HM Revenue
& Customs

Hybrid and other Mismatches

Summary of Responses

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Executive Summary

At Budget 2020, the government announced a consultation covering a number of aspects of the Hybrid and other Mismatches rules, which were introduced by the Finance Act 2016 and have been in force since 1 January 2017. These rules were introduced to implement the recommendations of Action 2 of the OECD's Base Erosion and Profit Shifting project.

The consultation ran from 19 March 2020 until 28 August 2020, the original closing date of 29 May 2020 having been extended due to the Covid-19 pandemic. In total the government received 21 written responses to the consultation, and held a number of virtual meetings with stakeholders.

Stakeholder feedback in many cases went beyond the issues identified in the consultation document. The government welcomed this engagement, being of the view that it was appropriate to consider the operation of the hybrid rules more broadly now they have been in force for three years.

This document summarises the feedback received in the consultation and the government's response. Draft legislation on certain aspects is being published alongside this document and will now be subject to a technical consultation running until 7 January 2021.

1 Introduction

Background

At Budget 2020 the government announced a consultation into certain aspects of the Hybrids and other Mismatches rules. These rules were first introduced by the Finance Act 2016, with effect from 1 January 2017.

The UK was the first country to implement rules countering hybrid mismatches based on the recommendations of Action 2 of the OECD's Base Erosion and Profit Shifting (BEPS) project. Since the introduction of the UK rules, a number of other jurisdictions have also implemented regimes to give effect to Action 2. In particular, EU member states were required to do so with effect from 1 January 2020 by the EU Anti-Tax Avoidance Directive.

The government was therefore keen to engage with the stakeholder community in order to ensure that the UK's hybrids rules were appropriately targeted and proportionate, with the benefit of three years of UK experience and within the international landscape as other jurisdictions implement BEPS.

The consultation ran from 19 March 2020 until 29 August 2020, the original closing date of 29 May 2020 having been extended due to the Covid-19 pandemic. In total the government received 21 written responses to the consultation, and held a number of virtual meetings with stakeholders.

This document provides a summary of the main issues raised by stakeholders in their written responses to the consultation (some of which went beyond the formal scope of the consultation), the government's proposed responses to those representations, and areas where the government is still seeking input.

Consultation responses

The majority of responses received covered all the areas addressed by the consultation document, as well as many others. There was a very high degree of consensus that the government was correct to review the issues raised in the consultation document, and a lesser but still significant degree of consensus as to most of the preferred changes to the hybrids rules to address those issues.

There was also a significant degree of overlap between submissions as to the issues raised which were not explicitly covered in the consultation document.

Intended approach

The government intends to make a number of legislative changes to reflect the consultation process.

In the majority of the cases where the amendments will have the effect of reducing the impact of the hybrids rules, or cause groups to cease to be impacted by the rules, those amendments will be retrospective, taking effect from the introduction of the hybrids rules in 1 January 2017. In other cases, unless otherwise stated, the amendments will be effective from Royal Assent of the relevant Finance Act.

The intention of the government in deciding what changes should be made has been to improve the practical workability of the hybrids rules and to make their impact more proportionate, while not departing from the principles set out in the OECD Action 2 report.

Next steps

The government would like to thank respondents for their helpful and constructive engagement with the consultation.

Draft legislation giving effect to certain policy decisions set out in this document is being published alongside this document. The government therefore welcomes feedback on this draft legislation.

The technical consultation on the draft legislation will run until 7 January 2021.

2 Double Deduction Rules

Q1. Can you identify and describe in detail structures that are disproportionately impacted by the double deduction rules due to their also involving inclusion/no deduction income? Please provide full group/jurisdictional context, nature of entities and scale of impact.

Q2. Can you identify which of the conditions of section 259ID are too restrictive? If a case could be made such that these were to be amended, what level of evidence of inclusion without deduction or disproportionate outcomes, would you suggest is necessary?

Q3. What would be the impact of utilising non-hybrid entities in these structures so that no counteraction would be required? Please consider and describe any economic, regulatory and foreign tax impacts.

Q4. Are foreign owned groups able to get relief for additional tax arising in the UK in consequence of applying the hybrid rules? If not, why not?

Q5. What mitigating steps have businesses undertaken in the 3 years since Part 6A came into effect?

Q6. What impact have other jurisdictions' corporate tax reforms had on the extent of the use of hybrid entities?

Q7. Would a broader change, enabling inclusion/no deduction income to be treated in the same way as dual inclusion income for the purposes of the double deduction mismatch rules, be a more appropriate solution to the concerns raised?

