

Hybrids and other mismatches (Lecture B1255 – 20.34 minutes)

Clause 36 introduces Schedule 7 which makes fifteen changes to Part 6A TIOPA 2010, ostensibly to ensure the hybrid mismatch rules operate as originally intended.

Before each amendment, the notes give the context in which they arise.

Definition of foreign tax

Taxes that can be counteracted under the rules include taxes on profits or income (excluding municipal levies and taxes imposed by provinces, states or other parts of the country), but not sales taxes or withholding taxes.

Schedule 7, Para 1 inserts para 3ZA into s259B(3) TIOPA 2010 with effect from Royal Assent.

A foreign tax is not an income tax or corporate tax on income if it is charged on income that has

1. arisen to an entity that is an opaque entity in the territory charging the tax but is not liable to tax on it; and
2. is to be brought into account for tax purposes by a different entity

Meaning of hybrid entity and investor

A hybrid entity is an entity that meets two conditions

- A. It is taxed as a separate person under the laws of any territory; and
- B. It is tax transparent in any other territory (i.e. in another jurisdiction its profits are taxable on another person(s) – usually its owners/investors).

The wording in A, 'any territory' is being amended to 'a relevant territory' which is then defined as

- a) the territory where the entity is established; or
- b) a territory where a person is resident for tax or otherwise within the charge to tax, and would be treated for tax purposes as receiving any distribution of profit made by the entity

Similarly, in B. the wording 'any territory' is replaced with 'a territory' and where it refers to 'person or persons other than' (the entity mentioned in A), this is being replaced by 'one of more persons (other than the entity mentioned in A) who are resident for tax purposes or otherwise within the charge to a tax in the territory'.

In other words, the territory cannot now be a totally unrelated territory to the structure being considered. The change applies with retrospective effect.

Situations where relevant debt relief is given

Normally, when a corporate lender writes off, impairs, or releases a debt of a connected company, the debit is disallowed under the loan relationship rules. If the borrower is in an insolvency procedure at that time, however (e.g. receivership, administration, liquidation), the loan relationship debit for the lender is allowable.

The borrower recognises a credit in its profit and loss account when it is notified that the liability is no longer payable. This credit is never taxable under the loan relationship rules.

For financial instrument hybrid mismatches (s259CB TIOPA 2010), the wording has been clarified to ensure that a mismatch cannot arise merely because the lender receives an allowable debit on the write off, impairment or release of a loan and the borrower is not taxed on it.

Old s259CB(3) said this would be the case where the 'excess' (i.e. the allowable debit not matched by a taxable credit for the borrower) arises by reason of a relevant debt relief provision. It now adds 'or in relevant debt relief circumstances' so as to put beyond doubt that the excess is never disallowed in these situations.

'Relevant debt relief circumstances' apply if any of the circumstances in new s259NEC – s259NEF TIOPA 2010.

New s259NEC: The amortised cost basis of accounting must have been used by the lender for the loan and a relevant release occurs when one of five conditions is met:

1. the release is part of a statutory insolvency arrangement (as defined in s1319 CTA 2009)
2. the release is not a release of relevant rights and is in consideration of ordinary shares (or a right to such shares)
3. the borrower meets an insolvency condition (insolvent liquidation, insolvent administration, insolvent administrative receivership, a provisional liquidator has been appointed and is not connected to the lender or corresponding procedures outside the UK)
4. the release is related to a stabilisation power under Part 1 Banking Act 2009
5. the release is not a deemed release nor a release of relevant rights and without it, it would be reasonable to assume that there would be a material risk that the borrower would be unable to pay its debts in the next 12 months

New s259NED: The amortised cost basis of accounting is used, the lender and borrower are connected companies and the release is neither a deemed release nor a release of relevant rights.

New s259NEE: amortised cost basis is used for the loan, the conditions in s357 CTA 2009 apply (which are identical to those in s259NEC condition C above) and

1. immediately before the conditions in s357 CTA 2009 were first met the parties were connected companies, and
2. immediately after that time they were not connected companies

New s259NEF – corporate rescue where a debt is released within 60 days of the payer and payee becoming connected.

