# INTM552500: Hybrids: Hybrid transfers (Chapter 4): 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](http://www.hmrc.gov.uk/gds/intm/attachments/INTM552490.docx), 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.

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