In considering this point please consider the consistency of any proposal with OECD principles.

Comments received from stakeholders

2.1 There was a unanimous desire among stakeholders who expressed a view to extend the mitigating provisions in s.259ID TIOPA 2010, introduced by the Finance Act 2018.

2.2 The issue with the double deduction rules is most relevant to US owned groups, where it is common for non-US group entities to be "checked open", meaning that they are seen as partnerships or entirely disregarded for US purposes, whilst

being seen as discrete taxpaying entities in their home jurisdictions such as the UK. These entities are therefore hybrids within the scope of the hybrids rules.

2.3 Stakeholders provided a number of illustrative group structures drawn from a variety of business sectors. The perceived problem in the operation of the rules almost always arose from a disadvantageous effect of a UK subsidiary being checked open, namely that many payments to the UK company from its US parent would not be deductible in the US but would be taxable in the UK.

2.4 This mismatch effect might be direct, in the case of a payment directly from the US parent to its checked open UK subsidiary, or it might be indirect. An indirect case could arise where a payment was made from the US parent to a checked open subsidiary outside the UK, and then subsequently payments were made from that overseas subsidiary to a UK subsidiary (either directly or via other group members). In all these cases, there was a disadvantageous inclusion/no deduction mismatch which, stakeholders contended, led to the hybrid rules having a disproportionate effect.

2.5 A related problem arises where arrangements exist between two members of a US owned group which have both been checked open. One of these companies may make a payment to a third party, which is doubly deductible. The other may receive a payment from a third party which is dual inclusion income. However, if a payment is made between the two companies with the economic effect of using the third party income to fund the third party payment, that intra-group payment will not create dual inclusion income and so cannot be used to mitigate the impact of the counteraction of the doubly deductible third party payment.

2.6 Some stakeholders acknowledged the potential complexity of rules which might seek to alleviate the problems where payments to the UK company with doubly deductible income were not made directly by its US parent. While an example with only two companies involved, in which the payment between them was directly referable to both the third party income and expenses (for example, a rental payment between an operating company and a property holding company which had borrowed to finance its property acquisition) was quite straightforward, in reality arrangements of this type often include many companies in many different jurisdictions, so that tracing funds would be complex. Those that sought to address this problem broadly favoured either a just and reasonable test (so a just and reasonable amount of the intra-group payment received by the UK company could be deemed to be dual inclusion income), or a tax avoidance motive test as a condition of counteraction. Other stakeholders suggested a more group-based approach, allowing dual inclusion income and counteracted amounts to be matched on a consolidated basis.

2.7 Many stakeholders made the point that the US tax reforms of 2017 had created strong incentives for US owned groups to check foreign subsidiaries open, not so much in order to save tax but to greatly simplify compliance.

2.8 Stakeholders consistently responded that it would often be prohibitively expensive to uncheck UK companies for US purposes (so ending their hybrid status) due to the deemed US tax disposals this would trigger. Additionally, as already noted, the 2017 US tax reforms create powerful incentives to keep non-US subsidiaries of US parents checked open. The US rules governing the availability of UK tax credits are complex, and full relief will very seldom be available.

2.9 In a non-US specific fact pattern, some stakeholders requested that profits allocated to a UK permanent establishment of an overseas company should be treated as dual inclusion income for the purposes of Chapter 10 of the hybrid rules. This situation is seen as analogous to the case of a US parent making a payment to its checked open UK subsidiary.

2.10 Finally, one stakeholder suggested that the double deduction rules should not apply to small and medium sized enterprises.

Government response

2.11 The government agrees that in many of the cases of the type described above, the hybrids rules are operating disproportionately. The hybridity created by the checking open of the UK subsidiary clearly has the potential to give rise to double deduction benefits of the type the legislation is intended to counteract. However, it also gives rise to disadvantages of the type set out above. As currently drawn, other than in the narrow subset of cases within the scope of s.259ID TIOPA 2010, the legislation effectively counteracts the gross hybrid benefit, rather than the net benefit taking account of the disadvantageous inclusion/no deduction mismatches.

2.12 The UK remains committed to the OECD BEPS process, and a key BEPS policy driver was to reduce the use of hybrid entities. The challenge for the UK is therefore to maintain adherence to the OECD BEPS principles and implement the BEPS action on hybrids in an effective and proportionate way which does not create undue barriers to foreign investment in the UK. Furthermore, this must be achieved without introducing undue complexity or practical uncertainty into the operation of the rules. The government does not believe it is possible to reach a theoretically perfect answer in all cases due to these constraints, so an element of compromise is unavoidable.

