conditions are all satisfied the hybrid transfer deduction/non-inclusion mismatch is counteracted in the UK under s259DF. U Co is denied a deduction for the substitute payment.

Note. Would the position be different if U Co did not receive the actual dividend on the I Co shares?

The fact that U Co receives the real dividend is not critical. The analysis would be the same if U Co were to pass on the I Co shares to some other party, related or unrelated, by means of a stock loan or repo for the same period of time. The essential deduction/non-inclusion mismatch and overall tax benefit to U Co and L Co, taken together, would be exactly the same.

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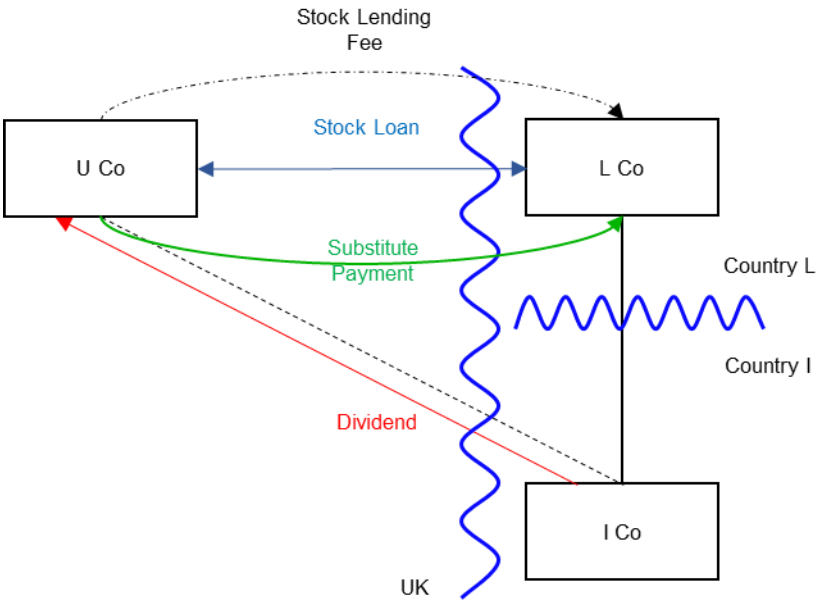
INTM552550: Hybrids: Chapter 4 - Hybrid transfers: Examples: Stock loan - UK financial trader borrows shares that are hybrid financial instruments

The facts in this example are essentially the same as in INTM552540, except that the dividend in respect of the I Co shares is taxable in Country L because the shares are hybrid financial instruments.

The stock loan provides a way round the Country L hybrid provisions equivalent to Chapter 3 of the UK provisions. Consequently, the financial trader exclusion cannot apply in the UK, even if the transactions between U Co and L Co are not a structured arrangement.

U Co is a financial trader. U Co and L Co are members of the same worldwide group and therefore related. I Co and L Co are also related parties. Country L exempts dividends, except where they are tax-deductible to the issuer of the shares. But those rules do not catch substitute payments in respect of such a dividend. If the dividend payment had been made directly to L Co, then Country L's hybrid mismatch rules would have taxed L Co on the dividend.



Background

- U Co is resident in the UK. It is a financial trader and all transactions in this arrangement are within its financial trade.
- L Co is incorporated and resident in Country L.
- L Co holds shares in I Co.

- I Co is incorporated and resident in Country I.

- U Co and L Co are in the same worldwide group and are related parties.

- L Co and I Co are related parties for the purposes of the tax laws of Country L.

- L Co enters into a stock lending transaction with U Co. Under the terms of the stock lending agreement, L Co transfers the I Co shares it holds to U Co. The agreement provides that U Co will transfer the same or similar shares to L Co 24 days later. U Co provides collateral (cash or high grade securities). L Co will return the collateral to U Co, along with any return made on the securities or interest due on cash, when the I Co shares are returned to L Co.

- The stock lending transaction might, in other circumstances, facilitate U Co selling these borrowed shares short or making a stock loan or repo to a customer who might intend to sell short. However, in this instance, U Co holds on to the shares until they are due for redelivery to L Co.

- U Co pays a stock lending fee to L Co.

- During the 24 day period the record date falls for the I Co shares. Under Country I tax law, the dividend payment is tax-deductible for I Co.

- U Co holds the stock on the record date and receives the actual dividend in respect of the I Co shares. Under the terms of the stock lending agreement U Co is required to make a substitute payment (manufactured dividend) to L Co. The amount of the substitute payment is related to the amount of the dividend received for the I Co shares but not necessarily the same.

- In the UK U Co takes the dividend received into account in computing the taxable profits of its financial trade. The substitute payment made by U Co is also taken into account in computing the taxable profits of its financial trade.

- Under the tax laws of Country L, L Co is not normally taxed on dividends. However, Country L has provisions equivalent to Chapter 3 of Part 6A. Under those provisions the I Co shares are hybrid financial instruments as dividends in respect of them are tax-deductible in Country I, but are not taxable income in Country L. Under those rules a dividend received from I Co is treated as taxable income of L Co.

- Under Country L tax law, substitute payments received in lieu of dividends are not taxable, and are not caught by the provisions equivalent to Chapter 3 in Country L.

- The benefits of any tax mismatch that might arise from the arrangements are not priced into the transaction.

Analysis – Applying the tests in s259DA TIOPA 2010

Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?

This is a stock lending arrangement that may be a hybrid transfer arrangement if it is an arrangement that provides for, or relates to, the transfer of a financial instrument and

- the dual treatment condition is met, or
- a substitute payment could be made.

The I Co shares are a financial instrument, as defined at s259N. The stock loan is, therefore, an arrangement providing for the transfer of a financial instrument.

Dual treatment condition
The dual treatment condition is met if, for tax purposes -

- one person regards the arrangement as equivalent to a transaction for the lending of money at interest, and a payment or quasi-payment made under or in connection with that arrangement is treated accordingly, and
- another person does not treat that payment or quasi-payment as equivalent to a transaction for the lending of money at interest.

On the facts given above, it is not clear that the dual treatment condition is met, so the substitute payment position must be considered.

Substitute payment
A payment or quasi-payment is a substitute payment if

- it consists of or involves an amount being paid or a benefit being given,
- the amount or value of the benefit is representative of a return of any kind arising on, or in connection with, the underlying financial instrument, and
- the amount is paid, or the benefit is given, to a person other than the recipient of the return on the underlying financial instrument.

In this case the stock lending arrangement requires U Co to make a substitute payment to L Co when U Co receives the dividend from I Co. U Co receives a return (the dividend) on the underlying financial instrument (the I Co shares). L Co receives an amount (from U Co) that is representative of that dividend and the payment to L Co is a payment made to a person who did not receive the dividend.

The payment to L Co by U Co in respect of the dividend from I Co is a substitute payment within the definition in s259DB(5).

Condition A is satisfied as a substitute payment could be made (and is, in fact, made) under the terms of the stock lending agreement.

Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?

There are several payments made under or in connection with the stock lending arrangement in relation to which an amount may be deducted from the payer's income. These include –

- payment of the stock lending fee
- payment of the substitute payment.

Condition B is satisfied.

Condition C: Is the payer or a payee within the charge to corporation tax for a relevant payment period?

U Co is within the charge to corporation tax in the UK, and is the payer of the stock lending fee and the substitute payment.

Condition C is satisfied.

Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the payment or quasi-payment?

There is no apparent mismatch in respect of the stock lending fee, so this is not considered further.

U Co is allowed a deduction for the substitute payment in the UK but the receipt of the substitute payment is treated as a non-taxable dividend in country L. This appears to result in a case 1 excess, because the relevant deduction by U Co exceeds the ordinary income brought into account by L Co. However, U Co is a financial trading company so the financial trader exclusion must also be considered.

Financial trader exclusion

Under s259DC(9) any part of excess to which the financial trader exclusion applies is to be disregarded.

The financial trader exclusion applies where conditions A, B and C set out at s259DE are satisfied.

- Condition A is met where one person treats a substitute payment as a return on the underlying instrument for tax purposes, and another person (the financial trader) brings that amount into account in calculating the profits of a trade.
- Condition B is met where the financial trader also brings any associated payments into account as trading income or expenses.
- Condition C is met if there would be no mismatch within Chapter 3 of the hybrids legislation (assuming the return on the underlying instrument arose and was paid direct to the payee), or any non-UK provisions equivalent to Chapter 3, or if the hybrid transfer arrangement is not a structured arrangement.

In this case, L Co treats the substitute payment as a return on the underlying instrument, that is, as a dividend. U Co is a financial trader and brings the substitute payment into account when calculating the profits of that trade. Condition A is met.

U Co also brings the dividend received from I Co into account when calculating trading profits, so condition B is met.

If the dividend payment were made directly from I Co to L Co then the Country L provisions equivalent to Chapter 3 of Part 6A would apply, because the underlying shares are hybrid financial instruments. Consequently condition C of the financial trader exclusion is not met, and the financial trader exclusion does not apply.

Condition D is satisfied.

Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?

U Co and L Co are related. There is no need to consider whether the arrangement is also a structured arrangement.

Condition E is satisfied.

Conclusion

All the conditions are satisfied so there is a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the deduction for the substitute payment.

Counteraction

As the conditions are all satisfied the hybrid transfer deduction/non-inclusion mismatch is counteracted in the UK under s259DF. U Co is denied a deduction for the substitute payment.

Note: Application to structured arrangement
Counteraction under s259DF could also arise if U Co and L Co were not related parties, and if the stock loan were a structured arrangement (including a wider arrangement also involving I Co).

The arrangements here appear to be designed to sidestep counteraction in Country L of a deduction/non-inclusion mismatch that would have arisen if an actual dividend were received by L Co. If it were critical to the success of the arrangements to obtain a deduction/non-inclusion mismatch in relation to the substitute payment, then the arrangement will be a structured arrangement and the conditions for counteraction in the UK will still be met.

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INTM553000: Hybrids: Chapter 5 - Hybrid payer: Contents

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INTM553010: Hybrids: Chapter 5 - Hybrid payer: Overview

Chapter 5 of Part 6A TIOPA 2010 counters deduction/non-inclusion mismatches that it is reasonable to suppose would otherwise arise from payments or quasi-payments because the payer is a hybrid entity, where

- there is an allowable deduction for the payer that exceeds the sum of ordinary income arising to the payee(s) for a permitted taxable period (a deduction/non-inclusion (D/NI) mismatch), and
- all or part of that excess arises because the payer is a hybrid entity.

Hybrid entity

A hybrid entity for the purpose of Chapter 5 of Part 6A TIOPA 10 is defined at s259BE as an entity that is regarded as a person for tax purposes under the law of any territory, and

- any of the income or profits of the entity are treated by any territory wholly or partly as the income or profits of a different person, or
- the entity is not regarded as a separate person for tax purposes under the law of a different territory.

Whether an entity has the relevant characteristics to be treated as a ‘hybrid entity’ is discussed at INTM550580.

Payments and quasi-payments

Payments and quasi-payments are discussed at INTM550540.

Ordinary income

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income, and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed at INTM550560.

There are special recognition rules at s259BD in instances of non-inclusion for treating an amount of income as if it had been included where it has been subjected to another territory’s controlled foreign companies (CFC) charge. This is discussed at INTM550570.

Conditions to be satisfied

Chapter 5 applies where the five conditions (A to E) identified in s259EA TIOPA 2010 are met. These conditions are:

Condition A

- There is a payment or quasi payment under, or **in connection with**, an arrangement (see INTM553030).

Condition B

- The payer is a hybrid entity (see INTM553040).

Condition C

- Either the hybrid payer or a payee is within the charge to UK corporation tax (see INTM553050).

Condition D

- It is reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch if it were not countered by this legislation or equivalent legislation outside the UK (see INTM553060).

Condition E

- There is a quasi-payment and the hybrid payer is also a payee, or
- The hybrid payer and a payee are in the same control group, or
- The arrangement is a structured arrangement (see INTM553070).

The mismatch is the amount of the excess which arises by reason of the hybrid payer being a hybrid entity. It does not matter if the excess arises for reasons other than the hybridity of the payer.

Counteraction

If all 5 conditions are met, the mismatch is countered by either

denying all or part of the deduction for the taxable period in which it is paid up to the amount of the mismatch (where the payer is within the charge to corporation tax) or

if no such restriction has been applied, treating the relevant amount of the mismatch - after deducting any income that is also taxed on the payee’s investor (see INTM553090) - as taxable income of the payee (where the payee is within the charge to corporation tax in the UK).

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INTM553020: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied

The conditions applicable for Chapter 5 of Part 6A TIOPA 2010 are set out at s259EA. For Chapter 5 to apply all of conditions A, B, C, D and E must be met.

INTM553030: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition A

INTM553040: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition B

INTM553050: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition C

INTM553060: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition D

INTM553070: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition E

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INTM553030: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition A

Condition A of s259EA TIOPA 2010 requires there to be a payment or quasi-payment made under, or in connection with, an arrangement.

Definitions of the key terms for this condition are at s259BB.

The phrase 'in connection with' is not defined and takes its ordinary meaning – a link between, relationship with or reference to the arrangement.

A payment is any transfer of money or money's worth in relation to which an allowable deduction would arise in calculating the taxable profits of the payer, if the hybrid and other mismatch rules in Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person from whom the transfer is made. A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if the hybrid and other mismatch rules in Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income arising to one or more persons if certain relevant assumptions to apply.

Relevant assumptions

The relevant assumptions when deciding if the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income are –

- if there is any question of whether an entity is separate from the payer, that is to be determined by the law of the payer jurisdiction (this will address situations where the payee jurisdiction does not recognise the payee as a separate entity)
- any payee or potential payee is assumed to have adopted the same accounting approach to those circumstances as the payer,

- any payee or potential payee is assumed to be resident for tax purposes in the payer jurisdiction, and

- any payee or potential payee is assumed to be carrying on a business in the payer jurisdiction and the circumstances giving rise to the payer’s deduction arise in connection with that business.

There is nothing to prevent an amount satisfying the definitions of being both a payment and a quasi-payment.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

- Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments where the circumstances giving rise to the deduction do not include economic rights, in substance, existing between the payer and the payee(s).

Condition A also requires that the payment or quasi-payment be made under an arrangement. S259NF contains the definition of an arrangement for the purposes of this legislation and it includes any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

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INTM553040: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition B

Condition B of s259EA TIOPA 2010 requires that the payer is a hybrid entity (hybrid payer). S259BE defines a payer as a hybrid entity where the payer is regarded as a distinct and separate person for tax purposes under the law of any territory, but

- the entity's income or profits are treated by any territory wholly or partly as taxable income or profits of a different person, or
- the entity is treated as part of another entity in a territory different to that mentioned in condition A.

For example, a UK company which has elected to be disregarded for US tax purposes under the check the box regime will satisfy condition B.

See INTM550580 for further details on the relevant requirements to satisfy the definition of being a hybrid entity.

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INTM553050: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition C

Condition C of s259EA TIOPA 2010 requires:

- the hybrid payer to be within the charge to UK corporation tax for a relevant payment period, or
- a payee to be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period.

The relevant payment period is the taxable period of the payer in which an amount may be deducted in relation to a payment or quasi-payment.

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INTM553060: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition D

Condition D of s259EA TIOPA 2010 asks whether it is reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a relevant deduction/non-inclusion mismatch (‘hybrid payer deduction/non-inclusion mismatch’) in relation to the payment or quasi-payment.

The test is whether a relevant deduction/non-inclusion mismatch would arise if Chapters 5 to 10 of Part 6A (or any equivalent non-UK legislation) did not apply.

There is no definition of the term “reasonable to suppose” in Part 6A, so the phrase will take its ordinary meaning. Generally this does not require either party to know how the transaction has in fact been treated by the counterparty, but only that, given the facts and circumstances, it would be reasonable to conclude that a mismatch may arise.

See INTM553080 for the requirements for a deduction/non-inclusion mismatch to be a hybrid payer deduction/non-inclusion mismatch.

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INTM553070: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition E

Condition E of s259EA TIOPA 2010 is satisfied where one of the following applies –

- (for a quasi-payment only) - the hybrid payer is also a payee,
- (for a payment or quasi-payment) - the hybrid payer and a payee are in the same control group at any time from when the arrangement is made to the last day of the payment period, or
- (for a payment or quasi-payment) - the arrangement is a structured arrangement.

A hybrid payer is also a payee if an entity is not a distinct and separate person from the payer for the purposes of a tax charged under UK law, but is a distinct and separate person under the law of the payer jurisdiction, and it would be reasonable to expect ordinary income to arise to that entity as defined in section 259BB(7).

For example, a payment made by a partnership to one of the partners has the same payer and payee from a UK perspective.

Control groups

Control groups are defined at s259NB. More detailed guidance on control groups is at INTM550610. A hybrid payer and a payee are in the same control group if:

- they are consolidated for accounting purposes,
- one entity participates directly or indirectly in the management, control or capital of the other,
- a third person(s) participates directly or indirectly in the management, control or capital of each of the entities,
- one entity has a 50% investment in the other, or
- a third person has a 50% investment in each of the entities within a 6 month period.

Structured arrangement

An arrangement is a structured arrangement where it is reasonable to suppose that -

- it is designed to secure a hybrid payee deduction/non-inclusion mismatch, or

- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch regardless of any other objective.

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INTM553080: Hybrids: Chapter 5 - Hybrid payer: Extent of the mismatch

If conditions A to E are met, the next step is to establish the extent of any hybrid payer deduction/non-inclusion mismatch for the purposes of Chapter 5, Part 6A of TIOPA 2010.

S259EB defines a hybrid payer deduction/non-inclusion mismatch in relation to a payment or quasi-payment as a mismatch where

- there is an allowable deduction for the hybrid payer that exceeds the sum of ordinary income arising to the payee(s), and

- all or part of that excess arises because the hybrid payer is a hybrid entity.

The legislation asks whether, if the payer had not been a hybrid entity, would the mismatch between the ordinary income of the payee and the allowable deduction of the payer have been reduced or eliminated? If so, to that extent then it is a hybrid payer deduction/non-inclusion mismatch.

The amount of hybrid payer deduction/non-inclusion mismatch is the amount of the excess that arises because the hybrid payer is a hybrid entity. In determining whether the mismatch arises from hybridity, it does not matter whether the excess arises for some other reason as well, and this is dealt with by a counter-factual test which asks whether the excess could arise when making the following assumptions –

- If the payee was not within the charge to tax because of an exclusion, immunity, exemption or relief, assume that the payee did not benefit from that exclusion, immunity, exemption or relief, and establish whether a mismatch would still have arisen.

  (Examples of such entities are exempted charitable corporations or companies benefitting from sovereign exemption.)

  If, on making the assumptions, the mismatch would no longer arise, then the mismatch arises because of the exemption. If, however, the mismatch still exists, the mismatch arises from the hybridity of the payer.

- If the payment or quasi-payment was not made in connection with a business carried on by the payee in the relevant jurisdiction, then assume it was made in connection with such a business and ask whether a mismatch would still have arisen.

  (For example, some jurisdictions do not tax residents on receipts which arise in connection with a business carried outside that jurisdiction.)

If, on making the assumptions, the mismatch would no longer arise, then the mismatch arises because of the territorial nature of the tax regime of the payee jurisdiction. If, however, the mismatch still exists, the mismatch arises from the hybridity of the payer.

There is no hybrid payer deduction/non-inclusion mismatch where

- there is no excess, or
- there is an excess, but none of it arises because the hybrid payer is a hybrid entity, or
- the relevant deduction is

  (a) a debit in respect of amortisation brought into account under s.729 or 731 CTA 2009 or

  (b) an amount deductible in respect of amortisation under an equivalent law of a territory outside the UK.

  These specific pieces of legislation relate to debits in respect of intangible fixed assets for writing down on accounting basis. But note that the exemption does not extend to impairments.

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INTM553090: Hybrids: Chapter 5 - Hybrid payer: Counteraction

The hybrid payer deduction/non-inclusion mismatch requires either the hybrid payer or the payee to be within the charge to UK corporation tax.

Where the hybrid payer is within the charge to UK corporation tax, section 259EC provides for a counteraction to reduce or eliminate the allowable deduction available to the hybrid payer. This is discussed at INTM553100.

Where it is the payee that is within the charge to UK corporation tax, and no provision equivalent to s259EC exists in the payer's jurisdiction to counteract the deduction available to the payer (or the deduction is not fully counteracted by an equivalent provision), then 259ED provides an alternative counteraction which requires the payee to bring into charge a relevant amount as income. This is discussed at INTM553110.

Any counteraction may be mitigated if, and to the extent that, the payer has dual inclusion income.

Dual inclusion income

For chapter 5 purposes dual inclusion income means an amount that arises in connection with the arrangement mentioned in condition A at 259EA(2), if that income is ordinary income of both

- the hybrid payer for the relevant payment period, and
- an investor in the hybrid payer for a permitted taxable period for the purposes of any tax charged in the investor jurisdiction.

Dual inclusion income does not include:-

- an inclusion for the purposes of a charge imposed under another country's controlled foreign company regime,
- taxable income of another group company even if it involves the same counterparty jurisdictions

The phrase 'in connection with' mirrors that used in condition A in respect of the payment or quasi-payment. It is not defined and takes its ordinary meaning – see INTM553030

An investor is defined at s259BE:-

- If the payer is a hybrid entity because its income or profits are treated as the income or profits of another person, an investor is any person who is treated as having that income, or

- If the payer is a hybrid entity because it is treated as a distinct and separate person in one territory but as part of another person in another territory, then the investor is the person in that other territory.

A permitted taxable period of an investor is a taxable period of that investor which

- begins at any time before the end of 12 months after the end of the accounting period within which the relevant deduction is claimed by the hybrid payer, or

- where the period begins after that –

    i. a claim has been made for the period to be a permitted period in relation to the amount of ordinary income, and

    ii. it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

If there is additional dual inclusion income in a later period any such claim to extend the permitted period should precede or accompany the Corporation Tax return and self-assessment to which it related and be within the normal assessing time limits.

Priority of counteraction

Counteraction to address the hybrid payer deduction/non-inclusion mismatch is considered first in respect of the hybrid payer (the primary counteraction). You should consider the counteraction against the payee(s) (the secondary counteraction) only if the hybrid payer is not within the charge to UK corporation tax.

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INTM553100: Hybrids: Chapter 5 - Hybrid payer: Counteraction: Hybrid payer

The counteraction where the hybrid payer is within the charge to UK corporation tax is set out at s259EC TIOPA 2010.

The counteraction is to deny a deduction for the payment period of the lower of

- the deduction claimed by the hybrid payer in respect of a payment or quasi-payment, and
- the amount of the hybrid payer deduction/non-inclusion mismatch,

unless and to the extent that it is deducted from dual inclusion income (INTM553090), arising in connection with the arrangement mentioned in Condition A of Chapter 5, for the period.

So if the hybrid payer has no dual inclusion income arising in connection with the arrangement, the relevant amount of the deduction is reduced by the amount of the restricted deduction (the hybrid deduction/non-inclusion mismatch).

Any restricted deduction that has been denied is carried forward and may be allowed as a deduction from dual inclusion income of the hybrid payer arising in future accounting periods.

Example
The table below shows the position for each accounting period of a hybrid payer within the charge to tax in the UK.

Accounting period	Relevant Deduction	Mismatch amount	Restricted Deduction	Dual inclusion income (DII)	Restricted deduction after DII	Restricted deduction c/f
31/12/17	300,000	200,000	200,000	Nil	200,000	200,000
31/12/18	350,000	300,000	300,000	60,000	240,000	440,000

The relevant deduction of 350,000 in the accounting period ending 31/12/18 has been met by 50,000 of ordinary income in a payee, and therefore the hybrid payer deduction/non-inclusion mismatch is 300,000. There is 60,000 of dual inclusion income in that period therefore 240,000 of the 300,000 mismatch amount will be restricted. As at 31/12/2018 this hybrid payer has accumulated unused restricted deductions of £440,000 to carry forward and deduct from dual inclusion income arising in later accounting periods.

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INTM553110: Hybrids: Chapter 5 - Hybrid payer: Counteraction: payee

This counteraction applies to a payee within the charge to UK corporation tax, where all or part of the hybrid payer deduction/non-inclusion mismatch is treated as income for the relevant ‘counteraction period’ of that payee.

The counteraction at s259ED applies where it is reasonable to suppose that

- there has been no counteraction against the hybrid payer under non-UK legislation equivalent to s259EC, or
- there has been counteraction against the hybrid payer under non-UK legislation equivalent to s259EC, but it does not fully counteract the mismatch.

Where no overseas provision equivalent to s259EC applies, the amount to be counteracted under s259ED is equal to the excess of the hybrid payer deduction/non-inclusion mismatch over and above the amount of dual inclusion income.

The mismatch is not fully counteracted if, and to the extent that, the hybrid payer has not been denied a deduction equivalent to the amount by which the hybrid payer deduction/non-inclusion mismatch (as quantified by s259EB) exceeds the dual inclusion income (as quantified by s259EC(4)), as outlined in INTM553100.

Where the mismatch has not been fully counteracted by an overseas provision, the amount to be counteracted under Part 6A is the lesser of

- the amount of the mismatch that it is reasonably supposed has not been restricted by the equivalent overseas rules, and
- the amount of the relevant deduction that is deducted from income other than dual inclusion income,

after deducting any dual inclusion income.

If there is more than one payee, the relevant amount and any dual inclusion income is apportioned on a just and reasonable basis, particularly taking into account

- any profit sharing arrangements between some or all of the payees, and
- payees to whom ordinary income would have been expected to arise, but to whom it did not arise.

For the purposes of these rules, the counteraction period is

- the payee's accounting period where that coincides with the payment period, or

- the first accounting period of the payee that is wholly or partly within the payment period.

Similarly, the payment period is the taxable period of the hybrid payer in which an amount may be deducted for the relevant payment or quasi-payment.

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INTM553190: Hybrids: Chapter 5 - Hybrid payer: Examples: Contents

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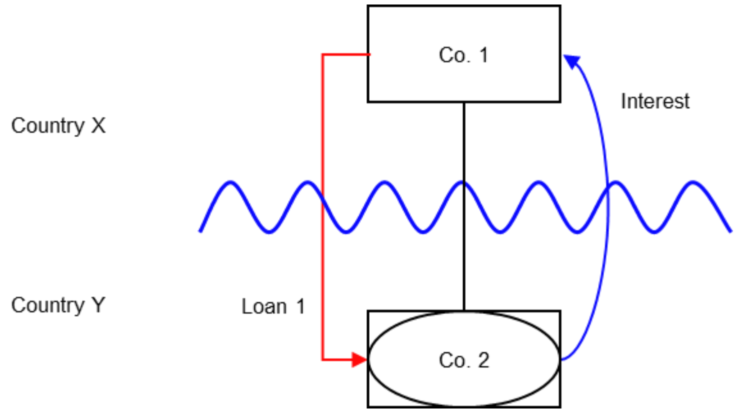
INTM553200: Hybrids: Chapter 5 - Hybrid payer: Example: Restricted deduction for interest payment



Background

- Co. 1 is resident in Country X
- Co. 1 establishes Co. 2, which is resident in Country Y
- Country Y treats Co. 2 as a distinct and separate person for tax purpose
- Country X considers Co. 2 to be a branch of Co.1, not a separate entity
- Co. 2 borrows money from Co. 1 on arm's length terms ('Loan 1')
- Country Y allows Co. 2 a deduction for interest payments made under the loan
- Country X does not tax the interest receipt as it considers the loan is an intra-company transaction.

Analysis - Applying the tests in s259EA TIOPA2010

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

Condition A: Are the payments made under, or in connection with, an arrangement?

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan 1), and the payment is made under that arrangement.

Condition A is satisfied.

Condition B: Is the payer a hybrid entity?

Country Y regards Co. 2 as a person, separate and distinct from Co. 1 under its domestic tax law. Country X treats the income and profits of Co. 2 as the income or profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C can be satisfied only if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y, in this example then condition C cannot be satisfied. It is not necessary to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 (s259K – s259KC) apply.

Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?

Given the information provided, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on Loan 1 (relevant deduction), and

- Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?

Co. 1 and Co. 2 are in the same control group as defined in s259NA. This is sufficient to satisfy Condition E in this example, and you need not go on to consider whether Loan 1 is also a structured arrangement.

In some cases you may want to consider if Loan 1 is a structured arrangement where it is not clear whether any of the control tests are met. In this example, there is insufficient information regarding the terms of the loan to make that determination.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a hybrid payer deduction/non-inclusion mismatch the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the payment of interest by Co. 2 under Loan 1 is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted.

You will also need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income
- You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example, if Co. 2 were not a hybrid entity, a mismatch would not arise. The extent of the mismatch arising by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

Counteraction

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

Primary Response

The primary counteraction is against the hybrid payer.

If the UK is +Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest deductions under Loan 1, per s259EC.

The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods. In this example there is insufficient information to determine whether there is any dual inclusion income.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

Secondary Response

Action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and you conclude that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then you would apply s259ED to treat the entire mismatch as income of the payee.

If you conclude that Country Y has provisions that apply but they do not fully counteract the mismatch then s259ED applies to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

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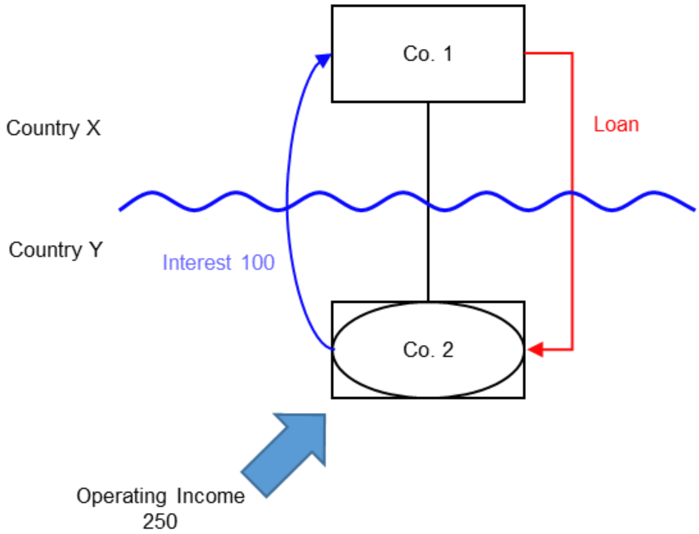
INTM553210: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income - Operating income



Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 2 borrows money from Co.1 to finance its ongoing operations (the ‘Loan’)
- Country Y allows a deduction for the interest payments made by Co. 2
- Country X ignores the receipt to Co.1 as it recognises Co.2 as a branch of Co.1
- Co. 2 also has operating income of 250 in the relevant period, subject to tax at the full marginal rate in Country Y. For the purposes of this example Co. 2 incurs no expenditure in earning this income.

Note: If Co. 2 did incur expenditure in earning this income, as would be expected, that expenditure should be considered under the Hybrid Entity Double Deduction rules in Chapter 9, to determine the extent that it gives rise to a hybrid entity double deduction amount.

This operating income of 250 is also recognised by Co. 1 and subject to tax at the full marginal rate in Country X

During the relevant period Co. 2 recognises interest expense of 100 arising on the Loan.

Analysis - Applying the tests in s259EA TIOPA 2010

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

Condition A: Are the payments made under, or in connection with, an arrangement?

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan 1), and the payment is made under that arrangement.

Condition A is satisfied.

Condition B: Is the payer a hybrid entity?

Country Y regards Co. 2 as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as a branch of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from its income for the interest paid on the Loan (relevant deduction), and

- Co. 1 will not include the interest received from Co. 2 in its ordinary income

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?