The conditions are:

1. the payer's acquisition of rights under the loan relationship is an arms' length transaction, and
2. immediately before the payer became a party to the loan, it was reasonable to assume that there would be a material risk that the borrower would be unable to pay its debts as they fall due in the next 12 months, or the value of its assets would be less than its liabilities (including contingent and prospective liabilities).

This change is applied retrospectively.

Investment trusts

Under SI2009/2034, an investment trust can designate a distribution which is legally a dividend as an interest distribution but not an amount in excess of the company's qualifying interest income for the period. It is then treated as interest for all tax purposes.

New s259CB(3A) is inserted into TIOPA 2010. If an 'excess' arises in respect of an interest distribution designation, it is taken not to arise by reason of the financial instrument and there cannot therefore be a hybrid mismatch counteraction.

This change applies retrospectively.

Deemed dual inclusion income

Where there is a payment between two connected entities and one of them is a hybrid entity, this can lead to a deduction/non-inclusion (D/Ni) mismatch. For example, if a US company has a UK subsidiary which the parent elects to disregard for US corporate tax purposes, the UK company is effectively treated as a branch of the US parent.

As such, its income and expenses are taxed in the US as part of the parent company. If there is (say) a loan from the parent to the UK subsidiary on which interest is payable, the UK subsidiary has interest expense which is ordinarily deductible.

But for US tax purposes, the loan is ignored as it is 'intra-entity', so the interest receivable on the loan by the US parent is not taxable in the US.

This represents a hybrid payer D/Ni mismatch and the UK subsidiary currently needs to disallow the interest expense unless it has dual inclusion income arising in connection with the loan (s259EC(4)).

This limitation is removed by FB 2021 so that potentially the net income of the UK subsidiary which is chargeable to corporation tax in the UK and again in the US as part of the profit of the US parent will count as dual inclusion, so that if the UK subsidiary is profitable there will be no disallowance under the hybrid mismatch rules.

To be dual inclusion income for the US parent, the income must represent 'ordinary income' for the purpose of any tax charged under the law of the parent's jurisdiction.

New paras 6 - 10 are added to s259EC to clarify that this includes the following requirements:

- a) under the law of any territory, the amount may not be deducted from the income of any person/body in calculating taxable profits for a relevant period
- b) if the person or body is resident in a zero-tax territory (either the person or body is not chargeable to tax, or is chargeable at 0%), the amount could not be deducted from the income of the person/body in calculating taxable profits if the person/body were resident in the UK
- c) under the law of the investor's jurisdiction, the amount could be deducted from its income in calculating its taxable profit if it was assumed that the payer would not meet the condition of being a hybrid payer in the investor's jurisdiction

The conditions are judged over a relevant taxable period for the investor. This is usually taken to be a period beginning within 12 months of the end of the payer's chargeable accounting period, but a later period can be considered if it is just and reasonable to do so.

If it is the recipient under the D/Ni mismatch which is within the charge to corporation tax, the same existing restriction that dual inclusion income must arise 'in connection with the arrangement' is removed.

This change is effective for accounting periods beginning on or after Royal Assent.

D/Ni mismatches related to transfers by permanent establishments (PEs)

The definition of dual inclusion income in s259FB which limits the disallowance of an excess PE deduction is amended to include reference to 'excessive PE inclusion income'.

This is then defined in new s259FC as normally just 'PE inclusion income' but where the permitted taxable period of the recipient begins more than 12 months after the end of the payer's chargeable accounting period, it is the amount of PE inclusion income that it is reasonable to suppose exceeds the aggregate effect on taxable profits.

PE inclusion income means an amount that:

- a) is in respect of the transfer of money or money's worth from the company in the foreign jurisdiction to the UK company which is actually made or is treated as made for corporation tax purposes, and
- b) it is reasonable to suppose that the amount will not result in a reduction in the taxable profits or an increase in a loss of the company for a relevant period

for the purpose of a tax charged under the law of the parent jurisdiction, or if there is a reduction in profits, the amount exceeds the 'aggregate effect on taxable profits' (any reductions in the taxable profits or increase in losses of the company for parent jurisdiction tax purposes).

Reductions of profits and increases of losses are ignored where the parent jurisdiction charges tax at 0%.

This change is effective for accounting periods beginning on or after Royal Assent.