2.13 The government has considered broadening the scope of the existing s.259ID TIOPA 2010 in order to relieve a greater variety of structures. However, this approach has been rejected on the basis that the variety in the detail of structures in place is too great. If this approach was pursued, it would be likely to lead to arbitrary differences in treatment for similar structures. This would not be a satisfactory outcome.

2.14 Accordingly, the government has decided to take a different approach. Under this, any payment which is received by a UK company and which gives rise to an inclusion/no deduction outcome may, subject to one caveat, be treated as dual

inclusion income of the UK company. As a result of being treated as dual inclusion income, that receipt may then be used to mitigate the impact of the hybrids counteraction of the double deduction amounts.

2.15 The caveat referred to above is that this treatment will only be available where the inclusion/no deduction treatment was created by the same element of hybridity as the double deduction under consideration. So, where a US parent makes a payment to its checked open UK subsidiary, the new treatment will be available. It would have been the checked open status of the UK subsidiary which gave rise to the counteracted double deduction; it is also that checked open status which gives rise to the inclusion/no deduction mismatch. However, if, for example, the UK subsidiary held a security which did not give rise to deductions for its issuer but the coupons on which were taxable in the UK, the coupons on that security would not be deemed to be dual inclusion income. This is on the basis that the security giving rise to the income would be a hybrid financial instrument, whilst the double deduction would arise due to the UK subsidiary being a hybrid entity.

2.16 The government has considered whether it would be possible or appropriate to extend this treatment to cases where the non-deductible payment from the US parent reaches the UK company via entities in other jurisdictions. We have concluded that such a measure would be too complex to be workable. Detailed rules would be needed around the tracing of funds through different jurisdictions, with evidential issues compounded by the cross-border nature of the arrangements. However, the new treatment will be available if the payment to the UK entity is made by another entity in the parent jurisdiction which is seen as transparent there. The deemed dual inclusion income treatment will be available if the payment would not have given rise to an inclusion/no deduction mismatch but for the hybridity of the UK company.

2.17 Similarly, the government has also considered whether it would be possible to address the related issue where doubly deductible payments made by a UK company are in substance funded by dual inclusion income received by a related party and then paid to the UK company under some form of intra-group arrangement. This would also require some kind of fund tracing approach, or a test looking at the overall substance of the arrangements at a group level. For the same reasons as outlined above, this proposal has been rejected.

2.18 In particular the government has rejected the possibility of providing for a just and reasonable apportionment as some stakeholders requested. This would lead to too great a level of uncertainty and create the potential for lengthy and difficult disputes. It was clear from our discussions with stakeholders that there was scope for material differences of opinion on the question of what would be just and reasonable.

2.19 Similarly, the suggestion of including a tax avoidance motive test has been rejected. It is a key feature of the hybrid rules that, save in respect of the targeted anti-avoidance rule in Chapter 13, they operate mechanically without requiring motive to be established. This principle is core to the operation of the rules.

2.20 However, the government recognises that there is significant potential for economic double taxation in this area and so will introduce a mitigating measure applicable solely within UK groups. Under the new rules, fellow UK resident members of UK group relief groups (including overseas property owning companies subject to the charge to corporation tax) will be able to "match" dual inclusion income received by group members (including income deemed to be dual inclusion income pursuant to the new measure referred to above) to counteracted amounts suffered by other group members. Where this entitlement is exercised, the "matched" dual inclusion income will be deemed to lose that status, since it will have been utilised to permit a counteracted relief to be used. This treatment will not only be available in relation to counteractions under Chapter 9: it may be used in any case where a counteraction limiting relief to use against dual inclusion income has arisen (for instance under Chapter 5).

2.21 The government agrees that the allocation of income to a UK permanent establishment of an overseas company is analogous to a payment from a US parent to its checked open UK subsidiary, so long as the overseas jurisdiction does not exempt profits from the UK branch. Accordingly, any income allocated to a permanent establishment in those circumstances will be deemed to be dual inclusion income in the same way as an actual payment would be.

2.22 The government does not accept that the application of the double deduction rules should be limited to non-small and medium sized enterprises. The question of such a limitation was considered and rejected when Part 6A was first introduced, and a change is not considered appropriate. In particular the government sees no reason to distinguish the double deduction rules from the rest of the hybrid rules in this respect, and a general change is not believed to be appropriate.

