# INTM550086 A: Hybrids: Introduction: Examples: Interaction with transfer pricing

**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.
* A payment is made from the Payer in Country D to the Partnership in Country C
* Investor 1 in Country A sees the underlying financial instrument as equity, and does not tax the return on it.
* Investor 2 in Country B sees the underlying 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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