UK Anti-Hybrid Rules:
Some challenges for corporate groups - and a limited opportunity for improvements

The UK's complex new regime for counteracting hybrid and other mismatches came into force on 1 January 2017. Most groups are likely to have some sense of what these rules are about, although our experience suggests that some taxpayers, and also HMRC, are just waking up to some of the more surprising implications of the UK's attempt to implement the recommendations of the OECD on BEPS Action 2.

In practice, published guidance is likely to be central to the operation of these rules for both groups and HMRC. The consultation on HMRC's draft guidance [available at https://www.gov.uk/government/consultations/hybrid-and-other-mismatches-draft-guidance] is open until 10 March 2017 – and groups would be well-advised to raise now the impact that the anti-hybrids legislation may have on their arrangements, especially where the rules give rise to unexpected difficulties.

Back to basics: what is a hybrid mismatch?
The OECD's base erosion and profits shifting (BEPS) project included, as Action 2, recommendations on neutralising the effect of hybrid mismatches. As the 2015 OECD final report explained (at pp.11 & 18):

> ***Executive summary***
> *Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.*
> …
>
> ***Hybrid element***
> *While cross-border mismatches arise in other contexts (such as the payment of deductible interest to a tax exempt entity), the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes. Some arrangements exploit differences between the transparency or opacity of an entity for tax purposes (hybrid entities) and others involve the use of hybrid instruments, which generally involve a conflict in the characterisation of the instrument (and hence the tax treatment of the payments made under it). …*
>
> *In most cases the causal connection between the hybrid element and the mismatch will be obvious.*

A simple example of mismatch caused by a "hybrid" instrument is where a borrower pays a (tax-deductible) coupon on an instrument which the recipient, in a different jurisdiction, characterises as a return on (tax-exempt) equity.

Mismatches involving "hybrid" entities can arise where an entity in jurisdiction X receives a payment which is not taxed in jurisdiction X because jurisdiction X treats the entity as transparent, whilst jurisdiction Y, in which the entity's shareholders / partners are based, does not tax the payment either because jurisdiction Y regards the entity as opaque.

The UK anti-hybrid legislation
New Part 6A TIOPA 2010 is intended to implement the OECD's recommendations on neutralising the effects of hybrid mismatches. However, a conscious decision has been taken to exceed in a number of important respects the approach which was endorsed by the OECD – a point which is noted in the draft HMRC guidance at INTM550030.

In large part, the difficulties that we are seeing stem from the departures that the UK legislation makes from the detailed recommendations in the OECD report.

This article highlights some of the features of typical corporate groups – particularly multinational groups – that merit attention now that the anti-hybrid rules must be taken into account in calculating profits which are subject to UK corporation tax. As there are no transitional rules for the new regime, existing transactions, and not just new arrangements, are in scope.

A further challenge is the absence of a motive test: the rules are not confined to those arrangements that have a main purpose of securing a tax advantage. That can cause particular issues where the application of the complicated, mechanical provisions appears to produce the "wrong" answer.

In the space available we have covered what seem to us to be some of the key issues, being:

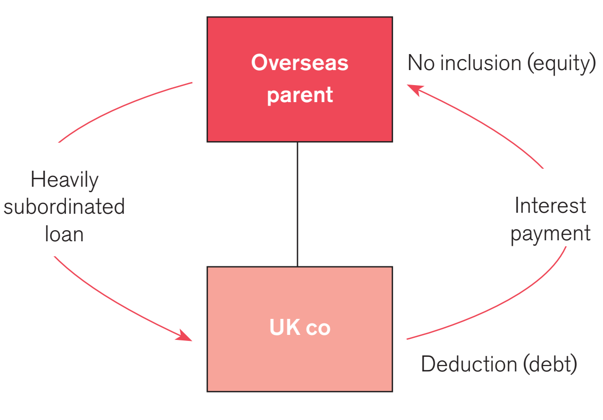
- shareholder loans;
- Luxembourg financing;
- UK companies with overseas PEs;
- companies operating through a UK PE; and
- US "check the box" regime and hybrid entities.