Hybrid entity double deduction (DD) mismatches

Where (say) a UK branch of a foreign company incurs expenditure with a third party which is deductible for corporation tax purposes, there will be a double deduction because the foreign company will also receive deduction.

Usually this is not counteracted because the branch income will be taxed both in the UK and the foreign jurisdiction so that it represents dual inclusion income.

At present s259IC(4) states that the restricted deduction cannot be deducted from the UK branch profits 'unless it is deducted from dual inclusion income for the period or s259ID income for the period'. The reference to s259ID income is removed by FB 2021 as s259ID is deleted by the Bill.

S259ICA is inserted and deals with 'deemed dual inclusion income'. This is defined as income where:

- a) under the law of any territory, the amount may not be deducted from the income of any person/body for tax purposes
- b) for a person/body in a zero-tax territory, the amount could not be deducted from the income of a person/body if they were resident in the UK, and
- c) in the investor jurisdiction, the amount could be deducted from its income in calculating its taxable profits if it were assumed that the payer would not meet the condition of being a hybrid payer in the investor's jurisdiction

This change is effective for accounting periods beginning on or after Royal Assent but an election can be made by 31 December 2021 to treat the change as retrospective.

Dual territory double deduction mismatches

Where a multinational company (one resident in jurisdiction A but with a PE in jurisdiction B), or a dual resident company incurs expenditure this can potentially be deducted twice, rather like hybrid entity double deduction mismatches.

In the case of multinationals, the counteraction is different depending on whether the UK is the parent jurisdiction or the PE jurisdiction.

FB2021 amends the definition of dual inclusion income where the UK is the PE's jurisdiction and the double deduction is not counteracted in the parent's jurisdiction to include the concept of 'excessive PE inclusion income' discussed above for 'D/NI mismatches related to transfers by permanent establishments'.

Deemed dual inclusion income – anti-avoidance

S259M sets out the conditions under which avoidance arrangements can be counteracted.

S259M(4) defined when a person obtains a 'relevant tax advantage'. S259M(4)(c) is added where the person does anything which, to any extent, results in an amount being treated as dual inclusion income of that person.

Allocation of dual inclusion within a group

New Chapter 12A is added to Part 6A TIOPA 2010, having effect for accounting periods beginning on or after 1 January 2021.

A dual inclusion income surplus ('a DII surplus') can be used by other group companies where five conditions are met:

- A. The dual inclusion income of a company (Company A) exceeds its counteraction amount, i.e. it has a 'DII surplus'
- B. Another company (Company B) has a counteraction amount exceeding its dual inclusion income (a 'DII shortfall')
- C. The periods of the DII surplus of Company A and DII shortfall of Company B overlap
- D. Both Company A and Company B are within the charge to corporation tax for the overlapping period
- E. There is a time during the overlapping period where Company A and Company B are part of the same group (as defined for group relief purposes).

If there is any part of the overlapping period where either of the companies is not within the charge to corporation tax or they are not members of the same group, this part is treated as not forming part of the overlapping period for either a surplus or a shortfall.

Company B must make an 'allocation claim' in its tax return for part or all of Company A's DII surplus, identifying the DII surplus to which it relates.

Company A must consent to the claim in writing to HMRC at or before the time the allocation claim is made and Company B must send a copy of the consent notice with its claim.

Company B must have matchable income (i.e. ordinary income that is not dual inclusion income) that is at least equal to the DII surplus to which the claim relates and this must be identified in the claim.

The amount of Company B's matchable income in the claim must equal the DII surplus claimed from Company A and must not exceed the unused DII shortfall of Company B for the shortfall period.

If the DII surplus of Company A arises in a period which only partly overlaps with the DII shortfall of company B, the DII surplus available to Company B must be apportioned.

The law ensures that DII can only be included once, so prior allocations of it to reduce counteractions must be deducted. There are similar provisions to ensure that DII shortfalls are only matched up to their total amount with DII allocations.

Allocation claims can be made within two years after the end of the accounting period of the claimant to which it relates. This is extended to 30 days after any enquiry into the return is completed, or 30 days after any assessment is issued as a result of the notice, or 30 days after any appeal against assessment has been finally determined, where relevant.

HMRC is permitted to accept late claims and later withdrawals of a claim.