Co. 1 and Co. 2 are in the same control group as defined at s259NA. That is enough to satisfy Condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example there is insufficient information regarding the terms of the loan to make that determination.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payer deduction/non-inclusion mismatch' the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the payment of interest by Co. 2 under the Loan is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted in the UK.

You will also need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by -

- the amount of Co. 2's deduction from income for the interest paid, less

- the amount of that interest payment that Co. 1 includes in its ordinary income.

You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

Primary response

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the Loan, per s259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Is there dual inclusion income?

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and
- was ordinary income of Co. 1 for the purposes of any tax under the law of Country X.

Although the definition of arrangement is wide, it does not include all transactions simply because they fall within the same payment period. In this example Co. 2's operating income is not part of the loan arrangements between Co. 2 and Co. 1: it arises from Co. 2's ordinary business activities. It is not dual inclusion income as defined in the legislation.

Therefore, although Co. 2's operating income is included in the income of Co. 1 and Co. 2 for tax purposes, and so would be ordinary income of both, it does not qualify as dual inclusion income in respect of this loan arrangement.

In this example there is no relevant dual inclusion income for the period, so all of Co. 2's interest deduction of 100 is a restricted deduction, and no relief is due.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

Secondary response

The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and it is reasonable to suppose that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then s259ED should be applied to treat the entire mismatch as income of the payee, Co. 1.

If it is reasonable to suppose that Country Y has provisions that apply, but they do not fully counteract the mismatch, then you apply s259ED to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, the amount of the mismatch is 100 and the dual inclusion income is 0, so 100 will be treated as income of Co. 1.

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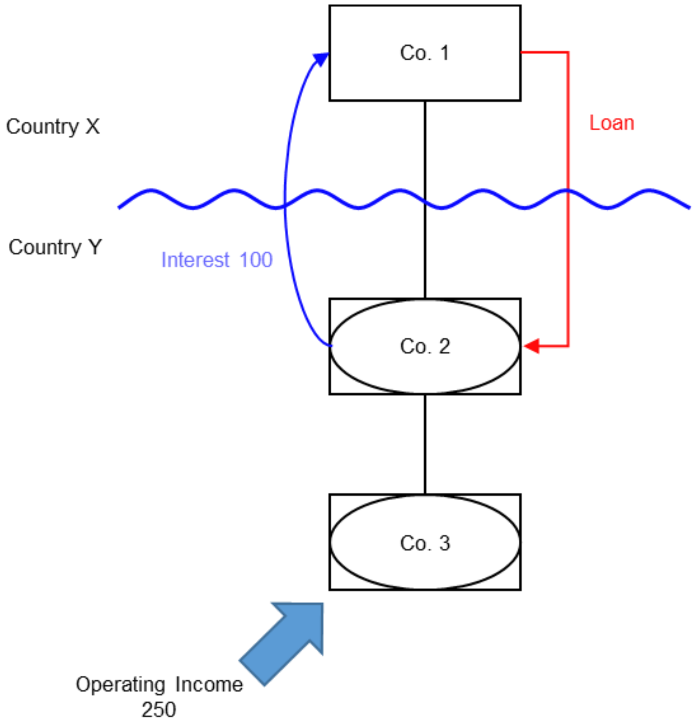
INTM553220: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income – Debt to fund acquisition of company with operating income



Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 2 borrows money from Co.1 (the 'Loan') to acquire the entire shareholding in Co. 3 from a 3rd party
- Co. 3 is also resident in Country Y
- Co. 3 is treated as a distinct and separate person for tax purposes in Country Y

- Co. 3 is a disregarded entity for tax purposes under the law of Country X
- Co. 2 has no operating income during the relevant period
- Co. 3 has operating income of 250 in the relevant period, which is subject to tax at the full marginal rate in Country Y
- Co. 2 receives regular distributions from Co. 3, but these are not subject to tax under the domestic legislation of either Country X or Country Y
- Country Y allows a deduction for the interest payments made by Co. 2.
- Country X ignores the receipt to Co.1 as it sees Co.2 as a branch of Co.1
- Country X recognises Co. 3’s operating income of 250 as income of Co. 1, which is subject to tax at the full marginal rate in Country X

During the relevant period Co. 2 recognises interest expenses of 100 arising from the Loan.

Analysis - Applying the tests in s259EA TIOPA 2010

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

Condition A: Are the payments made under, or in connection with, an arrangement?

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (the Loan), and the payment is made under that arrangement.

Note that the purpose of the Loan – to acquire Co.3 – is not part of the arrangement. Co. 2’s acquisition of Co. 3, together with the stream of operating income from Co. 3 is not part of the Loan arrangement.

Condition A is satisfied in respect of the Loan.

Condition B: Is the payer a hybrid entity?

Country Y regards Co. 2 (the payer) as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as an extension of Co. 1, and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to corporation tax in the UK, so in this example Condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then Condition C cannot be satisfied for the Loan. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on the Loan (relevant deduction), and

- Co. 1 will not include the interest received from Co. 2 in its ordinary income

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?

Co. 1 and Co. 2 are in the same control group as defined at s259NA. That is enough to satisfy Condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the Loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example there is insufficient information regarding the terms of the Loan to make that determination.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid payer deduction/non-inclusion mismatch’ the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the deduction of interest by Co. 2 under the Loan is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted in the UK.

You will need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by -

- the amount of Co. 2’s deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income

You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

Primary response

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the Loan, per s259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Is there dual inclusion income?

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income -

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and
- was ordinary income of Co. 1 for the purposes of any tax under the law of Country X

The facts of this example are that the operating income of Co. 3 does not arise from the Loan, and that consequently the operating income of Co. 3 is not dual inclusion income. In any case, the operating income is income of Co. 3 and not Co. 2 and would not meet the requirements for dual inclusion income.

In this example, therefore, there is no relevant dual inclusion income for the period, and so all of Co. 2's interest deduction of 100 in respect of the Loan is a restricted deduction.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

Secondary response

The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and it is reasonable to suppose that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then you apply s259ED to treat the entire mismatch as income of the payee, Co. 1.

If it is reasonable to suppose that Country Y has provisions that apply, but that they do not fully counteract the mismatch, then you apply s259ED to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, the amount of the mismatch is 100 and the dual inclusion income is 0, so 100 will be treated as income of Co. 1.

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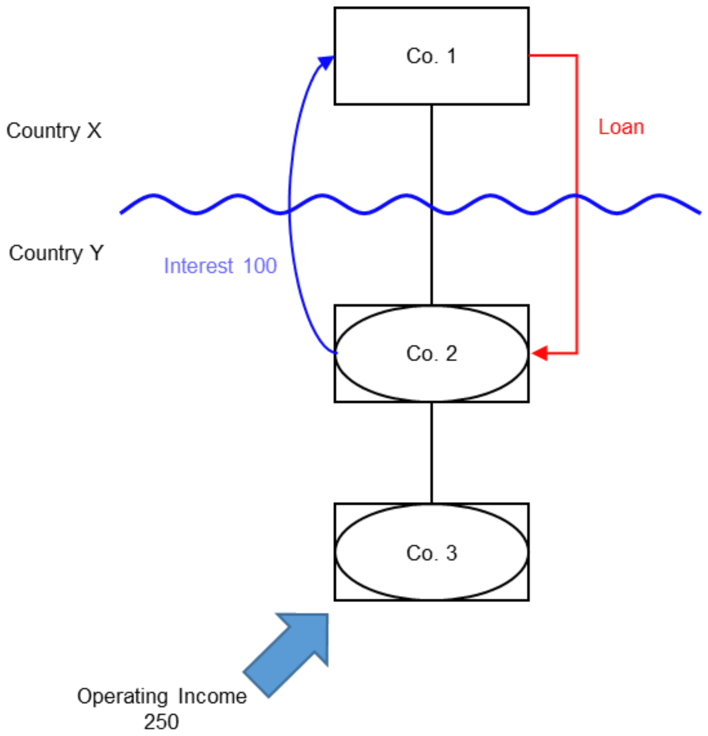
INTM553230: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income - Operating income in subsidiary of disregarded entity



Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 3 is also resident in Country Y
- Co. 2 owns the entire shareholding of Co. 3

- Co. 3 is also treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 3 is also a disregarded entity for tax purposes under the law of Country X
- Co. 2 borrows money from Co. 1 to finance its ongoing operations in Country Y (the ‘Loan’)
- Country Y allows a deduction for the interest payments made by Co. 2
- Country X ignores the interest receipt to Co. 1 as it regards Co. 2 as a branch of Co. 1.
- Co. 2 has no operating income during the relevant period but recognises interest expenses of 100 arising on the Loan
- Co. 3 has operating income of 250 in the relevant period, subject to tax at the full marginal rate in Country Y. For the purposes of this example Co. 3 incurs no expenditure in earning this income
- This operating income of 250 is also recognised by Co. 1 and subject to tax at the full marginal rate in Country X
- Co. 2 receives regular distributions from Co. 3, but these are not subject to tax under the domestic legislation of either Country X or Country Y

Analysis - Applying the tests in s259EA TIOPA 2010

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

Condition A: Are the payments made under, or in connection with, an arrangement?

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan), and the payment is made under that arrangement.

Condition A is satisfied.

Condition B: Is the payer a hybrid entity?

Co. 2 is the payer.

Country Y regards Co. 2 as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as a branch of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to corporation tax in the UK. In this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on the Loan (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?

Co. 1 and Co. 2 are in the same control group as defined at s259NA. That is sufficient to satisfy condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the Loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example, there is insufficient information regarding the terms of the loan to make that determination.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid payer deduction/non-inclusion mismatch’ the relevant counteractions need to be considered.

Amount of the mismatch

You will also need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2’s deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income
- You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

Primary response

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the loan, per S259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Is there dual inclusion income?

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income -

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and

- was also ordinary income of Co. 1 for the purposes of any tax under the law of Country X.

Although the definition of arrangement is drawn widely, it does not include all transactions simply because they fall within the same payment period. In this example Co. 3's operating revenue is not part of the loan arrangements between Co. 2 and Co. 1; it arises from Co. 3's ordinary business activities. It is not dual inclusion income as defined in the legislation.

Additionally, although the operating income is included as ordinary income of Co. 1, Co. 3 is the other party including it as ordinary income, rather than Co 2.

In this example there is no relevant dual inclusion income for the period, so all of Co. 2's interest deduction of 100 is a restricted deduction, and no relief is due.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

Secondary response

The secondary counteraction is applied to the payee.

In the UK, action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and it is reasonable to suppose that Country Y has no provisions that apply to the hybrid payer to counteract the mismatch, then s259ED applies to treat the entire mismatch as the income of the payee, Co. 1.

If it is reasonable to suppose that Country Y has provisions that apply but that they do not fully counteract the mismatch, s259ED applies to treat the part of the mismatch that has not been counteracted as the income of the payee (to ensure that the hybrid payer deduction/non-inclusion mismatch is fully counteracted).

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, there is no dual inclusion income and the amount of the mismatch is 100, to be treated as the income of Co. 1.

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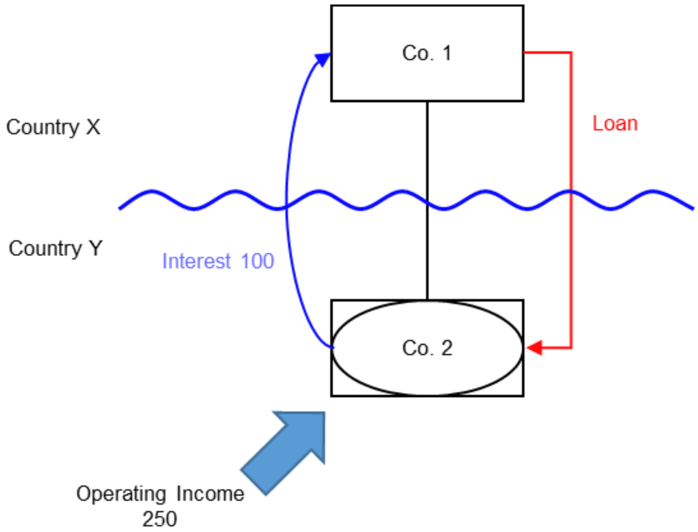
INTM553240: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income – Debt to fund 3rd party acquisition of business with operating income



Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding in Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes in Country Y
- Co. 2 is a disregarded entity for tax purposes in Country X
- Co. 2 borrows money from Co.1 (the 'Loan') to acquire a business from a 3rd party
- Country Y allows a deduction for the interest payments made by Co. 2
- Country X ignores the receipt to Co.1 as it recognises Co.2 as a branch of Co.1 for tax purposes
- Co. 2 has operating income of 250 during the relevant period only from the new business it used the funds to acquire
- The operating income of 250 is subject to tax at the full marginal rate in Country Y

- Co. 2 incurs no expenditure in earning this income.

Note: If Co. 2 did incur expenditure in earning this income, as would be expected, that expenditure should be considered under the hybrid entity double deduction rules to determine the extent that it gives rise to a hybrid entity double deduction amount.

This operating income of 250 is also recognised by Co. 1 and subject to tax at the full marginal rate in Country X.

Analysis - Applying the tests in s259EA TIOPA 2010

Do the interest deductions satisfy the relevant conditions for each payment period to fall within the scope of the hybrid payer deduction/non-inclusion mismatches rules?

Condition A: Are the payments made under, or in connection with, an arrangement?

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (the Loan), and the payment is made under that arrangement.

Note that the purpose of the Loan – to acquire a business – is not part of the same arrangement. Co. 2's acquisition of the business together with its operation to return a stream of operating income, is not part of the Loan arrangement but is derived from the carrying on an unrelated business. The Loan allowed Co. 2 to benefit from that opportunity, but was not determinate in the generation of those funds.

This should be contrasted with the example at INTM553250 (Dual inclusion income – Debt passed down to subsidiary) where the loan was determinate in providing that future income stream without material further action.

Condition A is satisfied in respect of the Loan.

Condition B: Is the payer a hybrid entity?

Country Y regards Co. 2 (the payer) as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as an extension of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE TIOPA 2010, so Condition B is satisfied.

Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to corporation tax in the UK, so in this example Condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then Condition C cannot be satisfied for the Loan. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

Co. 2 will deduct an amount from income for the interest paid on the Loan (relevant deduction), and

Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?

Co. 1 and Co. 2 are in the same control group as defined at s259NA TIOPA 2010. That is enough to satisfy Condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the Loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example there is insufficient information regarding the terms of the Loan to make that determination.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid payer deduction/non-inclusion mismatch’ the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the deduction of interest by Co. 2 under the Loan is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted in the UK.

You will need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income.

You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

Primary response

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the Loan, per s259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Is there dual inclusion income?

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and
- was ordinary income of Co. 1 for the purposes of any tax under the law of Country X.

Although the definition of arrangement is wide, it is unlikely to include the operating income from the business acquired. That income arose not in connection with the Loan (the arrangement), but in connection with the business activities undertaken. Consequently the operating income arising from the business acquired is not dual inclusion income.

In this example there is no relevant dual inclusion income for the period, so all of Co. 2's interest deduction of 100 in respect of the Loan is a restricted deduction, and no relief is due.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

Secondary response

The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction -

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and you conclude that it is reasonable to suppose that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then you apply s259ED to treat the entire mismatch as income of the payee, Co. 1.

If you conclude that it is reasonable to suppose that Country Y has provisions that apply but that they do not fully counteract the mismatch, then you apply s259ED to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, the amount of the mismatch is 100 and the dual inclusion income is 0, so 100 will be treated as income of Co. 1.

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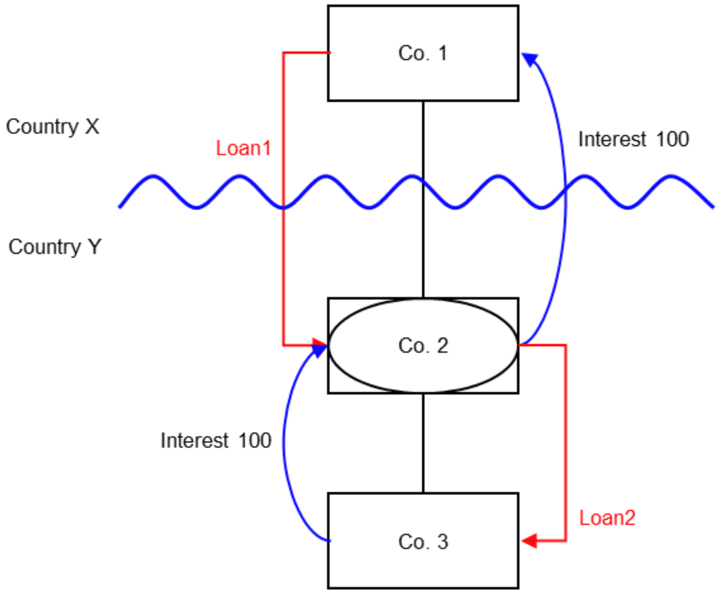
INTM553250: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income – Debt passed down to subsidiary



Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 3 is also resident in Country Y
- Co. 2 owns the entire issued shareholding of Co. 3
- Co. 3 is treated as a separate person for tax purposes under the law of both Country Y and Country X
- Co. 2 borrows money from Co.1 (Loan 1)

- Co. 2 is acting as a group treasury company and, as intended, this debt is passed down to Co. 3 at the same interest rate (Loan 2) to finance its ongoing operations

- Country Y allows a deduction for the interest payments made by Co. 3 under Loan 2

- Country Y allows a deduction for the interest payments made by Co. 2 under Loan 1

- Country Y subjects to tax the interest receipt to Co. 2 under Loan 2 at the full marginal rate

- Country X ignores the interest receipt to Co.1 under Loan 1 as it sees Co.2 as a branch of Co.1

- Country X subjects to tax the interest receipt from Loan 2 at the full marginal rate in Country X

Analysis - Applying the tests in s259EA TIOPA 2010

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

Condition A: Are the payments made under, or in connection with, an arrangement?

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan 1), and the payment is made under that arrangement.

The arrangement seems to encompass both Loan 1 and Loan 2, as the background suggests a dependency such that in the absence of Loan 2 then Loan 1 would not have occurred. However, the relevant payment here is that under Loan 1, with the payment under Loan 2 to be considered separately.

Condition A is satisfied in respect of Loan 1.

Loan 2 may itself also be tested to see if it also satisfies the conditions as a separate arrangement. For Loan 2 interest is paid by Co. 3 (the payer) to Co. 2 (the payee), assuming that a realistic view of the background does not suggest that Co. 1 is the true payee.

Condition A is satisfied in respect of Loan 2.

Condition B: Is the payer a hybrid entity?

For Loan 1 Country Y regards Co. 2 (the payer) as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as an extension of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

For Loan 2 Country Y regards Co. 3 (the payer) as a person, separate and distinct from Co. 2. No other jurisdiction is involved.

Co. 3 does not meet the conditions to be a hybrid entity, so Condition B is not satisfied for Loan 2. There is no need to consider conditions C to E in respect of Loan 2.

Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied for Loan 1. There would be no need to consider the remaining conditions.

Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on Loan 1 (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?

Co. 1 and Co. 2 are in the same control group as defined at s259NA TIOPA 2010. That is enough to satisfy Condition E in this example, and you need not go on to consider whether Loan 1 is a structured arrangement.

In some cases you may want to consider if Loan 1 is a structured arrangement where one of the other tests in Condition E is not obviously met. In this example there is insufficient information regarding the terms of the loan to make that determination.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payer deduction/non-inclusion mismatch' the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the deduction of interest by Co. 2 under Loan 1 is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted.

You will need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income
- You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

Primary response

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under Loan 1, per 259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Is there dual inclusion income?

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and
- was also ordinary income of Co. 1 for the purposes of any tax under the law of Country X.

The facts of this example suggest that Loan 1 and Loan 2 are co-dependent and therefore form part of the same arrangement mentioned in Condition A above. As the ordinary income from Loan 2 is included by both Co. 1 and Co. 2 then this satisfies the definition of dual inclusion income.

As the interest receipt on Loan 2 equals the interest deduction on Loan 1, then Co. 2 will be permitted to retain the deduction to offset against that dual inclusion income. There will therefore be no counteraction.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

Secondary response

The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, the dual inclusion income established above offsets the hybrid payer deduction/non-inclusion mismatch completely and therefore there is no counteraction.

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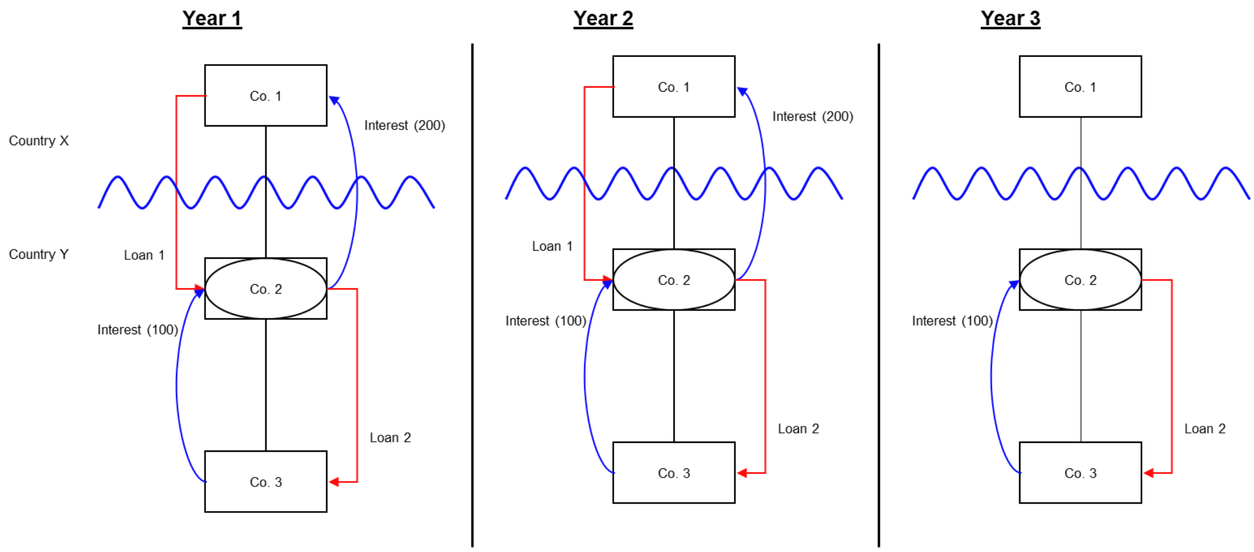
INTM553260: Hybrids: Chapter 5 - Hybrid payer: Example: Restricted deduction carried forward



Background

This continues from the example at INTM553250. All the relevant conditions are satisfied to characterise the deductions claimed under Loan1 as ‘hybrid payer deduction/non-inclusion mismatches’ for each payment period, and the income from Loan2 satisfies the requirements to be considered dual inclusion.

Year 1:

- Co.1 and Co.2 have corresponding payment periods
- the interest payment of 200 under Loan 1 is the restricted deduction
- interest of 100 payable under Loan 2 and is included in the ordinary income of both Co.1 and Co.2.

Year 2:

- the mismatch arising under Loan 1 in Year 2 remains at 200
- 100 is payable under Loan 2 is included in the ordinary income of both Co.1 and Co.2.

Year 3:

- Loan 1 has ceased and there is no longer any mismatch

- 100 is payable under Loan 2 and is included in the ordinary income of both Co.1 and Co.2.

YEAR 1

Loan 1:

- 200 paid by Co.2 is a relevant deduction
- The mismatch amount is the excess of the relevant deduction (200) over the amount taxable as income by Co.1 (nil)
- The mismatch is 200.

Loan 2:

- 100 is payable by Co.2
- The receipt of 100 is included as taxable income by both Co.1 and Co.2 and therefore satisfies the definition of dual inclusion income.

Restricted deduction for Co.2 is 200 as this is the relevant deduction (200) capped at the level of the mismatch (also 200). As there is dual inclusion income of 100 we can allow 100 of the restricted deduction against the 100 dual inclusion income.

The restricted deduction carried forward to subsequent period becomes 100 and may be utilised against any future dual inclusion income.

Relevant Deduction	Mismatch amount	Restricted Deduction	Dual inclusion income	Restricted deduction c/f
200	200	200	100	100

YEAR 2

- Nothing changes in year 2 in respect of Co.2
- The restricted deduction brought forward is 100
- The dual inclusion income remains at 100
- The relevant deduction remains at 200
- The mismatch amount also remains at 200.

The restricted deduction of 200 is utilised against the dual inclusion income of 100 so that the restricted deduction carried forward is again 100 and is added to the restricted deduction brought forward from previous payment period.

The total restricted deduction carried forward becomes 200 and may be utilised against any future dual inclusion income.

Relevant Deduction	Restricted deduction b/f	Mismatch amount	Restricted Deduction	Dual inclusion income	Restricted deduction c/f
200	100	200	200	100	200

YEAR 3

- Loan 1 has ceased so there is no longer a hybrid payer/non-inclusion mismatch
- 100 payable under Loan 2 continues to satisfy the definition of dual income for Co.2.

Co.2 can utilise 100 of the 200 restricted deduction brought forward against that dual inclusion income.

The remaining 100 would continue to be carried forward to subsequent periods of the hybrid payer and may be utilised against any future dual inclusion income.

Relevant Deduction	Restricted deduction b/f	Mismatch amount	Restricted Deduction	Dual inclusion income	Restricted deduction c/f
nil	200	Nil	Nil	100	100

If Loan 2 ceases in Year 4, so that there is no future dual inclusion income, then the 100 restricted deduction brought forward will no longer be relievable. As the corresponding receipt to Loan 1 will remain non-included, this does not create a double taxation issue, and is line with the underlying principles of the rule.

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INTM554000: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Contents

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INTM554010: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Overview

Chapter 6 of Part 6A TIOPA 2010 deals with mismatches within a multinational company. The legislation counteracts mismatches involving transfers of money or money's worth from a UK permanent establishment of a company to the company in the parent jurisdiction (that is, the head office of that company).

The Chapter applies if conditions A to C are met. The conditions are as follows:

Condition A

- There is a multinational company (see INTM554030).

Condition B

- There is a relevant permanent establishment deduction (see INTM554040).

Condition C

- If this legislation or equivalent non-UK provisions did not apply, the circumstances giving rise to the PE deduction would not result in increased taxable profits or reduced losses (see INTM554050).

Permanent Establishment

"Permanent establishment" is defined for the purpose of Part 6A at s259BF as

- a permanent establishment within the corporation tax acts, or
- any similar concept under the law of another territory.

Detailed guidance on the definition of permanent establishments within the UK is provided at INTM264050. In broad terms, under UK domestic law, a non-resident company has a permanent establishment in the UK if the company

- carries on a business wholly or partly through a fixed place of business in the UK, or
- appoints an agent in the UK to act on its behalf and that agent habitually exercises authority to do business on behalf of the company.

An example of a transfer by a UK permanent establishment (PE) of a multinational company could be where intellectual property owned by a multinational company is exploited by its PE in the UK, and for which it is deemed appropriate that ownership of that asset is attributable solely to the company in the parent jurisdiction and that a fee should be recognised as payable to the parent jurisdiction for that use. This situation will only arise if there is a double taxation agreement in place which contains the new Article 7 (see INTM267100).

When tax treaties contain the old Article 7, internal royalties are not recognised. If there is no treaty in place, UK domestic law applies in the same way as the old Article 7, and s31 CTA 2009 denies a deduction for royalties paid by the permanent establishment to another part of the same company.

If all 3 conditions are met then, to the extent of the mismatch (see INTM554060), it is to be counteracted by denying all or part of the permanent establishment ("PE") deduction in the UK (see INTM554070).

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INTM554020: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied

The conditions applicable for Chapter 6 of Part 6A TIOPA 2010 are set out at s259FA. For Chapter 6 to apply each of conditions A, B and C must be met.

[INTM554030: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Condition A]

[INTM554040: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Condition B]

[INTM554050: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Condition C]

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INTM554030: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition A

Condition A of s259FA TIOPA 2010 requires a company to be a multinational company.

A multinational company is defined by s259FA as a company that is

- resident for tax purposes in a territory outside the UK (the parent jurisdiction), and
- within the charge to corporation tax in the UK because it carries on a business in the UK through a permanent establishment.

Company is not defined in the legislation, so takes its normal meaning under UK law.

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INTM554040: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition B

Condition B of s259FA TIOPA 2010 requires there to be a PE deduction.

A PE deduction is defined as an amount that –

- may (in substance) be deducted from income in calculating the profits of the company that are chargeable to corporation tax in the UK, and

- is in respect of a transfer of money or money's worth to the company in the parent jurisdiction - that transfer must either be made, or be (in substance) treated as made, for the purposes of UK corporation tax.

For the purposes of s259FA, "the PE deduction" does not include 259FA(4A):

(a) a debit in respect of amortisation brought into account under s.729 or 731 CTA 2009 or

(b) an amount deductible in respect of amortisation under an equivalent law of a territory outside the UK.

Note that this exemption is restricted to amortisation and does not extend to impairment.

Some allocations of an amount between parties do not reflect a transfer from the PE to the parent jurisdiction. An example of this is a head office recharge. Some of the expenditure incurred by the company will be attributable to the PE. The simple attribution of this expenditure to the PE does not represent a deduction in the PE that is in respect of a transfer of money or money's worth to the parent jurisdiction. In substance, the counterparty to the deduction attributed to the PE is the provider of the goods or services that gave rise to the original expense.

If, however, the head office recharge includes an element representing value provided by the head office to the PE, then this element may be caught. An example would be where it is appropriate to reward the head office for negotiating bulk discounts by coordinating all the acquisitions of the group. In substance, the counterparty to this transaction resulting in the deduction would be the head office.

However, if a PE is permitted a deduction for an item of expenditure attributed to it, but the head office is also able to claim a deduction for the same amount, then the rules within Chapter 10 (Dual Territory Double Deduction Cases) may be at point, as it may constitute a double deduction mismatch within the scope of that Chapter.

A capital attribution tax adjustment (CATA) may represent a transfer of money's worth from the UK company to the company in the parent jurisdiction that – 259FA(4)(b)(ii) is (in substance) treated as being made for CT purposes.

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INTM554050: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition C

Condition C of s259FA TIOPA 2010 is satisfied if, disregarding the provisions of Chapters 6 to 10 of Part 6A, it is reasonable to suppose that those circumstances do not result in either (1)

- an increase in taxable profits of the company for any permitted taxable period, or

- a reduction of a loss made by the company for any permitted taxable period,

  for the purposes of tax charged in the parent jurisdiction, or

- the circumstances result in an increase in profits or a reduction of a loss for one or more permitted taxable periods, but the aggregate effect on taxable profits is less than the PE deduction.

The aggregate effect on taxable profits is the sum of

- any increases in taxable profits of the company for the purposes of the parent jurisdiction which are related to the PE deduction and

- the amount of any reduction of a loss made by the company.

For the purposes of 259FA (6) Condition C and 259FA(7) any increase in taxable profits or reduction in losses is to be ignored in any case where tax is charged at a nil rate under the law of the parent jurisdiction – effective from 1 January 2018.

When calculating the aggregate effect on taxable profits, you should take into account only the figures for a permitted taxable period that are in relation to a tax charged in the parent jurisdiction.

The aim is to establish whether the company has reflected a corresponding taxable receipt equal to the amount of the deduction claimed.

A permitted taxable period is a taxable period of the company for the purposes of a tax charged under the law of the parent jurisdiction, that

- begins before the end of 12 months after the end of the accounting period in which the PE deduction falls for the purposes of corporation tax in the UK, or

- where the period begins after that –

i. a claim has been made for the period to be a permitted period in relation to the amount of ordinary income, and

ii. it is just and reasonable for the circumstances giving rise to the PE deduction to affect the profits or loss made for that period rather than an earlier period.

