

# Draft Guidance

## Hybrid and Other Mismatches

The following draft guidance is provided to assist understanding of the application of the hybrids mismatch legislation, which take effect from 1st January 2017. The examples contained are based upon a selection of those contained within the OECD 'Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements', with additional draft examples dealing with hybrid transfers and permanent establishments.

Comments on the draft guidance are invited by 10 March 2017. Responses should be sent to [hybrids.mailbox@hmrc.gsi.gov.uk](mailto:hybrids.mailbox@hmrc.gsi.gov.uk)

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# **INTM550000: Hybrids: Contents**

This guidance aims, through explanation and examples, to assist in understanding the application of the hybrids legislation introduced by Finance Act 2016, which has effect from 1 January 2017.

The guidance largely follows the structure of the legislation. For each of the areas below the guidance gives a general overview of the legislation and how it is intended to apply, followed by more detailed analysis, and specific examples where appropriate.

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# **INTM550010: Hybrids: Chapter 1 - Introduction: Contents**

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## **INTM550020: Hybrids: Chapter 1 - Introduction: What is a hybrid or other mismatch?**

Part 6A of Taxation (International and Other Provisions) Act 2010 (TIOPA 2010) addresses arrangements that give rise to hybrid mismatch outcomes leading to a tax mismatch, and is based on the Organisation for Economic Co-operation and Development (OECD) recommendations in relation to Action 2 of the Base Erosion Profit Shifting (BEPS) project.

Mismatches can involve either double deductions for the same expense, or deductions for an expense without the corresponding receipt being fully taxed.

Hybrid mismatch outcomes can arise from hybrid financial instruments and hybrid entities, and from arrangements involving permanent establishments. They can also arise from hybrid transfers and dual resident companies.

The legislation aims to neutralise the tax mismatch created under these arrangements by altering the tax treatment of either the deduction, or the receipt, depending on the circumstances. The rules are designed to work whether both the countries affected by a cross-border arrangement have introduced rules based on the OECD recommendations, or just one. This legislation follows the recommendations in providing alternative responses to mismatches within the scope of the legislation. These are described as a 'primary response' and a 'secondary response'.

In the case of deduction/non-inclusion, the primary response is generally to deny a deduction to the payer. If this does not occur, the secondary response is to bring the receipt into charge for the payee.

In the case of double deductions the primary response is to deny a deduction to the parent or investor company. If this does not occur (because the tax law in the country in which the parent company is resident does not provide for this), the secondary response is to deny the deduction to the hybrid entity or permanent establishment, as appropriate.

An example of a hybrid financial instrument is an instrument giving rise to a payment that the law of the payer jurisdiction treats as deductible interest, by recognising it as a debt instrument, but which the payee jurisdiction recognises the instrument as an equity instrument and therefore treats the return as an exempt dividend in the hands of the payee. This would result in the payer getting a deduction, without the recipient being taxed on a receipt.

An example of a hybrid entity is a UK limited liability partnership (LLP) where it is treated as transparent by one jurisdiction (the UK), but treated as opaque by another jurisdiction. The effect is that one jurisdiction applies its tax rules to the partnership, whilst the other looks through the partnership and applies its tax rules to the partners. In the case where a payment is made to the LLP from a payer company, the UK would treat the receipt as taxable in the overseas territory but the overseas

territory would treat the receipt as taxable in the UK, with the consequence that the receipt would be untaxed in both territories. Permanent establishments can be used in a similar way to generate mismatches.

An example of a hybrid transfer is where a person sells shares to another party on condition that the shares will be returned 12 months later, during which time a dividend is paid in respect of those shares to the transferee. In form, the ownership of the shares has transferred and therefore the transferee is treated as the beneficial owner of the dividend. In substance, however, the transferor has not actually sold the shares and therefore may be treated as the beneficial owner of the dividend. This asymmetry presents opportunities for obtaining a deduction/ non-inclusion mismatch.

Part 6A targets hybrid mismatches in the following circumstances:

Deduction/non-inclusion outcomes involving:

- Hybrid Financial Instruments
- Hybrid Transfers
- Hybrid Entity Payers
- Hybrid Entity Payees
- Arrangements involving permanent establishments

Double deduction outcomes involving:

- Hybrid Entity Payers
- Dual Resident Companies
- Arrangements involving permanent establishments

The legislation also includes rules to deter arrangements which attempt to circumvent the main hybrid mismatch rules by routing a mismatch outcome to a third jurisdiction: such arrangements are known as 'imported' mismatches. These additional rules deal with double deduction or deduction/non-inclusion imported mismatch outcomes involving:

- Hybrid Financial Instruments
- Hybrid Entity Payees
- Hybrid Entity Payers
- Arrangements involving permanent establishments

## **INTM550030: Hybrids: Chapter 1 - Introduction: Why was new legislation introduced?**

In 2013 the OECD and G20 countries adopted a 15-point Action Plan to address Base Erosion Profit Shifting (BEPS). The Action Plan aims to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created, and to counter aggressive tax planning aimed at base eroding a jurisdiction.

BEPS includes tax planning strategies that exploit gaps and mismatches in the tax rules of different countries to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but where the tax rates are low, resulting in little or no overall corporate tax being paid.

In response to Action Point 2, the OECD and G20 countries agreed a set of rules designed to ensure that multinational entities can no longer derive a tax benefit from mismatch arrangements, including those arising from hybrid entities or hybrid financial instruments.

Part 6A of TIOPA 2010 is based on the recommendations of Action Point 2 of the BEPS project - 'Neutralising the effects of hybrid mismatch arrangements'.

The legislation also includes rules to tackle hybrid mismatch arrangements which involve permanent establishments. Permanent establishments of companies are often used as an alternative to hybrid entities in tax planning arrangements as they provide for similar mismatch opportunities. The measure covers such arrangements to ensure that groups cannot simply sidestep the OECD recommendations by using permanent establishments.