There are further provisions relating to what happens if the unused part of Company A's DII surplus is reduced to less than the amount stated in its notice of consent, assessments on other companies where consent was withdrawn or a new consent given (such that HMRC can pursue any company that benefited from A's consent for tax owed by Company B as a result of the consent being withdrawn/replaced/amended).

Financing cost of loan capital

FB 2021 amends s259FA(4) TIOPA 2010 to put beyond doubt that notional finance costs of a UK permanent establishment under the 'separate enterprise principle' of establishing the profits that are liable to corporation tax are not subject to counteraction under the hybrid mismatch rules.

This change applies retrospectively.

Carry forward of illegitimate overseas deductions

If the UK is the PE jurisdiction and there is no counteraction in the parent jurisdiction, a double deduction (DD) mismatch is only deductible to the extent it is not (in substance) deductible in a foreign jurisdiction against the non-dual inclusion income of any person ('illegitimate overseas deduction').

At present, to the extent a DD is an illegitimate overseas deduction, it cannot be carried forward for relief against future relevant income.

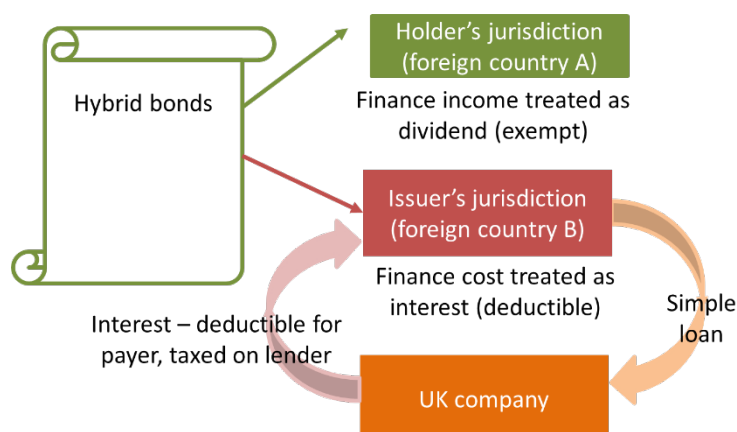
FB 2021 amends ss259IC, s259JB and s259JD to allow the carry forward of the illegitimate overseas deduction when the double deduction amount is deducted from the non-dual inclusion income of the investor in the hybrid entity (or the company in the case of a dual resident company).

This change is effective for accounting periods beginning on or after Royal Assent.

Imported mismatches

Where there is a hybrid mismatch outside the UK which is not counteracted by the jurisdictions concerned, and the transactions are part of an overarching arrangement involving a UK company, the mismatch can be counteracted in the UK company.

Example



There is no hybrid mismatch for the UK company's interest payable to the lender as it is a simple loan. The lender is taxable on the interest income and the UK company ordinarily gets a deduction for the interest payable.

However, the lender can offset its interest income from the UK company against the interest expense on the hybrid instrument finance costs payable to the holder.

If this is part of an overarching arrangement (which it is here as the finance is provided ultimately by the holding company for the benefit of the UK company), the imported mismatch rules may lead to disallowance of the UK company's interest expense if the conditions in s259KA are met.

S259KA currently sets out seven conditions (A – G) all of which must be met for counteraction to be considered.

FB 2021 has made several amendments to the imported mismatch rules.

1. Counteractions in relation to imported mismatch payments will be reduced proportionately to take account of any Part 4 TIOPA 2010 transfer pricing adjustments to the payment.
2. Condition E in s259KA(7) is amended to focus on situations where there is a territory outside the UK (other than one whose mismatch laws are equivalent to Part 6A TIOPA 2010) where a deduction in respect of the mismatch payment can be made for tax purposes.
3. Condition F is deleted.
4. Condition G is amended to remove reference to 'P' (the payer) being in the same control group as the payer as this makes no sense.
5. S259KE is introduced to put beyond doubt that the disallowance in the UK entity cannot exceed the amount of the mismatch outside the UK that was imported. Taking the example above, if the UK company had interest expense of £110 million and the deductible finance cost for entity in Country B was £101 million, the UK company's counteraction cannot exceed £101 million.

This change is effective for accounting periods beginning on or after Royal Assent.

