# INTM555230: Hybrids: Hybrid payee (Chapter 7): Example: Payments to hybrid entity (reverse hybrid) partially excluded

INTM555230 structure diagram

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


## 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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