The UK government announced its intention on 5 October 2014 to introduce domestic legislation to give effect to the recommendations of Action Point 2, and a consultation document was published at Autumn Statement 2014. This legislation has been informed by consideration of responses to the consultation, by further engagement with stakeholders, and by publication of the final OECD report.

### **Who is likely to be affected by this legislation**

Groups with a UK or overseas parent involved in cross-border or domestic transactions involving a mismatch in the tax treatment within the UK, or between the UK and another jurisdiction, which falls within the scope of the legislation.

### **Operative date**

Part 6A of TIOPA 2010 applies to deductions arising or accruing on or after 1 January 2017 involving hybrid entities or instruments which give rise to a hybrid mismatch outcome. There are no grandfathering provisions and instruments issued before this date will come within scope.

## **INTM550040: Hybrids: Chapter 1 - Introduction: Overview of legislation**

The hybrids legislation is at Part 6A of the Taxation (International and Other Provisions) Act 2010 (“TIOPA 10”). The legislation replaces the tax arbitrage regime that was in place from March 2005.

Part 6A of TIOPA 10 potentially applies to deduction/non-inclusion mismatches and double deduction mismatches involving –

- payments or quasi-payments in connection with financial instruments
- hybrid transfers
- hybrid entities
- companies with permanent establishments
- dual resident companies

The legislation targets specific types of mismatches, setting out:

- the conditions to be satisfied in each instance, and
- what adjustments are to be made for corporation tax purposes to counteract the mismatch.

If the conditions applicable to a particular type of mismatch are satisfied, the mismatch is counteracted by:

- disallowing the deduction claimed, or
- bringing within the charge to tax in the UK an amount of income representing the mismatch amount.

Part 6A of TIOPA 10 contains 14 chapters –

- chapters 1, 2 and 14 contain definitions of key terms used throughout the legislation
- chapters 3 to 10 each targets a specific type of hybrid or other mismatch
- chapter 11 counteracts mismatches involving importation to third territories
- chapter 12 contains provisions to amend an adjustment made to counteract a mismatch where new information becomes available
- chapter 13 contains anti-avoidance provisions.



## **INTM550050: Hybrids: Chapter 1 - Introduction: When does the legislation take effect?**

Part 6A of the Taxation (International and Other Provisions) Act 2010 was introduced by section 66/Schedule 10 of Finance Act 2016 ("FA 16"), and has effect from 1 January 2017.

The commencement provisions for chapters 3 to 11 are set out at paragraphs 18 to 22 of Schedule 10, FA 16.

Broadly speaking, the legislation applies from 1 January 2017 for –

- deduction/non-inclusion mismatches arising from deductions on or after that date
- deduction/non-inclusion mismatches arising from deductions in a payment period beginning on or after that date
- double deduction mismatches for accounting periods beginning on or after that date
- imported mismatch payments arising from deductions on or after that date
- imported mismatch payments arising from deductions in a payment period beginning on or after that date

There are transitional rules for payment periods and accounting periods that begin before 1 January 2017 and end after that date at paragraphs 23 and 24 of Schedule 10, FA 16.

In these cases the payment/accounting period is treated as 2 separate taxable periods -

- one ending on 31 December 2016, and
- the other beginning on 1 January 2017.

Amounts are apportioned to each of these periods on a time basis, unless that produces a result that is unjust or unreasonable. In those circumstances, the amounts should be apportioned on a just and reasonable basis.

For transactions between 16 March 2005 and 31 December 2016 involving hybrids and mismatches the arbitrage rules set out at INTM590000 onwards may apply.

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		Recommended hybrid mismatch rule		
Mismatch	Arrangement	Response	Defensive rule	Scope
D/NI	Chapter 3: Hybrid and other Mismatches from Financial Instruments	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
D/NI	Chapter 4: Hybrid Transfer Mismatches	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
D/NI	Chapter 5: Hybrid Payer Mismatches	Deny payer deduction	Include as ordinary income	Control group and structured arrangements
D/NI	Chapter 6: Mismatches Relating to Transfers by Permanent Establishments	Deny deduction to UK PE		No limitation on response
D/NI	Chapter 7: Hybrid Payee Mismatches	Deny payer deduction	Include as ordinary income in investor then LLP	Control group and structured arrangements
D/NI	Chapter 8: Multinational Payee Mismatches	Deny payer deduction		Control group and structured arrangements
DD	Chapter 9: Hybrid Entity Mismatches	Deny investor deduction	Deny payer deduction	Related parties and structured arrangements

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DD	Chapter 10: Dual Territory Mismatches	<p>For dual resident company, deny deduction</p> <p>For multinational company, deny parent jurisdiction deduction</p>	For multinational company, deny deduction to UK PE	No limitation on response
Indirect D/NI	Chapter 11: Imported Mismatches	Deny payer deduction		Members of control group and structured arrangements

## **INTM550500: Hybrids: Chapter 2 - Definition of key terms**

Part 6A of TIOPA 10 applies to mismatches involving –

- financial instruments as defined in s259N
- hybrid entities as defined in s259BE
- UK permanent establishments of multi-national companies as defined in s259BF
- multi-national companies as defined in s259HA(4)
- dual resident companies as defined in s259JA(3)
- hybrid payees as defined in s259GA(3)
- hybrid payers as defined in s259EA(3)
- hybrid transfer arrangements as defined in s259DB
- imported mismatch arrangements as defined in s259KA

Other key expressions for Part 6A of TIOPA 10 are defined in chapters 1, 2 and 14, and additional definitions are included within the chapters to which they apply.

An index of defined expressions is set out at Part 4A of Schedule 11, TIOPA 10 (as amended by paragraph 17 of Schedule 10, FA 16).

[INTM550510: Hybrids: Chapter 2 - Definition of key terms: Meaning of tax](#)

[INTM550520: Hybrids: Chapter 2 - Definition of key terms: Equivalent provisions outside the UK](#)

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## **INTM550510: Hybrids: Chapter 2 - Definition of key terms: Meaning of tax**

S259B TIOPA 2010 defines the meaning of tax for the purposes of this legislation as -

- income tax
- the charge to corporation tax on income
- diverted profits tax
- the CFC charge
- foreign tax or
- a foreign CFC charge.

