# INTM551210: Hybrids: Financial instruments (Chapter 3): 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](https://www.gov.uk/hmrc-internal-manuals/international-manual/intm551170)).

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.


## 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](http://www.hmrc.gov.uk/gds/intm/attachments/INTM551220.docx)).

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](https://www.gov.uk/hmrc-internal-manuals/international-manual/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).

[Return to contents](https://www.gov.uk/hmrc-internal-manuals/international-manual/intm550000)