3 Acting Together Definition

Q8. Do you recognise the concerns raised and consider that a change would be beneficial in better targeting the application of the hybrid rules? Please identify and describe the circumstances that reflect these concerns.

Q9. What modifications do you consider would address your concerns and how would you anticipate these acting in practice?

Q10. Are there any other commercial arrangements which should be considered in the same way as loans and guarantees as described above?

Q11. Having regard to the purpose of the legislation, can you identify and describe any situations potentially caught by the other heads of the "acting together" test in sections 259ND(7)(a), (b) and (d) which in your view should be modified? How would you suggest these rules should be modified and why?

Comments received from stakeholders

3.1 Those stakeholders who commented on the acting together proposals were unanimous in their view that the existing provisions are too broad, and as a result have the potential to bring parties within the scope of the hybrids rules who are in reality commercially independent.

3.2 Some stakeholders favoured an approach of carving out normal commercial lending arrangements and/or rights granted purely to protect a lender's interests as a creditor from consideration in the acting together test. Others preferred to reflect OECD language around factors having a material impact on the value or control of any rights or interests of the investors in the test.

3.3 While all stakeholders were clear that in their view a third party which had lent to a group but was otherwise unconnected with it should not be seen as acting together with group members in any respect, many made the additional point that third parties with small equity stakes should also not be regarded as acting together. This point was in their view particularly pertinent given the economic difficulties created by the Covid-19 pandemic, which were likely to lead to refinancing negotiations and a likelihood that existing "pure" lenders would take some equity in their borrowers.

3.4 The majority of stakeholders who raised this point were of the view that such equity holdings were unlikely to exceed 5% and that this would therefore be a suitable threshold.

3.5 Some stakeholders sought clarification of the meaning of “profits available for distribution” in the language testing the economic value of equity holdings for the purposes of the acting together rules. This was driven by a concern that the phrase could in some circumstances include payments received by loan creditors.

3.6 Numerous stakeholders also raised a point relating to funds structured as partnerships. In their view it is wrong that all investors in a partnership should be deemed to be acting together by reason of having delegated the exercise of rights over an investee company to the fund manager. Some called for a removal of the rule treating partners as acting together. Some suggested an exclusion for investors in widely held collective investment schemes. Others favoured an approach akin to that adopted by Luxembourg, where there is a rebuttable presumption that any investor holding less than 10% of a fund is not acting together with their co-investors.

Government response

3.7 The government agrees that the existing acting together rules are too broad.

3.8 The government also agrees that it would be appropriate to permit a small level of equity ownership by otherwise unconnected contractual counterparties of group members without triggering the acting together test.

3.9 The government is not persuaded to amend the rules so that they exclude defined normal commercial lending arrangements, or arrangements which have a material impact on the value or control of rights, as these involve subjective concepts which may lead to uncertainty in the application of the rules in practice.

3.10 Instead, the government will legislate to disapply the existing acting together rules in any case where a contractual counterparty either holds no equity in any group member, or where it holds an equity stake of no greater than 5%. The level of equity will be tested by reference to economic reality as well as legal form, as is currently the case when considering the availability of group relief. Additionally, equity stakes at different levels of the counterparty group will be aggregated. This measure will have the effect of excluding normal commercial lending arrangements, as well as small minority equity investments without any lending, and so should address the concerns raised.

3.11 HMRC can confirm that the reference to profits available for distribution is intended to carry its corporate legal meaning and so refers only to amounts which could lawfully be distributed under the Companies Acts. It is not intended to encompass payments which would be deemed to be distributions for tax purposes even though as a legal matter they are not. It is also not intended to encompass the entitlements of creditors *qua* creditors on windings up. This point will be addressed in a future iteration of HMRC’s guidance.

3.12 The government does not agree that as a general matter partners should no longer be treated as acting together. This is a point of principle which applies across a range of legislation.

3.13 However, the government accepts that as drawn the legislation can impose disproportionate burdens in relation to minority investors in funds. Accordingly, it will legislate to provide that an investor in a collective investment scheme which is a partnership will not be treated as acting together with its fellow partners by reason of its interest in the partnership if that interest is less than 10%.

4 Exempt Investors in Hybrid Entities

Q12. Do you agree that a change of the type described above would be beneficial?

Q13. What entities other than pension funds might qualify for the exemption (whether implemented via principles based definition or lists)?