Foreign tax means any tax that corresponds to United Kingdom income tax or United Kingdom corporation tax.

The UK's corporation tax regime subjects returns on income and capital to tax. 'Foreign tax' is tax which is either a tax on income which corresponds to income tax, or is charged on income and corresponds to the UK charge to corporation tax on income.

Corresponding taxes chargeable by provinces, states or other parts of a country are also included within this definition as are any taxes levied on behalf of a municipality or local body.

## **INTM550520: Hybrids: Chapter 2 - Definition of key terms: Equivalent provisions outside the UK**

Any provision of an overseas territory's law that is based on the Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements, published on 5 October 2015, or any replacement or supplementary publication, is to be considered to be equivalent to this legislation.

## **INTM550530: Hybrids: Chapter 2 - Definition of key terms: Payments, quasi- payment, payer and payee**

### **Payment**

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer for a taxable period, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

### **Quasi-payment**

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer for a taxable period, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons, were certain relevant assumptions to apply.

### **The relevant assumptions**

The relevant assumptions to be applied when deciding if the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income are:

- if there is any question of whether an entity is separate from the payer, the laws of the payer jurisdiction are to be considered to determine this point (this will address situations where the payee jurisdiction does not recognise the payee as a separate entity)
- any payee or potential payee is assumed to have adopted the same accounting approach to those circumstances as the payer,
- any payee or potential payee is assumed to be resident for tax purposes in the payer jurisdiction, and
- any payee or potential payee is assumed to be carrying on a business in the payer jurisdiction and the circumstances giving rise to the payer's deduction arise in connection with that business.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments where the circumstances giving rise to the



deduction do not involve economic rights existing between the payer and a payee.

There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment, and in most instances it would do so.

An example of a quasi-payment could be an interest free loan being treated as issued at a discount that qualifies for finance relief (see example at [INTM551180](#)). Whereas a deduction granted by a territory for an amount of deemed interest on an interest free loan (see example at [INTM551170](#)) would not be a quasi-payment because there is no re-characterisation of the loan, nor consideration of the relationship between the parties.

## **Payer**

The payer is the person who makes the transfer and in relation to which an amount may be deducted for the purposes of calculating the payer's taxable profits.

## **Payee**

A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises as a result of the payment.

Where there is a quasi-payment the payee is any person to whom

- an amount of ordinary income arises as a result of a quasi-payment, or
- it would be reasonable to expect an amount of ordinary income to arise on the basis of the relevant assumptions.

## **Payer also Payee**

The payer can also be a payee where the entity is treated as the payer under United Kingdom law, but as a separate entity in the other jurisdiction. For example, a payment to a UK partner made by a partnership treated as opaque in the overseas jurisdiction but as transparent in the UK, would from a UK perspective, have the same Payer and Payee.

## **INTM550540: Hybrids: Chapter 2 - Definition of key terms: Ordinary income**

### **Ordinary income**

Ordinary income means income that is brought into account when calculating taxable profits, and upon which a tax equivalent to the UK tax upon income (whether income tax or corporation tax) is charged.

A receipt will not be treated as omitted from ordinary income because it has been characterised differently under the payee regime (see the example at [INTM551300](#) where although a finance return is characterised as proceeds from a share sale by a share trader, and therefore included within trading profits as income, it is taxed at the same rate as a finance return would have been and so is ordinary income).

In general, the refund of tax paid on an amount of income will not prevent this amount from being treated as included within ordinary income. Such refunds may occur, for example where a refund is triggered by a reduction in the company's charge to tax as a result of a relief or other adjustment unconnected to that income. Such a relief is termed 'qualifying loss relief' and includes losses that can be used to reduce exposure to corporation tax or income tax. For example tax will not be treated as refunded if the territory has subjected a receipt to tax, but refunds it due to relief equivalent to UK Group relief, the carry back of losses, or simply by incurring generic allowable expenditure in earning the profits that exceeds the income received.

But where it is a feature of the relevant jurisdiction's tax regime that the tax on income can be refunded, whether to the company or another person, without the application of qualifying loss relief, but perhaps because it is income of a specified character, then such amounts are not included in ordinary income.

A payment or quasi-payment that is subject to a tax rate of 0% is not ordinary income. Such income is not brought into account for the purpose of calculating a tax charge because no tax charge can arise.

The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the extent of that inclusion, can be found within s259BC TIOPA 2010.

### **Controlled foreign companies regimes**

Usually consideration as to whether a receipt has been included within ordinary income will be restricted to the 'payee', however there are special recognition rules in s259BD which consider whether income received by another person may be included in ordinary income. These rules provide that in considering whether income has been included or under-taxed, income

may be treated as if it had been fully included to the extent that it has been subjected to charge under a controlled foreign company (CFC) regime.

Where the payee is included within another territory's regime equivalent to the UK Controlled Foreign Company rules then it may be recognised as being included within ordinary income to the extent it has been included under those rules. See [INTM550550](#) for a more detailed explanation.

## **INTM550550: Hybrids: Chapter 2 - Definition of key terms: Controlled foreign companies**

If an amount has not been included within the ordinary income of the payee then this will normally be sufficient to identify it as a case of non-inclusion. However, it may be that the receipt has been included within a regime equivalent to the United Kingdom's Controlled Foreign Company (CFC) regime.

There are special rules in Part 6A to deal with CFC inclusion. Where income has given rise to a charge under an equivalent CFC regime, these rules will treat the income as if it has been included in line with the computation set out in s259BD. The rules apply only for the purposes of Chapter 3 (Hybrid Financial Instruments) and Chapter 4 (Hybrid Transfers).

The rules apply to the part of the income that is not treated as ordinary income of the payee, or is treated as under-taxed but which arises from the relevant payment or quasi-payment under, or in connection with, a financial instrument.