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INTM554060: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Extent of the mismatch

If all of conditions A to C of s259FA are satisfied, the next step is to establish the extent of any excessive PE deduction for the purposes of Chapter 6.

The calculation of the excessive PE deduction will depend on the outcome of Condition C.

If it is reasonable to suppose that there was no increase in taxable profits nor reduction of losses, the excessive PE deduction is the amount of the PE deduction claimed.

If it is reasonable to suppose that there was an increase in taxable profits or a reduction of losses, but that this was less than the PE deduction claimed, then the excessive PE deduction is the PE deduction claimed, less the aggregate effect on taxable profits.

For the purposes of 259FA the PE deduction does not include

(a) a debit in respect of amortisation brought into account under s.729 or 731 CTA 2009 (writing down the capitalised cost of an intangible fixed asset), or

(b) an amount that is deductible in respect of amortisation under an equivalent law of a territory outside the UK.

Note that this exemption is restricted to amortisation and does not extend to impairment.

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INTM554070: Hybrids: Chapter 6 - Transfers by UK permanent establishments of multinational companies: Counteraction

Action to counter the excessive permanent establishment (PE) deduction is set out at s259FB. There is only one counteraction and it applies where the PE is in the UK. The excessive PE deduction may not be deducted from the company's income for the relevant PE period, unless it is deducted from dual inclusion income of the company.

Dual inclusion income is the amount arising during an accounting period that is ordinary income (see INTM550560) of the company for both

- that accounting period for UK corporation tax, and
- a permitted taxable period for the purposes of any tax charged under the law of the parent jurisdiction.

The dual inclusion income does not have to be connected to the circumstances giving rise to the deduction, but includes all income that is included in both jurisdictions.

To the extent that the company has dual inclusion income in the accounting period, all or part of the excessive PE deduction may be deducted from that income.

Any proportion of the excessive PE deduction that has been denied is carried forward and may be allowed as a deduction from any dual inclusion income of the company arising in future accounting periods.

The company may not benefit from an exclusion such as branch (PE) exemption. Where profits attributed to the PE are taxed in the parent jurisdiction, then the parent jurisdiction may therefore not recognise any dealings between the head office and the PE. In this case, such dealings may fall within the scope of Chapter 6.

Where the PE is profitable it is unlikely that there will be a counteraction as the relevant dual inclusion income should exceed the PE deduction. However, if either the PE is loss-making, or the deduction exceeds the dual inclusion income (for example, if some of the income of the PE is not taxable in the parent jurisdiction), then the excess deduction will be denied to the UK PE.

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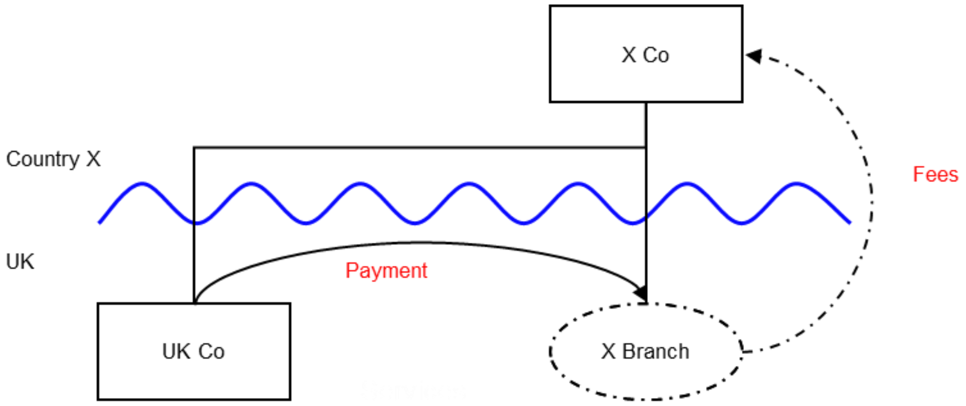
INTM554080: Hybrids: Chapter 6 - Transfers by UK permanent establishments of multinational companies: Example



Background

- X Co is a non-UK resident company resident in Country X
- X Co has a UK permanent establishment, X Branch
- UK Co is a UK resident company that is entirely owned by X Co
- The profits of X Branch are taxable in the UK only, as Country X's domestic legislation has an exemption for foreign branches
- UK Co pays fees to X Branch, which are brought into account as income of X Branch in the UK
- The accounts for X Branch show a deduction for the transfer of money or money's worth to X Co
- That transfer to X Co is not brought into account when calculating the profits of X Co under its domestic tax regime.

Analysis - Applying the tests in s259FA TIOPA 2010

Does the deemed payment by X Branch to X Co satisfy the relevant conditions to fall within the scope of Chapter 6?

Condition A: Is the company a multinational company?

X Co is a company resident for tax purposes in a territory outside the UK, Country X. X Co carries on a business in the UK through a permanent establishment, X Branch, and is within the charge to corporation tax in the UK on the profits attributable to X Branch.

Condition A is satisfied in respect of X Co.

Condition B: Is there a PE deduction?

X Branch either makes a transfer of money or money's worth to X Co, or is treated as doing so as it is in recognition of that transfer for which the deduction is permitted. X Branch may deduct that amount from its income when calculating its profits chargeable to corporation tax in the UK.

Condition B is satisfied.

Condition C: Is it reasonable to suppose that the circumstances giving rise to the PE deduction is not matched by an increase in taxable profits?

In this example it is reasonable to suppose that the circumstances giving rise to the PE deduction for X Branch in the UK do not result in any increase in the taxable income of X Co in Country X. This is because Country X's legislation exempts income from foreign branches.

Condition C is satisfied.

Conclusion

As all the relevant conditions are satisfied the PE deduction is subject to a counteraction under Chapter 6.

Counteraction

There is no recognition of the transfer when calculating the profits of X Co. Therefore, the extent of the mismatch (termed the excessive PE deduction) is the entire amount of the PE deduction of X Branch.

The excessive PE deduction may be deducted only from dual inclusion income of X Co. In this example X Co does not have any dual inclusion income, so X Branch cannot deduct any of the excessive PE deduction. The unused deduction is carried forward to subsequent accounting periods, and may be used against dual inclusion income of those periods.

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INTM555000: Hybrids: Chapter 7 - Hybrid Payee: Contents

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INTM555010: Hybrids: Chapter 7 - Hybrid Payee: Overview

Chapter 7 of Part 6A TIOPA 2010 counters mismatches involving payments or quasi-payments (INTM550540) to a hybrid entity where it is reasonable to suppose the mismatch arises because the entity is a hybrid entity (INTM550580).

For the Chapter to apply, five conditions, Conditions A to E must be met.

Condition A

There is a payment or quasi-payment made under, or in connection with, an arrangement (see INTM555030).

Condition B

The payee is a hybrid entity (see INTM555040).

Condition C

- Either the payer, or
- an investor in a hybrid payee, is within the charge to UK corporation tax, or
- the hybrid payee is a limited liability partnership (see INTM555050)

Condition D

It is reasonable to suppose that there would be a mismatch arising by reason of a payee being a hybrid entity, if it were not countered by the hybrid mismatch legislation or equivalent legislation outside the UK (see INTM555060).

Condition E

- It is a quasi-payment and the payer is also a hybrid payee,
- The payer and a hybrid payee are within the same control group, or
- The arrangement is a structured arrangement (see INTM555070).

If all of these conditions are met, then there is a hybrid payee D/NI mismatch if a payment or quasi-payment gives rise to a deduction which exceeds the ordinary income arising to the payee(s) for a permitted taxable period, to the extent that the excess is due to the payee(s) being hybrid entities.

The hybrid mismatch rules do not generally seek to neutralise temporary tax mismatches and so the permitted period for inclusion in ordinary income is any period that begins before the end of 12 months after the end of the taxable period in which the payment was deducted, or such longer time as (on a claim) is just and reasonable.

Where there is a hybrid payee that

- is resident in a territory for the purposes of a tax charged at a higher rate than nil, or
- has a permanent establishment that is not charged to tax on its ordinary income, and
- the payment or quasi-payment does not give rise to any CFC charge,

a 'relevant amount' of the excess is treated as arising because of hybridity (see INTM555090).

Counteraction

If all 5 conditions are met, then the hybrid payee D/NI mismatch is countered as follows –

- where the payer is within charge to corporation tax, deny a deduction for the amount of the mismatch (see INTM555110), or
- where an investor in the hybrid payee is within the charge to corporation tax, and it is reasonable to suppose that there has been no other sufficient counteraction within the Chapter, treat the relevant amount as taxable income of the investor (see INTM555120), apportioning the income between investors if required, or
- where the hybrid payee is an LLP within the charge to corporation tax, and there has been no other sufficient counteraction within the Chapter, treat the relevant amount as taxable income arising to the LLP (see INTM555130).

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INTM555020: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied

The conditions applicable for Chapter 7 of Part 6A TIOPA 2010 are set out at s259GA. For Chapter 7 to apply each of conditions A, B, C, D and E must be met.

INTM555030: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition A

INTM555040: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition B

INTM555050: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition C

INTM555060: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition D

INTM555070: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition E

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INTM555030: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition A

Condition A of s259GA, TIOPA 2010 requires there to be a payment or quasi-payment made under, or in connection with, an arrangement. Definitions of the key terms for this condition are at s259BB.

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person who makes the transfer. The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and

- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply.

See INTM550540 for more detail on quasi-payments.

There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment.

Condition A also requires that the payment or quasi-payment be made under an arrangement. S259NF sets out the definition of an arrangement for the purposes of this legislation to include any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

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INTM555040: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition B

Condition B of s259GA TIOPA 2010 requires a payee to be a hybrid entity (a hybrid payee).

A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

A hybrid entity is defined at s259BE as an entity that is regarded as a distinct and separate person for tax purposes under the law of any territory, but

- its income or profits are treated wholly or partly as the income or profits of another person (or would be if there were any), or
- it is not regarded as a distinct and separate person for tax purposes under the law of another territory.

See INTM550580 for further details on the definition of a hybrid entity.

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INTM555050: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition C

Condition C of s259GA requires

- the payer to be within the charge to UK corporation tax for a relevant payment period, or
- an investor in a hybrid payee to be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period, or
- a hybrid payee that is a limited liability partnership.

The relevant payment period is the taxable period of the payer in which an amount may be deducted for a payment or quasi-payment.

Investor

An investor is defined at s259BE.

If the payee is a hybrid entity because its income or profits are treated as the income or profits of another person, an investor is any person who is treated as having that income.

If the payee is a hybrid entity because it is treated as a person in one territory but is not recognised as a separate and different person under the law of another territory, an investor in that payee is any entity that is

- recognised in the first territory as a separate and different person to the payee, but
- not recognised in the other territory as a separate and different person to the payee.

Limited Liability Partnership (LLP)

A Limited Liability Partnership (LLP) is governed by the Limited Liability Partnership Act 2000. It must be registered at Companies House and have at least two designated members. In law, an LLP is a body corporate.

Guidance on the UK tax treatment of LLPs can be found at PM131410 onwards.

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INTM555060: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition D

Condition D of S259GA is that it is reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a relevant deduction/non-inclusion mismatch (a hybrid payee deduction/non-inclusion mismatch) in relation to the payment or quasi-payment

The test is whether a relevant deduction/non-inclusion mismatch would arise if Chapters 7 to 10 of Part 6A TIOPA 10 (or any equivalent non-UK legislation) did not apply.

There is no definition of the term reasonable to suppose in Part 6A, so it takes its ordinary meaning. Generally this does not require either party to actually know how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it would be reasonable to conclude that a mismatch may or may not arise.

The inclusion of this phrase is intended to assist in the practical application of Condition D. Parties to the payment or quasi-payment should take all reasonable steps to establish whether a mismatch will arise, taking account of the relevant tax laws of the territories involved and the relevant facts and circumstances.

In applying this condition, it is appropriate to consider the relevance and extent of the information available between companies within the same group, and between parties to structured arrangements. It should not be necessary for the parties to await final resolution of the relevant tax returns.

When considering entities that are part of a consolidation regime, s259BE(4) applies in most instances so that the lead company in the consolidation is an investor in the company that actually receives the payment. A relevant mismatch should not arise where this is the case.

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INTM555070: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition E

Condition E is satisfied where one of the following applies:

- the payer is also a hybrid payee (for a quasi-payment only),
- the payer and a hybrid payee, or an investor in a hybrid payee, are in the same control group at any time from when the arrangement is made to the last day of the payment period, or
- the arrangement is a structured arrangement.

A payer may also be a hybrid payee in respect of a quasi-payment only where the UK is not the payer jurisdiction, and the hybrid payee

- is an entity that is not a separate person from the payer under UK tax law, and
- is an entity that is a separate person from the payer for tax purposes in the payer's jurisdiction, and
- it would be reasonable to expect that entity to have an amount of ordinary income arising as a result of the circumstances giving rise to the quasi-payment.

Control groups are defined at s259NB, and more detailed guidance on control groups is at INTM550610.

An arrangement is a structured arrangement if it is reasonable to suppose that

- it is designed to secure a hybrid payee deduction/non-inclusion mismatch, or
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

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INTM555080: Hybrids: Chapter 7 - Hybrid Payee: Extent of the mismatch - general

If conditions A to E of s259GA TIOPA 2010 are satisfied the next step is to establish the extent of any hybrid payee deduction/non-inclusion mismatch for the purposes of Chapter 7.

S259GB(1) defines a hybrid payee deduction/non-inclusion mismatch in relation to a payment or quasi-payment as a mismatch where

- there is an allowable deduction for the payer that exceeds the sum of ordinary income arising to each of the payees for a permitted period, and
- all or part of that excess arises because one or more of the payees is a hybrid entity

There is no hybrid payee deduction/non-inclusion mismatch so far as the relevant deduction is

(a) a debit in respect of amortisation brought into account under s.729 or 731 CTA 2009 or

(b) an amount deductible in respect of amortisation under an equivalent law of a territory outside the UK.

Note that this exemption is restricted to amortisation and does not extend to impairment.

The hybrid mismatch rules do not generally seek to neutralise temporary tax mismatches and so the permitted period for inclusion in ordinary income is a period of 12 months after the end of the taxable period in which the payment was deducted, or such longer time as (on a claim) is just and reasonable.

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INTM555090: Hybrids: Chapter 7 - Hybrid Payee: Extent of the mismatch – hybrid payee not chargeable to tax in any territory

There are a number of areas where the provisions in Part 6A TIOPA 2010 have a broader scope than the OECD recommendations. One example of this is where Chapter 7 of Part 6A applies to mismatches arising because a hybrid payee is not within the charge to tax in any territory.

The legislation treats an amount as arising from the payee being a hybrid payee where the conditions set out at s259GB(3) are satisfied.

S259GB(3) treats a relevant amount of the excess as arising from hybridity where

- a hybrid payee is not resident in any territory which imposes a tax charge, including tax charged at a nil rate or
- a hybrid payee does not have ordinary income arising from a payment or quasi-payment in respect of a permanent establishment in any territory, and
- (in both circumstances) that payee does not have income arising from the payment or quasi-payment on which a CFC charge arises.

The excess is the amount by which the relevant deduction exceeds the sum of ordinary income arising to the payees, and which results wholly or partly from the hybridity of one or more of the payees.

A “relevant amount” of the excess is defined at s259GB(4) as the lesser of the excess, and the amount of ordinary income that would arise to a particular payee by reason of the payment or quasi-payment if

- that payee were a company, and
- the payment was made in connection with a UK trade carried on by the payee through a UK branch.

Where there are multiple payees in relation to any payment or quasi-payment, it is important to calculate a relevant amount of the excess for each payee (from a UK perspective) before carrying out a separate s259GB(3) test on each relevant amount. This ensures that the relevant amounts are not all treated as arising from the hybridity of just one payee and that any disallowance is proportionate. (See example at INTM555210).

Where the payee is a partnership, when considering the “relevant amount" in s259GB(4) it is to be assumed that no ordinary income arises to the payee if a partner is entitled to the amount, and the payee would not be regarded as a hybrid entity when considering only the laws of the jurisdictions where

- the partnership is established, and
- the partner is resident for tax purposes.

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INTM555100: Hybrids: Chapter 7 - Hybrid Payee: Counteraction

Counteraction to address the hybrid payee deduction/non-inclusion mismatch is considered first in respect of the payer (the primary counteraction).

The second counteraction, against investors in the hybrid payee(s), applies if the payer is not within the charge to UK corporation tax.

The third counteraction, against an LLP that is a hybrid payee, applies if the primary counteraction and the secondary counteraction do not apply to address the mismatch.

Details of each of the counteractions are provided in the following pages.

INTM555110: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Payer

INTM555120: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Investor in a hybrid payee

INTM555130: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: LLP

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INTM555110: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Payer

The counteraction where the payer is within the charge to UK corporation tax is set out at s259GC.

The payer is denied a deduction for the payment period for the amount of the hybrid payee deduction/non-inclusion mismatch.

The payment period is the taxable period of the payer in which an amount may be deducted for the relevant payment or quasi-payment.

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INTM555120: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Investor in a hybrid payee

This counteraction applies to investors in a hybrid payee and treats all or part of the hybrid payee deduction/non-inclusion mismatch as income of the investor for the relevant counteraction period of that investor.

The counteraction at s259GD applies only where the investor is within the charge to UK corporation tax and where it is reasonable to suppose that

- no counteraction against the payer is possible under s259GC or equivalent non-UK provisions, or
- counteraction against the payer is possible under non-UK provisions equivalent to s259GC, but does not fully counteract the mismatch.

Where no overseas provision equivalent to s259GC applies, the amount counteracted is an amount equal to the hybrid payee deduction/non-inclusion mismatch.

The mismatch is fully counteracted by a non-UK provision if this equivalent provision reduces the payer’s deduction by the full amount of the mismatch (as quantified under s259GB). In all other cases the amount of the deduction that has not been counteracted is the lesser of

- the amount of the deduction that the payer may still deduct, and
- the amount of the mismatch that is not counteracted by the non-UK provision equivalent to s259GB.

If there is more than one investor the relevant amount is apportioned on a just and reasonable basis, as their share of the relevant amount for the counteraction period, having regard (in particular) to:

- any profit sharing arrangements between some or all of the payees, and
- the extent to which it is reasonable to suppose that the mismatch arises by reason of each hybrid payee being a hybrid entity

The counteraction period is:

- the investor’s accounting period where that coincides with the payment period, or
- the first accounting period of the investor that is wholly or partly within the payment period

The payment period is the taxable period of the payer in which an amount may be deducted for the relevant payment or quasi-payment.

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INTM555130: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Hybrid payee is a LLP

This counteraction applies to a hybrid payee that is a Limited Liability Partnership (LLP), and treats all or part of the hybrid payee deduction/non-inclusion mismatch as income arising to the hybrid payee on the last day of the payment period.

The counteraction at s259GE applies only where it is reasonable to suppose that there has been

- no counteraction against the payer under s259GC, or any equivalent non-UK provisions,
- no counteraction against investors in a hybrid payee is possible under s259GD, or any equivalent non-UK provisions, or
- if counteraction has been applied under the above provisions, it does not fully counteract the mismatch.

The mismatch is fully counteracted only if the application of the above provisions reduces the payer's deduction by the full amount of the mismatch (as quantified under s259GB). When considering this, the amount of the mismatch is adjusted to take account of any secondary counteraction against investors in the hybrid payee.

The mismatch is not fully counteracted if the payer may still deduct part of the mismatch. In these cases the amount of the mismatch not counteracted is the lesser of

- the amount of the deduction that the payer may still deduct, and
- the amount of the mismatch that it is reasonable to suppose is not counteracted by sections 259GC and 259GD, or equivalent non-UK provisions.

If there is more than one hybrid payee you should apportion the relevant amount on a just and reasonable basis, particularly taking into account

- any profit sharing arrangements between some or all of the payees, and
- the extent to which it is reasonable to suppose that the mismatch arises by reason of each hybrid payee being a hybrid entity.

Section 863 ITTOIA 2005 (treatment of certain limited liability partnerships for income tax purposes) and section 1273 of CTA 2009 (treatment of certain limited liability partnerships for corporation tax purposes) may allocate the income of an LLP carrying on a trade, profession or business with a view to profit to its members.

For the purposes of these rules s259GE(8) will disapply those sections and the LLP is chargeable to corporation tax on any income treated as arising as a result of counteraction under s259GE.

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INTM555200: Hybrids: Chapter 7 - Hybrid payee: Examples: Contents

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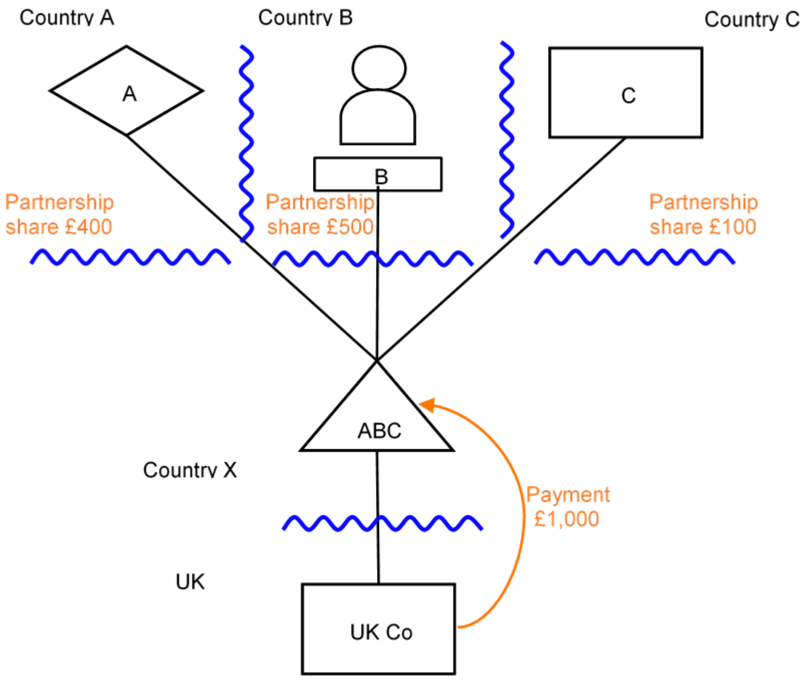
INTM555210: Hybrids: Chapter 7 – Hybrid Payee: Example: Calculating the mismatch where there are multiple payees



Background

- ABC Partnership is established in Country X, which regards it as transparent for tax purposes.
- ABC Partnership holds all the issued share capital in UK Co, which is resident in the UK and liable to tax there. The UK regards ABC Partnership as transparent for tax purposes.
- Trust A, which is established in Country A, is a partner in ABC Partnership. Country A regards ABC Partnership as transparent for tax purposes.
- Trust A is entitled to a 40% share of the profits etc. of ABC Partnership.
- Trust A is a tax exempt entity in Country A, and is not taxed on profits etc. derived from ABC Partnership.
- Individual B, who is resident in Country B, is a partner in ABC Partnership. Country B regards ABC Partnership as transparent for tax purposes.
- Individual B is entitled to a 50% share of the profits etc. of ABC Partnership.

- Individual B is liable to tax in Country B on the profits etc. derived from ABC Partnership.

- C Co, resident in Country C, is a partner in ABC Partnership. Country C regards ABC Partnership as opaque.

- C Co is entitled to a 10% share of the profits etc. of ABC Partnership.

- C Co is liable to tax on its own profits etc. in Country C, but is not liable to tax on profits etc. derived from ABC Partnership.

- UK Co makes a payment of interest to ABC Partnership in respect of a loan from ABC Partnership.

Analysis – Applying the tests in s259GA TIOPA 2010

Does the interest payment satisfy the relevant conditions and fall within the scope of the hybrid payee deduction/non-inclusion mismatch rules?

Condition A: Is a payment made under, or in connection with, an arrangement?

There is a payment of interest by UK Co to ABC Partnership under the loan agreement. The loan agreement is an arrangement.

Condition A is satisfied.

Condition B: Is a payee a hybrid entity?

ABC Partnership is a hybrid entity because Country C regards it as a person for tax purposes, whilst Countries A, B, X and Z treat some or all of its income or profits as belonging to another person/persons for tax purposes.

Condition B is satisfied.

Condition C: Is the payer or an investor within the charge to corporation tax for the relevant period, or is the hybrid payee a limited liability partnership?

The charge to corporation tax is the charge to corporation tax in the UK. UK Co, the payer, is liable to corporation tax in the UK.

Condition C is satisfied.

Condition D: Is it reasonable to suppose that there is, or will be, a hybrid payee deduction/non-inclusion mismatch in relation to the payment?

It is reasonable to suppose that UK Co will be permitted a deduction of £1,000 from income for the interest payment made (the relevant deduction) for a taxable period.

It is also reasonable to suppose that ABC Partnership does not have any ordinary income arising as a result of the payment, but that Individual B will have ordinary income of £500 representing 50% of the payment. Neither Trust A nor C Co have ordinary income arising as a result of the payment made by UK Co.

There is a hybrid payee deduction/non-inclusion mismatch under s259GB(1) if

- the relevant deduction exceeds the sum of ordinary income arising to each payee, and
- all or part of the excess arises by reason of one or more payees being hybrid.

In this case, the relevant deduction of £1,000 is matched by ordinary income of £500 arising to a payee (Individual B). The excess is therefore £500, representing the amounts attributable to Trust A and C Co by ABC Partnership.

The next step is to test whether that excess of £500 arises by reason of ABC Partnership being a hybrid entity. Part of the excess, the amount of £100 allocated to C Co, arises by reason of ABC Partnership being a hybrid entity. If Country C viewed ABC Partnership as transparent, then the amount allocated to C Co would be ordinary income of C Co and no mismatch would arise.

The £400 allocated to Trust A, does not arise by reason of ABC Partnership being a hybrid entity as both Country X and Country A view ABC Partnership as transparent.

However, the provisions at section 259GB(3) that may apply to treat part of the excess as arising by reason of ABC Partnership being a hybrid entity (to the extent that is not already the case).

Section 259GB(3) treats a relevant amount of the excess as arising by reason of one of the payees being a hybrid entity where -

- a payee is a hybrid entity, and
- that payee is not resident for tax purposes in any territory,
- that payee does not have ordinary income from a permanent establishment in any territory as a consequence of the payment, and
- income arising to that payee is not brought into account in computing profits for a CFC charge.

Applying these tests to the facts given –

- ABC Partnership is a payee
- ABC Partnership is a hybrid entity,
- there is no territory where ABC Partnership is resident for the purposes of a tax charged under the law of that territory,
- there is no territory where ABC Partnership has ordinary income arising from a permanent establishment and
- no income arises to ABC Partnership which is brought into account for the purposes of a CFC charge.

As the conditions for s259GB(3) are met the next step is to establish what the relevant amount of the excess is that needs to be considered. The relevant amount is computed as set out in s259GB(4), as amended by s259GB(4A) in partnership cases.

Section 259GB(4) defines the relevant amount of the excess as the lower of –

- the amount of the excess, and
- an amount equal to the amount of ordinary income that it is reasonable to suppose would arise to the payee if the payee were a company trading in the UK through a UK permanent establishment and the payment was received in connection with that trade.

This amount of ordinary income to be used in this comparison is amended by s259GB(4A) where –

- the payee is a partnership,
- a partner in the partnership is entitled to an amount of the payment, and
- the partnership would not be regarded as a hybrid entity under the laws of the territories where the partnership and the relevant partner are tax resident/established.

If these conditions are met, it is assumed that no ordinary income arises to the payee for the amount of the payment to which the partner is entitled when carrying out the comparison at s259GB(4).

In this example, the conditions under s259GB(4A) are met in relation to Trust A as -

- ABC Partnership is a payee and is a partnership
- Trust A is entitled to £400 of the payment of £1,000 received by ABC Partnership
- ABC Partnership would not be regarded as a hybrid entity if only the laws of Country A and Country X applied.

Consequently, for the purposes of the comparison at s259GB(4) it is assumed that no ordinary income arises to the ABC Partnership to the extent of the amount of £400 to which Trust A is entitled.

The conditions under s259GB(4A) are also met in relation to Individual B as -

- ABC Partnership is the payee and is a partnership
- Individual B is entitled to £500 of the payment of £1,000 received by ABC Partnership

- ABC Partnership would not be regarded as a hybrid entity if only the laws of Country B and Country X applied.

Consequently, for the purposes of the comparison at s259GB(4) it is assumed that no ordinary income arises to the ABC Partnership to the extent of the amount of £500 to which Individual B is entitled.

The conditions under s259GB(4A) are not met in relation to C Co as ABC Partnership is regarded as a hybrid entity if the laws of Country C and the UK are applied.

Returning to comparison under s259GB(4) the relevant amount of the excess is £100, that is, the lower of –

- £500, the excess, and
- £100, the amount of ordinary income that would arise to ABC Partnership in respect of the payment of £1,000, as reduced in respect of Trust A and Individual B under s259GB(4A).

As the relevant amount of the excess is the £100 already identified as a hybrid payee deduction / non-inclusion mismatch under s259GB(1)(b), there is no need to deem a further amount of the excess as arising by reason of the hybridity of ABC Partnership.

Condition D is satisfied, and the extent of the hybrid payee deduction/non-inclusion mismatch is £100.

Condition E: Are the payer and the hybrid payee or investor in the same control group or is there a structured arrangement?

UK Co (the payer) and ABC Partnership (the hybrid payee) are in the same control group as ABC Partnership owns 100% of the issued shares in UK Co.

UK Co (the payer) and Individual B (an investor in the hybrid payee) are in the same control group as Individual B has a 50% investment in UK Co.

Condition E is satisfied.

There is no indication that this is a structured arrangement.

Conclusion

All the relevant conditions are satisfied to characterise the arrangement as a hybrid payee deduction/non-inclusion mismatch, so the relevant counteractions will need to be considered.

Counteraction

Counteraction where the UK is the payer jurisdiction

Primary Response
As the UK is the payer jurisdiction, s259GC applies to reduce the deduction available to UK Co by the extent of the hybrid payee deduction/non-inclusion mismatch.

In this instance, UK Co would be denied £100 of the £1,000 deduction.

Counteraction where the UK is in the position of Country B (investor jurisdiction)

Secondary Response
If the UK were in the position of Country B, counteraction under s259GD should be considered to the extent that the mismatch is not countered under s259GC (or a non-UK equivalent provision).

In this instance, s259GD cannot apply as Individual B includes their share of the income from the partnership as ordinary income, and in any case an individual is not within the charge to corporation tax.

[If Individual B were a company (B Co), it did not include its 50% share of partnership income in ordinary income and there was no primary response to counter this mismatch, s259GD(4) would apply to treat the hybrid payee deduction/non-inclusion mismatch as income of B Co].

Counteraction where a hybrid payee is a UK Limited Liability Partnership (LLP) (UK is Country X)

Tertiary response
If ABC Partnership were a UK LLP then, to the extent that the hybrid payee deduction / non-inclusion mismatch has not already been fully counteracted under s259GC or s259GD (or non-UK equivalent provisions), s259GE applies.

Under s259GE(4) an amount equal to the hybrid payee deduction / non-inclusion mismatch (that is, £100 of the deduction claimed by UK Co) is treated as income of ABC Partnership arising on the last day of the payment period. This income is brought within the charge to corporation tax on ABC Partnership under Chapter 8 of Part 10 of CTA 2009.

S259GE(8) dis-applies s863 ITTOIA 2005 (treatment of certain limited liability partnerships for income tax purposes) and s1273 CTA 2009 (treatment of certain limited liability partnerships for corporation tax purposes) in relation to ABC Partnership to the extent needed to give effect to the counteraction under s259GD.