Following a review of some of the likely difficulties for corporate groups, we conclude at the end of this update that groups should consider raising with HMRC the points that will affect them in practice.

Action should be taken sooner rather than later, as the period in which formal representations will be accepted by HMRC in relation to the draft guidance closes on 10 March 2017.

Shareholder loans

Figure 1



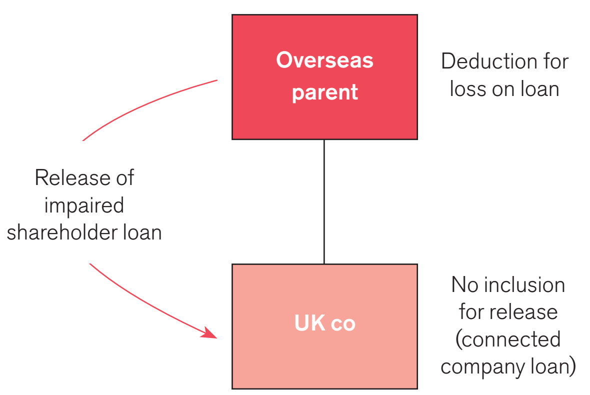
One aspect of the anti-hybrids project that has received plenty of attention is the rule counteracting mismatches which arise from hybrid instruments. This is in Chapter 3 of new Part 6A TIOPA 2010.

Many groups have been reviewing their arrangements to identify whether they include hybrid instruments, typically a financial instrument which is treated differently in two jurisdictions as a result of its terms or features. Examples include deeply subordinated debt, which might be regarded as (exempt) equity in the lender jurisdiction, or preferred equity certificates which are again often treated as equity in the hands of the subscriber but (deductible) debt for the issuer [figure 1].

One surprising theme that emerges from the draft HMRC guidance on the hybrid rules is that a "plain vanilla" loan – i.e. debt on arm's length terms – can potentially be caught by the anti-hybrid rules. This is counter-intuitive since "normal" instruments ought to be the opposite of "hybrid" instruments.

Take this example: a UK company borrows from its non-UK parent on arm's length terms. The borrower gets into financial difficulties and the loan is released [figure 2]. In the parent's accounts there is a loss on the loan which is relievable for tax purposes in the non-UK jurisdiction. The income shown in the borrower's accounts is, however, disregarded for UK tax purposes because this is a connected company loan relationship (s.358 CTA 2009).

Figure 2



You can see the mismatch: a deduction in the non-UK jurisdiction but no inclusion in the UK. But is it a hybrid mismatch? The expectation must be that the answer is "no", since the loan is "plain vanilla" and on arm's length terms – hardly a "hybrid" instrument. And the OCED final report on BEPS Action 2 records at page 231 that the release of a debt obligation – in exactly these circumstances – is not a payment to which the hybrid rules should apply (Example 1.20).

On this point, the draft HMRC guidance points the other way. At INTM551200, HMRC give this same example (using the same picture as in the OECD report) and conclude that there is a hybrid mismatch, such that the UK exemption should be overridden by the anti-hybrid rules with the UK borrower then taxed on the amount of the release.

To explain the contradiction, the first point to appreciate is that HMRC are taking a very wide view of the concept of hybridity. Their analysis is that the shareholder relationship in this example, which is what brings s.358 CTA 2009 into play, is a feature of the loan. This turns what would be a non-hybrid loan in the hands of a third party creditor into a hybrid loan in the hands of the parent company – even though the terms of the loan are exactly the same. The statutory reference here is s.259CB(2)(b) TIOPA 2010, which tells you that a mismatch on a financial instrument is a hybrid mismatch if it "arises by reason of the terms, of any other feature, of the financial instrument". Absent the draft HMRC guidance, the natural conclusion would be that an instrument on "normal" arm's length terms – i.e. without special terms or features – falls outside this rule. And this conclusion is fortified by the recommendation in the OECD report, which is as follows:

> ***3. Rule only applies to a payment under a financial instrument that results in a hybrid mismatch***
> A payment under a financial instrument results in a hybrid mismatch where the mismatch can be attributed to the terms of the instrument. A payment cannot be attributed to the terms of the instrument where the mismatch is solely attributable to the status of the taxpayer or the circumstances in which the instrument is held.