Calculating the amount of income to be included

### **Step 1**

The first step is to determine the extent to which the relevant income (i.e. the income which is either under-taxed or not included in the payee's ordinary income) is included within the calculation of chargeable profits that could be exposed to a CFC charge.

### **Step 2**

The second step is to determine, by reference to the apportionment threshold for the companies with an interest in the CFC, what part of the chargeable profits that are actually subject to a CFC charge. The UK's CFC rules require each relevant controlling party (termed a 'chargeable company') to hold a 25% interest in the CFC, below which they will not be subject to a CFC charge. S259BD applies the same de minimis holding interest level as the UK CFC rules.

The effect of this step is to minimise the compliance burden that can arise from having to compute the CFC charge arising from large numbers of small holdings.

### **Step 3**

To the extent that the income in question has actually been included within a relevant CFC charge, it will be treated as ordinary income of the relevant payee.

For example, if a payment of 100 is treated as a dividend in the payee territory, but as debt in the payer territory, and benefits from a 90% dividend exclusion then 10 will be treated as included in ordinary income under the payee rules. If the entire receipt has been included within a CFC charge on the parent then the balance of 90 will be treated as included in ordinary income under these rules.

## **INTM550560: Hybrids: Chapter 2 - Definition of key terms: Hybrid entities**

### **Hybrid entity**

A hybrid entity is defined in s259BE. An entity has the relevant characteristics to be treated as a hybrid entity if it meets two conditions; A and B.

Condition A requires that:

- the entity is treated as a person for tax purposes under the law of any territory.

Condition B requires that:

- the entity's income or profits are treated by any territory wholly or partly as taxable income or profits of a different person, or
- the entity is not regarded as distinct from the person identified for tax purposes of Condition A (for example because it is a branch of a company).

### **Investor and Investor Jurisdiction**

When considering condition B, the different person is an investor in the hybrid entity and the territory in which the investor is within charge to tax is the investor jurisdiction.

If the entity is not regarded as a person for tax purposes under the law of a different territory the investor in the hybrid entity is the entity treated as a person.

Under the definitions adopted for the legislation, examples of hybrid entities to which the legislation applies include:

- those which arise as a result of two territories with laws that consider the general characteristics of the entity and lead to different outcomes as to whether the entity should be regarded as opaque or transparent for tax purposes.
- those which result from a territory's specific domestic provision which treats an entity of a specific type in a certain manner for tax purposes, where this treatment may not be followed by other territories.

For example the income and gains of a UK Limited Liability Partnership are treated under UK tax law as arising to its members, if it carries on a business. Other territories may treat it in line with its form, as a body corporate, and

regard it as a distinct taxable entity with income and gains which therefore do not arise to its members.

- Hybrid entities which result from a territory's specific domestic provision which allows certain entities to determine how they are to be treated for tax purposes i.e. whether they should be opaque or transparent for tax purposes.

For example the US tax code includes provision for entities to be treated as transparent or opaque for tax purposes by election (the check the box rules).

## **INTM550570: Hybrids: Chapter 2 - Definition of key terms: Permanent establishment**

The meaning of permanent establishment is widely drawn and includes anything that is a permanent establishment within the meaning of s1119 CTA 2010, or within any similar concept outside the United Kingdom. This includes any overseas concept of a permanent establishment that is not based on Article 5 of the Model Tax Convention on Income and Capital published by the Organisation for Economic Cooperation and Development.



## **INTM550580: Hybrids: Chapter 2 - Definition of key terms: Further terms**

### **Financial Instruments**

Financial instruments for the purpose of Part 6A TIOPA 2010 are defined in s259N TIOPA 2010. The definition includes –

- arrangements where profits and deficits would fall within the loan relationship regime
- contracts where profits and losses would fall within the derivative contracts rules
- specific types of finance arrangements within Part 16 of CTA 2010
- an issued share
- arrangements that provide a person with economic benefits corresponding to those attaching to an issued share
- a financial instrument as defined for UK generally accepted accounting practice (“GAAP”).

The definition excludes anything that is a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209) (See [INTM551014](#)).

An agreement for the transfer of a financial instrument is not expected in itself to meet the definition of a financial instrument but may be a hybrid transfer falling within Chapter 4, see [INTM552000](#) et seq.

### **Relevant Investment Fund**

A Relevant investment fund is defined by s259NA to be any of the following funds which meet the genuine diversity of ownership condition (whether or not a clearance has been given to that effect).

- an open-ended investment company within the meaning of s613 of CTA 2010,
- an authorised unit trust within the meaning of s616 of that Act, or
- an offshore fund within the meaning of s354 of TIOPA 2010.

## Control Groups

Control Groups are defined by s259NB. A person (A) is in the same control group as another person (B) throughout any period for which they are consolidated for accounting purposes, or on any day on which the participation condition is met in relation to them, or on any day on which the 50% investment condition is met in relation to them.

A and B are consolidated for accounting purposes for a period if:

- their financial results for the period are required to be comprised in group accounts,
- their financial results for the period would be required to be comprised in group accounts but for the application of an exemption, or
- their financial results for the period are in fact comprised in group accounts.

Group accounts means accounts prepared under s399 of the Companies Act 2006, or any corresponding provision of the law of a territory outside the United Kingdom.

The Participation Condition is met in relation to A and B (the relevant parties) on a day if, within the period of 6 months beginning with the day:

- one of the relevant parties directly or indirectly participates in the management, control or capital of the other, or
- the same person or persons directly or indirectly participate in the management, control or capital of each of the relevant parties.

The definition of participation in management, control or capital takes the same meaning as it does for transfer pricing, further details can be found at INTM412060.

The 50% Investment Condition is met in relation to A and B if:

- A has a 50% investment in B, or
- a third person has a 50% investment in each of A and B.

## Related Persons

Two persons are related on any day that they are in the same control group (see above), or they meet the 25% investment condition.

The 25% investment condition is met in relation to a person A and another person B if:

- A has a 25% investment in B, or
- a third person has a 25% investment in each of A and B.