Q14. What evidential requirements would be necessary to back up a taxpayer's contention that a new exemption of this type was available? Would the "reasonable to suppose" test suffice or would it be appropriate to require something different?

Comments received from stakeholders

4.1 Those stakeholders who commented on the exempt entities section of the consultation document were unanimous in their view that the existing rules were disproportionate.

4.2 Accordingly, there was also unanimity that the existing approach of the legislation, which effectively deemed the tax free nature of an exempt entity's receipt to be derived from hybridity even where the receipt would still have been tax free without that hybridity, should be softened.

4.3 There was no consensus amongst commenting stakeholders as to the preferred means of identifying exempt entities which might qualify for the more generous treatment, other than that a principles-based approach was likely to give rise to too much uncertainty. Some stakeholders suggested adopting the definition of qualifying institutional investors from the substantial shareholding exemption rules in schedule 7AC TCGA 1992. However, others said this definition was itself insufficiently precise, and sometimes difficult for non-UK entities to apply with confidence. Some stakeholders suggested that charities, or all not for profit organisations, might be granted the more generous treatment; one suggested that all non-taxpayers should qualify.

4.4 Stakeholders also suggested that in addition to the problem with Chapter 7 of the hybrids rules which was identified by the consultation document, issues of a similar nature could arise under Chapter 5 and those should also be addressed.

4.5 Finally, one stakeholder suggested that non-exempt entities should also qualify for the more generous treatment in the absence of a tax avoidance motive.

Government response

4.6 The government agrees that the existing rules are disproportionate in their treatment of exempt entities. It has therefore decided to modify the application of the rules to such entities.

4.7 While acknowledging the reservations of some stakeholders, the government has decided to offer the new treatment to qualifying institutional investors within the TCGA qualifying institutional investor definition referred to above. The two sets of rules are aimed at broadly the same types of entity, and this approach has the virtue of consistency.

4.8 The government has also decided to amend Chapter 5 and Chapter 7 of the hybrids rules in order to ensure that disproportionate outcomes, as described, relating to exempt investors cannot arise under either Chapter.

4.9 The government does not agree that counteractions should not arise in respect of non-exempt investors where there is no tax avoidance motive. It is fundamental to the operation of the hybrid rules that motive or purpose is irrelevant, save in relation to the targeted anti-avoidance rule in chapter 13.

5 Other Issues Raised

General interaction of the hybrids rules and transfer pricing

Comments received from stakeholders

5.1 Many stakeholders raised the interaction of the hybrid rules and the transfer pricing rules. This was prompted by a refresh of HMRC's guidance on the subject published in December 2019.

5.2 In meetings, many stakeholders reflected a widely held view that the two regimes might not be cumulative in effect, so that in relation to deduction/non-inclusion outcomes, the disallowance should be the larger of that imposed by transfer pricing rules or the hybrids rule in isolation, rather than the cumulative effect of the two. Only one stakeholder recommended this approach in its written submission, but it did not offer grounds for its recommendation.

Government response

5.3 HMRC is very clear that the view referred to above is incorrect in both policy and law. As a policy matter it would lead to taxpayers which are subject to transfer pricing adjustments obtaining a better tax result than those actually transacting on arm's length terms, which would be a perverse outcome.

5.4 HMRC is also clear that the cumulative approach is the correct reading of the current law. Detailed new guidance setting out the correct interpretation of the law was published on 18 August 2020. No change to the legislation is considered necessary to deliver this interpretation.

Interaction of Chapter 11 of the hybrids rules with transfer pricing

Comments received from stakeholders

5.5 Some stakeholders questioned whether the imported mismatch rules in Chapter 11 Part 6A TIOPA 2010 operated proportionately in cases where the payment by a UK company which was potentially subject to counteraction was itself subject to a transfer pricing adjustment.

5.6 The issue here is that any counteraction under Chapter 11 is computed by reference to the quantum of the imported mismatch which a payment from the UK funds, in whole or part. That quantum is determined by reference to the laws of the payee and payer jurisdictions and not the amount deducted in the UK. In the

simplest case where the mismatch is funded solely by the UK company, the full amount of the mismatch is subject to counteraction, even where the UK company's payment exceeds an arm's length amount and so is subject to a transfer pricing adjustment.

5.7 Stakeholders have argued that this effect was unfair. They contend that if the UK company had in fact paid an arm's length amount, the imported mismatch would have been correspondingly reduced.