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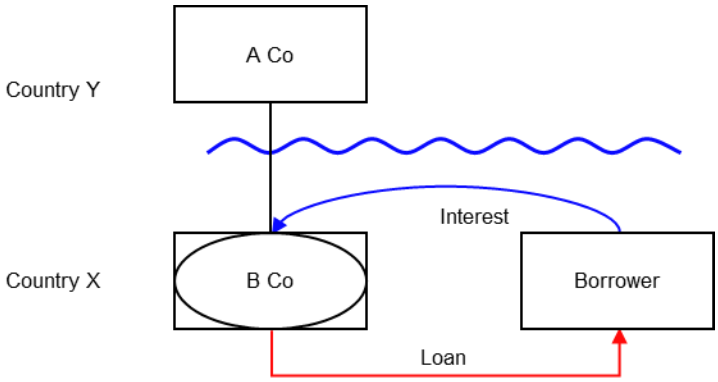
INTM555220: Hybrids: Chapter 7 - Hybrid Payee: Example: investor is a tax-exempt entity



Background

Note: A reverse hybrid is any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction. A deductible payment made to a reverse hybrid payee may give rise to a mismatch in tax outcomes, where that payment is not included in the ordinary income in the jurisdiction where the payee is established, or in the jurisdiction of any investor in that payee.

- A Co is a company resident in Country Y
- A Co is exempt from tax under Country Y law
- B Co is an entity incorporated in Country X and is wholly owned by A Co
- Country X treats B Co as transparent for X tax purposes, i.e. it is not a separate taxable person from A Co
- Country Y treats B Co as opaque, i.e. as a separate taxable person from A Co
- Borrower Co is a company resident in Country X, and is not connected to either A Co or B Co
- Borrower Co borrows money from B Co on arm’s length and standard commercial terms (the Loan)
- Country X allows Borrower Co a deduction for interest payments made on the loan

- Country X does not tax the interest receipt by B Co as it regards the income as belonging to A Co.

- Country Y does not tax the interest receipt as it regards the income as belonging to B Co (a company resident in Country X).

- The arrangements have been designed to secure a hybrid mismatch.

Analysis – Applying the tests in s259GA TIOPA 2010

Do the interest payments satisfy the relevant conditions and thus fall within the scope of the hybrid payee deduction/non-inclusion mismatch rules?

Condition A: Are payments made under, or in connection with, an arrangement?

Transactions took place resulting in a transfer of money (the interest payments) directly from Borrower Co (payer) to B Co (payee), which represents a payment.

There was an arrangement (the Loan agreement), and payments were made under that arrangement.

Condition A is therefore satisfied.

Condition B: Is the payee a hybrid entity?

B Co is the payee. Country X regards B Co as transparent for tax purposes, so the income or profits are treated by Country X as those of A Co. Country Y treats B Co as a taxable person separate from A Co, and regards the income as arising to B Co (a company resident in Country X).

B Co has the characteristics of a hybrid entity, and Condition B is met.

When a person (in this instance, B Co) is treated as a separate entity by an investor (A Co) and as transparent under the laws of the establishment jurisdiction (Country X), this is a reverse hybrid.

Condition C: Is the payer or investor within the charge to corporation tax for the relevant period, or is the hybrid payee a limited liability partnership?

The charge to corporation tax is the charge to corporation tax in the UK. In this example condition C will be satisfied if

- the UK is Country X, or

- the UK is Country Y, or

- the hybrid payee is a LLP

If none of these circumstances are satisfied then Condition C is not met, and it is not necessary to consider the remaining conditions.

Condition D: Is it reasonable to suppose that there is, or will be, a hybrid payee deduction/non-inclusion mismatch in relation to the payment?

Given the background above it is reasonable to suppose that if the hybrids legislation, or its foreign equivalent, did not apply

- Borrower Co would deduct an amount from income for the interest paid on the Loan (the relevant deduction), and
- Neither B Co nor A Co would include the interest received from Borrower Co in its ordinary income.

This mismatch arises as a consequence of the contrasting treatment of B Co for tax purposes in Country X and Country Y, so is directly attributable to the fact that B Co is a hybrid entity. If B Co had been recognised as an entity separate from A Co in Country X it is reasonable to suppose that B Co would have included the interest payments in its ordinary income.

Condition D is satisfied.

Condition E: Is the payer also a hybrid payee, are the payer and either the hybrid payee or the investor within the same control group or is there a structured arrangement?

This condition has three possible tests that can be met, so we must examine these in turn. If any of the three are met then this condition is met.

In this example, the payer (Borrower Co) is not a hybrid payee. Condition E is not met by this test.

The hybrid payee, B Co, is not in the same control group as Borrower Co. Condition E is not met by this test.

However, the arrangements were designed to secure the mismatch, so there is a structured arrangement.

Condition E is satisfied.

Amount of the mismatch

If conditions A to E are satisfied, the payment of interest by Borrower Co under the Loan is a hybrid payee deduction/non-inclusion mismatch, and UK counteraction must be considered.

The extent of the mismatch must be calculated by quantifying the excess, which in this example is given by

- the amount of Borrower's deduction from income for the interest paid, less
- the amount of that interest payment included as ordinary income of A Co and B Co.

How much of that amount arises because B Co is a hybrid entity is then considered. In this example, if B Co were not a hybrid entity then either B Co would be recognised by Country X as a separate taxable person or Country Y would recognise it as a transparent entity. In either scenario it would be reasonable to suppose that the amount of ordinary income, equal to the interest received, would be recognised, and that a mismatch would not arise.

The extent of the mismatch arising by reason of B Co being a hybrid entity is therefore the full amount of the interest.

Conclusion

Assuming all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payee deduction/non-inclusion mismatch', the relevant counteractions will need to be considered.

Counteraction

The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y or if B Co is an LLP.

Counteraction where the UK is in the position of Country X (payer jurisdiction)

Primary Response
The primary counteraction is against the payer.

If the UK is Country X (the payer jurisdiction) Borrower Co's deduction for interest payments to B Co is restricted (s259GC).

Counteraction where the UK is in the position of Country Y (investor jurisdiction)

Secondary Response
In this example, if the UK is Country Y and it is concluded that Country X has no provisions that apply to counteract the mismatch on the payer, then the UK legislation applies to treat the entire mismatch as income of A Co.

If it is concluded that Country X has provisions that apply but they do not fully counteract the mismatch then the UK provisions apply to treat part of the mismatch as income of A Co, to ensure the hybrid payee deduction/non-inclusion mismatch is fully counteracted.

Counteraction where B Co is an LLP

Tertiary Response
In this example the tertiary response (counteraction against a LLP that is a hybrid payee) is unlikely to apply - as both the payer and the hybrid payee are resident in the UK, the primary response applied against the payer takes priority, and will fully counteract the mismatch.

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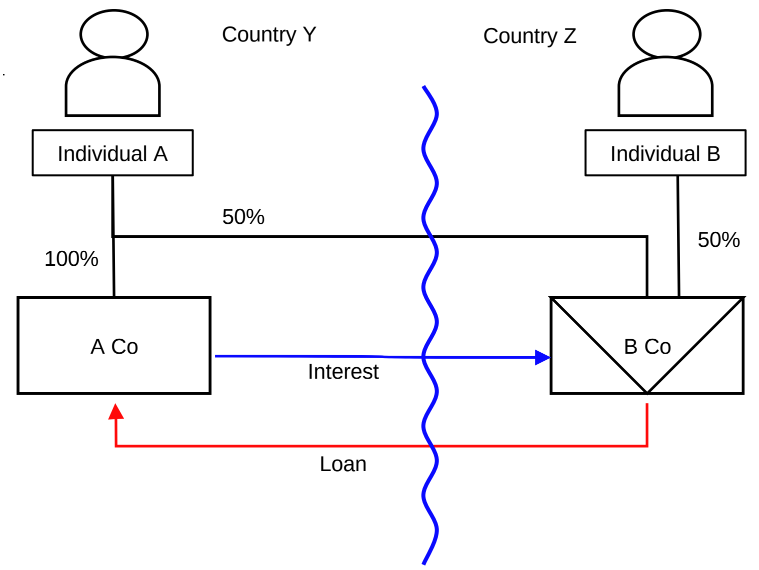
INTM555230: Hybrids: Chapter 7 - Hybrid Payee: Example: Payments to hybrid entity (reverse hybrid) partially excluded



Background

- Two individuals, one resident in Country Y (Individual A) and one in Country Z (Individual B) agree to make a loan to A Co.

- Individual A wholly owns A Co.

- Individual A and Individual B each hold 50% of the voting power in B Co.

- B Co is incorporated in Country Z.

- B Co is treated by Country Z as transparent (i.e. its income or profits are treated in Country Z as those of Individual A and Individual B).

- Individuals A & B do not make the loan directly to A Co but make equal contributions of the relevant amount into B Co, which then loans this amount to A Co (the Loan).

- The Loan does not satisfy the conditions required to fall within the ‘hybrids and other mismatches from financial instruments’ rules. This is because the mismatch does not arise from a feature of the instrument but rather because of the presence of a hybrid entity.

- A Co pays interest on the Loan and may claim a deduction for that expense in Country Y.

- B Co attributes half the interest receivable to Individual A and half to Individual B.
- Individual B is subject to tax on his share of the interest receivable at the full marginal rate applicable to interest income in Country Z.
- Individual A does not include the interest receivable in his ordinary income in either Country Z or Country Y. Country Z does not tax foreign source income attributable to a non-resident person. Country Y recognises B Co as a separate person for tax purposes so Individual A is not subject to tax on income from B Co.

Note: In practice the background above may not be easily obtained from the relevant tax return. If standard information requests to the relevant company do not address concerns it may be necessary to consider other powers available, such as 3rd party information notices or potential cross-country information requests (through JITSIC). Your local International Tax Specialist may have further information on how certain entities are characterised for tax purposes under foreign tax regimes.

Analysis – Applying the tests in s259GA TIOPA 2010

Do the interest payments satisfy the relevant conditions and thus fall within the scope of the hybrid payee deduction/non-inclusion mismatch rules?

Condition A: Are payments made under, or in connection with, an arrangement?

Transactions took place resulting in a transfer of money (the interest payments) from A Co. (payer) to B Co (payee), which represents a payment.

There was an arrangement encompassing the contributions to B Co, the Loan agreement with A Co, and the allocation of that interest to Individual A and Individual B.

Condition A is satisfied.

Condition B: Is a payee a hybrid entity?

The payees are B Co (the person receiving the interest payment), and Individual B (who has ordinary income arising as a result of the payment).

Country Y regards B Co as a separate taxable person to Individual A. Country Z regards B Co. as transparent so treats B Co's interest receipts as ordinary income of Individual A and Individual B. .

B Co has the characteristics of a hybrid entity, and Condition B is met. A reverse hybrid is any person that is treated as a separate entity by an investor and as transparent under the laws of the establishment jurisdiction.

Individual B is not a hybrid entity, as he is regarded as a person under the laws of both Country Z and Country Y.

Condition C: Is the payer or an investor within the charge to corporation tax for the relevant period, or is the hybrid payee a limited liability partnership?

The charge to corporation tax is the charge to corporation tax in the UK. In this example condition C can be satisfied if

- the UK is Country Y (the payer jurisdiction), or
- the UK is Country Z and the hybrid payee is a LLP.

If the UK is neither Country Y nor Country Z condition C is not met, and it is not necessary to consider the remaining conditions.

If that is the case, and the mismatch is not countered by another territory, the imported mismatch rules at Chapter 11 should be considered.

Condition D: Is it reasonable to suppose that there is, or will be, a hybrid payee deduction/non-inclusion mismatch in relation to the payment?

It is reasonable to suppose that A Co will be permitted a deduction against its ordinary income for the interest payments made under the Loan (the relevant deduction) for a taxable period.

It is also reasonable to suppose that neither B Co nor Individual A will be charged to tax on the interest receipts attributable to Individual A.

Consequently, this mismatch is attributable to the contrasting treatment of B Co for tax purposes in Country Y and Country Z, and so results from the fact that B Co is a hybrid entity. If either:

- B Co had been recognised as an entity separate from Individual A in Country Z, or
- B Co had not been recognised as an entity separate from Individual A in Country Y

then it is reasonable to suppose that either B Co (in the former situation) or Individual A (in the latter situation) would have included the interest payments in its ordinary income. It therefore arises by reason of B Co (a payee) being a hybrid entity.

Condition D is therefore satisfied.

To the extent that the amounts attributable to Individual B have been subject to tax in Country Z, there will be no hybrid payee deduction/non-inclusion mismatch arising from those payments.

The extent of the hybrid payee deduction/non-inclusion mismatch is equal to the payments attributable to Individual A.

Condition E: Are the payer and the hybrid payee or investor in the same control group or is there a structured arrangement?

A Co (payer) and B Co (reverse hybrid) are all part of the same control group, as defined under s259NB, as Individual A, who holds at least 50% of the voting power both companies.

(Even if Individual A were to hold less than 50% of the voting power in B Co, the facts suggest that the arrangement was designed to secure a hybrid payee deduction/non-inclusion mismatch, and therefore it may qualify as a structured arrangement).

Condition E is met.

Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a hybrid payee deduction/non-inclusion mismatch, the extent of the mismatch and counteractions need to be considered.

Counteraction

As all of the conditions are met the mismatch should be counteracted under Chapter 7.

Counteraction where the UK is in the position of Country Y (payer and investor jurisdiction)

Primary Response
Where the UK is in the position of Country Y, then A Co will be denied a deduction to the extent of the hybrid payee deduction/non-inclusion mismatch, which in this instance would be the full amount of the hybrid payee deduction/non-inclusion mismatch (being 50% of the payments).

Secondary Response
If the UK is the investor jurisdiction, there is no secondary response under s259GD as Individual A is not within the charge to corporation tax.

Counteraction where a hybrid payee is a UK Limited Liability Partnership (LLP)

Where B Co is an LLP the UK then, to the extent that the hybrid payee deduction/non-inclusion mismatch has not already been fully counteracted in Country Y, then the remaining amount of the mismatch (i.e. the amount attributable to Individual A) will be treated as income arising to B Co on the last day of the payment period. If no counteraction has been applied, then the counteraction under s259GE TIOPA 2010 will apply to the full amount attributed to Individual A.

This income will be brought within the charge to corporation tax on B Co under Chapter 8 of Part 10 of CTA 2009.

Section 863 ITTOIA 2005 (treatment of certain limited liability partnerships for income tax purposes) and section 1273 of CTA 2009 (treatment of certain limited liability partnerships for corporation tax purposes) may apply to allocate the income of an LLP to its members where that LLP is carrying on a trade, business or (if income tax) profession with a view to profit. For the purposes of these rules, s259GE(8) will dis-apply those sections for the purposes of bringing this income into charge on B Co.

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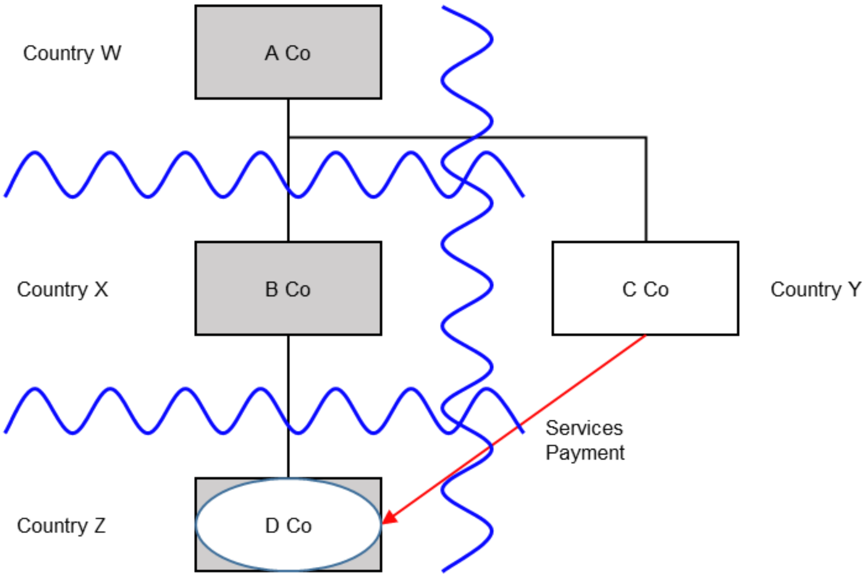
INTM555240: Hybrids: Chapter 7 - Hybrid Payee: Example: Payment to reverse hybrid caught by CFC regime



Background

- A Co is resident in Country W.
- A Co owns all shares in B Co, which is a company resident in Country X.
- A Co also owns all shares in C Co, which is a company resident in Country Y.
- B Co has established D Co under the laws of Country Z.
- D Co is regarded as transparent for tax purposes under the law of Country Z, such that Country Z treats the income and profits of D Co as attributable to B Co. However, D Co is regarded as a person for tax purposes under the law of Country X. It is therefore a reverse hybrid.
- D Co receives a services payment from C Co, but receives no other income.
- Country W's CFC regime treats service income paid by a related party as attributable income and subjects such income, where all other relevant conditions are met (assumed to be satisfied here), to taxation. In this case, Country W's CFC rules extend to the service income

received by D Co, which it also regards as a person for tax purposes under the law of Country W.

Analysis - Applying the tests in s259GA TIOPA 2010

Do the interest payments satisfy the relevant conditions and thus fall within the scope of the hybrid payee deduction/non-inclusion mismatches rules?

Condition A: Are payments made under, or in connection with, an arrangement?

The services payment is a transfer of money from C Co to D Co and it is made under the arrangement, which includes the transaction involving the provision of the relevant services by D Co and the subsequent compensation.

Condition A is satisfied.

Condition B: Is the payee a hybrid entity?

D Co is the payee and is regarded as a person for tax purposes under the law of Country X.

Country Z treats D Co's service payment receipts as the income of B Co for tax purposes.

Therefore D Co is a hybrid entity, and Condition B is met.

Condition C: Is the payer or investor within the charge to corporation tax for a relevant period or is the hybrid payee a limited liability partnership?

In the event the UK is in the position of Country Y, C Co is the payer and would be within the charge to corporation tax.

In the event the UK is in the position of Country X, B Co is the relevant investor and would be within the charge to corporation tax.

Condition C will therefore be satisfied under either of the above scenarios.

In the event that D Co is an LLP, Condition C will also be satisfied.

Condition D: Is it reasonable to suppose that there is, or will be, a hybrid payee deduction/non-inclusion mismatch in relation to the payment?

It is reasonable to suppose that Country Y will permit C Co a full deduction for the service payments (the relevant deduction). It is also reasonable to suppose that the payment received by D Co will not be included in its ordinary income. D Co is regarded as transparent under Country Z's jurisdiction, but as a taxable entity (opaque) in Country X, so neither are likely to bring it into charge.

This mismatch arises as a consequence of the contrasting treatment of D Co for tax purposes in Country X and Country Z, so is directly attributable to the fact that D Co is a hybrid entity. If either:

- D Co had been recognised as an entity separate from B Co in Country Z, or
- D Co had not been recognised as an entity separate from B Co in Country X

then it is reasonable to suppose that either D Co (in the former situation) or B Co (in the latter situation) would have included the interest payments in its ordinary income. It therefore arises by reason of D Co (a payee) being a hybrid entity.

Condition D is satisfied.

Extent of the mismatch

The excess of the deduction over the amount not included in this example is equal to the total payment for services.

However, A Co subjects the service payments to a CFC charge (either a UK CFC charge or its foreign equivalent). Where there is a hybrid payee deduction/non-inclusion mismatch between the parties that are directly involved in the transaction, then recognition should be given to any CFC charge suffered on that same receipt per s259BD TIOPA 2010.

In this case, the receipt has been wholly brought into account by A Co in calculating D Co.'s chargeable profits for the purpose of that charge.

Having recognised the CFC charge, the result is that no hybrid payee deduction/non-inclusion mismatch remains. There is therefore no need to consider the remaining conditions.

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INTM556000: Hybrids: Chapter 8 - Multinational payee: Contents

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INTM556010: Hybrids: Chapter 8 - Multinational payee: Overview

Chapter 8 of Part 6A TIOPA 2010 counters mismatches where it is reasonable to suppose the mismatch would otherwise arise from payments or quasi-payments, where the payer is within the charge to CT, because a payee is a multinational company.

The chapter counteracts mismatches by altering the CT treatment of the payer.

Multinational company

A multinational company for the purpose of Chapter 8 of Part 6A is defined at s259HA. A company is a multinational company if it is

- resident for tax purposes in a territory (the parent or head office jurisdiction), and
- regarded as carrying on a business through a permanent establishment in another territory (whether so regarded under the law of the parent jurisdiction, the PE jurisdiction or any other territory).

Conditions to be satisfied

The legislation applies where 5 conditions in s259HA (A to E) are met.

Condition A

There is a payment or quasi-payment under or in connection with an arrangement (see INTM556030).

Condition B

The payee is a multinational company (see INTM556040).

Condition C

The payer is within the charge to UK corporation tax,

Or

(From 1 January 2020) the multinational company is UK resident for the payment period, and regarded under UK law as carrying on a business in another territory through a PE, but is *not* regarded under the law of the PE jurisdiction as doing so (see INTM556050).

Condition D

It is reasonable to suppose that there would be a mismatch arising by reason of the payee being a multinational company, if the mismatch was not countered by this legislation or equivalent legislation outside the UK (see INTM556060).

Condition E

The relevant parties are in the same control group, or it is reasonable to suppose the arrangement is a structured arrangement designed to secure the mismatch or under which the economic benefits of the mismatch are shared (see INTM556070).

Counteraction

If all 5 conditions are met the mismatch is counteracted by denying all or part of the payer's deduction.

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INTM556020: Hybrids: Chapter 8 - Multinational payee: Conditions to be satisfied

The conditions applicable for Chapter 8 of Part 6A are set out at s259HA. For Chapter 8 to apply each of conditions A, B, C, D and E must be met.

INTM556030: Hybrids: Chapter 8 - Multinational payee: Condition A

INTM556040: Hybrids: Chapter 8 - Multinational payee: Condition B

INTM556050: Hybrids: Chapter 8 - Multinational payee: Condition C

INTM556060: Hybrids: Chapter 8 - Multinational payee: Condition D

INTM556070: Hybrids: Chapter 8 - Multinational payee: Condition E

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INTM556030: Hybrids: Chapter 8 - Multinational payee: Condition A

Condition A of s259HA requires there to be a payment or quasi-payment made under, or in connection with, an arrangement. Definitions of the key terms for this condition are at s259BB.

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons if certain assumptions were to apply.

See INTM550540 for more detail on quasi-payments.

There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments if the circumstances giving rise to the deduction do not include economic rights between the payer and a payee.

Condition A also requires that the payment or quasi-payment be made under an arrangement. S259NF sets out the definition of an "arrangement" for the purposes of this legislation to include any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

Ordinary income

In broad terms, ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at INTM550560.

There are special recognition rules at s259BD for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign companies (CFC) charge. This is discussed in more detail at INTM550570. Return to contents

INTM556040: Hybrids: Chapter 8 - Multinational payee: Condition B

Condition B of s259HA requires a payee to be a multinational company.

A multinational company is defined at s259HA as a company that is

- resident for tax purposes in a territory (the parent jurisdiction), and
- regarded as carrying on a business through a permanent establishment in another territory.

Company is not defined in the legislation, so takes its normal meaning under UK law.

A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

If a company is recognised in a particular jurisdiction that does not mean that it cannot also be regarded as having a permanent establishment. Whether there is a permanent establishment is dependent on the facts. See INTM153060.

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INTM556050: Hybrids: Chapter 8 - Multinational payee: Condition C

Condition C of s259HA requires the payer to be within the charge to UK corporation tax for a relevant payment period.

From 1 January 2020 there is an additional subsection to Condition C, which specifies that the condition is also met if the multinational company is

- UK resident for the payment period, and
- under the law of the parent jurisdiction, is regarded as carrying on a business in the permanent establishment (PE) jurisdiction through a PE in that territory, but
- is not regarded as doing so by the law of the PE jurisdiction.

The payer is the person who makes a payment.

The relevant payment period is the taxable period of the payer in which an amount may be deducted for a payment or quasi-payment.

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INTM556060: Hybrids: Chapter 8 - Multinational payee: Condition D

Condition D of s259HA asks whether it is reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a multinational payee deduction/non-inclusion mismatch in relation to the payment or quasi-payment.

The test is whether a relevant deduction/non-inclusion mismatch would arise if Chapters 8 to 10 of Part 6A (or any equivalent non-UK legislation) did not apply.

There is no definition of the term “reasonable to suppose” in Part 6A, so the phrase will take its ordinary meaning. Generally this does not require either party to know how the transaction has been treated by the counterparty: it requires only that, given the facts and circumstances, it is reasonable to conclude that a mismatch would arise in these circumstances.

See INTM556080 for the requirements for a deduction/non-inclusion mismatch to be a multinational payee deduction/non-inclusion mismatch.

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INTM556070: Hybrids: Chapter 8 - Multinational payee: Condition E

Condition E of s259HA is satisfied where one of the following applies -

- (for a quasi-payment only) the payer is also a payee,
- (for a payment or quasi-payment) the payer and the multinational payee are in the same control group at any time from when the arrangement is made to the last day of the payment period, or
- (for a payment or quasi-payment) the arrangement is a structured arrangement.

A payer may also be a payee in respect of a quasi-payment only where the UK is not the payer jurisdiction, and the payee -

- is an entity that is not a separate person from the payer under UK tax law, and
- is an entity that is a separate person from the payer for tax purposes in the payer's jurisdiction, and
- it would be reasonable to expect that entity to have an amount of ordinary income arising as a result of the circumstances giving rise to the quasi-payment

Control groups

Control groups are defined at s259NB, and more detailed guidance on control groups is at INTM550610.

Structured arrangements

An arrangement is a structured arrangement if it is reasonable to suppose that-

- it is designed to secure a multinational payee deduction/non-inclusion mismatch, or
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or the terms of the arrangement otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

It is likely, but not essential, that all parties would be aware that the instrument or arrangement may create a relevant mismatch whether by virtue of its structure, terms, conditions or simply that the price reflects that benefit.

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INTM556080: Hybrids: Chapter 8 - Multinational payee: Extent of the mismatch

If conditions A to E of s259HA are satisfied, the next step is to establish the extent of any multinational payee deduction/non-inclusion mismatch for the purposes of Chapter 8, Part 6A of TIOPA 2010.

S259HB(1) defines a multinational payee deduction/non-inclusion mismatch in relation to a payment or quasi-payment as a mismatch where

> (a) there is an allowable deduction for the payer that exceeds the sum of ordinary income arising to each of the payees, and
>
> (b) all or part of that excess arises because one or more of the payees is a multinational company.

The extent of the multinational payee deduction/non-inclusion mismatch is equal to the excess that arises as mentioned in (1)(b).

Amortisation

There is no multinational payee deduction/non-inclusion mismatch so far as the relevant deduction is

- A debit in respect of amortisation brought into account under section 729 or 731 CTA 2009, or
- An amount deductible in respect of amortisation under provision of the law of a territory outside the UK that is equivalent to either of those sections.

Determining the extent of the mismatch

The legislation requires a comparison of the amount of the excess identified above with the excess that would arise in a counterfactual position. This is detailed at s259HB (2A). The counterfactual position is arrived at by making the assumption that the payee is not a multinational company, and that the payment or quasi-payment arose to the payee in the parent jurisdiction and not in the jurisdiction of its PE. If, on making this assumption:

- the amount of the excess remains unchanged or increases, then there is no mismatch arising as a result of the payee being a multinational company.
- the amount of the excess is reduced, then the amount by which the excess is reduced is the mismatch that arises because the payee is a multinational company.

The amount of the multinational payee deduction/non-inclusion mismatch is the amount of the excess that arises because the payee is a multinational company.

If the PE jurisdiction makes no provision for charging tax on companies, then the excess that arises is not to be taken to arise by reason of that payee being a multinational company.

It does not matter if the excess would have arisen for other reasons as well.

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INTM556090: Hybrids: Chapter 8 - Multinational payee: Counteraction

Payer is within the charge to CT

The counteraction where the payer is within the charge to UK corporation tax is set out at s259HC TIOPA 2010. The payer's deduction for the payment period is reduced by an amount equal to the multinational payee deduction/non-inclusion mismatch.

From 1 January 2020: Payee is a UK resident multinational company

If the payee that is a multinational company

- is UK resident for the payment period, and
- under the law of the parent jurisdiction is regarded as carrying on a business in a PE jurisdiction through a permanent establishment in that territory, but
- is not regarded as doing so by the law of that jurisdiction

an amount equal to the multinational payee deduction/non-inclusion mismatch is treated as arising to the multinational company ion the UK and nowhere else for the payment period.

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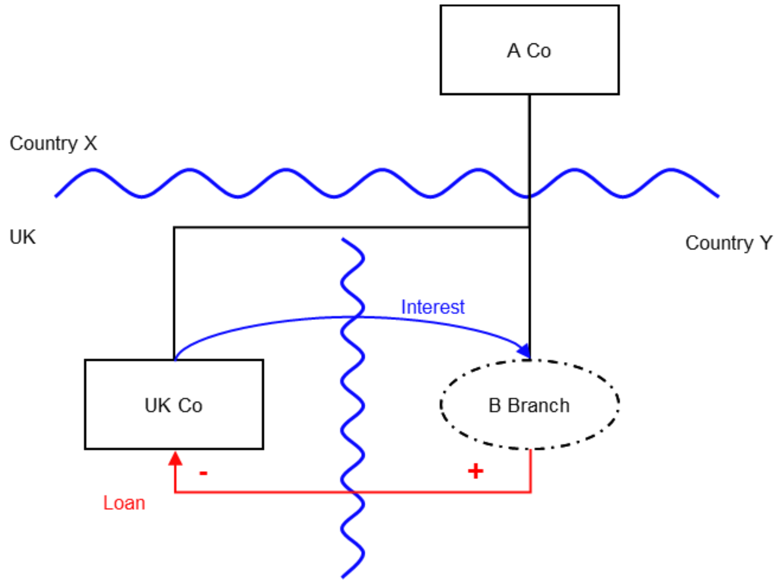
INTM556100: Hybrids: Chapter 8 - Multinational payee: Example: Branch exemption – Only one country recognises a PE



Background

- A Co is a company resident in Country X
- UK Co is a company resident in the UK, and A Co owns its entire shareholding
- A Co lends money to UK Co (the Loan) through a branch located in Country Y (B Branch)
- The UK allows a deduction for the interest payments made by UK Co
- Country X treats the Loan as attributable to a permanent establishment (B Branch) and exempts or excludes the interest receipts from taxation. This exemption or exclusion could be under Country X's domestic law or as a result of the application of the Country X-Y treaty
- Country Y, however, does not tax the interest income because A Co is not treated as having a sufficient taxable presence in Country Y to constitute a permanent establishment under local law. The payment of interest therefore gives rise to an intra-group mismatch (a D/NI outcome).

Analysis - Applying the tests in s259HA TIOPA 2010

Do the interest payments from UK Co to the B Branch under the Loan satisfy the relevant conditions to fall within the scope of this chapter?

Condition A: Is a payment made under, or in connection with, an arrangement?

A transaction took place resulting in an interest payment directly from UK Co (payer) to A Co (payee). The interest payment is in relation to the Loan made from A Co to UK Co. The arrangement is therefore the Loan and the resulting interest payment.

Condition A is therefore satisfied.

Condition B: Is a payee a multinational company, according to the definition at s259HA(4)?