## **Meaning of "50% investment" and "25% investment"**

These terms are relevant for the Control and Related Persons definitions. Determining whether the investment condition has been met uses the same tests for both a 50% investment and 25% investment.

A person ("P") has an X% investment in a company ("C") if it is reasonable to suppose that

- P possesses or is entitled to acquire X% or more of the share capital or issued share capital of C,
- P possesses or is entitled to acquire X% or more of the voting power in C, or
- if the whole of C's share capital were disposed of, P would receive (directly or indirectly and whether at the time of disposal or later) X% or more of the proceeds of the disposal.

Similarly, a person (P) has an X% investment in another person (Q) if it is reasonable to suppose that P would receive, directly or indirectly and whether at the time or later, X% or more of

- the distributed amount if the whole of Q's income were distributed, or
- Q's assets which would be available for distribution in the event of a winding-up of Q or in any other circumstances.

References to a person receiving any proceeds, amount or assets also include references to the proceeds, amount or assets being applied, directly or indirectly, for that person's benefit.

In determining what percentage investment a person has in another person consideration is also given to whether the person and another third person can be considered to be acting together.

## **Partnerships**

S259NE defines the treatment of a person who is a member of a partnership.

Any reference to income, profits or an amount of the person includes a reference to the person's share of the income, profits, or an amount of the partnership determined by apportioning between the partners on a just and reasonable basis.

A partnership includes an entity established under the law of a territory outside the UK of a similar character to a partnership.

## **INTM550590: Hybrids: Chapter 2 - Definition of key terms: Summary of definitions given**

### **Summary of definitions**

A summary of definitions and where they can be found in guidance is provided here for ease of reference:

"Arrangement" includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

"CFC" and "CFC charge" have the meaning given by s259B(4). ([INTM550550](#))

"The Commissioners" means the Commissioners for Her Majesty's Revenue and Customs.

"Control group" has the meaning given by s259NB. ([INTM550580](#))

"Financial instrument" has the meaning given by s259N. ([INTM550580](#))

"Foreign CFC" and "foreign CFC charge" have the meaning given by s259B(4). ([INTM550550](#))

"Hybrid entity" has the meaning given by s259BE. ([INTM550560](#))

"Investor", in relation to a hybrid entity, has the meaning given by s259BE(4). ([INTM550560](#))

"Investor jurisdiction" has the meaning given by s259BE(4). ([INTM550560](#))

"Ordinary income" is to be read in accordance with sections 259BC and 259BD. ([INTM550540](#))

"Payee" in relation to a payment, has the meaning given by s259BB(6)(a), and in relation to a quasi-payment, has the meaning given by s259BB(6)(b). ([INTM550530](#))

"Payee jurisdiction" has the meaning given by 259BB(9). ([INTM550530](#))

"Payer" in relation to a payment, has the meaning given by s259BB(1)(a), and in relation to a quasi-payment, has the meaning given by s259BB(2). ([INTM550530](#))

"Payment" has the meaning given by s259BB(1). ([INTM550530](#))

"Payment period" in relation to a payment, has the meaning given by s259BB(1)(b), and in relation to a quasi-payment, has the meaning given by s259BB(2). ([INTM550530](#))

"Permanent establishment" has the meaning given by s259BF. ([INTM550570](#))

"Quasi-payment" has the meaning given by s259BB(2) to (5). ([INTM550530](#))

"Related" has the meaning given by s259NC. ([INTM550580](#))

"Relevant deduction" in relation to a payment, has the meaning given by s259BB(1)(b), and in relation to a quasi-payment, has the meaning given by s259BB(2)(a). ([INTM550530](#))

"Relevant investment fund" has the meaning given by s259NA. ([INTM550580](#))

"Tax" has the meaning given by s259B. ([INTM550510](#))

"Taxable period" means--

- in relation to corporation tax, an accounting period,
- in relation to income tax, a tax year,
- in relation to the CFC charge, a relevant corporation tax accounting period (within the meaning given by section 371BC(3)),
- in relation to a foreign CFC charge, a period (by whatever name known) that corresponds to a relevant corporation tax accounting period, and
- in relation to any other tax, a period for which the tax is charged.

"Taxable profits" is to be read in accordance with sections 259BC(2) and 259BD(5)." ([INTM550550](#))

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## **INTM551010: Hybrids: Chapter 3 - Financial Instruments: Overview**

Chapter 3 of Part 6A, TIOPA 2010 addresses 2 cases of deduction/non-inclusion mismatch involving financial instruments. These are mismatches that

- result in an allowable deduction that is not matched by a fully taxable receipt – a deduction/non-inclusion mismatch (D/NI mismatch), and
- arise from payments or quasi-payments (see [INTM551021](#)) made under, or in connection with, a financial instrument.

Financial instruments for the purpose of Part 6A TIOPA 2010 are defined at s259N. The definition includes –

- arrangements where profits and deficits would fall within the loan relationship regime
- contracts where profits and losses would fall within the derivative contracts rules
- specific types of finance arrangements within Part 16 of CTA 2010
- an issued share
- arrangements that provide a person with economic benefits corresponding to those attaching to an issued share
- a financial instrument as defined for UK generally accepted accounting practice (“GAAP”).

The definition excludes anything that is a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209) (see [INTM551014](#)).

An agreement for the transfer of a financial instrument is not expected in itself to meet the definition of a financial instrument but may be a hybrid transfer falling within Chapter 4, see [INTM552000](#) *et seq.*

### **Interaction with other UK legislation**

The hybrid mismatch rules do not contain a priority order for considering the application of other legislation. However, because of the mechanical nature of these rules, and while dependent on the facts and circumstances, it is generally the case that those within the ambit of the hybrid rules will need to consider their application, to determine if a counteraction is to be applied,

before considering other legislation which could affect the deductibility of payments or the taxation of receipts.

## **Conditions to be met for Chapter 3 to apply**

For a deduction/non-inclusion mismatch arising from a financial instrument to fall within Chapter 3, four conditions; Conditions A to D must be met.