Government response

5.8 The government agrees that Chapter 11 operates disproportionately in this case.

5.9 Accordingly, the government proposes to legislate such that the imported mismatch amount, as defined, should be computed in all respects as if the amount deemed to be funded by a payment from the UK was reduced by an amount equal to the transfer pricing adjustment suffered by the UK payer.

Securitisation vehicles

Comments received from stakeholders

5.10 Many stakeholders expressed concerns that the hybrids rules could impact the taxation of securitisations in unintended ways. In their view, it was inappropriate for the hybrid rules to have any application to securitisation vehicles, since such vehicles are subject to a specific tax regime designed to ensure that they are taxed only on a nominal amount of retained profit.

Government response

5.11 The government acknowledges that, as currently drawn, the hybrid rules can impact some securitisation arrangements. This was not intended.

5.12 Accordingly, the government will legislate to provide that payments to and by securitisation vehicles within the specific regime providing for their taxation shall not be subject to counteractions under the hybrid rules. Such an exemption is envisaged by the OECD Action 2 report.

Investment trusts

Comments received from shareholders

5.13 In a similar issue to that relating to securitisation vehicles, some stakeholders were concerned that payments of deductible dividends by investment trusts might be subject to counteraction under Chapter 3 of the hybrids rules, just as payment of

interest to investment trusts used to fund such deductible dividend payments might also be argued to be subject to counteraction.

5.14 As with the securitisation case, stakeholders did not believe that it was appropriate for the hybrids rules to impact the specific regime put in place to allow investment trusts to be taxed in a particular way.

Government response

5.15 The government agrees that the investment trust regime should not be adversely impacted by the hybrids rules, and as currently drafted the interaction between the two regimes is unclear.

5.16 Accordingly, the government will legislate to provide that any mismatch arising from the payment of a deductible dividend by an investment trust shall not be regarded as arising from the terms or other features of the instrument, such that Chapter 3 of the hybrid rules cannot apply. We will also legislate to ensure that receipts of interest by investment trusts will be regarded as ordinary income of the investment trust, notwithstanding that such receipts create an entitlement on the part of the investment trust to declare a deductible dividend and so give rise to a relief.

US Global Intangible Low-Taxed Income (GILTI)

Comments received from stakeholders

5.17 Some stakeholders raised the question of whether income subject to the US GILTI charge would be considered to be ordinary income for the purposes of the UK hybrid rules. This would be the case if either the GILTI income was subject to a "relevant tax" in the US (ie one corresponding to UK corporation tax), or if the GILTI charge was similar to the UK CFC charge.

5.18 Those stakeholders were concerned at the potential for economic double taxation if GILTI was not recognised as ordinary income, since income received by an entity would potentially be taxed in the US via the GILTI process even if it was not taxed in the jurisdiction where it was received.

Government response

5.19 The government acknowledges that not recognising any GILTI as ordinary income has the potential to lead to economic double taxation in some cases. In particular, where the US parent subject to the GILTI charge has sufficient losses to shelter its deemed GILTI income, the GILTI income is effectively brought into account for US tax purposes in full. However, where this is not the case, the position is significantly more complex. Factors such as the specific 50% deduction in respect of GILTI income, and the ability to net off losses of loss making overseas subsidiaries of US parents against the profits of others when computing the

chargeable GILTI amount, will, in many cases, make computation of the amount of the GILTI income which could be considered to be taxed normally, and so treated as ordinary income, very difficult. However, the government's view is that it is clear in such cases that it would be conceptually wrong to allow all GILTI income to be treated as ordinary income. Furthermore, in particular circumstances, if income subject to the GILTI charge was deemed to be ordinary income, hybrid benefits could still accrue.

5.20 The government has considered carefully whether it would be practical to legislate to try and determine the extent to which GILTI income might properly be regarded as ordinary income in a formulaic way which could deliver reasonable answers in all cases, but has concluded that this would be too complex. Accordingly, the government has decided that income subject to the GILTI charge should not be regarded as ordinary income for the purposes of the hybrid rules.

5.21 The government does not regard the GILTI charge as similar to the UK CFC charge. Although the two measures both seek to tax profits of foreign subsidiaries in the hands of their parents, they are otherwise almost entirely different. The nature of the profits subject to each charge, and the mechanisms for computing and imposing the charges, are materially different.

5.22 The government also believes that insofar as it is operating to collect charges on GILTI income, US federal corporate income tax is not operating in a manner corresponding to UK corporation tax since it is levying tax on an entity by reference to the profits of a different entity. The government will legislate to clarify that GILTI income is not to be regarded as ordinary income for the purposes of the hybrid rules.