A Co is resident in Country X (the parent jurisdiction) for the purposes of a tax charged under the law of that territory, and it is also regarded as carrying on a business in another territory - Country Y (the PE jurisdiction) - through a permanent establishment (B Branch) in that territory.

Therefore A Co (the payee) is a multinational company and Condition B is satisfied.

Condition C: Is the payer or the multinational company within the charge to Corporation Tax for the payment period?

UK Co is the payer and within the charge to Corporation Tax.

Condition C is therefore satisfied.

Condition D: Is it reasonable to suppose that there would be a multinational payee deduction/non-inclusion mismatch in relation to the payment?

There will be a multinational payee deduction/non-inclusion mismatch if the relevant deduction exceeds the amount of ordinary income arising to each payee for a permitted taxable period, and all or part of that excess arises by reason of one or more of the payees being a multinational company.

Given the facts above, it is reasonable to suppose that UK will permit UK Co an interest deduction (the relevant deduction) under the Loan against its ordinary income.

It is also reasonable to suppose that no ordinary income will arise in either A Co or B Branch as:

- Country X treats the interest receipt as attributable to B Branch and exempts or excludes it from taxation. This could be under Country X’s domestic law or as a result of the application of the Country X-Y treaty.

- Country Y does not treat A Co is having a sufficient taxable presence in Country Y to constitute a permanent establishment under local law, and therefore does not extend its domestic law to tax that receipt.

Therefore the relevant interest deduction is in excess of the ordinary income recognised (nil). This excess arises from the fact that A Co is a multinational entity, as Country X gives up its taxing rights over this interest income for this reason. There is therefore a multinational payee deduction/non-inclusion mismatch of the full value of the interest payment.

Condition D is satisfied.

Condition E: Are the payer and the multinational company in the same control group, or is the arrangement a structured arrangement?

A Co and UK Co are in the same control group within the definition at s259NB, and therefore this condition is satisfied.

Condition E would also be met if A Co and UK Co were not in the same control group, but it was reasonable to suppose that this was a structured arrangement designed to secure a multinational company deduction/non-inclusion mismatch (even if it were also designed to secure a commercial or other objective).

Conclusion

All the conditions are satisfied to characterise the arrangement involving the payment of interest under the Loan as a multinational payee deduction/non-inclusion mismatch under Chapter 8, and the relevant counteractions therefore need to be considered after first considering the extent of the mismatch.

Extent of the mismatch

Section 259HB (2) states that the extent of the multinational payee deduction/non-inclusion mismatch is equal to the excess that arises by reason of the payee being a multinational company.

Section 259HB (2A) sets out how to arrive at the amount of the excess which arises by reason of the payee being a multinational company. A comparison is made to the position which would arise if A Co was not a multinational company, i.e. it did not have a branch in the PE jurisdiction, and all amounts of ordinary income arising by reason of the payment of interest were to arise to A Co in the parent jurisdiction.

In this case, if under the law of Country X the ordinary income would not result in a multinational payee deduction/non-inclusion mismatch, we can conclude that the whole of the mismatch arises by reason of A Co being a multinational company.

Counteraction

S259HC applies to reduce UK Co's allowable deduction by the amount of the mismatch.

Where the deduction allowed to the payer exceeds the amount of ordinary income arising to the payee, and that excess arises by reason of one or more payees being multinational companies (regardless of any other reason), the extent of the mismatch is equal to that excess.

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INTM557000: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Contents

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INTM557010: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Overview

Chapter 9 of Part 6A TIOPA 2010 counters mismatches involving hybrid entities where it is reasonable to suppose that all or part of an amount could be deducted from

- the income of the hybrid entity for a taxable period of the entity, and
- the income of an investor in the hybrid entity for a taxable period of that investor.

Conditions to be satisfied

The legislation applies where 3 conditions (A to C) are met.

Condition A

There is an amount (or part of an amount) that it is reasonable to assume could be deducted from the income of both the hybrid entity and an investor in the hybrid entity for the purposes of calculating their respective taxable profits, in different jurisdictions (see INTM557030).

Condition B

Either the hybrid entity or any of the investors in the hybrid entity are within the charge to UK corporation tax (see INTM557040).

Condition C

The hybrid entity and any investor are related at any time in the hybrid or investor taxable periods: or it is reasonable to suppose that the arrangement is a structured arrangement either designed to secure the mismatch or under which the economic benefits of the mismatch are shared (see INTM557050).

Counteraction

If all 3 conditions are met, the mismatch is then countered by –

- denying all or part of the deduction claimed by the investor(s) where they are within the charge to corporation tax (See INTM557070), or
- denying all or part of the deduction claimed by the hybrid entity where the hybrid entity is within the charge to corporation tax (See INTM557075).

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INTM557020: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Conditions to be satisfied

The conditions applicable for Chapter 9 of Part 6A TIOPA 2010 are set out at s259IA. For Chapter 9 to apply each of conditions A, B and C must be met.

INTM557030: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition A

INTM557040: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition B

INTM557050: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition C

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INTM557030: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition A

Condition A of s259IA is met if it is reasonable to suppose that an amount, or part of an amount, may be deducted by both a hybrid entity and an investor in that entity.

Hybrid entity

A hybrid entity is defined at s259BE.

Whether an entity has the relevant characteristics to be treated as a 'hybrid entity' is discussed in more depth at INTM550580. Generally an entity may be treated as having those characteristics if it is regarded as a person for tax purposes under the law of any territory, and

- its income or profits are treated wholly or partly as the income or profits of another person, or
- it is not regarded as a separate person for tax purposes under the law of another territory.

Investor and Investor Jurisdiction

An investor is defined at s259BE(4).

If an entity is a hybrid entity because its income or profits are treated as the income or profits of another person, an investor is any person who is treated as having that income.

If an entity is a hybrid entity because it is treated as a person in one territory but is not recognised as a separate and different person under the law of another territory, an investor is any entity that is

- recognised in the first territory as a separate and distinct person to the hybrid entity, but
- not recognised in the other territory as a separate and distinct person to the hybrid entity.

An investor jurisdiction is any territory in which an investor is within the charge to a tax.

A hybrid entity may have multiple investors.

It is possible that not all investors will have an investor jurisdiction.

Reasonable to suppose

There is no definition of the term reasonable to suppose in Part 6A, so the phrase takes its ordinary meaning. Generally this does not require either party to know how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it would be reasonable to conclude that a double deduction will arise.

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INTM557040: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition B

Condition B of s259IA requires that

- the investor is within the charge to corporation tax in the UK for the investor deduction period, or
- the hybrid entity is within the charge to corporation tax in the UK for the hybrid entity deduction period.

The investor deduction period is the taxable period of the investor in which the amount is deducted for the purposes of calculating taxable profits of that investor.

The hybrid entity deduction period is the taxable period of the hybrid entity in which the amount is deducted for the purposes of calculating taxable profits of the entity.

The taxable period is defined at s259NF. Broadly speaking, the taxable period is the period for which the specific tax is charged.

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INTM557050: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition C

Condition C of s259IA is satisfied where one of the following applies –

- the hybrid entity and any investor in it are related at any time in the relevant deduction period, or
- the arrangement, to which the hybrid entity or any investor in it is party to, is a structured arrangement.

Related persons is defined at s259NC. More detailed guidance on related persons is at INTM550610 but in broad terms a hybrid entity and an investor are related on any day that

- they are in the same control group, or
- one holds a 25% investment in the other, or
- a third person holds a 25% investment in both entities

Control groups are defined at s259NB. More detailed guidance on control groups is at INTM550610.

Structured arrangement

An arrangement is a structured arrangement if it is reasonable to suppose that–

- it is designed to secure a hybrid entity double deduction amount, or
- the terms of the arrangement share the economic benefit of the double deduction between the parties to that arrangement, or the terms of the arrangement reflect the fact that a double deduction was expected to arise.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid entity double deduction mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

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INTM557060: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction

If conditions A to C of s259IA are met the mismatch is countered by restricting the amount of the deduction in the UK.

The hybrid entity double deduction mismatch requires either the hybrid entity or an investor in the hybrid entity to be within the charge to UK corporation tax for the relevant deduction period. The counteraction then applies to reduce the allowable deduction available to that person by the amount that it is reasonable to suppose could be deducted twice.

Any counteraction is mitigated to the extent that the deduction may be set against any dual inclusion income or in appropriate circumstances section 259ID income in the relevant deduction period.

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INTM557070: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction: Investor in hybrid entity

The counteraction where an investor in a hybrid entity is within the charge to UK corporation tax is set out at s259IB.

An investor may deduct the amount of the hybrid entity double deduction mismatch (after adjusting for any illegitimate overseas deduction) from dual inclusion income of the investor deduction period.

Where the amount deducted by the investor exceeds the dual inclusion income in the period, the excess may be carried forward to use against dual inclusion income of the investor in future accounting periods.

Illegitimate overseas deduction

The amount of the double deduction that may be set against dual inclusion income of the investor is permanently reduced by the amount of any illegitimate overseas deduction.

An illegitimate overseas deduction arises where it is reasonable to suppose that all or part of the hybrid entity double deduction amount is, in substance -

- deducted under the law of a territory outside the UK
- from the income of any person for a taxable period, and
- the income from which it is deducted is not dual inclusion income of the investor for an accounting period.

This may occur, for example, where the double deduction creates a loss for the hybrid entity, and that loss is surrendered under a group relief regime.

The illegitimate overseas deduction is treated as if it had already been allowed in a previous accounting period. It will not form part of any unused hybrid entity double deduction amount carried forward.

Dual inclusion income

Dual inclusion income of the investor is the amount of income arising during an accounting period that is ordinary income of both

- the investor for that period, and
- the hybrid entity for a permitted taxable period for the purposes of any tax charged outside the UK.

Ordinary income

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition (including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income) is in s259BC, and the concept is discussed further at INTM550560.

Permitted taxable period

A taxable period of a hybrid entity is a permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the investor, or
- begins in a later period if a claim has been made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

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INTM557075 Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction: Hybrid entity

The counteraction where a hybrid entity is within the charge to UK corporation tax is set out at s259IC.

The section applies where it is reasonable to suppose that either

- no equivalent provision applies in the investor jurisdiction to counteract the double deduction in the investor jurisdiction, or
- such a provision does apply, but the hybrid entity double deduction amount exceeds the amount that is prevented or counteracted under those provisions. i.e. an element of the double deduction as quantified at s259IA has not been counteracted, and in addition
- either the hybrid entity and any investor are in the same control group at any time in their deduction periods, or they are party to a structured arrangement.

Where this section applies, a hybrid entity may have a deduction for the amount of the hybrid entity double deduction (after adjusting for any illegitimate overseas deduction) only to the extent that it is set against dual inclusion income or 259ID income of the hybrid entity deduction period.

Where the amount deducted by the hybrid entity exceeds the dual inclusion income and 259ID income in the period, the excess may be carried forward to use against dual inclusion income (see below for definition) of the hybrid entity in future accounting periods.

Illegitimate overseas deduction

The amount of the double deduction allowed to the hybrid entity is reduced by the amount of any illegitimate overseas deduction.

An illegitimate overseas deduction arises where it is reasonable to suppose that all or part of the hybrid entity double deduction amount is, in substance -

- deducted under the law of a territory outside the UK
- from the income of any person for a taxable period, and
- the income from which it is deducted is not dual inclusion income of the hybrid entity for an accounting period.

This may occur, for example, where the double deduction creates a loss for an investor in the hybrid entity, and that loss is surrendered under a group relief regime.

The illegitimate overseas deduction is treated as if it had already been allowed in a previous accounting period. It will not form part of any unused hybrid entity double deduction amount carried forward.

Dual inclusion income

Dual inclusion income is the amount of income arising during an accounting period to the hybrid entity, where that income is ordinary income of both

- the hybrid entity for that accounting period, and
- an investor in the hybrid entity for a permitted taxable period for the purposes of any tax charged in the investor jurisdiction.

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition (including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income) is at s259BC and the concept is discussed further at INTM550560.

There are special recognition rules at s259BD in instances of non-inclusion in ordinary income for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign companies (CFC) charge. This is discussed at INTM550570.

Permitted taxable period

A taxable period of an investor is a permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the hybrid entity, or
- begins in a later period if a claim is made, and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

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INTM557080 Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Stranded deductions

Where the investor is within the charge to corporation tax:

If the Commissioners for HMRC are satisfied that no future dual inclusion income will arise to the investor, then the stranded deduction may be deducted in calculating the investor's taxable total profits of the relevant period. A stranded deduction is the amount of the hybrid entity double deduction that has not been deducted from dual inclusion income in an earlier accounting period.

If a stranded deduction cannot be used against the total profits of the investor in the relevant period, it may be carried forward and set against total profits of future periods.

Where the hybrid entity is within the charge to corporation tax:

If the Commissioners for HMRC are satisfied that no future dual inclusion income will arise to the hybrid entity, then the stranded deduction may be deducted in calculating the hybrid entity's total profits of the relevant period. A stranded deduction is the amount of any hybrid entity double deduction that has not been deducted from dual inclusion income in an earlier accounting period.

If a stranded deduction cannot be used against the total profits of the hybrid entity in the relevant period, it may be carried forward and set against total profits of future periods.

Commissioners Consideration

Stranded deductions are likely to arise in scenarios where an entity ceases permanently i.e. is struck off such that there is no future prospect of dual inclusion income arising. Where stranded deductions are to be considered by the Commissioners full details should be sent to the Base Protection Policy team, BAI -

- by email to: hybrids.mailbox@hmrc.gov.uk, or
- by post to: HM Revenue & Customs
  Base Protection Policy Team,
  Business Assets & International
  S0862, Floor 4 Rear
  Central Mail Unit
  Newcastle, NE98 1ZZ

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INTM557085: Hybrids: Chapter 9 – Hybrid entity within the charge to CT: Section 259ID income, Capital Allowances

Section 259ID income

This section applies where the hybrid entity is within the charge to corporation tax, the restricted deduction exceeds the dual inclusion income of the hybrid entity (if there is any) and four conditions, A to D are met.

The conditions are:

- Condition A: the investor in the hybrid entity makes a payment to the hybrid entity, and no amount is deductible, under the law of the investor jurisdiction, from the income of the investor in respect of the payment.

- Within this section 'payment' takes its ordinary meaning and not that as defined at 259BB

- Condition B: as a result of the payment, an amount of ordinary income arises to the hybrid entity for the hybrid entity deduction period.

- Condition C: the payment, made by the investor to the hybrid entity, is made in direct consequence of a payment made to the same investor by an unrelated person to either the investor or the hybrid entity.

- Section 259NC defines related person.

- The phrase 'in direct consequence' is not defined and takes its ordinary meaning i.e. an effect that is a result of an event or occurrence suggesting something that follows on, there is a prescribed order to the events.

- Condition D: as a result of the payment made by the unrelated party, an amount of ordinary income arises to the investor that makes the payment to the hybrid entity referred to in condition A.

  Note that the legislation refers specifically to 'the' investor and should not be interpreted more widely to include 'any' investor.

Capital Allowances – whether claimed or not

When the hybrid entity is within the charge to corporation tax, condition A at 259IA will be met where capital allowances could be claimed if there could also be a similar deduction for depreciation in the investor jurisdiction.

If conditions B and C at 259IA are also met there will be a hybrid entity double deduction amount which will be represented as the restricted deduction.

By virtue of 259IC(4) the restricted deduction may not be deducted from the hybrid entity's income for the hybrid entity deduction period unless it is deducted from dual inclusion income or 259ID income.

It should be noted that, as the counteraction operates to deny the deduction then there can be no counteraction where capital allowances have been disclaimed and in those circumstances there will be no requirement under 259IC(5)(a) and (b) to carry forward an amount.

If, in a subsequent year, capital allowances are claimed then they are computed in the ordinary way.

Where appropriate the capital allowances claimed should be adjusted to deny relief. The method of tracking adjustments is not defined however it is expected that the capital allowances computation would remain unchanged and the adjustment would be shown as an additional entry in the CT computation.

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INTM557190: Hybrids: Chapter 9 – Hybrid entity double deduction mismatches: Examples: Contents

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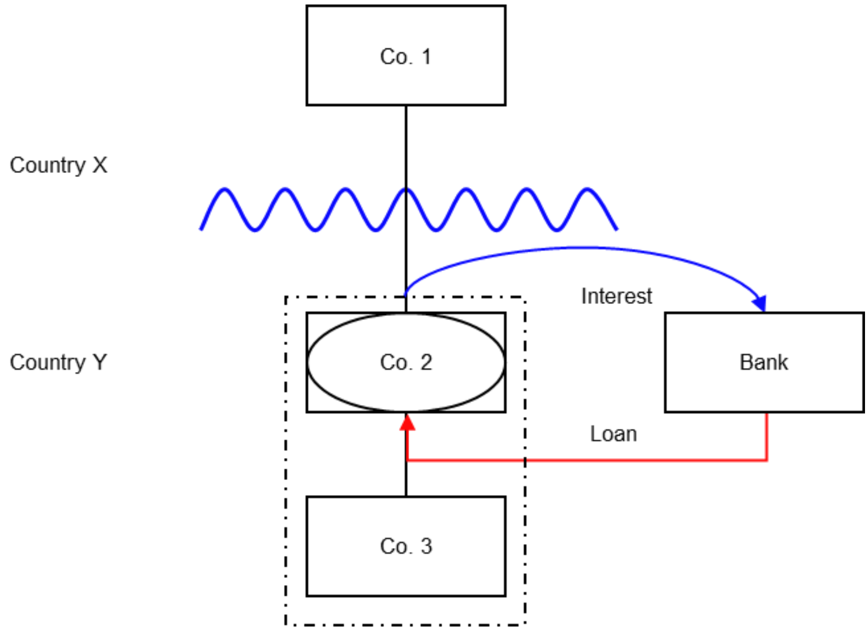
INTM557200: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: No dual inclusion income



Background

- Co. 1 is a company resident in Country X.
- Co. 2 is a company resident in Country Y, and Co. 1 owns its entire shareholding
- Co. 2 is treated as a separate person for tax purposes in Country Y but as a disregarded entity for tax purposes in Country X.
- Co. 3 is also resident in Country Y, and Co. 2 owns its entire shareholding
- Country Y operates a tax consolidation regime such that Co. 2 may surrender its deductions to Co. 3 for tax purposes
- Co. 2 borrows money from a bank resident in Country Y (the Loan).
- Country X allows Co. 1 a deduction for the underlying interest, as it sees Co. 2 as a branch of Co. 1.
- Country Y allows a deduction for the interest payments made by Co. 2, which can be surrendered to Co. 3.

Analysis - Applying the tests in s259IA TIOPA 2010

Do the hybrid entity double deduction mismatch rules in Chapter 9 apply to the interest payment made by Co. 2?

Condition A: Is it reasonable to suppose that there is an amount that could be deducted both from the income of a hybrid entity and also from the income of an investor?

Co. 2 is a hybrid entity, as its profits are treated as the profits of Co. 1 under Country X's law, but it is regarded as being a separate person for tax purposes under the law of Country Y.

Co. 1 is the investor in Co. 2.

It is reasonable to suppose that deductions arising under the Loan could be deducted against the income of both Co. 2 and Co. 1 for the purposes of calculating their taxable profits.

Condition A is satisfied. The extent of the hybrid entity double deduction is the full amount of the interest payments under the Loan.

Condition B: Is either Co. 1 (an investor in the hybrid entity) or Co. 2 (the hybrid entity) within the charge to corporation tax for the deduction period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co.1, Co.2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co.1 nor Co.2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Are the hybrid entity and its investor related, or is there a structured arrangement?

The hybrid entity (Co. 2) and its investor (Co. 1) are related within the definition at s259NC by virtue of being in the same control group.

Condition C is satisfied.

Conclusion

All the conditions are satisfied to characterise the payments of interest as a hybrid entity double deduction mismatch, so the relevant counteractions must be considered.

Counteraction

The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where UK is in the position of Country X (the investor jurisdiction).

Primary Response
Where the UK is in the position of the investor jurisdiction, s259IB applies.

As the hybrid entity double deduction amount is in substance deducted from the income of Co 3 in Country Y, and that income is not dual inclusion income of Co 2, there is an illegitimate overseas deduction for all of the hybrid entity double deduction amount. Co. 1 will be denied a deduction for the entire amount.

The illegitimate overseas deduction is treated as if it were deducted in an earlier period. Consequently there is no amount for Co. 1 to carry forward.

Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)

The UK does not operate a consolidation regime, but a similar result to that described above could arise if Co 2 had no income and surrendered its losses to Co 3.

Secondary response
Where the UK is in the position of the payer jurisdiction (Co. 2), and the hybrid entity double deduction amount has not been fully counteracted by Country X, then s259IC applies if the secondary counteraction condition is met.

The secondary counteraction condition is met in this case as Co 1 and Co 2 are in the same control group throughout the hybrid entity deduction period.

In this instance there is no illegitimate overseas deduction as amounts surrendered to Co 3 are deducted from the income of Co 3 under UK law.

The UK will deny Co. 2 a deduction for the hybrid entity double deduction amount as there is no dual inclusion income Co. 2 may carry forward the unused hybrid entity double deduction and deduct it from any dual inclusion income arising in subsequent accounting periods.

If the Commissioners are satisfied that Co 2 will not have any dual inclusion income any unused hybrid entity double deductions become stranded deductions. Co 2 may deduct these stranded deductions from total taxable profits of subsequent accounting periods.

As Co 2 no longer has a deduction, there is no loss to surrender to Co 3.

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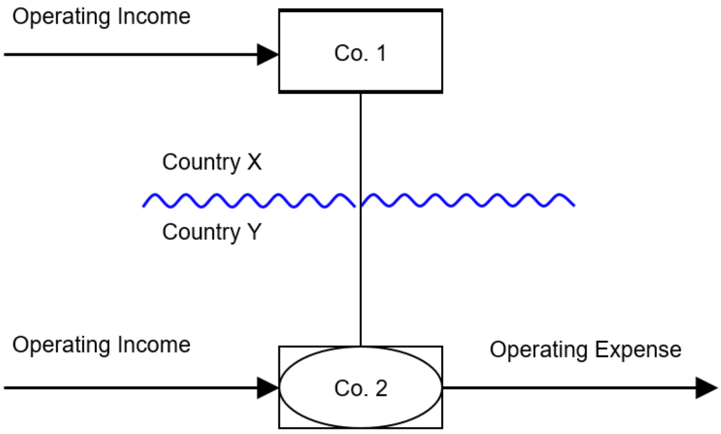
INTM557210: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Timing and recognition differences – permitted periods – illegitimate overseas deduction

This example demonstrates how the permitted periods operate when calculating dual inclusion income along with the consequences of illegitimate overseas deductions.



Typically, the UK would be in the position of Country Y and so this example treats Co. 2 as being in the UK.

Background

- Co. 1 is resident in Country X and owns all the issued shares in Co.2, which is resident in Country Y (UK).
- Co. 2 is treated as a taxable person in Country Y (UK) but is not a separate taxable person under the tax law in Country X.
- Co. 2's income or profits are taxable in Country X (as income or profits of Co.1) and in Country Y (UK) (as income or profits of Co. 2).
- Co. 1 has 500 of operating income spread evenly over a two year period.
- Co. 2 has 500 of operating income over a two year period.
- Co. 2 has 320 of operating expenses in each year.
- Co. 2's income and expenses are treated as taxable income and deductible expenditure under the laws of both Country X and Country Y.

- Co. 2's income and expenditure are recognised in different amounts and in different periods in Country X and Country Y (UK).

Under Country X law

Co. 2's operating income is treated as arising:
- Year 1 100, and
- Year 2 400

Co. 2's operating expenses are treated as:
- Year 1 (220), and
- Year 2 (420)

Under Country Y (UK) law

Co. 2's operating income is treated as arising:
- Year 1 300
- Year 2 200

Co. 2's operating expenses are treated as:
- Year 1 (320)
- Year 2 (320)

The position for Co. 1 and Co. 2 before any consideration of Chapter 9 is –

YEAR 1 - Co. 1 (Investor) – Country X		**YEAR 1 - Co. 2 (Hybrid entity) – Country Y (UK)**	
INCOME		**INCOME**	
Operating income Co. 1	250	Operating income Co. 2	300
Operating income Co. 2	100		
EXPENDITURE		**EXPENDITURE**	
Operating expenses Co. 2	(220)	Operating expenses Co. 2	(320)
TAXABLE INCOME	130	TAXABLE INCOME (LOSS)	(20)
YEAR 2 - Co. 1 (Investor) – Country X		**YEAR 2 - Co. 2 (Hybrid entity) – Country Y (UK)**	
INCOME		**INCOME**	
Operating income Co. 1	250	Operating income Co. 2	200
Operating income Co. 2	400		
EXPENDITURE		**EXPENDITURE**	
Operating expenses Co. 2	(420)	Operating expenses Co. 2	(320)
TAXABLE INCOME	230	TAXABLE INCOME (LOSS)	(120)

Analysis - Applying the tests in s259IA TIOPA 2010

Does Chapter 9 apply to restrict any hybrid entity double deduction arising under this structure?

Condition A: Is it reasonable to suppose an amount could be deducted both from the income of a hybrid entity for a taxable period, and also from the income of an investor for a taxable period?

Co. 2 is regarded as a separate person for tax purposes under the law of Country Y (UK) but its income and expenses are treated as income and expenses of Co. 1 under Country X's law. Co. 2 is therefore a hybrid entity. Co.1 is the investor in Co. 2.

It is reasonable to suppose that operating expenses incurred by Co. 2 could be deducted from income of both Co. 2 and Co. 1 for the purposes of calculating their taxable profits.

Condition A is satisfied.

Condition B: Is either Co. 1 (an investor in the hybrid entity) or Co. 2 (the hybrid entity) within the charge to corporation tax for the deduction period?

The charge to corporation tax is the charge to the corporation tax in the UK.

Assuming for this example that Country Y is UK. Condition B is satisfied.

[If the UK was Country X, or both Country X and Country Y (i.e. a wholly domestic transaction), Condition B would be satisfied, as either Co.1 or both Co. 1 and Co. 2 would be within the charge to corporation tax.

If the UK was neither Country X nor Country Y, then Condition B would not be not satisfied, as neither Co.1 nor Co.2 would be within the charge to corporation tax. You would then need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 applied.]

Condition C: Are the hybrid entity and its investor related, or is there a structured arrangement?

Co. 1 is related to Co. 2 within the definition at s259NC through its 100% investment.

Condition C is satisfied.

Conclusion

As all the conditions are satisfied, the relevant counteraction must be considered in respect of amounts identified as hybrid entity double deductions.

Counteraction

The counteraction applied depends on whether the UK is in the position of Country X or Country Y.

Counteraction where the UK is Country Y (the hybrid entity jurisdiction)

Secondary Response

If Country X has fully counteracted the hybrid entity double deduction under provisions equivalent to those at Part 6A, no further action is necessary in the UK.

Where the hybrid entity double deduction amount is not fully counteracted in Country X, or Country X does not have provisions equivalent to those in Part 6A, the UK counteraction is under s259IC. The hybrid entity double deduction amount may only be deducted from dual inclusion income or section 259ID income of the hybrid entity for the hybrid entity deduction period.

Year 1

In this example it is assumed that Country X has no provisions equivalent to those under Part 6A.

Expenses paid in Year 1 by the hybrid entity 320.

The 320 is an amount or part of an amount that –

- could be deducted from the income of the hybrid entity for the purposes of calculating the taxable profits of that entity for a taxable period, and

- could also be deducted, under the law of the investor jurisdiction, from the income of an investor in the hybrid entity for the purposes of calculating the taxable profits of that investor for a taxable period.

The fact that part of the amount is deducted in one taxable period and another part of the amount may be deducted in another taxable period in Co.1 does not prevent identification and counteraction of the double deduction amount.

Consequently, the hybrid entity double deduction amount is 320.

Dual inclusion income of the hybrid entity for an accounting period is defined at s259IC(10) as an amount that is ordinary income of both -
- the hybrid entity for that accounting period for corporation tax purposes, and
- the investor for a permitted taxable period under the law of the investor jurisdiction.

A taxable period of the investor is permitted where it begins within 12 months of the end of the hybrid entity's accounting period (or later in certain circumstances, on a claim).

In Year 1 there is an amount of 300 included in ordinary income of Co. 2 in the accounting period that is also included in ordinary income of Co. 1 in a permitted period. Co. 1 includes 100 operating income of Co.2 in Year 1 and 400 operating income of Co. 2 in Year 2. The 300 ordinary income of Co. 2 in Year 1 is therefore included to the extent that 100 is regarded by Co. 1 in Year 1 and to the extent that 200 is regarded by Co. 1 in Year 2.

Dual inclusion income is 300 in Year 1.

There is no section 259ID income in this example.

The restricted deduction is 320, that is the hybrid entity double deduction amount. There is a counteraction in respect of the full hybrid entity double deduction amount of 320, however 300 of the counteracted amount may be deducted from dual inclusion income for that period.

Illegitimate Overseas Deduction in Year 1

We must then consider whether the remaining 20 is an "illegitimate overseas deduction" as defined at s259IC(8).

Co. 1 has operating income of 250 in Year 1, which is not dual inclusion income, and against which 20 of the hybrid entity double deduction amount is deducted under the law of Country X. The remaining 20 is therefore an "illegitimate overseas deduction" and so it is taken to have already been deducted for a previous accounting period of the hybrid entity and is not carried forward.

Year 2

The hybrid entity double deduction amount is 320.

In Year 2, there is 200 included in ordinary income of Co.2 in the accounting period that is also ordinary income of Co. 1 in a permitted period (200 of the ordinary income of 400 of Co. 2 as regarded by Co.1 in Year 2 has already been accounted for as dual inclusion income within the permitted period for Year 1). There may be further dual inclusion income in Year 3 that would be within the permitted period, but there is nothing to suggest that is the case from the figures presented.

Dual inclusion income is 200 in Year 2.

There is no section 259ID income in this example.

The restricted deduction is 320 (= hybrid entity double deduction amount). There is a counteraction in respect of the full hybrid entity double deduction amount of 320, however, 200 may be deducted from dual inclusion income for that period.

Illegitimate Overseas Deduction in Year 2

We must then determine whether the excess hybrid entity double deduction amount of 120 (calculated as the total of 320 - less the amount of 200 set against the dual inclusion income) is available to carry forward by Co. 2.

Co. 1 has operating income of 250 in Year 2, which is not dual inclusion income, and against which the remaining 120 of the hybrid entity double deduction amount is deducted under the law of Country X. The remaining 120 is therefore an “illegitimate overseas deduction” and so it is taken to have already been deducted for a previous accounting period of the hybrid entity and is not carried forward.