### **Condition A**

- there is a payment or quasi-payment involving a financial instrument

### **Condition B**

- one of the parties is within the charge to UK corporation tax

### **Condition C**

- there would be a mismatch, if it were not countered by this legislation, or equivalent legislation outside the UK, arising by reason of specific features of the payer, payee, the financial instrument or the arrangements connected with the financial instrument, and

### **Condition D**

- there is sufficient connection in the relationship between the relevant parties, or it is reasonable to suppose it was structured to achieve that benefit.

If all 4 conditions are met the mismatch is countered by -

- reducing the amount of the deduction claimed where the payer is within the charge to corporation tax in the UK, or
- treating the relevant amount as taxable income where the payee is within the charge to corporation tax in the UK.

## **Extent of the Chapter 3 mismatch and relevant counteractions**

If Conditions A to D are met, then the next step is to quantify the amount of the mismatch. For this purpose a mismatch falls into one of two Cases.

Case 1 deals with mismatches where

- the deduction exceeds the total amount of ordinary income arising to payees, and

- that excess is wholly or partly attributable to the terms or features of the financial instrument.

The amount of the mismatch is the excess.

Case 2 deals with mismatches where

- the income is under-taxed (i.e. it is brought into charge as ordinary income, but at a lower rate than the highest rate that could be charged on income from financial instruments), and
- the under-taxed amount is wholly or partly attributable to the terms or features of the financial instrument.

The amount of the mismatch is the under-taxed amount.

For an explanation of what is included within ordinary income see [INTM551011](#).

## **INTM551011: Hybrids: Chapter 3 - Financial Instruments: Overview: Ordinary Income**

In broad terms, ordinary income means income that is brought into account when calculating taxable profits, and on which a tax equivalent to the UK tax upon income (whether income tax or corporation tax on income) is charged.

A receipt will not be treated as omitted from ordinary income because it has been characterised differently under the payee regime (see the example at [INTM551300](#) where although a finance return is characterised as proceeds from a share sale by a share trader, and therefore included within trading profits as income, it is taxed at the same rate as a finance return would have been and so is ordinary income).

### **General**

A receipt taxed as a capital gain will not be included within ordinary income, although the tax may be taken into consideration in determining the extent to which the receipt is 'under-taxed' (Case 2).

In general, the refund of tax paid on an amount of income will not prevent this amount from being treated as included within ordinary income. Such refunds may occur, for example where a refund is triggered by a reduction in the company's charge to tax as a result of a relief or other adjustment unconnected to that income. Such a relief is termed 'qualifying loss relief' and includes losses that can be used to reduce exposure to corporation tax or income tax. For example tax will not be treated as refunded if the territory has subjected a receipt to tax, but refunds it due to relief equivalent to UK Group relief, the carry back of losses, or simply by incurring generic allowable expenditure in earning the profits that exceeds the income received.

But where it is a feature of the relevant jurisdiction's tax regime that the tax on income can be refunded, whether to the company or another person, without the application of qualifying loss relief, but perhaps because it is income of a specified character, then such amounts are not included in ordinary income.

A payment or quasi-payment that is subject to a tax rate of 0% is not ordinary income. Such income is not brought into account for the purpose of calculating a tax charge because no tax charge can arise.

The full definition of ordinary income, including restrictions on what may be regarded as ordinary income and the how specific reliefs may be treated as reducing the extent of that inclusion, can be found within s259BC.

## **Controlled foreign companies regimes**

Usually consideration as to whether a receipt has been included within ordinary income will be restricted to the 'payee', however there are special recognition rules at s259BD which consider whether income received by another person may be included in ordinary income. These rules provide that in considering whether income has been included or under-taxed, income may be treated as if it had been fully included to the extent that it has been subjected to charge under a controlled foreign company (CFC) regime.

Where the receipt is included within a third country's CFC regime which is equivalent to the UK CFC rules, then it may be recognised as being included within ordinary income to the extent it has given rise to a CFC charge under those rules. See [INTM551012](#) for a more detailed explanation.

## **INTM551012: Hybrids: Chapter 3 - Financial Instruments: Overview: Recognition of a CFC Charge**

If an amount has not been included within the ordinary income of the payee then this will normally be sufficient to identify it as a case of non-inclusion. However, it may be that the receipt has been included within a regime equivalent to the United Kingdom's Controlled Foreign Company (CFC) regime.

There are special rules in Part 6A to deal with CFC inclusion. Where income has given rise to a charge under an equivalent CFC regime, these rules will treat the income as if it has been included in line with the computation set out at s259BD. The rules apply only for the purposes of Chapter 3 (Hybrid Financial Instruments) and Chapter 4 (Hybrid Transfers).

The rules apply to the part of the income that is not treated as ordinary income of the payee, or is treated as under-taxed but which arises from the relevant payment or quasi-payment under, or in connection with, a financial instrument.

### **Calculating the amount of income to be included**

#### **Step 1**

The first step is to determine the extent to which the relevant income (i.e. the income which is either under-taxed or not included in the payee's ordinary income) is included within the calculation of chargeable profits that could be exposed to a CFC charge.

#### **Step 2**

The second step is to determine, by reference to the apportionment threshold for the companies with an interest in the CFC, what part of the chargeable profits that are actually subject to a CFC charge. The UK's CFC rules require each relevant controlling party (termed a 'chargeable company') to hold a 25% interest in the CFC, below which they will not be subject to a CFC charge. S259BD applies the same *de minimis* holding interest level as the UK CFC rules.

The effect of this step is to minimise the compliance burden that can arise from having to compute the CFC charge arising from large numbers of small holdings.

**Step 3**

To the extent that the income in question has actually been included within a relevant CFC charge, it will be treated as ordinary income of the relevant payee.

For example, if a payment of 100 is treated as a dividend in the payee territory, but as debt in the payer territory, and benefits from a 90% dividend exclusion then 10 will be treated as included in ordinary income under the payee rules. If the entire receipt has been included within a CFC charge on the parent then the balance of 90 will be treated as included in ordinary income under these rules.