HMRC's analysis at INTM551200 turns this on its head by asserting that the circumstances in which a "normal" loan is held (e.g. between parent and subsidiary) can be a cause of a hybrid mismatch which is attributable to the terms of a financial instrument.

The second point is about "payments". As noted above, the release of a debt is not generally regarded as a "payment", so it is not something that the OECD considers to be within the scope of the anti-hybrids project. The UK legislation sidesteps this by introducing the concept of a "quasi-payment", a concept which can be paraphrased as anything in respect of which you might expect somebody to get a tax deduction (s.259BB TIOPA 2010 sets out the full definition). Since the loss on the release of the loan to the subsidiary in the example above is eligible for non-UK tax relief, it is a quasi-payment and thus the hybrid instruments rule is in play.

In the light of that example, you can see that the scope of Chapter 3 of Part 6A TIOPA 2010 (hybrid and other mismatches from financial instruments) is wider than groups have been led to expect. In practice this will mean that any tax mismatches between different jurisdictions on intra-group instruments should be examined critically to test for potential counteraction under the hybrid mismatch rules.

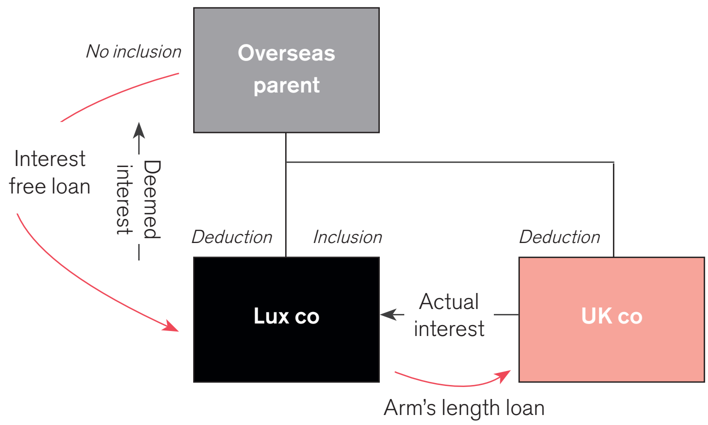
Luxembourg financing

It should come as no surprise that financing that is routed through Luxembourg requires particular attention in applying Part 6A TIOPA 2010. Examples of potential problem areas include convertible preferred equity certificates (CPECs), which are generally treated as debt in Luxembourg but equity elsewhere (in particular in the US), and the various circumstances in which a deduction is available in Luxembourg for "deemed" interest, for example on some interest-free loans. Deemed interest is a particular issue in situations where there is no deemed interest receipt in the lender jurisdiction.

There is a thorny question as to whether statutory deductions which are available where there is no underlying payment should be treated as payments (or quasi-payments) for the purpose of the hybrid rules. The OECD recommendation on this point has been included in the UK legislation at s.259BB(3) TIOPA 2010, but you then need to contrast OECD example 1.14 (which says the deemed deduction is not caught by the anti-hybrid rules) with HMRC's example at INTM551170 (which says that it is).

Mismatches involving Luxembourg can arise either directly, where a UK corporation tax payer is the counterparty, or indirectly, where a deduction which represents a Luxembourg mismatch is "imported" in to the UK (Chapter 11 Part 6A TIOPA 2010) – as in [figure 3].

Figure 3



UK companies with overseas PEs

One area where the UK anti-hybrid rules have made a complete departure from the recommendations of the OECD is in relation to companies that are resident in one jurisdiction and operate through a branch (i.e. permanent establishment, or PE) in another jurisdiction.