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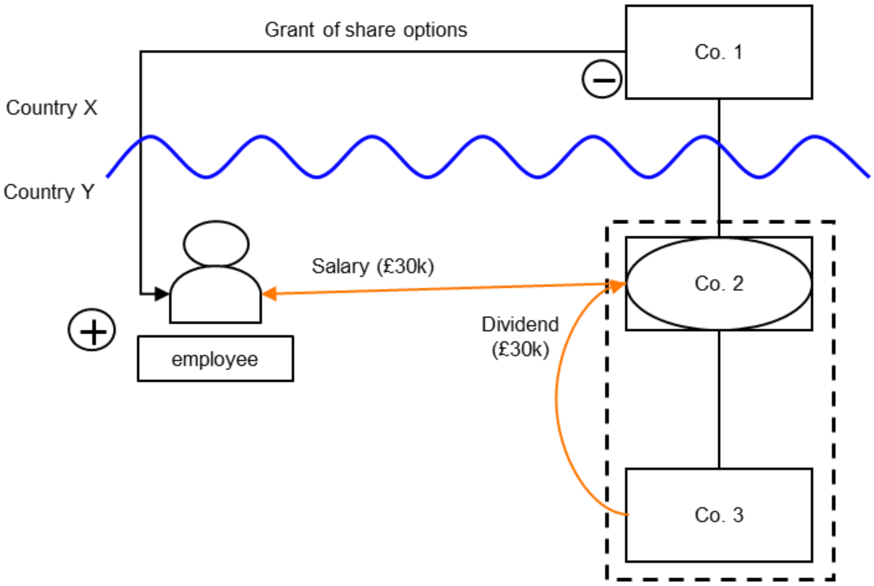
INTM557220: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Grant of share options



Background

- Co. 1 establishes Co. 2 as the holding company for its operating subsidiary Co. 3.
- Co. 2 is treated as a separate person for tax purposes in Country Y but income or profits are treated as income or profits of Co. 1 for tax purposes by Country X.
- Co. 2 and Co. 3 are members of the same tax group and therefore, under the tax laws of Country Y, the net loss of Co. 2 can be set-off against ordinary income of Co. 3.
- Co. 2 has a single employee who is entitled to an annual salary of £30k. The salary cost is funded by a dividend payment from Co. 3 that is exempt from taxation in both Country Y and Country X.
- The employee also participates in a share incentive scheme which provides the employee with an option to acquire shares in Co. 1. The grant of the share option is deductible under the laws of both countries, but Country X values the grant of share option as £20k and Country Y values it as £15k.

Note: In this scenario the UK will only allow a deduction for the grant of share options once the shares are awarded. In addition the accounting deduction in the UK would be denied by virtue of sections 1038 CTA 2009 and 1038A CTA 2009, with any relief being granted by Part 12 CTA 2009 and measured by reference to the market value of the shares and the income tax position of the recipient.

Analysis - Applying the tests in s259IA TIOPA 2010

Does the payment of salary and grant of share options to the employee give rise to a hybrid entity double deduction amount?

Condition A: Is it reasonable to suppose an amount could be deducted both from the income of a hybrid entity and also from the income of an investor?

Co. 2 is a separate taxable person under the tax law of Country Y. Income or profits of Co. 2 are treated as the income or profits of Co. 1 under the tax law of Country X. Co. 2 is a hybrid entity, provided by s259BE, with Co. 1 being the relevant investor.

Given the facts above, it is reasonable to suppose that Co. 1 will receive a £30k deduction against its income for the salary payment and a £20k deduction for the granting of the share options, under the laws of Country X (the investor jurisdiction).

It is also reasonable to suppose that, under the laws of Country Y (the hybrid entity jurisdiction), Co. 2 will receive a £30k deduction against its income for the salary payment and a £15k deduction for the granting of Co. 1's share options by Co. 1 to the employee of Co. 2.

Condition A is satisfied

The extent of the hybrid entity double deduction amount is

- the salary cost of £30k, and
- the amount of £15k in relation to the grant of Co. 1's share options to the employee of Co. 2 (that is, the £15k deducted by Co. 2 which is also included in the £20k deducted by Co. 1).

Condition B: Is either Co. 1 (investor in the hybrid entity) or Co. 2 (the hybrid entity) within the charge to corporation tax for the deduction period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co.1, Co.2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co.1 nor Co.2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Are the hybrid entity and one or more investors in it related, or is there a structured arrangement?

The hybrid entity (Co. 2) and its investor (Co. 1) are related within the definition of s259NC.

Condition C is satisfied.

Conclusion

As all the conditions are satisfied, the relevant counteraction must be considered in respect of amounts identified as hybrid entity double deductions.

Counteraction

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where UK is in the position of Country X (the investor jurisdiction)

Primary response
Where the UK is in the position of Country X, s259IB will apply

As the hybrid entity double deduction amount is in substance deducted from the income of Co 3 in Country Y, and that income is not dual inclusion income of Co 2, there is an illegitimate overseas deduction for all of the hybrid entity double deduction amount. Co. 1 will be denied a deduction for the entire amount.

The illegitimate overseas deduction is treated as if it were deducted in an earlier period. Consequently there is no amount for Co. 1 to carry forward.

Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)

Secondary response
Where the UK is in the position of the payer jurisdiction (Co. 2), and the hybrid entity double deduction amount has not been fully counteracted by Country X, then s259IC applies if the secondary counteraction condition is met.

The secondary counteraction condition is met in this case as Co 1 and Co 2 are in the same control group throughout the hybrid entity deduction period.

In this instance there is no illegitimate overseas deduction as amounts surrendered to Co 3 are deducted from the income of Co 3 under UK law.

Co. 2 is denied the deduction for the salary payment of £30k and the grant of share options of £15k, because Co. 2 has no dual inclusion income to set it against. Co. 2 may carry forward the £45k and deduct it from any dual inclusion income arising in subsequent accounting periods.

If the Commissioners are satisfied that Co 2 will not have any dual inclusion income again (i.e. entity ceased, struck off), any unused hybrid entity double deductions become stranded deductions. Co 2 may deduct these stranded deductions from total taxable profits of subsequent accounting periods.

As Co. 2 no longer has a deduction for the £45k, there is no loss for it to surrender to Co. 3.

Note: If the share options have not yet been awarded then under UK law they will not be considered as allowable deductions until they have been awarded.

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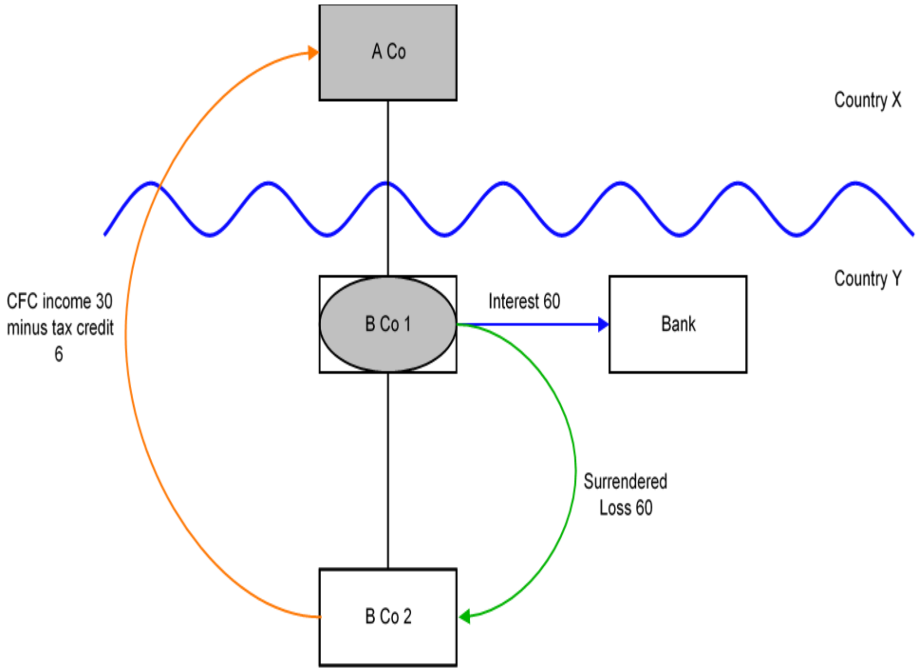
INTM557230: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Calculating dual inclusion income under a CFC regime



Background

- A Co is resident in Country X and owns 100% of the shares in B Co 1.
- B Co 1 has no income during the period and owns 100% of the shares in its trading company, B Co 2. Both are resident in Country Y.
- B Co 1 takes out a loan (the 'Loan') from a local Bank, with interest of 60 arising in the period. As it has no income, this leads to a trading loss of 60 which it can surrender to B Co 2 to relieve against its ordinary income.
- B Co 1 income or profits are treated as income or profits of A Co under Country X law and therefore A Co can also claim a deduction of 60 in relation to the interest.
- B Co 2 has other income during the period of 90. After the deduction of 60 this leaves B Co 2 with profits of 30.
- A Co is subject to a CFC charge on B Co 2's profits of 90, with relief available for the relevant tax suffered on those profits in Country Y. (Note that A Co cannot be subject to a CFC charge on the profits of B Co 1 since

B Co 1 is a disregarded entity under the tax law of Country X so cannot be a controlled foreign company).

Analysis - Applying the tests in s259IA TIOPA 2010

Do the hybrid entity double deduction mismatch rules apply to the interest payment made by B Co 1?

Condition A: Is it reasonable to suppose an amount could be deducted both from the income of a hybrid entity and also from the income of an investor?

B Co 1 is recognised as a separate taxable person for tax purposes under the law of Country Y, but its income or profits are treated as the profits of A Co under the law of Country X. B Co 1 is a hybrid entity and A Co is the investor.

Given the facts above, it is reasonable to suppose that a deduction in relation to the interest arising under the Loan will be permitted as a deduction against the ordinary income of both A Co and B Co 1 in calculating their taxable profits.

Condition A is satisfied.

The hybrid entity double deduction is the full amount of the interest deduction under the Loan.

Condition B: Is either A Co (the investor in the hybrid entity) or B Co (the hybrid entity) within the charge to corporation tax for the deduction period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co.1, Co.2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co.1 nor Co.2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

Condition C: Are B Co 1 (the hybrid entity) and A Co 1 (the investor) related, or is there a structured arrangement?

A Co 1 and B Co 1 are related within the definition at s259NC.

Condition C is satisfied.

Conclusion

As all the conditions are satisfied, the relevant counteraction must be considered in respect of amounts identified as hybrid entity double deductions.

Counteractions

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where UK is in the position of Country X (the investor jurisdiction)

Primary response
Where the UK is in the position of Country X, s259IB will apply

The hybrid entity double deduction amount of 60 is in substance deducted from the income of B Co 2 in Country Y, so there is an illegitimate overseas deduction to the extent that it is deducted from income that is not dual inclusion income of the investor.

Dual inclusion income only includes amounts included in the taxable profits of both the investor and the hybrid entity i.e. A Co and B Co 1 respectively. The income recognised in the CFC charge in A Co, being 90, is that arising to B Co 2 and therefore is not dual inclusion income.

Consequently there is an illegitimate overseas deduction of 60, and A Co will be denied a deduction for that amount.

The illegitimate overseas deduction is treated as if it were deducted in an earlier period. Consequently there is no amount for A Co to carry forward.

Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)

Secondary response
Where the UK is in the position of the payer jurisdiction (B Co 1), and the hybrid entity double deduction amount has not been fully counteracted by Country X, then s259IC applies if the secondary counteraction condition is met.

The secondary counteraction condition is met in this case as B Co 1 and A Co are in the same control group throughout the hybrid entity deduction period.

In this instance there is no illegitimate overseas deduction as amounts surrendered to B Co 2 are deducted from the income of B Co 2 under UK law.

B Co 1 is denied a deduction for the hybrid entity double deduction of 60 as it has no dual inclusion income to set it against. B Co. 1 may carry forward the 60 and deduct it from dual inclusion income of B Co 1 arising in subsequent accounting periods.

If the Commissioners are satisfied that B Co 1 will not have any future dual inclusion income (i.e. entity struck off / ceased), any unused hybrid entity double deductions become stranded deductions. B Co 1 may deduct these stranded deductions from total taxable profits of subsequent accounting periods.

As B Co 1 no longer has a trading loss, there is nothing to surrender to B Co 2. B Co 2 is taxable on its full profits of 90.

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INTM558000: Hybrids: Chapter 10 - Dual Territory Double Deduction: Contents

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INTM558010: Hybrids: Chapter 10 - Dual Territory Double Deduction: Overview

Chapter 10 of Part 6A TIOPA 2010 counters double deduction mismatches arising to either

- a dual resident company, or
- a company with a permanent establishment (a 'relevant multinational company').

For Chapter 10 to apply, both Condition A and Condition B in s259JA must be met:

Condition A

A company is a

- dual resident company, or
- relevant multinational company.

Condition B

There is an amount that, in the absence of Chapter 10 and any equivalent overseas rules, it is reasonable to suppose could be deducted from both the company's income for corporation tax purposes, and from its income for the purposes of a tax charged by an overseas territory, by reason of the company being a dual resident company or relevant multinational company. This double deduction is the dual territory double deduction amount.

Where both these conditions are met, the counteractions are broadly as follows:

- For a dual resident company, the dual territory double deduction amount may be deducted only from dual inclusion income for the period, with any excess being carried forward for future periods. The amount of the dual territory double deduction allowed is also restricted by the amount of any illegitimate overseas deduction.
- For a relevant multinational where the UK is the parent jurisdiction, the dual territory double deduction amount may be deducted only to the extent that it is not an impermissible overseas deduction.

  For a relevant multinational where the UK is the PE jurisdiction, and there is no counteraction of the deduction under the law of the parent jurisdiction, the dual territory double deduction amount may be deducted only from dual inclusion income for that period, with any excess being carried forward to future periods. The amount of the dual territory double deduction allowed is also restricted by the amount of any illegitimate overseas deduction.

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INTM558020: Hybrids: Chapter 10 - Dual Territory Double Deduction: Conditions to be satisfied

The conditions applicable for Chapter 10 of Part 6A TIOPA 2010 are set out at s259JA. For Chapter 10 to apply both conditions A and B must be met.

INTM558030: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition A

INTM558040: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition B

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INTM558030: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition A

Condition A

Condition A of s259JA requires that a company is either

- a dual resident company, or
- a relevant multinational company.

Dual resident company

A dual resident company for the purpose of Chapter 10 is defined at s259JA(3). A company is a dual resident company if it is resident in the UK, and it is also within the charge to a tax under the law of a territory outside the United Kingdom because

- it derives its status as a company from that law,
- its place of management is in that territory, or
- it is for some other reason treated as resident under the law of that territory.

Note that a UK company's foreign subsidiary (upon whose profits a CFC charge is based) is not a dual resident company. While the subsidiary is *deemed* to be a UK resident company in order to compute the assumed taxable total profits for UK CFC purposes per section 371SD(1)(a) TIOPA 2010, it is not in fact a UK resident company.

Relevant multinational company

A relevant multinational company is defined at 259JA(4). It is a company that is -

- within the charge to tax in a jurisdiction (known as "the PE jurisdiction"), in which it is not resident for tax purposes, because it carries on business in that territory through a permanent establishment in that territory, and
- either –
    i. the PE jurisdiction is the UK, or
    ii. the territory in which the company is resident for tax purposes (known as "the parent jurisdiction"), is the UK.

Company is not defined in the legislation, so takes its normal meaning under UK law.

Permanent establishment includes anything that is a permanent establishment within the meaning of section 1119 CTA 2010, or within any similar concept outside the United Kingdom. An overseas concept of a permanent establishment is not excluded simply because it is not based on Article 5 of the OECD model tax convention on income and capital.

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INTM558040: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition B

Condition B of s259JA asks if it is reasonable to suppose that there is an amount which could, by reason of the company being either a dual resident or a multinational company, be deducted from the income of the company for corporation tax purposes and also deducted for the purposes of a tax charged under the law of an overseas territory.

Reasonable to suppose

There is no definition of the term reasonable to suppose in Part 6A, so the phrase will take its ordinary meaning. Generally this does not require either party to know how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it would be reasonable to suppose that a double deduction mismatch arises.

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INTM558050: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction: Dual territory double deduction

If conditions A and B are satisfied the counteractions set out at s259JB, s259JC and s259JD apply to counter the mismatch in the UK.

The counteraction varies depending on whether the company is dual resident or a relevant multinational company, and whether the UK is the parent or PE jurisdiction.

INTM558060: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction - dual resident company

INTM558070: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction - relevant multinational and the UK is the parent jurisdiction

INTM558080: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction - relevant multinational and the UK is the PE jurisdiction

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INTM558060: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction - dual resident company

The counteraction where a dual resident company is within the charge to UK corporation tax is set out at s259JB. A dual resident company may have a deduction for the amount of the dual territory double deduction mismatch only to the extent that

- it is not reduced by an illegitimate overseas deduction, and
- it is set against any dual inclusion income of the company for that period.

Where there is insufficient dual inclusion income in the period, the amount of the dual territory double deduction denied may be carried forward and deducted only from dual inclusion income of the company in subsequent accounting periods.

Illegitimate overseas deduction

The dual territory double deduction amount that may be set against dual inclusion income of the company must be reduced by the amount of any illegitimate overseas deduction.

An illegitimate overseas deduction is defined at s259JB(6) as all or part of the dual territory double deduction where it is reasonable to suppose that

- the amount is in substance deducted
- under the law of a territory outside the UK
- from the income of any person for a taxable period, and
- the income from which it is deducted is not dual inclusion income of the company.

This may occur, for example, where the deduction creates a loss in the territory outside the UK which is subsequently surrendered as group relief to another company in that territory.

The illegitimate overseas deduction is treated as if it had already been deducted in a previous accounting period. This means that this part of the deduction is permanently denied, and it should not be included in the amount of any unused dual territory double deduction carried forward.

Dual inclusion income

Dual inclusion income of the company for an accounting period means an amount that is ordinary income of both

- the company for that period for corporation tax purposes, and

- the company for a permitted taxable period for the purposes of a tax charged under the law of a territory outside the UK.

Ordinary income

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at INTM550560.

There are special recognition rules at s259BD covering instances of non-inclusion which treat an amount of income (where it has been subjected to another territory's controlled foreign companies (CFC) charge) as if it had been included. This is discussed further at INTM550570.

Permitted taxable period

A taxable period of a hybrid entity is 'permitted' if the period

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the investor, or

- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

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INTM558070: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction - relevant multinational and the UK is the parent jurisdiction

The counteraction where the UK is the parent jurisdiction of a relevant multinational company is set out at s259JC.

Where the UK is the parent jurisdiction of a relevant multinational company, the dual territory double deduction amount is reduced by any impermissible overseas deduction. If there is no impermissible overseas deduction, then the deduction is allowed in full (subject to other UK tax provisions).

Where the dual territory double deduction requires to be reduced - just and reasonable adjustments, including by assessment, are to be made.

Example INTM558210 illustrates the counteraction involving an impermissible overseas deduction and group relief.

Impermissible overseas deduction

An impermissible overseas deduction is defined at s259JC(2) as all or part of the dual territory double deduction amount that

- is in substance deducted
- under the tax law of a territory outside the UK
- from the income of any person for any taxable period and
- that income is not dual inclusion income of the company.

Dual inclusion income

Dual inclusion income of the company means an amount that is ordinary income of both

- the company for an accounting period for corporation tax purposes, and
- the company for a permitted taxable period for the purposes of a tax charged under the law of a territory outside the UK.

Effective use of a loss in PE territory

Where a loss arises in the PE territory that may be utilised, for example, in a consolidation regime or similar. When establishing the extent of the double deduction available in the UK parent company, the amount of the effective PE loss should be apportioned between the relevant entities on a pro rata basis in the absence of facts to suggest otherwise.

For example:

- Relevant multinational and UK is parent jurisdiction
- Foreign PE with deduction creating loss 500
- Within consolidation regime with PE;
    - Co.A – profit 1000
    - Co.B – loss 1000

In order to determine what proportion of the PE loss is utilised by Co.A apply a pro rata approach. Such that Co.A uses 1/3 PE loss /double deduction (333) and 2/3 Co.B loss (667). The UK company could utilise the remaining 167 PE double deduction subject to dual inclusion income. The 333 used by Co.A would be an impermissible overseas deduction.

Ordinary income

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at INTM550560.

There are special recognition rules at s259BD covering instances of non-inclusion which treat an amount of income (where it has been subjected to another territory's controlled foreign companies (CFC) charge) as if it had been included. This is discussed at INTM550570.

Permitted taxable period

A taxable period of a hybrid entity is 'permitted' if the period

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the company, or
- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

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INTM558080: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction - relevant multinational and the UK is the PE jurisdiction

The counteraction where the UK is the PE jurisdiction of a relevant multinational company is set out at s259JD. The counteraction applies where there is no provision in the parent jurisdiction equivalent to this legislation which counteracts the mismatch.

Where the UK is the PE jurisdiction of a relevant multinational company, the dual territory double deduction amount is allowed only to the extent that -

- it is not reduced by an illegitimate overseas deduction, and
- it is deducted from dual inclusion income of the company for that period.

Where there is insufficient dual inclusion income in the period, the amount of the dual territory double deduction amount denied may be carried forward and deducted from dual inclusion income of the company in subsequent accounting periods.

Illegitimate overseas deduction

The dual territory double deduction amount that may be set against dual inclusion income of the company must be reduced by the amount of any illegitimate overseas deduction.

An illegitimate overseas deduction is defined at s259JD(6) as all or part of the dual territory double deduction where it is reasonable to suppose that

- the amount is in substance deducted
- under the law of a territory outside the UK
- from the income of any person for a taxable period, and
- the income from which it is deducted is not dual inclusion income of the company.

This may occur, for example, where the deduction creates a loss in the parent jurisdiction which is subsequently surrendered as group relief to a company outside the UK. Example INTM558210 illustrates the counteraction and impact on group relief.

The illegitimate overseas deduction is treated as if it had already been deducted in a previous accounting period. This means that this part of the deduction is permanently denied, and it should not be included in the amount of any unused dual territory double deduction carried forward.

Dual inclusion income

Dual inclusion income of the company for an accounting period means an amount is both ordinary income of the company

- for that period for corporation tax purposes, and
- for a permitted taxable period for the purposes of a tax charged under the law of a territory outside the UK.

Ordinary income

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at INTM550560.

There are special recognition rules at s259BD covering instances of non-inclusion which treat an amount of income (where it has been subjected to another territory's controlled foreign companies (CFC) charge) as if it had been included. This is discussed at INTM550570.

Permitted taxable period

A taxable period of a company is a permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the company, or
- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

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INTM558085: Hybrids: Chapter 10 - Dual Territory Double Deduction: Stranded deductions

Stranded deductions arise when the dual territory double deduction amount can no longer be deducted from dual inclusion income following a permanent change in circumstances.

Where relief is possible it is given in step 2 section 4(2) CTA 2010 in calculating the company's taxable total profits.

Stranded deductions – Dual Resident Company

If the Commissioners are satisfied that the company has ceased to be a dual resident company and the company has not been able to deduct the dual territory double deduction amount from dual inclusion income of subsequent periods, then the stranded deduction may be deducted from the company's total profits in the period in which it ceased to be dual resident, or in subsequent accounting periods.

Stranded deductions – Relevant Multinational Company

If the Commissioners are satisfied that the company has ceased to be a relevant multinational company and the UK PE has not been able to deduct the dual territory double deduction amount from dual inclusion income of subsequent periods, then the stranded deduction may be deducted from the PE's total profits in its final accounting period (i.e. the period in which the company ceased to be a relevant multinational company).

Where stranded deductions need to be considered by the Commissioners full details should be sent to the Base Protection Policy team, BAI -

- by email to: hybrids.mailbox@hmrc.gov.uk, or

- by post to:

HM Revenue & Customs
Base Protection Policy Team,
Business Assets & International
S0862, Floor 4 Rear
Central Mail Unit
Newcastle
NE98 1ZZ

INTM558200: Hybrids: Chapter 10 – Dual Territory Double Deduction: Examples: Contents

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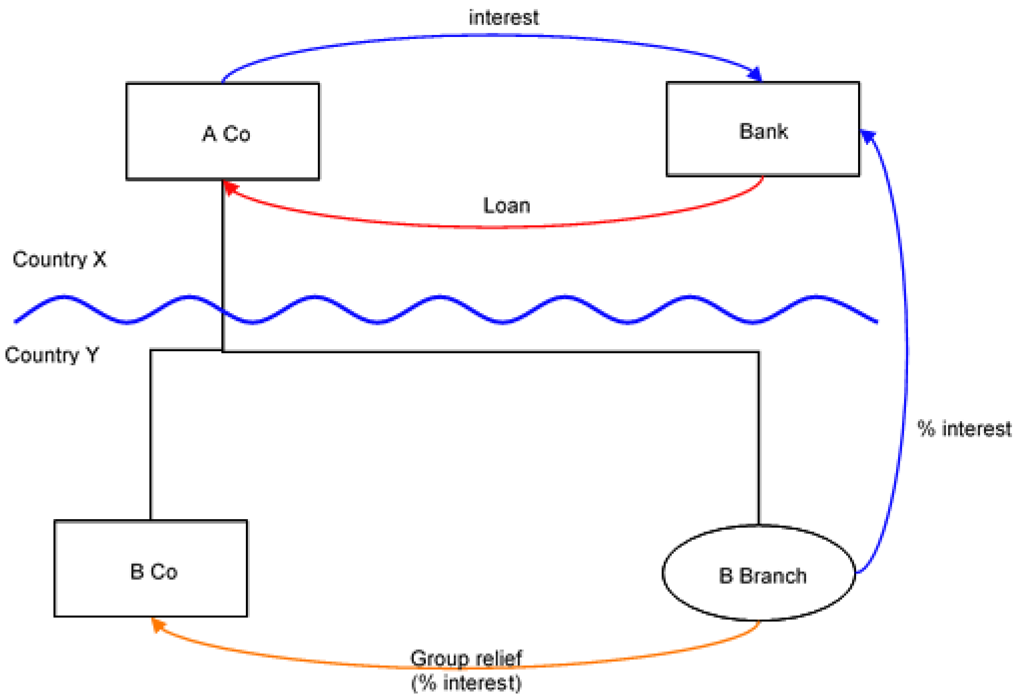
INTM558210: Hybrids: Chapter 10 - Dual territory double deduction: Examples: Multinational company double deduction



Background

- A Co is resident in Country X, and has a permanent establishment in Country Y ('B Branch').
- Both Country X and Y treat B Branch as giving rise to a permanent establishment in Country Y.
- A Co borrows money from an unrelated third party (Bank) and uses the loan to fund income-earning assets in Country Y.
- Country X allows A Co a deduction for the full amount of this interest expense.
- Country Y allows B Branch a deduction for a portion of the interest expense ('%interest') on the same loan.
- B Branch does not have any income and surrenders the loss arising from the interest deduction to B Co (a group company resident in Country Y) under a group relief provision of Country Y.

Analysis - Applying the tests in s259JA TIOPA 2010

Do the interest payment by A Co and the interest deduction allowed to B Branch satisfy the relevant conditions to fall within the scope of the dual territory double deduction rules?

Condition A: Is there a relevant multinational or dual resident company?

The definition of relevant multinational company is given at s259JA(4).

S259JA(4)(a) is satisfied as A Co is within the charge to tax in a country in which it is not resident because it carries on business in Country Y ('the PE jurisdiction') through a permanent establishment (B Branch).

If the UK is either Country X (the parent jurisdiction) or Country Y (the PE jurisdiction), the requirements at s259JA(4)(b) are met and A Co is a relevant multinational company.

Condition A is satisfied.

If the UK is neither Country X nor Country Y then the condition is not satisfied. If this is the case then the imported mismatch rules within s259K TIOPA 2010 should be considered.

Condition B: Is it reasonable to suppose that there is a dual territory double deduction amount that arises because the company is a multinational or dual resident company?

Given the facts above, it is reasonable to suppose that Country X will permit A Co a full deduction for the interest expense under the loan in the payment period.

It is also reasonable to suppose that Country Y will also permit a proportion of the interest expense (% interest) to be deducted in calculating the taxable income of Branch B, which is merely a part of A Co.

This double deduction arises because A Co is a relevant multinational company.

Condition B is satisfied.

The extent of the dual territory double deduction amount is %interest, being the amount of the interest deduction allowed to Branch B in Country Y.

Conclusion

As both conditions are satisfied, the relevant counteraction must be considered in respect of amounts identified as dual territory double deductions.

Counteraction

The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where the UK is in the position of Country X (parent jurisdiction)

Where the UK is in the position of Country X (the parent jurisdiction) then s259JC will apply.

There is no dual inclusion income arising in relation to A Co/B Branch. The deduction in B Branch creates a loss which is surrendered as group relief to B Co. The dual territory double deduction amount is in substance deducted from the income of B Co. Consequently, the amount surrendered is an impermissible overseas deduction.

The interest deduction available to A Co is reduced by this impermissible overseas deduction.

If B Branch did not surrender its loss, there would be no impermissible overseas deduction and there would be no need to restrict the deduction available to A Co.

Counteraction where the UK is in the position of Country Y (the PE jurisdiction)

Where the UK is in the position of Country Y (the PE jurisdiction), and it is reasonable to suppose that the dual territory double deduction amount has not been fully counteracted by any other country under a counteraction equivalent to s259JC, then s259JD will apply.

The UK will deny B Branch a deduction for the dual territory double deduction amount to the extent that it is not set against dual inclusion income. In this example, as B Branch has no income there can be no dual inclusion income and so the full dual territory double deduction (% interest) will be denied. As the UK has denied the deduction, B Branch no longer has a loss to surrender under group relief provisions. If there had been dual inclusion income, the dual territory double deduction could be allowed as a deduction in B Branch to the extent that;

- it did not exceed the dual inclusion income

- the measure of dual inclusion income was restricted by the amount of any illegitimate overseas deduction in Country X.

Any dual territory double deduction amount that cannot be deducted from B Branch's dual inclusion income for the deduction period is carried forward and deducted from dual inclusion income of subsequent accounting periods.

If the Commissioners are satisfied that –

- the company has ceased to be a relevant multinational company, and
- B Branch has not been able to deduct the dual territory double deduction from dual inclusion income of subsequent periods,

then those stranded deductions may be deducted from B Branch's taxable total profits in its final accounting period (i.e. the period in which the company ceased to be a relevant multinational company).

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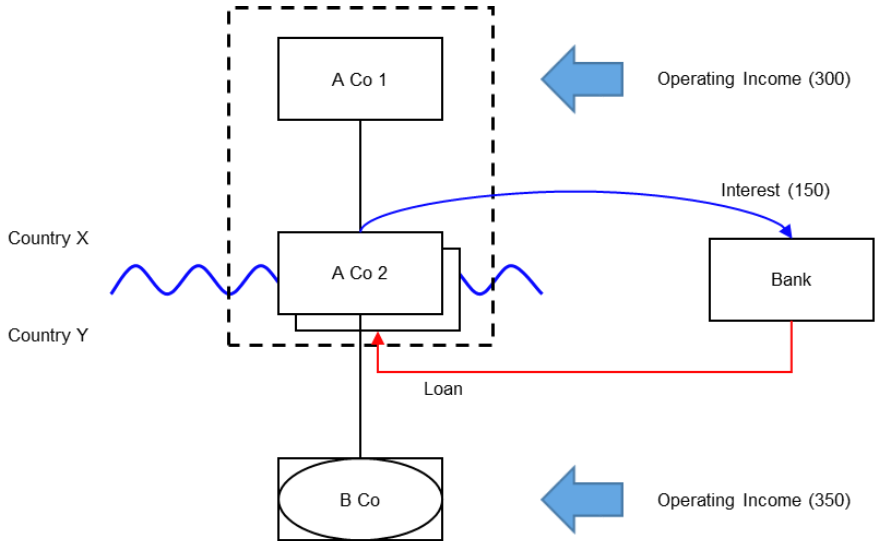
INTM558220: Hybrids: Chapter 10 - Dual territory double deduction: Examples: Dual-resident company double deduction

This example illustrates a double deduction (DD) outcome arising as a result of a company being dual resident.



Background

- A Co 1 is resident in Country X. A Co 1 owns all the shares in A Co 2.
- A Co 2 is a dual–resident company that is resident for tax purposes in both Country X and Country Y.
- A Co 1 is consolidated with A Co 2 under Country X law.
- A Co 2 acquires all of the shares in B Co.
- B Co is treated as a separate entity under Country X law, but is recognised as fiscally transparent under Country Y law.
- A Co 2 borrows money from a bank. The loan interest (150) is deductible in both Country X and Country Y.
- Operating income of 300 arises to A Co 1, and 350 to B Co.
- A Co 2 has no other income or expenditure.