5.23 On a related matter, one stakeholder requested that HMRC should maintain a public list of those CFC regimes which it considered to be sufficiently similar to the UK regime as to qualify as "foreign CFC charges". It is not practical for HMRC to analyse all the CFC regimes of the world in order to create such a list. Where taxpayers consider there is uncertainty, they should contact HMRC Hybrids team via the non-statutory clearance process, setting out the operation of the relevant overseas CFC regime, and HMRC will offer a view.

Illegitimate overseas deductions

Comments received from stakeholders

5.24 Many stakeholders identified issues with the rules on "illegitimate overseas deductions" within Chapters 9 and 10 of the hybrid rules. These rules were generally considered to be too restrictive at present. Two features in particular were identified as problematic.

5.25 The first point concerns the way in which the rules permanently deny relief in a UK subsidiary or branch where a deduction is utilised by the parent or headquarters to

shelter income that is not taxable in the UK. In such a case, in a subsequent accounting period, if dual inclusion income is received, there will be no relief to shelter it in the overseas jurisdiction. As things stand, the deduction in the UK would be permanently denied and so unavailable for carry forward. If carry forward was permitted, then in the subsequent profitable accounting period the UK subsidiary or branch would pay no tax to the extent of the deduction, but the parent or headquarters would suffer tax on the full amount. Ignoring the timing difference, the overall result is no different from a situation where the subsidiary or branch was profitable and so the doubly deductible amount was set against dual inclusion income in full in the year in which it arose.

5.26 The second point concerns cases where the doubly deductible relief is utilised not by the dual resident or multinational company, but by another group entity (whether by way of a group relief style mechanism or because of a wider tax consolidation). Here it is argued that in a similar way to the above, the relief is no longer available to shelter future dual inclusion income, so that over time the position will equalise in the same way as described above.

Government response

5.27 The government agrees that the rules operate unduly restrictively in the first case. Accordingly, it will legislate to provide that where a relief is used by the multinational or dual resident company to set against its own single inclusion income, the relief will not be permanently denied in the subsidiary or branch.

5.28 However, the government does not believe it is right to extend this more favourable treatment to the second category of cases. While it is acknowledged that in some cases this may produce a harsh result, adopting this approach is likely to create opportunities for manipulation which would frustrate the purpose of the provisions.

Issues with Chapter 11

Comments received from stakeholders

5.29 Many stakeholders commented on the difficulties created by Conditions E and F of Chapter 11. Condition E broadly tests whether equivalent overseas provisions to the hybrid mismatch rules in Part 6A apply in relation to an overseas mismatch (and prevents any counteraction under Chapter 11 if they do), while Condition F broadly tests whether a counteraction would arise for UK purposes if the UK company that is potentially subject to counteraction under Chapter 11 were placed in the shoes of one of the parties to the overseas mismatch.

5.30 Condition E is problematic because it requires scrutiny not of the overseas regime as a whole in order to determine equivalence, but of specific provisions within the other regime which must be equivalent to specific provisions of the UK rules. It

also raises the issue of whether equivalent provisions can be said to "apply" where no counteraction ultimately results.

5.31 Condition F is difficult because it is unclear what attributes the UK company is considered to have when it is deemed to stand in the shoes of another entity. This can create odd results, both to the advantage and disadvantage of taxpayers.

Government response

5.32 The government agrees that Condition E and Condition F could be improved. Accordingly, significant changes will be made.

5.33 Condition E will be recast so that it tests whether an overseas regime as a whole can be seen as equivalent to part 6A as a whole. Where this is the case, the consequence will be that a counteraction under Chapter 11 cannot arise. This will remove the difficulties around the need to identify specific equivalent provisions, and debate whether they have applied in the event that the overseas regime makes no counteraction. It is hoped that this change will give rise to much greater certainty, and a more proportionate outcome when dealing with countries which have adopted the BEPS recommendations.

5.34 Condition F will be repealed. It is part-duplicating the tests in Condition D (as to whether there is a mismatch) and Condition G (as to whether there is sufficient connection between the relevant parties). Those tests should stand alone to determine the position. It operates to exclude many cases which as a policy matter should attract counteractions under Chapter 11, while also adding complexity and uncertainty in other cases.

Sections 259GB(3) and (4A)

Comments received from stakeholders

5.35 A number of stakeholders commented that s.259GB(3) TIOPA 2010 was unduly harsh in its operation. This section is a restrictive provision that effectively deems the entirety of any mismatch to arise by reason of a hybrid payee even when under normal principles this mismatch is not caused by hybridity. It was primarily targeted at cases where the payee was a company resident in a tax haven and disregarded by its parent.