## **INTM551013: Hybrids: Chapter 3 - Financial Instruments: Overview: Quasi-payments, foreign exchange losses, losses on derivatives**

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer for a taxable period, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons, were certain relevant assumptions to apply.

See [INTM550530](#) for a fuller definition.

Where an exchange loss arises because of a change in value of a final instrument or repo arising solely by reason of the relevant company's functional currency, that loss does not give rise to a quasi-payment.

### **Debt instruments and repos – exchange loss arising to a UK company**

A simple debt instrument denominated in a particular currency (which will be a financial instrument as defined in s259N and within the ambit of Chapter 3) will not give rise to an exchange difference if that currency is the same of the company's functional currency. For instance, a bond or loan denominated in euros will not give rise to an exchange difference in the accounts of a company where that company's functional currency is the euro. However, where a company's functional currency is sterling a profit or loss can arise because of changes in the value of the euro relative to sterling.

The same applies to a repo, which may give rise to a hybrid transfer arrangement within Chapter 4 –s259DB. For instance a company may sell securities to a counterparty for €100 and agree to buy them back three months later for €101. This gives rise to an in-substance borrowing of €100 with a funding cost of €1. Where the company has a functional currency of the euro no exchange differences will arise on the in-substance debt.

An exchange loss on a debt denominated in a currency that is not its functional currency will normally give rise to a UK tax deduction under the loan relationships regime. Thus, the requirement in s259BB (2)(a) is met and there is a "relevant deduction".

It might be argued that if the exchange rate had changed in the opposite direction, there would have been an exchange gain and thus no relevant deduction. However, there is nothing in the definition of a quasi-payment that requires consideration of alternative outcomes and the symmetry of treatment between an exchange gain and an exchange loss on the financial instrument does not mean that a loss cannot give rise to a quasi-payment.

It is therefore necessary to consider whether, making the assumptions in s259BB(4), “it would be reasonable to expect an amount of ordinary income to arise to one or more other persons as a result of the circumstances giving rise to the relevant deduction”, as is required by s259BB(2)(b). Clearly, in this context, the other person referred to will be another party to debt as the corresponding debt creditor, referred to here as “the counterparty”.

There are two key assumptions that need to be made

- The “payee” is resident in the same tax jurisdiction as the payer and is carrying on business there (s259BB(4)(c)).
- The payee applies the same approach to accounting as the payer (s259BB(4)(b)).

Thus, where a UK company is, say the debtor under a debt instrument and has suffered an exchange loss, then it is necessary to test the tax treatment of a UK company that is a creditor to the same instrument and applies same approach to accounting. For example, if the debtor applies UK GAAP standard FRS 102 or IFRS, it must be assumed that the creditor does the same.

Where both companies apply either of these accounting standard it is not necessarily the case that it will affect their choice of functional currency; the functional currency is determined by applying the relevant accounting standard and taking into account its fact pattern. In essence under both section 30 of FRS 102 and IAS 21, the functional currency of an entity is the currency of the primary economic environment in which the entity operates, which requires consideration of the entirety of its business and in some cases how independent its business is from that of its parent.

In consequence it is perfectly possible that, say, the debtor will have a sterling functional currency and the creditor a euro functional currency, despite adopting the same approach to accounting, because of their differing primary economic environment. So where the financial instrument is a euro-denominated debt an exchange loss of the debtor will not necessarily be matched by an exchange gain on the creditor.

This will also be the case where both are UK companies (adopting the same approach to accounting) as the corporation tax treatment of the companies will still reflect their accounting functional currency - so there will be a corresponding tax mismatch.

Consequently, making the assumptions required by s259BB(4), where the debtor company suffers an exchange loss, which is tax-deductible, it would not be reasonable to expect an amount of ordinary income to arise to another person, in this case the hypothetical creditor. So, the requirements of s259BB(2)(b) are not met and the exchange loss of the debtor company does not give rise to a quasi-payment.

In this scenario, of a UK resident company with a sterling currency suffering an exchange loss on a euro-denominated loan, there is neither a payment nor a quasi-payment. An actual mismatch will not be subject to counteraction because there cannot be a "hybrid or otherwise impermissible deduction/non-inclusion mismatch" in relation to a payment or quasi-payment – s259CB(1).

This is the case even if there is a mismatch in respect of, say, an accrual of interest expense on the instrument that may be counteracted.

The same conclusion applies if a repo priced in euros is substituted for the debt instrument. An exchange difference on an in-substance euro debt will not be a quasi-payment and there will not be a "hybrid or otherwise impermissible deduction/non-inclusion mismatch" within s259DC(1).

## **Debt instruments – exchange loss arising to a non-UK company**

The UK tax regime for debt and repos respects the functional currency of the company. The same would not necessarily be the case under other jurisdictions' tax regimes. For instance, exchange differences might always have to be measured by reference to that jurisdiction's legal currency, irrespective of the functional currency of the company. Accordingly in making the assumptions in s259DD(4), that the counterparty is a company carrying business in and resident in the same jurisdiction of the company that has an exchange loss on a debt, a gain taxable as ordinary income would be expected to arise to the counterparty. Thus the exchange loss would give rise to a quasi-payment.

Where this is the case it is necessary to consider (for instance) whether a counteraction could apply where the UK has neither gain nor loss because, say, a loan is denominated in sterling and the counterparty suffers a tax-deductible exchange loss in a jurisdiction that requires exchange differences to be computed by reference to the official currency, irrespective of functional currency.

See the example at [INTM551250](#), in which it is concluded that no counteraction would arise under s259CE.

## Derivatives

The position as regards exchange losses on derivatives and fair value losses on derivatives more generally is different. This is because the fair value of a derivative will respond to changes in value of its underlying subject matter, irrespective of the functional currency of a company: a comparison of the value of this subject matter with some fixed price or other variable will always be a feature of the terms of the derivative. In an option or forward the comparison is with a fixed amount. Other simple derivatives will have two legs each exposed to a different variable.