Without counteraction the combined position for the AB group is set out below:

Country X A Co 1 and A Co 2 combined			Country Y A Co 2 and B Co combined		
	Tax	Book		Tax	Book
Income			Income		
Operating income of A Co 1	300	300	Operating income of B Co	350	350
Expenditure			Expenditure		
Interest Paid by A Co 2 to bank	-150		Interest Paid by A Co 2 to bank	-150	-150
Net profit		300	Net profit		200
Taxable profit	150		Taxable profit	200	

The net effect of the structure is that the AB group has a net return of 500 profits, but the taxable profits are only 350.

Analysis - Applying the tests at s259JA TIOPA 2010

Does the interest payment by A Co 2 satisfy the relevant conditions to fall within the scope of the dual territory double deduction rules?

Condition A: Is there a relevant multinational or a dual-resident company?

The definition of a dual resident company is given at s259JA(3).

Condition A is satisfied if the UK is either Country X or Country Y, as A Co 2 is resident for tax purposes in both countries.

If the UK is neither Country X nor Country Y then the condition is not satisfied. If this is the case then the imported mismatch rules within s259K TIOPA 2010 should be considered.

Condition B: Is it reasonable to suppose that there is a dual territory double deduction that arises because the company is a relevant multinational or dual resident company?

Under the laws of Country X, A Co 2 can deduct the 150 interest amount from its income for tax purposes.

Under the laws of Country Y, A Co 2 can also deduct the 150 interest amount from its income for tax purposes.

Condition B is satisfied. The extent of the dual territory double deduction amount is 150.

Conclusion

As both conditions are satisfied the relevant counteraction needs to be considered.

Counteraction

Where the dual territory double deduction mismatch arises because the company is a dual resident company, s259JB applies.

Where the UK is either Country X or Country Y the dual territory double deduction amount of 150 will be denied in the UK because there is an illegitimate overseas deduction in respect of the entire dual territory double deduction.

If the UK is Country X, it is reasonable to suppose that the dual territory double deduction amount of 150 is in substance set against the income received by B Co in Country Y (which is treated in Country Y as the income of A Co 2), and that income is not dual inclusion income of A Co 2.

If the UK is Country Y, it is reasonable to suppose that the dual territory double deduction amount of 150 is in substance set against the income of A Co 1 in Country X, and that the income of A Co 1 is not dual inclusion income of A Co 2.

In both scenarios the amount of the dual territory double deduction that may be allowed in the UK is reduced to nil by the illegitimate overseas deduction, and there is no amount to carry forward. In each instance the illegitimate overseas deduction is treated as if it had been deducted in a previous accounting period of A Co 2.

If the non-UK jurisdiction has also adopted a provision equivalent to s259JB TIOPA 2010, then that jurisdiction too may also deny the deduction for the interest payment (150).

The position following such a counteraction in both territories is set out below:

Country A A Co 1 and A Co 2 combined			Country B A Co 2 and B Co combined		
	Tax	Book		Tax	Book
Income			Income		
Operating income of A Co 1	300	300	Operating income of B Co	350	350
Adjustment	150		Adjustment	150	
Expenditure			Expenditure		
Interest Paid by A Co 2 to bank	-150		Interest Paid by A Co 2 to bank	-150	-150
Net profit		300	Net profit		200
Taxable profit	300		Taxable profit	350	

The net effect under the counteraction is that the AB group realises 500 of net profit, but its taxable profit has increased to 650. The 150 excess taxable income is a result of both countries applying the same rule and both denying the dual territory double deduction amount, thus resulting in some double taxation. The AB group will need to engage with the tax administrations of Country X and Country Y to see if they can resolve this situation, for example through the mutual agreement procedure.

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INTM559000: Hybrids: Chapter 11 - Imported mismatches: Contents

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INTM559100: Hybrids: Chapter 11 - Imported mismatches: Overview

Chapter 11 of Part 6A TIOPA 2010 contains provisions denying deductions in connection with payments or quasi-payments that are made under, or in connection with, imported mismatch arrangements.

The chapter applies to payments and quasi-payments made under an imported mismatch arrangement that is one of a series of arrangements where -

- one or more of the arrangements result in a relevant mismatch,
- the series of arrangements is in pursuit of, or in relation to, an over-arching arrangement, and
- a UK company is the payer in relation to the imported mismatch arrangement.

Where the 7 conditions (A to G) are met, the counteraction is to deny a deduction to the UK company by reference to the imported mismatch payment.

The amount of the deduction denied is computed taking into account the UK company’s share of the relevant mismatch on a just and reasonable basis.

The mismatch subject to counteraction is the relevant mismatch, that is -

- the mismatch that would arise if the UK company were the payer, a payee or an investor in the hybrid entity (as appropriate), or
- the excessive PE deduction.

Example

- X Co (resident in Country X) lends to Y Co (resident in Country Y), using a hybrid financial instrument that results in a deduction for Y Co and no taxable income for X Co – a hybrid mismatch.
- Y Co then makes a plain vanilla loan to UK Co (resident in the UK). UK Co has a deduction for the interest payment to Y Co, and Y Co includes the interest receipt in its ordinary income – no mismatch arises.
- Y Co sets its own deduction from the hybrid financial instrument with X Co against the interest income from UK Co – so the net position is no effective taxation of the interest from UK Co.

Chapter 3 concerning hybrid financial instruments does not counteract the hybrid mismatch because UK Co is party to a non-hybrid loan with Y Co. The imported mismatch rules in Chapter 11 will counteract the hybrid mismatch in the UK, if these arrangements are part of an over-arching arrangement

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INTM559200: Hybrids: Chapter 11 - Imported mismatches: Conditions to be satisfied

Chapter 11 of Part 6A TIOPA 2010 applies if all seven conditions set out at s259KA are met.

[INTM559210: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition A]

[INTM559220: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition B]

[INTM559230: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition C]

[INTM559240: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D]

[INTM559250: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition E]

[INTM559260: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition F]

[INTM559270: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition G]

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INTM559210: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition A

Condition A of s259KA asks whether a payment or quasi-payment (the imported mismatch payment) has been made under, or in connection with, an arrangement (the imported mismatch arrangement).

A payment is any transfer of money or money's worth in relation to which an allowable deduction would arise in calculating the taxable profits of the payer if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person from whom the transfer is made.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply

See INTM550540 for more detail on quasi-payments. There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are *not* quasi-payments where the circumstances giving rise to the deduction do not include economic rights between the payer and a payee.

S259NF defines an arrangement to include any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

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INTM559220: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition B

Condition B of s259KA is that the payer in relation to the imported mismatch payment is within the charge to corporation tax for the payment period.

The payment period is the taxable period of the payer in which an amount may be deducted, in relation to the payment or quasi-payment.

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INTM559230: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition C

Condition C of S259KA is that the imported mismatch arrangement is part of a series of arrangements.

A series of arrangements is defined at s259KA(5) as a number of arrangements where each arrangement is entered into in pursuance of, or in relation to, another arrangement (the over-arching arrangement).

A simple example of a series of arrangements might be –

- a loan arrangement between X Co and Y Co (the X/Y Loan)
- a loan arrangement between Y Co and UK Co (the Y/UK Loan)
- the X/Y Loan directly or indirectly funds the Y/UK Loan

Over-arching arrangements and third party borrowing

A company that raises funds by borrowing on a "plain vanilla" basis from a person will need to consider the application of Chapter 11 even if it is not part of the same control group. In considering condition C it will need to consider whether the arrangement under which the funding is provided is part of an "over-arching arrangement" within the meaning of S259KA.

The company will generally be able to conclude that the arrangement under which the funding is provided is not part of an over-arching arrangement where:

- the company borrows money under a straightforward loan agreement that has no features indicative of a hybrid financial instrument,
- the borrowing is on normal commercial terms,
- the only reason why the company and the person may be considered to be in the same control group is that the person has, or may have a 50% investment in the company by virtue of the loan,
- the only relationship or connection between the company and the lender is that the company has borrowed money from the person, and
- the arrangement under which the funding is provided is not a structured arrangement within the meaning of Chapter 3.

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INTM559240: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D

Condition D of S259KA is that there is a relevant mismatch.

Mismatch

There is a relevant mismatch under s259KA(6)(a) if there is a payment or quasi-payment -

- under an arrangement within the series of arrangements,
- that is not the imported mismatch arrangement, and
- in relation to which it is reasonable to suppose there is, or will be, a hybrid or other mismatch within Chapters 3, 4, 5, 7, 8 or 9 of Part 6A, *or*
- in relation to which it is reasonable to suppose there is, or will be, a dual territory double deduction (s259KB).

The amount of the relevant mismatch is

- the amount of the mismatch as calculated under the relevant provision of Chapters 3 to 5, or Chapters 7 to 9, or
- the amount of the dual territory double deduction.

S259KB defines a dual territory double deduction as an amount that can be deducted from the company’s income in any two territories.

Excessive PE deduction

There is also a relevant mismatch under s259KA(6)(b) where -

- there is an arrangement within the series of arrangements,
- that arrangement is not the imported mismatch arrangement, and
- as a consequence of that arrangement there is, or will be, an excessive PE deduction (s259KB).

A PE deduction is defined at s259KB(3) as an amount that -

- is in respect of a transfer of money or money’s worth from the company in the PE jurisdiction to the company in another territory, and

- may, in substance, be deducted from the company’s income when calculating the taxable profits of the company in the PE jurisdiction for a taxable period.

For the purposes of this section a PE deduction does not include

- a debit in respect of amortisation that is brought into account under s729 or s731 CTA 2009, or

- an amount that is deductible in respect of amortisation under a provision of the law of a territory outside the UK that is equivalent to either of those two sections.

S259KB(4) defines a PE deduction as excessive to the extent that the PE deduction exceeds the amount of any increase in profits or reduction in losses of the company for tax purposes, for a permitted taxable period, in the parent jurisdiction that arise from the circumstances giving rise to the PE deduction.

This is subject to s259KB (4A) which states that any increase in taxable profits or reduction of losses is to be ignored in any case where tax is charged at a nil rate under the law of the parent jurisdiction.

A taxable period of the company is “permitted” for the purposes of s259KB(4) if

- it begins before the end of 12 months after the end of the taxable period mentioned in s259KB(3), or

- where the period begins after that, a claim has been made for a period to be permitted and it is just and reasonable for the circumstances giving rise to the PE deduction to affect the profits or losses made for that later period.

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INTM559250: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition E

Condition E at s259KA is that it is reasonable to suppose that there is

- a mismatch payment and Chapters 3 to 5 or Chapters 7 to 10 do not apply in relation to the tax treatment of any person, or
- a mismatch payment and there is no non-UK equivalent of Chapters 3 to 5 or Chapters 7 to 10 that applies in relation to the tax treatment of any person, or
- an excessive PE deduction in respect of which Chapter 6 (or a non-UK equivalent provision) does not apply in relation to the tax treatment of any person.

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INTM559260: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition F

Condition F is that -

- it is reasonable to suppose that Chapters 3 to 5 or Chapters 7 to 10 would apply to the payer of the imported mismatch payment if that person were a payer or payee in relation to the mismatch payment,

- it is reasonable to suppose that Chapters 3 to 5 or Chapters 7 to 10 would apply to the payer of the imported mismatch payment in relation to the mismatch payment if that person were an investor in a hybrid entity and the relevant mismatch were either a hybrid payee deduction/non-inclusion mismatch or a hybrid entity double deduction,

- it is reasonable to suppose that a non-UK provision equivalent to Chapters 3 to 5 or Chapters 7 to 10 would apply in relation to the payer of the imported mismatch payment if that person were a payer or payee in relation to the mismatch payment,

- it is reasonable to suppose that a non-UK provision equivalent to Chapters 3 to 5 or Chapters 7 to 10 would apply to the payer of the imported mismatch payment in relation to the mismatch payment if that person were an investor in a hybrid entity and the relevant mismatch is either a hybrid payee deduction/non-inclusion mismatch or a hybrid entity double deduction, or

- the relevant mismatch is an excessive PE deduction.

Condition F requires comparison with a counterfactual position, which assumes that Condition D is met and puts the UK payer (as identified in Condition B) in the position of payer, payee or investor in relation to the mismatch identified in Condition D.

A PE deduction is defined at s259KB(3) as an amount that -

- is in respect of a transfer of money or money's worth from the company in the PE jurisdiction to the company in another territory, and

- may, in substance, be deducted from the company's income when calculating the taxable profits of the company in the PE jurisdiction

S259KB(4) defines a PE deduction as excessive to the extent that the PE deduction exceeds the amount of any increase in profits or reduction in losses of the company for tax purposes in the parent jurisdiction that arises from the circumstances giving rise to the PE deduction. Return to contents

INTM559270: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition G

Condition G of S259KA asks whether –

- the UK payer of the imported mismatch payment is in the same control group as either the payer or payee (or, in respect of an excessive PE deduction, the company with the PE), in relation to the mismatch payment, at any time from when the over-arching arrangement (see INTM559230) is made to the last day of the payment period in relation to the imported mismatch payment (see INTM559210), or

- the arrangement is a structured arrangement.

Control groups

Control groups are defined at s259NB. More detailed guidance on control groups is at INTM550610.

Structured arrangement

An arrangement is a structured arrangement if it is reasonable to suppose that-

- it is designed to secure a hybrid payer deduction/non-inclusion mismatch, or

- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or the terms of the arrangement otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

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INTM559300: Hybrids: Chapter 11 - Imported mismatches: Counteraction

If conditions A to G are satisfied, then s259KC counteracts the relevant mismatch by reducing the payer's deduction in relation to the imported mismatch payment by the payer's share of the relevant mismatch.

The relevant mismatch is defined and calculated under condition D, as discussed at INTM559240. The imported mismatch payment is defined under condition A and is discussed at INTM559210.

Dual Inclusion Income

Reductions under section 259KC have effect subject to section 259KD.

If Condition D at s259KA (6) applies, and it is reasonable to suppose a mismatch arises as a result of any of Chapters 5, 7, 8, 9 or 10, or due to an excessive PE deduction, a counteraction under s259KC is not to exceed the relevant net amount.

The relevant net amount means:

- For mismatches arising under Chapters 5 to 9, it is the amount which could not be deducted from that person's income under that chapter (ignoring the effect of any carry-forward provisions in those chapters), or
- For mismatches arising under Chapter 10, the amount by which the dual territory double deduction of the company for a deduction period exceeds its dual inclusion income for that period, or
- For excessive PE deductions, the amount by which the excessive PE deduction for the permitted taxable period exceeds its dual inclusion income for that period.

Due consideration for the dual inclusion income of the parties to the relevant mismatch should be taken into account, where appropriate. However, this will not extend to considering whether the income of the UK payer is dual inclusion income.

For (b) above, "dual inclusion income" means an amount that is both ordinary income of the company for that period for the purpose of a tax charged under the law of one territory, and ordinary income of the company for the purposes of a tax charged under the law of another territory.

For (c) above, "dual inclusion income" of a company for a period means an amount that is ordinary income for the purposes of taxes charged in both the parent and PE jurisdictions.

INTM559310: Hybrids: Chapter 11 - Apportioning the relevant mismatch

Mismatch payment

If there is more than one relevant payment in relation to the relevant mismatch, then the UK company is subject to a counteraction based on its share of the relevant mismatch.

The share of the relevant mismatch is determined by apportioning the relevant mismatch between every payer in relation to the relevant payment on a just and reasonable basis, having regard to the extent to which the imported mismatch payment made by the UK company and the other relevant payments fund (directly or indirectly) the mismatch payment.

It is presumed that, to determine a 'just and reasonable' allocation, the mechanical allocation rules from the OECD 2015 Final Report are used as a starting position.

S259KC(8) places the onus on the UK company payer of the imported mismatch payment to identify and justify other relevant payments.

A simple example might be where the relevant mismatch is in relation to a hybrid financial instrument whereby the receipt was effectively 50% undertaxed. If a portion of the funds (say 40%) obtained under this instrument was on-lent to the UK under a plain vanilla debt (under which interest payments (the imported mismatch payments) were made, and the balance (say 60%) was on-lent to a company in a non-UK territory, then a just and reasonable apportionment of the relevant mismatch might be 40% of it.

For the purposes of determining the appropriate apportionment of the relevant mismatch, the imported mismatch payment is to be taken to fund a mismatch payment, unless it can be shown that the mismatch payment has instead been funded (directly or indirectly) by one or more relevant payments.

Excessive PE deduction

In the case of an excessive PE deduction where a payment is actually made, and there is more than one relevant payment that can be considered as funding the relevant mismatch, then the recognition of the relevant share of the mismatch borne by the UK company follows the same test as for the mismatch payment. The share of the relevant mismatch is determined by apportionment on a just and reasonable basis, having regard to the extent to which the imported mismatch payment made by the UK company and the other relevant payments fund the mismatch transfer of money or money's worth.

Where there is an excessive PE deduction that is in substance treated as being made for tax purposes, but no payment is actually made, then it is necessary to consider on a just and reasonable basis to what extent the imported mismatch payment made by the UK company and the other relevant payments would have funded the mismatch transfer if it had actually been made.

Again, s259KC(5) and (6) place the onus on the company to show that the relevant mismatch was funded by other relevant payments, with a de-facto presumption (in the absence of evidence to the contrary) that it was funded by the UK's imported mismatch payment.

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INTM559400: Hybrids: Chapter 11 – Imported mismatches: Examples: Contents

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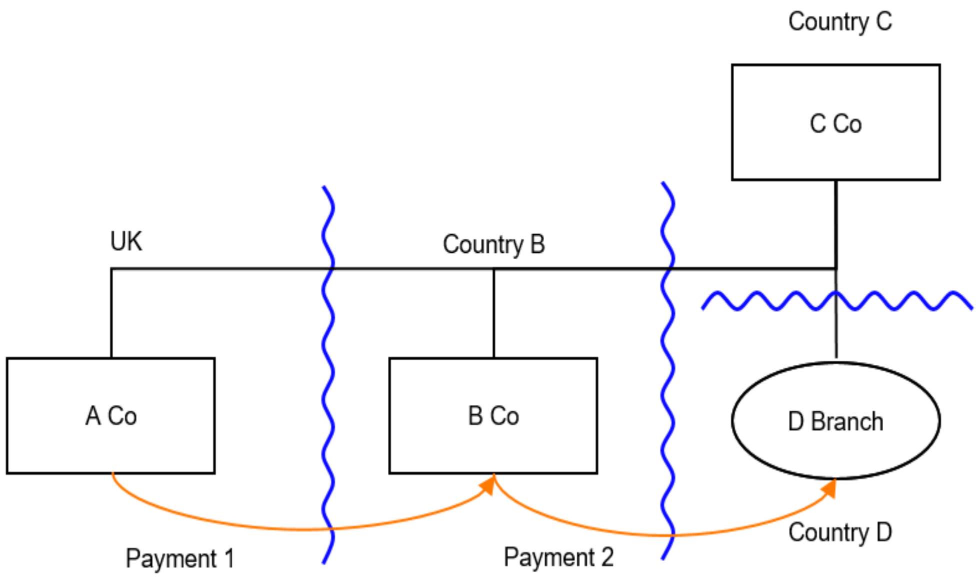
INTM559405: Hybrids: Chapter 11 – Imported mismatches: Examples: Series of arrangements



Background

- C Co is resident in Country C and is the 100% shareholder of A Co, resident in the UK, and B Co, resident in Country B. C Co also operates a branch in Country D.
- Under the laws of Country C, C Co is regarded as carrying on a business through a permanent establishment (PE) in Country D.
- Under the laws of Country D, C Co is *not* regarded as carrying on a business through a PE in Country D.
- A Co is the distributor for the group. A Co makes payments of 100 (payment 1) for goods to B Co. The UK allows a deduction for the payment made by A Co.
- Country B treats the receipt as taxable on B Co.
- B Co sources products from the group manufacturing divisions including D Branch of C Co. B Co makes payments of 100 for goods to Branch D. Country B allows a deduction against income for the payment made by B Co.

- Country C treats the receipt under Payment 2 as attributable to its PE (D Branch) and exempts or excludes the income receipt from taxation. Country D, however, does not tax the income because C Co is not treated as having a PE under local law.
- The payment therefore gives rise to an intra-group mismatch (a D/NI outcome) because a deduction is available in Country B with no corresponding taxable income recognised in either Country C or Country D.
- Neither Country B nor Country C have rules equivalent to part 6A and so do not counteract the mismatch which arises under payment 2.

Analysis – Applying the tests in s259KA TIOPA 2010

Are the relevant conditions satisfied to bring this example within the scope of the imported mismatches rules?

Condition A: Are there payments or quasi-payments made under, or in connection with, an arrangement?

Payment 1 and payment 2 are both payments made under, or in connection with, an arrangement.

Condition A is met.

Condition B: Is the payer in relation to that imported mismatch arrangement within the charge to corporation tax for a relevant payment period?

A Co is a payer in relation to the Payment 1 arrangement and is within the charge to corporation tax.

Condition B is met.

Condition C: Is this arrangement one of a number of arrangements which are each entered into in pursuance of, or in relation to, an over-arching arrangement (a series of arrangements)?

Payment 1 and payment 2 each constitute a relevant arrangement, and taken together form a series of arrangements (an over-arching arrangement). The over-arching arrangement here as defined in s259KA(5) includes the payment from A Co to B Co, and the payment from B Co to D Branch.

Condition C is satisfied for payment 1 in relation to payment 2.

Condition D: Under an arrangement within this series (other than the imported mismatch arrangement), is there a payment or quasi-payment

in relation to which it is reasonable to suppose that there would be a relevant mismatch (as targeted by Part 6A rules)?

Neither C Co nor D Branch bring the payment into ordinary income, because the law of Country D does not regard C Co as carrying on a business in Country D, but the law of the parent jurisdiction does.

C Co meets the definition of a multinational company for the purposes of Chapter 8, so if the payment from B Co to D Branch gives rise to a mismatch, it would satisfy the conditions to fall within Chapter 8.

As the payee, C Co, is regarded as carrying on a business through a permanent establishment under the laws of the parent jurisdiction, but under the laws of the PE jurisdiction is not regarded as doing so, and a mismatch arises because the payee is a company with a permanent establishment, Chapter 8 of Part 6A TIOPA 2010 may have applied if the UK were Country B or Country C.

Condition D is met in respect of payment 2. The relevant mismatch is the extent as computed under Chapter 8, which is the entire deduction arising to B Co.

Condition E: Is it reasonable to suppose that there will be no relevant counteractions under the Part 6A rules, or their foreign equivalent provision?

As noted in the Background, neither Country B nor Country C have adopted provisions equivalent to Part 6A TIOPA 2010 so they do not counteract the mismatch arising under Payment 2.

Condition E is met.

Condition F: Does Condition D apply, and is either the relevant mismatch an excessive PE deduction or is it reasonable to suppose that a chapter within Chapters 3 to 10 of TIOPA 2010, other than Chapter 6, or its foreign equivalent, would apply to the relevant mismatch in relation to the tax treatment were the UK payer in relation to the imported mismatch payment was substituted for the payer or payee?

As noted above, Condition D applies.

The relevant mismatch is not an excessive PE deduction, but if the UK payer (A Co) were substituted for B Co or C Co, it is reasonable to suppose that Chapter 8 would apply to the deduction claimed for Payment 2, because a multinational payee deduction/non-inclusion mismatch has arisen in relation to the payment.

Condition F is satisfied.

Condition G: Is the payer (A Co) in relation to the imported mismatch payment within the same control group as the payer (B Co) or payee (C Co/D Branch) of the mismatch payment within the relevant period, or is there a structured arrangement?

All the companies are within the same control group, as defined at s259NB.

Condition G is met. It is not necessary to consider whether this is a structured arrangement.

Conclusion

All the relevant conditions are satisfied, so the relevant counteraction under the imported mismatch rules must be considered.

Counteraction under s259KC

The relevant deduction that may be deducted from A Co's income for the payment period is to be reduced by the amount, and A Co's share, of the relevant mismatch.

The share of the mismatch is to be determined on a just and reasonable basis by apportioning the extent to which the imported mismatch payment and any other relevant payment funds, directly or indirectly, the mismatch payment.

In this example, the relevant mismatch (payment 2) is 100 from B Co to D Branch, and is funded on a just and reasonable basis directly by 100 from A Co to B Co.

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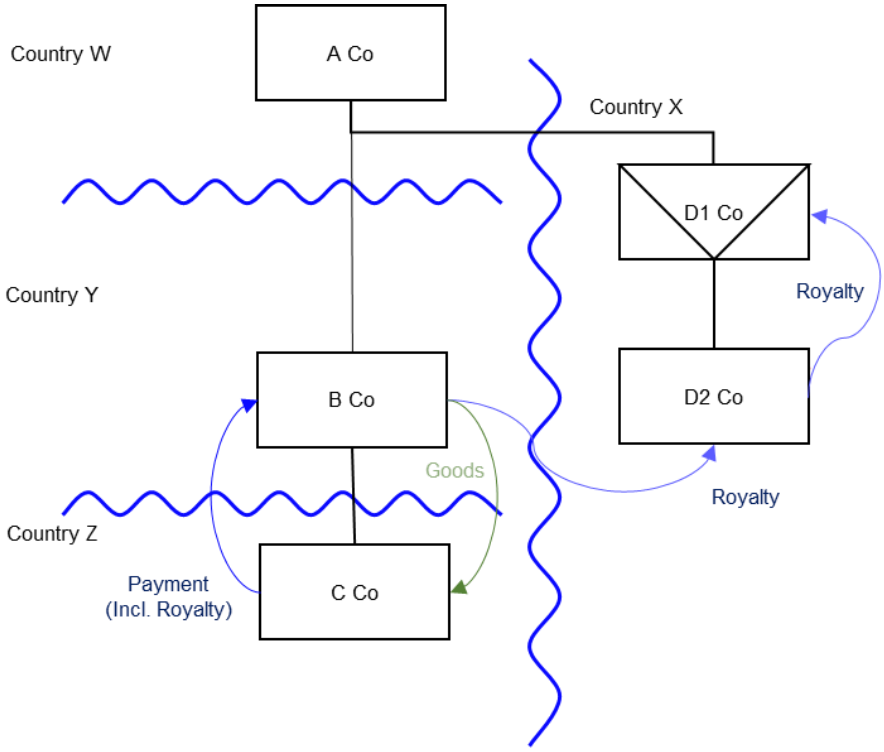
INTM559410: Hybrids: Chapter 11 - Imported mismatches: Examples: Manufactured royalty



Background

- A Co is a company resident in Country W
- B Co is a company resident in Country Y, and A Co owns its entire shareholding
- C Co is a company resident in Country Z, and B Co owns its entire shareholding
- D1 Co is a corporate entity established and resident in Country X, with A Co as its sole member
- D1 Co is regarded as transparent in Country X but opaque by Country W. As such its profits are subject to tax in neither Country X nor Country W
- D2 Co is a company resident in Country X, and D1 Co owns its entire shareholding

- This group (including A Co, B Co, C Co, D1 Co and D2 Co) holds intellectual property (IP) in D1 Co

- D1 Co grants a licence to D2 Co to exploit that IP in exchange for royalties

- B Co produces and sells goods exploiting the IP - granted by D2 Co in exchange for royalties

- B Co sells some of those goods to C Co

- Country Z grants C Co a deduction for the cost of those goods purchased, which includes an amount that can be attributed to the IP

- Country Y subjects B Co to tax on the corresponding receipt, but its profits are reduced by a deduction corresponding to the royalty paid to D2 Co

- D2 Co, in turn, pays D1 Co a royalty under the licence agreement, for which Country X allows a deduction.

- As D1 Co is treated as transparent in Country X but opaque in Country W, D1 Co is in effect a hybrid payee. Chapter 7 may have applied if the UK were Country X or Country W.

- For the purposes of this example, however, the UK is not Country X or Country W, as neither Country X nor Country W have rules equivalent to the rules within Part 6A TIOPA 2010.

Analysis - Applying the tests in s259KA TIOPA 2010

Are the relevant conditions satisfied to bring this example within the scope of the imported mismatches rules?

Condition A: Are there payments or quasi-payments made under, or in connection with, an arrangement?

Both the royalty paid by B Co to D2 Co (the B/D2 arrangement) and the payment (including an element of royalty) from C Co to B Co (the C/B arrangement) are payments made under, or in connection with, an arrangement.

Condition A is satisfied.

Condition B: Is the payer in relation to that imported mismatch arrangement within the charge to corporation tax for a relevant payment period?

Where the UK is Country Y, B Co is a payer in relation to the B/D2 arrangement and is within the charge to corporation tax.

Where the UK is Country Z, C Co is a payer in relation to the C/B arrangement and is within the charge to corporation tax.

Condition B is satisfied.

Condition C: Is this arrangement one of a number of arrangements which are each entered into in pursuance of, or in relation to, an over-arching arrangement (a series of arrangements)?

As identified in Condition A the royalty paid by B Co to D2 Co, and the payment (including the element of royalty) from C Co to B Co, are relevant arrangements, and both of these form a number of related arrangements that includes the royalty payment from D2 Co to D1 Co.

The over-arching arrangement here, as defined in s259KA(5), includes the payment from C Co to B Co, the royalty payment from B Co to D2 Co and the royalty payment from D2 Co to D1 Co.

Condition C is satisfied for either the B Co to D2 arrangement or the C Co to B Co arrangement in relation to the royalty payment from D2 Co to D1 Co.

Condition D: Is there a relevant mismatch?

As D1 Co is transparent in Country X but opaque in Country W, D1 Co is a hybrid entity and would have been subject to the rules in Chapter 7 TIOPA 2010.

The relevant arrangement in the series is therefore the royalty paid from D2 Co to D1 Co and the mismatch payment would be a hybrid payee deduction/non-inclusion mismatch within Chapter 7.

Condition D is satisfied in respect of the royalty paid from D2 Co to D1 Co.

The relevant mismatch is the extent of the mismatch as computed under Chapter 7.

Condition E: Is it reasonable to suppose that there will be no relevant counteractions under the Part 6A rules, or their foreign equivalent provision?

Neither Country W nor Country X have adopted rules equivalent to rules within Chapter 3 to 10 TIOPA 2010, so they do not counteract the mismatch arising from the royalty payment between D2 Co and D1 Co.

If Country Y does not apply a provision equivalent to Chapter 11 (an imported mismatch rule), then there is no counteraction under the tax law of a territory outside the UK.

Condition E is satisfied.

Condition F: Is Condition D met, and is the relevant mismatch an excessive PE deduction or is it reasonable to suppose that a chapter within Chapters 3 to 10 of TIOPA 2010 (other than Chapter 6), or equivalent non-UK provisions, would apply to the relevant mismatch in relation to the tax treatment if the UK payer were the payer (D2 Co) or a payee (D1 Co)?

Condition D is met.

If the UK payer were substituted for D2 Co, a UK payer would be making a payment to a hybrid entity, so it is reasonable to suppose that Chapter 7 – Hybrid Payee would apply to the relevant mismatch in relation to the tax treatment in that scenario.

Condition F is satisfied.

Condition G: Is the payer in relation to the imported mismatch payment within the same control group as the payer (D2 Co) or payee (D1 Co) of the mismatch payment within the relevant period, or is there a structured arrangement?

All the companies are within the same control group, as defined at s259NB.

Condition G is met.

There is no need to consider whether this is a structured arrangement.