5.36 The scope of s.259GB(3) TIOPA 2010 was reduced in relation to partnerships by a 2018 amendment, inserting s.259GB(4A). Some were in favour of the repeal of s.259GB(3) whilst others suggested that more entities be excluded from the impact of the provision via s.259GB(4A).

Government response

5.37 The government remains of the view that s.259GB(3) is necessary in order to counteract a number of structures that produce a tax benefit through a hybrid payee, but is also sympathetic to the view that an exclusion from its operation which is applicable only to partnerships may be too narrow.

5.38 Particular issues are generated in relation to US limited liability corporations ("LLCs") which are held solely by members that view them as transparent for tax purposes. Accordingly, the government will legislate to treat such LLCs in the same way as partnerships for these purposes.

5.39 Additionally, in a related point, the government will legislate to amend s.259BE TIOPA 2010 so that it only requires consideration of the laws of jurisdictions relevant to the arrangements under consideration rather than, as now, all foreign law.

Relevant debt relief provisions

Comments received from stakeholders

5.40 Many stakeholders drew attention to a technical problem with the provisions in Chapter 3 of the hybrid rules which prevent counteractions in situations to which "relevant debt relief provisions" within the loan relationships rules apply.

5.41 The relevant debt relief provisions allow debts to be written off without giving rise to tax charges for the borrowers, in limited circumstances. Chapter 3 has the potential to apply in such cases as the creditors will likely obtain relief for the loss in value of their debts. Given the wider policy that such debt releases should not be taxed, the intention is that Chapter 3 should not apply in these circumstances.

5.42 Due to changes in accounting treatment since their enactment, the relevant debt relief provisions in the loan relationships rules are now redundant. There is nothing for them to relieve. However, this means that they do not apply and so Chapter 3 is not switched off in the circumstances it is intended to be.

Government response

5.43 The government is aware of this unintended consequence and will legislate to prevent it. Chapter 3 will be amended so that no counteraction can arise in the same circumstances as would have engaged the relevant debt relief provisions had they been necessary.

R&D tax relief and the double deduction rules

Comments received from stakeholders

5.44 Some stakeholders raised an issue relating to the special regime for research and development expenditure. This regime permits an additional amount over and above the actual expenditure incurred to be deducted when that expenditure is incurred on qualifying research and development.

5.45 Stakeholders argue that it is unfair that where the relief potentially arising from the actual expenditure is subject to a counteraction by reason of being doubly deductible, the additional relief is lost altogether.

Government response

5.46 HMRC agrees that the interaction of the research and development regime and the hybrid regime produces an unduly restrictive effect if viewed in this way. The additional deduction will not as a rule be doubly deductible, since it is a UK specific incentive to carrying on research and development activity in the UK. There is therefore no reason why it should be subject to counteraction under the hybrid rules. HMRC guidance will be updated to clarify the position.

US Dual Consolidated Loss rules ("DCL")

Comments received from stakeholders

5.47 A few stakeholders have concerns regarding the interaction of the US Dual Consolidated Loss rules (DCL) with Part 6A and believe that the rules operate to deny loss relief in both jurisdictions.

5.48 Stakeholders argue that the DCL rules should be treated as equivalent legislation despite having been enacted prior to the OECD BEPS reports.

Government response

5.49 HMRC agrees that there should not be a UK counteraction where the US has denied loss relief in respect of double deduction amounts. HMRC guidance will be updated to clarify the interaction. Other recommendations accepted above in respect of dual inclusion income and illegitimate overseas deductions will further simplify the economic impact of DCL rules.

5.50 The government rejects the suggestion that the DCL rules should be treated as equivalent to Part 6A. They do not address the full scope of measures and are not based on the Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements published by the OECD on 5th October 2015 or any replacement or supplementary publication.

Annexe A: List of stakeholders consulted

Alternative Credit Council – Alternative Investment Manager Association Limited
Ashurst
Aviva Investors
Baker & Mackenzie
British Property Federation
British Venture Capital Association
Chartered Institute of Taxation
Deloitte
Ecobat Technologies
EY
FTI Consulting
Global Infrastructure Investor Association
Grant Thornton
KPMG
Macfarlanes
Pinsent Masons
PwC
RSM UK Tax and Accounting Limited
Slaughter and May
Weil Gotschal & Manges
White & Case