INTM555220: Hybrids: Hybrid payee (Chapter 7): Example: investor is a tax-exempt entity

A Co is a company resident in Country Y

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 (that is, it is not a separate taxable person from A Co) 

Country Y treats B Co as a separate taxable person from A Co

A Co is exempt from tax under Country Y law

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. 


## 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.

For payments made after 10 June 2021 (the date of Royal Assent of the Finance Bill 2021), any excess arising to Qualifying Institutional Investors (“QIIs”) should not be taken account of for the purposes of calculating the hybrid payee deduction/non-inclusion mismatch if the conditions in s259GB(2A) and (2B) are met. This would be relevant in considering the excess attributable to A, due to its tax-exempt status, which means it is likely to meet the definition of a QII provided in Paragraph 30A of Schedule 7AC TCGA 1992.

However, the changes for QIIs (in 259BC(8A) ensures that income is to be treated as ordinary income notwithstanding the fact it is not subject to tax. Therefore, the analysis above, in considering what the outcome would be if Country Y saw B as transparent, still holds because although they would be tax exempt, they would still be in receipt of ordinary income.

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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