Conclusion

As all the relevant conditions are satisfied to characterise the imported mismatch payments under either (or both) the C Co to B Co arrangement and the B Co to D2 Co arrangement as giving rise to a relevant mismatch. The relevant counteraction under the Imported Mismatch rules must be considered.

Counteraction

Where there is more than one relevant payment in relation to the relevant mismatch arising, each company's share of the relevant mismatch will be determined by apportioning it on a just and reasonable basis, having regard to the extent that it funds the Imported Mismatch.

Counteraction where the UK is in the position of Country Y

Where the UK is in the position of Country Y, then s259KC will apply to deny B Co a deduction to the extent that it directly or indirectly funds the relevant mismatch.

Therefore, s259KC will apply to deny B Co a deduction for the royalty payments made to D2 Co, to the extent that they do not exceed the royalty payments made by D2 Co to D1 Co. As D2 Co would be exposed to tax in Country X on any excess it is not part of the mismatch payment.

Counteraction where the UK is in the position of Country Z

Where the UK is in the position of Country Z, then s259KC will apply only to the extent that the mismatch payment attributed to B Co has not been fully counteracted in Country Y by a provision equivalent to the Imported Mismatches rule. Any counteraction taken in Country Y will reduce the extent to which the mismatch is imported into Country Z.

If the relevant mismatch has been fully counteracted in Country Y then there is no remaining imported mismatch to be addressed in Country Z. S259KB will therefore not apply to deny C Co from deducting an amount in relation to that part of the payment which is attributable to the IP.

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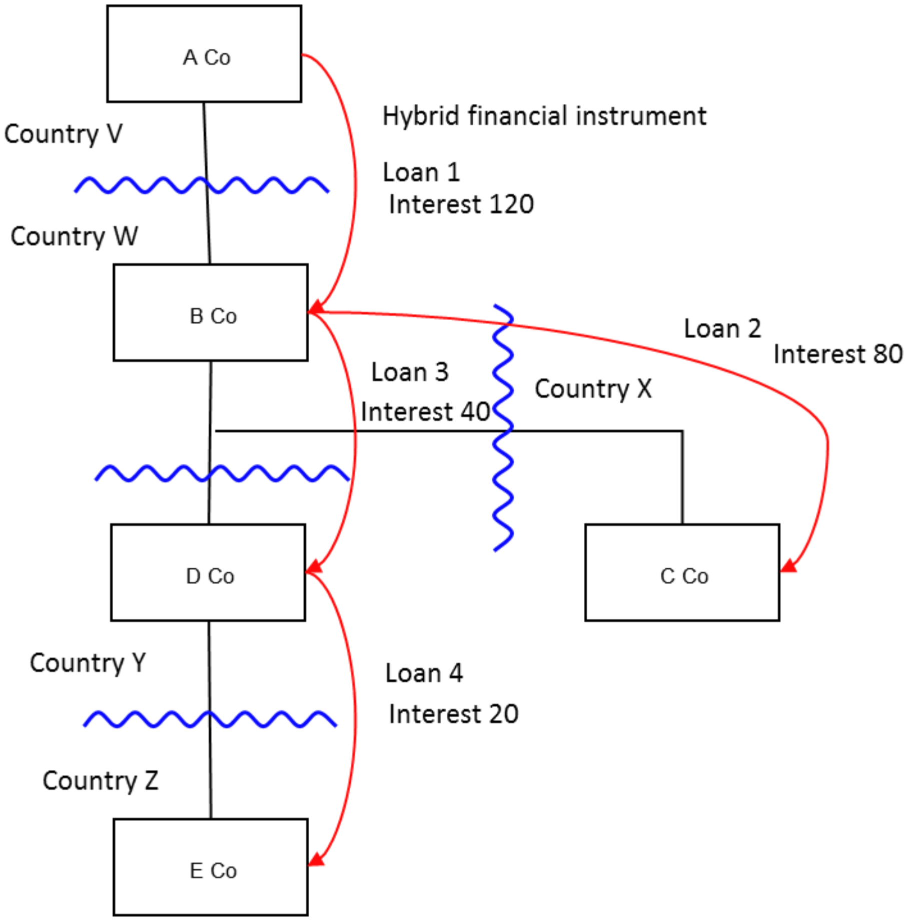
INTM559420: Hybrids: Chapter 11 - Imported mismatches: Examples: Hybrid loan funded by several relevant payments



Background

- A Co is resident in Country V, and owns all the shares in B Co (resident in Country W)
- B Co owns all the shares in C Co (resident in Country X) and D Co (resident in Country Y)
- D Co owns all the shares in E Co (resident in Country Z)
- A Co makes a loan (interest payable 120) to B Co (Loan 1) under which the payments of interest are treated as deductible in calculating B Co.'s ordinary income but which are treated as non-taxable equity receipts in calculating A Co.'s ordinary income.

- The terms of Loan 1 satisfy the conditions in Chapter 3 at s259CA.
- Neither Country V nor Country W have rules equivalent to Part 6A and so do not counteract the mismatch which arises under Loan 1
- B Co on-lends two thirds of the funds provided under Loan 1 (resulting in interest payable of 80) to C Co (Loan 2) and the balance (with interest payable of 40) to D Co (Loan 3).
- D Co on-lends half of the funds provided under Loan 3 (that is, a sum on which interest of 20 is payable) to E Co (Loan 4)
- B Co, C Co, D Co and E Co under the laws of Country W, Country X, Country Y and Country Z respectively treat the relevant loans as debt instruments and treat the payments of interest as deductible or as taxable as ordinary income in the relevant jurisdictions accordingly.

Analysis - Applying the tests in s259KA

Are the relevant conditions satisfied to bring this example within the scope of the imported mismatches rules in Chapter 11?

Condition A: Are there payments or quasi-payments made under, or in connection with, an arrangement?

Loan 2, Loan 3 and Loan 4 each constitute an imported mismatch arrangement (where the UK is Country X, Country Y or Country Z respectively) and the relevant interest payments are each transfers of money made under them.

Condition A is met.

Condition B: Is the payer in relation to that imported mismatch arrangement within the charge to corporation tax for a relevant payment period?

As the UK has adopted the Part 6A rules, the assumption is that the UK is not either Country V or Country W.

Where the UK is Country X, C Co is a payer in relation to the Loan 2 arrangement and is within the charge to corporation tax.

Where the UK is Country Y, D Co is a payer in relation to the Loan 3 arrangement and is within the charge to corporation tax.

Where the UK is Country Z, E Co is a payer in relation to the Loan 4 arrangement and is within the charge to corporation tax.

Condition B is met as long as one of the above is satisfied.

Condition C: Is this arrangement one of a number of arrangements which are each entered into in pursuance of, or in relation to, an over-arching arrangement (a series of arrangements)?

As identified in Condition A, Loan 2, Loan 3 and Loan 4 each constitute a relevant arrangement, and together with loan 1 form a series of arrangements.

Loan 4 was made pursuant to Loan 3, which was made pursuant to Loan 1. This is part of the over-arching arrangement as defined in s259KA(5) where the UK is in the position of either Country Y or Country Z.

Loan 2 was also made pursuant to Loan 1. This is therefore part of the over-arching arrangement as defined in s259KA(5) where the UK is in the position of Country X.

Condition C is satisfied for Loan 2, Loan 3 and Loan 4 in relation to Loan 1.

Condition D: Under an arrangement within this series (other than the imported mismatch arrangement), is there a payment or quasi-payment in relation to which it is reasonable to suppose that there would be a relevant mismatch (as targeted by Part 6A rules)?

The terms of Loan 1 are such that they would satisfy the conditions to fall within Chapter 3.

The relevant arrangement in the series is therefore Loan 1 and the relevant mismatch would be a hybrid or otherwise impermissible deduction/non-inclusion mismatch within Chapter 3.

Condition D is met in respect of Loan 1.

The relevant mismatch here is the extent of the mismatch as computed under Chapter 3, which is the entire 120 deduction arising to B Co.

Condition E: Is it reasonable to suppose that there will be no relevant counteractions under the Part 6A rules, or their foreign equivalent provision?

As stated above in the Background, neither Country V nor Country W have adopted an equivalent provision to the rules within Chapters 3 to 10 TIOPA 2010, so they do not counteract the mismatch payment arising under Loan1.

If the UK were in the position of Country Z, and Country Y has not adopted equivalent provision to Chapter 11 (imported mismatches), then Condition E is satisfied.

Condition F: Is Condition D met, and is either the relevant mismatch an excessive PE deduction or is it reasonable to suppose that a chapter within Chapters 3 to 10 of TIOPA 2010, other than Chapter 6, or its foreign equivalent, would apply to the relevant mismatch in relation to

the tax treatment were the UK payer in relation to the imported mismatch payment was substituted for A Co (the payee) or B Co (the payer)?

Condition D is met.

It is reasonable to suppose that Chapter 3, or a non-UK equivalent, would have applied to the deductions claimed under Loan 1 (the mismatch payment) had the UK payer been substituted for either B Co or A Co.

Condition F is satisfied.

Condition G: Is the payer (C Co, D Co or E Co) in relation to the imported mismatch payment within the same control group as the payer (B Co) or payee (A Co) of the mismatch payment within the relevant period, or is there a structured arrangement?

All the companies are within the same control group, as defined at s259NB.

Condition G is met.

It is not necessary to consider whether this is a structured arrangement.

Conclusion

As all the relevant conditions are satisfied, the relevant counteraction under the imported mismatch rules must be considered.

Counteraction under s259KC

There is more than one relevant payment in relation to the relevant mismatch of 120 arising between A Co and B Co and therefore each company's share of the relevant mismatch will be determined by apportioning it on a just and reasonable basis, having regard to the extent that the imported mismatch and the other relevant payments fund the relevant mismatch.

In this example, the relevant mismatch (120) is funded, on a just and reasonable basis, by 80 from C Co, 40 from D Co and 40 (indirectly) from E Co through D Co.

Note: The onus is on the relevant company within the charge to UK corporation tax to justify the other payments as relevant payments and to justify the extent to which they should be considered as also funding the relevant mismatch. In this example the allocation is obvious. However, if loan 1 was only for 80, and it used 40 of its own retained cash to fund the balance, then the starting presumption would be that the entire payment made by the relevant company within the charge to UK corporation tax had funded the relevant mismatch of 80. It would be up to the company to show that this is not appropriate.

Counteraction where the UK is in the position of Country X

Where the UK is Country X, then s259KC will apply to deny C Co a deduction in relation to the payments under Loan 2, which (in this example) would be the entire deduction of 80.

Counteraction where the UK is in the position of Country Y

Where the UK is Country Y, then s259KC will apply to deny D Co a deduction in relation to the payments under Loan 3, which (in this example) would be the entire deduction of 40.

Counteraction where the UK is in the position of Country Z

Where the UK is Country Z, then s259KC will apply only to the extent that the relevant mismatch attributed to D Co (the deduction of 40) has not been fully counteracted in Country Y by any provision equivalent to Part 6A.

Therefore, if the entire mismatch of 40 has not been fully counteracted, then s259KC will apply to deny E Co the deduction of 20 in relation to the payments under Loan 4 to the extent of the remaining mismatch.

If the facts were such that 20 of the mismatch of 40 was already counteracted (and 20 not counteracted), then E Co's entire deduction of 20 would be denied (as this would be the extent of the mismatch which had not been counteracted).

If 30 of the mismatch was counteracted (and 10 not counteracted), then 10 of E Co's deduction of 20 would be denied.

If the entire 40 has been fully counteracted, then s259KC will not apply to deny E Co from deducting an amount in relation to the payments under Loan 4.

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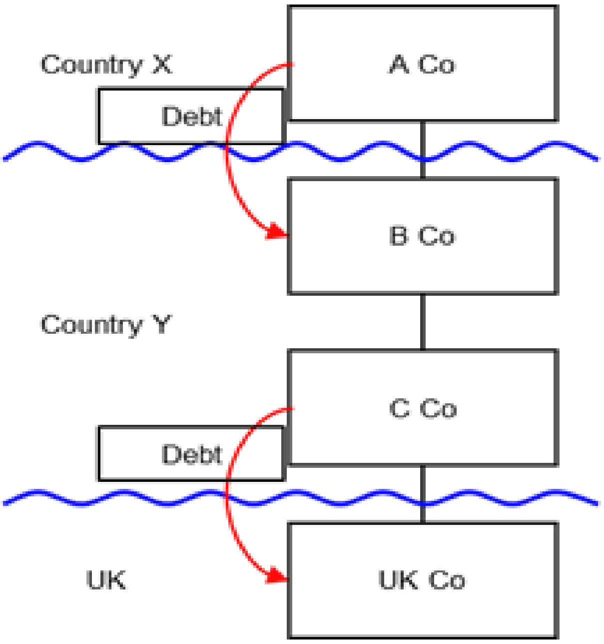
INTM559430: Hybrids: Chapter 11 - Imported mismatches: Examples: Loan funded by equity



Background

- A Co (resident in Country X) funds B Co (resident in Country Y) with hybrid debt through a hybrid financial instrument (HFI)
- B Co pushes the funds down to C Co as equity
- C Co makes a plain vanilla loan to UK Co.
- B Co and C Co are resident in the same jurisdiction (Country Y).
- B Co surrenders the hybrid loan deductions to C Co which C Co uses to shelter the interest received from UK Co.

For the purposes of this example, the UK is the country of residence of UK Co. Neither Country X nor Country Y have applied rules equivalent to the rules within Part 6A TIOPA 2010.

Analysis - Applying the tests in s259KA TIOPA 2010

Are the relevant conditions satisfied to bring this example within the scope of the Imported Mismatches rules?

Condition A: Are there payments, or quasi-payments, made under, or in connection with, an arrangement (the imported mismatch arrangement)?

The payment of interest from UK Co to C Co and the payment of interest from B Co to A Co are payments made under, or in connection with, an arrangement.

Condition A is therefore satisfied.

Condition B: Is the payer, in relation to that imported mismatch arrangement, within the charge to corporation tax for a relevant payment period?

UK Co is a payer in relation to the UK Co to C Co arrangement and is within the charge to corporation tax.

Condition B will therefore be satisfied.

Condition C: Is this arrangement one of a number of arrangements which are each entered into in pursuance of, or in relation to, an over-arching arrangement (a series of arrangements)?

As identified in Condition A, the interest payment from UK Co to C Co is a relevant arrangement, and it forms part of a number of related arrangements that includes the interest payment from B Co to A Co.

The over-arching arrangement here, as defined in s259KA(5) TIOPA 2010, includes the payment from UK Co to C Co and the interest payment from B Co to A Co.

In this example, the funds lent under the hybrid financial instrument are passed as equity to C Co before being lent on to UK Co. As a question of fact, there is a connection between the arrangements and they are pursuant to an over-arching arrangement.

Condition C will therefore be satisfied in relation to the interest payment from B Co to A Co.

[Note: If, in this example, B Co did not surrender the hybrid loan deductions to C Co but instead used them against its other profits, with the result that C Co paid tax on the interest it received, Condition C would still be satisfied. While C Co's interest receipt would not be sheltered by a hybrid deduction, the hybrid debt would still be used to fund the loan to UK Co, and (as a question of fact) there would be a connection between the arrangements and they would be pursuant to an over-arching arrangement].

[Note: If the facts were the same as for this example, except that B Co did not pass on the funds lent under the HFI to C Co as equity, but instead C Co used funds from a different source that were not connected to the HFI loan (as a question of fact) to lend to UK Co, then the steps would not have been taken pursuant to an overarching arrangement and Condition C would not be satisfied]

Condition D: Under an arrangement within this series (other than the imported mismatch arrangement), is there a payment or quasi-payment in relation to which it is reasonable to suppose that there would be a relevant mismatch (as targeted by the Part 6A TIOPA 2010 rules)?

As stated above, with the funding between A Co and B Co being in the form of a hybrid financial instrument, there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch in relation to a payment or quasi-payment where B Co has a deduction which exceeds the amount of ordinary income that arises to A Co, and all or part of that excess arises by reason of the terms, or any other features, of the financial instrument. There is thus a payment or quasi-payment in relation to which there would be a relevant mismatch which might be countered by the rules in Chapter 3 of Part 6A TIOPA 2010.

The relevant arrangement in the series is therefore the interest payment by B Co to A Co and the mismatch payment would be a hybrid financial instrument deduction/non-inclusion mismatch within Chapter 3.

Condition D is therefore satisfied in respect of the interest paid from B Co to A Co.

The relevant mismatch here is the extent of the mismatch as computed under Chapter 3.

Condition E: Is it reasonable to suppose that there will be no relevant counteractions under the Part 6A rules, or their foreign equivalent provision?

As stated in the Background above neither Country X nor Country Y have adopted rules equivalent to rules within Chapter 3 to 10 TIOPA 2010, so they do not counteract the mismatch payment that is the interest payment between B Co and A Co.

If the UK were in the position of Country Z, then on the assumption that Country Y has not adopted equivalent provision to Chapter 11 (an imported mismatch rule), then no counteraction under the tax law of a territory outside the UK has been applied.

Condition E is therefore satisfied.

Condition F: Is either the relevant mismatch an excessive PE deduction or is it reasonable to suppose that a chapter within Chapters 3 to 10 of TIOPA 2010, other than Chapter 6, or its foreign equivalent, would apply to the relevant mismatch in relation to the tax treatment were the UK

payer in the relevant position of the payer (B Co), payee (A Co) or (if relevant) investor?

The rule within Chapter 3, or its foreign equivalent, would have applied to the royalty payment between B Co and A Co (the mismatch payment) had B Co or A Co been within the charge to UK corporation tax.

Condition F is therefore satisfied.

Condition G: Is the relevant payer that is within the charge to UK corporation tax within the same control group as the payer (B Co) or payee (A Co) of the mismatch payment within the relevant period, or is there a structured arrangement?

All the companies are within the same control group, as defined at s259NB TIOPA 2010.

Condition G is met.

Conclusion

As all the relevant conditions are satisfied to characterise the imported mismatch payments under the B Co to A Co arrangement as giving rise to a relevant mismatch. The relevant counteraction under the Imported Mismatch rules must be considered.

Counteraction

Where there is more than one relevant payment in relation to the relevant mismatch arising, each company's share of the relevant mismatch will be determined by apportioning it on a just and reasonable basis, having regard to the extent that it funds the Imported Mismatch.

Section 259KC will apply to deny UK Co a deduction to the extent that it directly or indirectly funds the relevant mismatch.

Therefore s259KC will apply to deny UK Co a deduction for the interest payments made to C Co, to the extent that they do not exceed the interest payments made by B Co to A Co.

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INTM561100: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Contents

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INTM561110: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Overview

Chapter 12 of Part 6A TIOPA 2010 provides for compensatory adjustments where an amount has been counteracted under another chapter within Part 6A, but in the light of subsequent events it becomes apparent that the counteraction was unwarranted or excessive.

S259L (see INTM561120) applies where a counteraction is applied under Part 6A but the understanding upon which that counteraction was based subsequently turns out to be incorrect, so that either no mismatch arises, or the mismatch is smaller than that originally calculated. Such adjustments as are just and reasonable may be made in these circumstances.

S259LA (see INTM561130) applies where a deduction arising from a payment or quasi-payment is reduced by application of Chapters 3, 4, 7 and 8, and the only reason for the reduction is that the ordinary income arose to the payee outside the permitted period. If an amount of ordinary income subsequently arises in a later period, an amount equal to the amount of that ordinary income, but no more than the reduction of the allowable deduction, may be deducted in calculating the taxable profits of the payee for that later period.

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INTM561120: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Adjustments where suppositions cease to be reasonable

S259L applies to adjust the tax consequence where a counteraction under Part 6A was applied, but where the supposition upon which that adjustment depended turns out to be incorrect, and subsequent additional information suggests that the targeted mismatch was of a lesser amount with different tax consequences.

There are numerous situations where the application of the rules depends upon whether it is reasonable to suppose that a targeted mismatch would arise, or that an equivalent provision under the law of a non-UK territory would not apply to address that mismatch.

There are several reasons why the rules rely on the making of reasonable suppositions. The question of whether a corresponding receipt actually becomes included in ordinary income or whether a non-UK territory applies a corresponding counteraction, for example, may not be answered until a significant time after a UK company has to make its self-assessment.

The rules are not intended to cause double taxation unnecessarily, and where it is later established that a supposition made for the purposes of applying Part6A is incorrect, a just and reasonable adjustment can be made under s259L.

The adjustment can be made by means of an assessment, the modification of an assessment, amendment or disallowance of a claim, or otherwise. The time limits which apply are those which are relevant to the adjustment necessary and to the company to which the counteraction was applied. The aim of these provisions is to give flexibility in determining how a just and reasonable adjustment can be given effect

S259L does not apply in circumstances to which s259LA applies (see INTM561130).

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INTM561130: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Deduction from taxable total profits where an amount of ordinary income arises late

S259LA TIOPA 2010 applies where a deduction arising from a payment or quasi-payment is reduced by application of Chapters 3, 4, 7 and 8 and the only reason for the reduction is that the ordinary income arose to the payee outside the permitted period. If an amount of ordinary income arises in a later period, an amount equal to the amount of that ordinary income, but no more than the reduction of the allowable deduction, may be deducted in calculating the taxable profits of the payee for that later period.

This section applies where a deduction has been denied to a payer within the charge to corporation tax (the UK payer) because the relevant payment or quasi-payment gave rise to:

- a hybrid or otherwise impermissible deduction/non-inclusion mismatch under the rules in Chapter 3 (see INTM551000)
- a hybrid transfer deduction/non-inclusion mismatch under the rules in Chapter 4 (see INTM552000)
- a hybrid payee deduction/non-inclusion mismatch under the rules in Chapter 7 (see INTM555000), or
- a multinational payee deduction/non-inclusion mismatch under the rules in Chapter 8 (see INTM556000).

The section applies if

- the only reason for the mismatch under these Chapters was that it was reasonable to suppose that the deduction exceeded the total ordinary income arising by reason of the payment or quasi-payment arising within the permitted taxable period, and
- an amount of ordinary income arises later, outside the permitted taxable period, by reason of the payment or quasi-payment and for reasons unconnected to the application of Part6A or equivalent overseas rules.

Adjustment

Where this section applies then an amount equal to the late income may be deducted from the payer's total taxable profits in the accounting period within which the late period ends.

The deduction is recognised at step 2 in s4(2) CTA 2010. Therefore, it is not given in computing the amount within the computation of the company's total profits for the period, but is relieved against total profits after they have been computed. If there are insufficient total profits in that period, then the unusable balance of the deduction is carried forward to be treated as being relievable in the next subsequent period, and so on, until it can be so offset.

A consequence of granting relief in this manner is that the deduction does not retain its original character. For example, if the counteraction was against a trading deduction or a non-trade loan relationship debit, then it will not remain as such and therefore can neither create nor augment a trading loss or a non-trading deficit on loan relationships for that period. By extension, therefore, it will not be eligible for group relief or any other transfer of relief that is dependent on the character of the payment.

Exceptions

As indicated earlier, it will not be possible to set an amount of ordinary income against the adjusted deduction if the ordinary income arises only because of another counteraction by an overseas equivalent of Part 6A.

No deduction is available in the later period if one of the other rules within Part 6A would apply to counteract the relevant mismatch..

If the relevant receipt exceeds the amount counteracted, then this section does not apply to the excess.

The following examples illustrate the application of s259L.

Example: Hybrid payer deduction/non-inclusion mismatch

A Chapter 5 counteraction is applied to a UK hybrid payer, on the assumption that there would be a hybrid payer deduction/non-inclusion mismatch. This assumption was based on the fact that the payee jurisdiction would disregard the hybrid payer, and therefore no ordinary income would be recognised by the payee in that jurisdiction.

Subsequently, it transpires that the payee jurisdiction had not disregarded the hybrid payer, but in fact treated it as a separate taxable entity (because it did not meet the precise requirements of the relevant tax law in that jurisdiction). As a result, the payee did bring into account ordinary income which matched the relevant deduction claimed by the UK payer.

In these circumstances, a consequential adjustment under Chapter 12 would be appropriate, because the reasonable supposition which was made when a counteraction was applied under Chapter 5 would no longer be reasonable, given the actual treatment in the payee jurisdiction.

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INTM561200: Hybrids: Chapter 13 - Other provisions: Anti-avoidance

Section 259M TIOPA 2010 contains a targeted anti-avoidance rule (TAAR). Arrangements that attempt to circumvent the hybrid and other mismatches rules may be caught and counteracted by s259M.

Arrangements may be counteracted by s259M where

- the main purpose, or one of the main purposes, of those arrangements is to enable any person to obtain a tax advantage by avoiding the hybrid and other mismatches rules, or any overseas equivalent, and
- if s259M did not apply, the arrangements would achieve that purpose.

Arrangements are defined as including any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

The rule applies where a person is

- within the scope of UK corporation tax, or
- would be within the scope of UK corporation tax but for the arrangements.

Chapter 13 applies in relation to "relevant avoidance arrangements" that would, absent s259M, provide a "relevant tax advantage" to a person who either is or would be within the charge to corporation tax.

The relevant tax advantage is counteracted by a just and reasonable adjustment to the person's corporation tax treatment, per s259M(2).

Adjustments by means of assessment, modification of an assessment, amendment, disallowance of a claim or otherwise are provided for by s259M(3).

A "relevant tax advantage" is defined in s259M(4) as where a person avoids the application of Part 6A, or any non-UK equivalent rules, and so prevents either the restriction of a deduction, or an amount being taxed as income.

A "relevant avoidance arrangement" is defined at s259M(5) as being an arrangement where the main purpose, or one of the main purposes, is to obtain a relevant tax advantage.

Chapter 13 will not apply in cases where obtaining the tax advantage is regarded as consistent with the principles and policy objectives underlying Part 6A.

When considering the principles and policy objectives underlying Part 6A, regard can be taken, where appropriate, to the principles and objectives set out in the Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements, published by the Organisation for Economic Cooperation and Development on 5 October 2015 (or any replacement, update or supplement to it).

However, it may not always be appropriate to consider the OECD Report. For example, it would not be appropriate to have regard to the OECD Report if the UK has expressed an intention to depart from that Report.

Similarly, if the OECD Report is subsequently replaced or updated, or if any supplement is added to the Report, it will not be appropriate to give regard to the Report if the relevant revision, addition or supplement indicates a material departure from the understanding of the Report when the legislation was drafted.

One consequence of the introduction of Part 6A may be that companies look to restructure with a view to removing hybrid entities from their group structures, or to change their funding arrangements with the aim of reducing their use of hybrid financial instruments. Where the replacement structures and funding arrangements do not fall within the policy scope of the OECD Report it is unlikely that the Part 6A TAAR would apply, though the application of other legislation might need to be considered.

All cases where it is considered that s259M applies should be referred to the Base Protection Policy team, BAI –

- by email to: hybrids.mailbox@hmrc.gov.uk, or
- by post to:

  HM Revenue & Customs
  Base Protection Policy Team,
  Business Assets & International
  S0862, Floor 4 Rear
  Central Mail Unit
  Newcastle
  NE98 1ZZ

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INTM597000: Hybrids: Chapter 14 - Operational guidance: Contents

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INTM597010: Hybrids: Chapter 14 - Operational guidance: When does the legislation take effect?

Part 6A of the Taxation (International and Other Provisions) Act 2010 was introduced by section 66/Schedule 10 of Finance Act 2016 ("FA 16"), and has effect from 1 January 2017. The commencement provisions for chapters 3 to 11 are set out at paragraphs 18 to 22 of Schedule 10, FA 16

Broadly speaking, the legislation applies from 1 January 2017 for -

- deduction/non-inclusion mismatches arising from deductions made on or after that date
- deduction/non-inclusion mismatches arising from quasi-payments in a payment period beginning on or after that date
- double deduction mismatches for accounting periods beginning on or after that date
- imported mismatch payments arising from payments made on or after that date
- imported mismatch payments arising from quasi-payments in a payment period beginning on or after that date.

There are transitional rules for payment periods and accounting periods that begin before 1 January 2017 and end after that date at paragraphs 23 and 24 of Schedule 10, FA 16.

In these cases the payment/accounting period is treated as 2 separate taxable periods -

- one ending on 31 December 2016, and
- the other beginning on 1 January 2017.

Apportion amounts to each of these period on a time basis, unless that produces a result that is unjust or unreasonable. In those circumstances, apportion the amounts on a just and reasonable basis.

Transactions between 16 March 2005 to 31 December 2016 involving hybrids and mismatches fall within the arbitrage rules set out at INTM590000 onwards.

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INTM597020: Hybrids: Chapter 14 - Operational guidance: Non-statutory clearance applications

HMRC will, on request, consider clearance applications in respect of the application of the Part 6A hybrid and other mismatch rules in line with the general guidance on non-statutory business clearances in situations where there are points of genuine uncertainty.

In line with a number of similar provisions, HMRC will not consider a clearance application concerning the application of the TAAR provided by Chapter 13 of Part 6A.

Precisely what information the application should contain will depend on the nature of the clarification requested, the nature of the potential mismatch and the entities involved. Consequently it is not feasible to list the information required in all circumstances but the more relevant information provided with the initial application, the greater the likelihood it can be considered without the need for the provision of additional information.

HMRC would expect to receive the following information in all applications -

- A clear indication at the start of the application as to what chapters and particular legislation the request for clearance refers to and for which accounting periods

- Details of the UK resident company, or UK permanent establishment of a foreign company, potentially impacted by the hybrids mismatches legislation, including the name, registered office address and UTR of each such UK company, and the counteraction expected by each if the there is a mismatch

- Details of any non-UK entities involved in the mismatch arrangements, including the name and address of each entity

- A description of all business undertaken by all the entities relevant to understanding the application. Any anticipated changes in subsequent accounting periods should also be detailed.

- The nature and extent of all direct or indirect transactions or arrangements relevant to the application. Any anticipated changes in subsequent accounting periods should also be detailed.

- Details of the group and UK ownership structure

- Diagrams of the relevant part of the overall group structure that contains the entities involved in the potential hybrid mismatch (and any other connected entities with which these transact or are involved in an arrangement) together with the UK connection clearly detailed. Where changes are expected in the group structure it would be helpful for anticipated changes to be highlighted.

- A full description of the overall structure, arrangements and transactions relevant to the application of the hybrid mismatches legislation. This should include any step plans, diagrams, group structure, contracts, agreements or other relevant documents that cover the various stages of the arrangements.

- Tax analysis for the specific legislation in relation to which clearance is sought, providing both the UK and anticipated foreign tax treatment.

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INTM597030: Hybrids: Chapter 14 - Operational guidance: Clearances: Where to send clearance applications

Clearance applications should be sent electronically, together with all relevant supporting documentation, to hybrids.mailbox@hmrc.gov.uk.

If the company has a customer compliance manager (CCM) any clearance application should be copied to the CCM. The application and supporting documents should not be sent as self-extracting zip files, as these files are blocked by our software.

If the company does not wish to use email, the clearance application may be sent to the following address:

HM Revenue & Customs
Base Protection Policy Team,
Business Assets & International
S0862, Floor 4 Rear
Central Mail Unit
Newcastle
NE98 1ZZ

The clearance applications will be reviewed within the normal HMRC turnaround time of 28 working days. If further information is required in order fully to consider the application, then a fresh turnaround time of up to 28 days will apply from the time the further information is provided.

Applications involving novel or complex issues will need more time to allow for more detailed discussion and this may involve ongoing correspondence and meetings before resolution. If this is the case, it is likely that the CCM and tax specialists assigned to the company will be involved as well as the Base Protection Policy team. In all cases, comments on the application from the CCM or the case team are welcome.

https://www.gov.uk/guidance/non-statutory-clearance-service-guidance

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