Overseas branches are, of course, a common feature of multinational businesses and it is not immediately obvious what they have to do with the project to eliminate hybrid mismatches. The answer, according to HMRC, is that without these rules groups would be able to sidestep the OECD recommendations on hybrids by using PEs to achieve mismatch outcomes (draft guidance at INTM550030). You might therefore expect to find a targeted anti-avoidance rule in relation to the use of overseas PEs to produce synthetic hybrid mismatches.

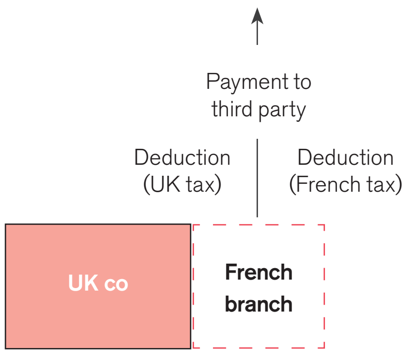
What we have instead is a rule which treats all UK resident companies with PEs as within the scope of the anti-hybrid rules.

The width of this rule can be illustrated using the most straightforward example possible [figure 4]. Assume that UK Co has a branch in Paris and that it has not made an election to treat its overseas PEs as exempt from UK corporation tax. The profits of the Paris branch will be taxable both in the UK (given the worldwide basis of taxation for UK resident companies) and also in France (on a PE attribution basis). Credit should be available under the UK / France treaty to eliminate double taxation.

That computation is then subject to adjustment under Chapter 10 of Part 6A TIOPA 2010, which requires the company to identify, for each deduction which is available in calculating profits for UK and French tax purposes, matching ordinary income which is taxable in both the UK and France within a permitted time period (referred to as "dual inclusion income"). Any amount which is deductible in both territories but which is not matched with dual inclusion income will result in a denial of the UK deduction. Given the endless possibilities for mismatches or partial mismatches (as to timing, for example, or the nature of particular receipts for local tax purposes), this is potentially an onerous compliance burden for UK companies that operate through PEs.

Contrary to what you might expect, the rule applies to <u>all</u> payments / quasi-payments, with no requirement for the involvement of a connected party or a structured arrangement.

Figure 4



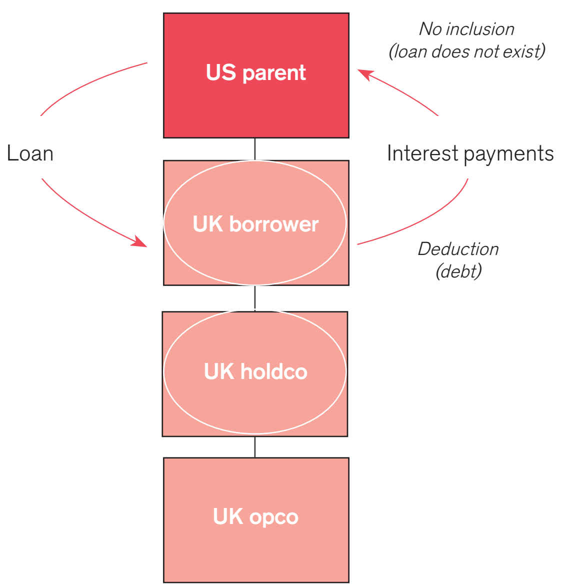
Companies operating through a UK PE
In addition to the point made about UK companies with overseas PEs, Chapter 10 of Part 6A 2010 also brings into scope the reverse position: overseas companies with a UK PE.

For groups that have a UK PE, the question is again whether all of their UK deductions (if also deductible in the jurisdiction of residence) are matched by dual inclusion income.

US "check the box" regime and hybrid entities
One aspect of the international tax system that was squarely within the sights of the OECD recommendations is the planning opportunities that arise from the US "check the box" rules, which (broadly) allow groups to elect to treat corporations as if they were branches of their parent company for US tax purposes.