Meaning of 'act together'

One of the conditions in each relevant Chapter of Part 6A TIOPA 2010 usually involves whether the parties are in the same control group or are 'related'. Control groups usually require at least 50% investment of one in the other or by a common owner and related persons require at least a 25% investment.

Where two parties ('P' and 'T') act together in relation to a person ('U'), their interests are aggregated.

The definition of acting together in s259ND TIOPA 2010 is amended by FB 2021.

Paras 7A and 7B replace the detail that was in old para 7.

P and T act together if:

1. They have a partnership agreement that it is reasonable to suppose is designed to affect the value of T's rights or interests in U, or relates to the exercise of any of T's rights in U, or
2. The same person manages all or some of P's rights in U and T's rights in U, or

If P has a relevant investment in U:

3. P and T are connected (s163 TIOPA 2010 – spouses, relatives, spouse's relatives, relatives' spouses, trustees and settlors and connected persons), or
4. P can secure that T acts in accordance with P's wishes, or T can reasonably be expected to act in accordance with P's wishes (and vice-versa), or
5. P and T have an arrangement where it is reasonable to suppose that it is designed to affect the value of any of T's rights or interests in U or relates to the exercise of any of T's rights in U

Interests of less than 5% are now ignored and do not need to be aggregated even if two parties act together but still needed to be aggregated with connected persons.

This change has effect retrospectively.

Qualifying institutional investors in hybrid entities

Several amendments have been made to the mismatch rules for hybrid entity D/NI mismatches where the investor is a qualifying institutional investor.

New s259NDA defines a qualifying institutional investor as having the same meaning as para 30A, Schedule 7AC TCGA 1992 (substantial shareholding exemption).

They are

- A. Pension schemes
- B. Life assurance businesses
- C. Sovereign wealth funds etc.
- D. Charities
- E. Investment trusts
- F. Authorised investment funds with genuine diversity of ownership, and
- G. Exempt authorised unit trusts

Para 8A is inserted in s259BC to treat income as ordinary income if it would normally be included in the taxable profits of a person but for the fact that the person is a qualifying institutional investor.

S259EB (hybrid payer D/NI mismatches) and s259GB (hybrid payee D/NI mismatches) are amended to exempt counteraction where it is attributable to a qualifying institutional investor based in a territory (i.e. tax resident there, or if not resident in any country, where it is established) where the hybrid entity is transparent for tax purposes.

This change has effect for accounting periods beginning on or after Royal Assent.

Securitisation companies

New s259NEZA excludes securitisation companies from hybrid mismatch adjustments, retrospectively.

A securitisation company is defined by SI 2006/3296 as company that has a retained profit and is

- a) a note-issuing company
- b) an asset-holding company
- c) an intermediate borrowing company
- d) a warehouse company, or
- e) a commercial paper funded company

Each has its own conditions to meet the definition.

Transparent funds

New Chapter 13A is inserted into Part 6A TIOPA 2010.

New s259MA defines a transparent fund as a collective investment scheme or alternative investment fund where, if all the profits or income arise from UK sources and its participants were within the scope of income tax, its profits would be taxed on the participants.

Deduction/Non-inclusion mismatches

Where the mismatch is a D/NI mismatch involving a financial instrument, hybrid transfer (e.g. a repo), hybrid payer or hybrid payee, is not a structured arrangement and it is reasonable to suppose that a proportion of the payment or quasi-payment is attributable to a person because of an interest in a transparent fund, new s259MB applies.

If it is reasonable to suppose that the proportion attributable is less than 10% of the 'relevant amount', it is ignored in determining the extent of the mismatch. However, the interests of connected persons are aggregated in determining the proportion attributable.

The 'relevant amount' is the amount of ordinary income reasonably expected to arise to the primary fund as a result of the payment if the primary fund was a person to whom ordinary income would arise as a result of the payment (or circumstances, if it is a quasi-payment).

Double deduction mismatches

Where a hybrid entity double deduction mismatch arises and the investor and the hybrid entity are not related, s250MC exempts counteraction where it is reasonable to suppose that the proportion attributable is less than 10% of the double deduction amount subject to the same conditions as above.

Imported mismatches

A similar exemption applies to imported mismatches (new s259MD).

This change has effect for accounting periods beginning on or after Royal Assent.