A simplified "tower" funding structure is shown in [figure 5]. The arbitrage here is in relation to the loan between the US parent and the UK borrower, which gives rise to a UK deduction for interest but is disregarded for tax purposes in the US because a "check the box" election has been made to treat the UK borrower as a branch of the US parent.

Figure 5



Chapter 5 of Part 6A TIOPA 2010 should now operate to disallow the UK deduction, so the question for groups that have been funded in this way – and who are likely to be alive to this issue already – is how to restructure to achieve efficient financing without involving hybrid mismatches. In answering that, two important factors to keep in mind are:

— the targeted anti-avoidance rule for arrangements which are designed to avoid the effect of the anti-hybrid rules (s.259M TIOPA 2010); and

— the general principle that non-inclusion is more problematic that inclusion at a low rate when it comes to applying the anti-hybrid rules.

The issues with "checked open" entities go much further than unwinding tower structures or avoiding deductible payments between disregarded subsidiaries and their parent entity. That is because a checked open corporation is by definition almost always a "hybrid entity" (applying the definition in s.259BE TIOPA 2010) as it is regarded as a person for tax purposes under the law of the UK (or another relevant jurisdiction) whereas it is not regarded as a distinct and separate person under the law of the US.

Where a hybrid entity is entitled to a deduction for UK corporation tax purposes, or where a UK deduction arises in connection with an imported mismatch involving a checked open entity, that deduction may be restricted under Part 6A TIOPA 2010 in a number of circumstances. In such circumstances, four separate Chapters in Part 6A will require attention, being:

— Chapter 5: hybrid payer deduction / non-inclusion mismatches;

— Chapter 7: hybrid payee deduction / non-inclusion mismatches;

— Chapter 9: hybrid entity double deduction mismatches; and

— Chapter 11: imported mismatches.

In our experience, Chapters 5 and 7 are proving particularly difficult to apply in practice because they require a counter-factual exercise which can deem a mismatch arising for non-hybrid reasons (e.g. where the ultimate recipient is tax-exempt) to be attributable to the hybrid nature of the entity.

In very broad terms, where a hybrid entity is the payer (i.e. making a deductible payment), the test of whether the hybridity of that entity is the cause of non-inclusion by a recipient requires that you ignore the fact that the recipient may be tax exempt in its home jurisdiction and the fact that it may be subject to tax only on local source profits (s.259EB(4) TIOPA 2010). There will thus be some circumstances where the hybridity of the entity has not driven the mismatch outcome but it is nonetheless caught by Chapter 5 of Part 6A TIOPA 2010.

Where the recipient of a deductible payment is a hybrid entity (e.g. a UK limited partnership – which is transparent in the UK but often opaque overseas), any mismatch will be deemed to arise from the hybridity of the recipient unless the entity is subject to tax on a residence, PE or CFC basis in another territory. This is the effect of Chapter 7 of Part 6A TIOPA 2010, and in particular s.259GB(3) TIOPA 2010.

A limited opportunity to make improvements

In our view, the improvements which are required to the anti-hybrid rules go beyond matters which are susceptible to clarification by way of guidance. The UK suffers from "first-mover" disadvantage, in that it has legislated to give effect to the recommendations of the OECD in relation to BEPS Action 2 before any other jurisdictions have tried these rules out.

In addition, by choosing to exceed the carefully reasoned recommendations of the OECD, HMRC have added further difficulties to what was already a tricky area. Ideally, parliamentary time would be found to iron out some of kinks in the primary legislation – but there seems little prospect of that in the short term (and of course the rules are already in force).

That said, given some of the difficulties that we have highlighted here, groups will want to achieve further certainty on how these rules are supposed to apply to their arrangements in practice.

In that regard, the draft guidance which was published at the end of 2016 is something that groups should consider commenting on. HMRC has stated that it will keep the consultation period open on this draft guidance until 10 March 2017.

Resources

Draft HMRC guidance:
https://www.gov.uk/government/consultations/hybrid-and-other-mismatches-draft-guidance

OECD final report:
http://www.oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm

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