A very simple example of a derivative is a currency swap. A company would have a “short” euro position on a currency swap if it agreed to pay €100m in three years’ time at a 6-month euro LIBOR on €100m every 6 months, in return for receiving £90m in three years’ time and receiving a 6-month sterling LIBOR on £90m every 6 months (£90m is assumed to be the spot rate equivalent of €100m on entry into the swap). This is similar to making a three year loan of £90m and borrowing €100m from the same counterparty, but the credit risks are offset. The swap is primarily exposed to two variables, the value of €100m and the value of £90m.

If the euro strengthens against sterling the company will make an exchange loss, as the in-substance €100m loan it effectively exchanged for the £90m loan will be a relatively heavier burden. This is not dependent on the functional currency of the company because the sterling leg is built into the swap and the relative movement in value of the euro relative to sterling inevitably changes the fair value of the swap. The change in value results from the comparison of one leg of the swap with another, rather than, say, between the single leg of a euro-denominated debt security and a company’s sterling functional currency. Regardless of the functional currency the company will have a liability that is now considered more expensive, effectively exchanging euros for sterling.

Derivatives including currency swaps will normally be accounted for on a fair value basis whether under IFRS (IFRS 10) or FRS 102 (section 12). For the swap considered here, the fair value movement is almost entirely driven by the euro/ sterling exchange rate. (There will be some “noise” because of the effect of changes in interest rates between the 6-monthly resets of the LIBOR rates.). If a UK company with a short euro position on the swap made a fair value loss on the derivative, this would give rise to a “relevant deduction” within s259BB(2)(a). If the assumptions in s259BB(4) are made as regards the swap counterparty, it would be expected to have a corresponding gain irrespective of its functional currency, which would be subject to corporation tax and so treated as ordinary income . Accordingly, the condition in s259BB(2)(b) would be satisfied.

Thus the UK company’s fair value loss on the derivative gives rise to a quasi-payment. This will generally be the case for fair value losses on derivatives.

Whether a counteraction arises depends on whether the other conditions in s259CA are satisfied.

## **INTM551014: Hybrids: Chapter 3 - Financial Instruments: Overview: Regulatory Capital Securities**

The definition (of hybrid financial instruments) excludes anything that is a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209) as amended by SI 2015/2056.

Banks and insurers are required to fund a proportion of their activities through loss-absorbent forms of capital called regulatory capital.

The rules for banks are derived from Basel III, which requires banks to hold capital equal to at least 6% of their Risk Weighted Assets. Of that 6%, 4.5% must be Common Equity Tier 1 (CET1) capital and 1.5% can be Additional Tier 1 (AT1) capital.

The rules for insurers are under Solvency II, which requires insurers to issue financial instruments to meet their Tier 1 and Tier 2 capital requirements.

The issuance of AT1 and Tier 2 instruments reflects the fact that ordinary share capital is expensive, so regulators allow banks and insurers to meet a proportion of these requirements by issuing these instruments. AT1 has certain characteristics of both equity and debt as they pay a regular coupon but are perpetual and can be converted to equity in a time of stress and, as such, are hybrid capital instruments. The taxation of AT1 and Tier 1 instruments (for insurers) and Tier 2 instruments that are not shares is provided for by The Taxation of Regulatory Capital Securities Regulations 2013 SI 2013/3209 ("The Regulations") as amended by SI2015/2056.

These financial instruments may be treated differently under different countries' tax systems and, as a result, can give rise to hybrid mismatch outcomes. Without some form of exclusion these regulatory-motivated arrangements could be caught by these rules, disadvantaging certain banking and insurance groups that operate cross-border.

Excluding anything that is a regulatory capital security, for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209) as amended by SI 2015/2056, from the definition of 'financial instrument' ensures that such capital is not caught inadvertently by the hybrid mismatch rules.

## **INTM551020: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied**

The conditions applicable for Chapter 3 of Part 6A TIOPA 2010 are set out at s259CA.

[INTM551021: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition A](#)

[INTM551022: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition B](#)

[INTM551023: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition C](#)

[INTM551024: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition D](#)

# **INTM551021: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition A**

## **Condition A**

Condition A requires a payment or quasipayment to be made under, or in connection with, a financial instrument. Definitions of the key terms for this condition are at S259BB.

The definition of financial instrument is provided within [INTM551010](#). It is likely that where the definition of financial instrument is satisfied by one party to the agreement, it will also be satisfied for the counterparty. However, this is not always the case and it may be that this condition is only satisfied in respect of one of the parties to the transaction (see the example at [INTM551280](#)).

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person who makes the transfer. A payee is any person to whom:

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply.

For example see [INTM551160](#) in relation to the discount on a zero coupon convertible note, treated as accrued interest.

## **Relevant assumptions**

The relevant assumptions when deciding if the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income are –



- if there is any question of whether an entity is separate from the payer, that is to be determined by the law of the payer jurisdiction, (this will address situations where the payer does not recognise the payee as a separate entity, for example the permanent establishment of a head office)
- any payee or potential payee is assumed to have adopted the same accounting approach to those circumstances as the payer,
- any payee or potential payee is assumed to be resident for tax purposes in the payer jurisdiction, and
- any payee or potential payee is assumed to be carrying on a business in the payer jurisdiction and the circumstances giving rise to the payer's deduction arise in connection with that business.

See [INTM551160](#) for an example of how the relevant assumptions are applied.

There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment, and in most instances it would.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

- Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments where the circumstances giving rise to the deduction do not involve economic rights between the payer and a payee.
- This could include relief granted by a territory for an amount of deemed interest on an interest free loan (see example at [INTM551170](#)), which can be contrasted with an interest free loan being treated as issued at a discount that qualifies for finance relief (see example at [INTM551180](#)). The former relief does not seek to re-characterise the loan, but allows for relief in spite of this.

As the relationship of the payment to the financial instrument is merely that it be made under or in connection with it, this will include payments to either alter the terms of the instrument (e.g. see [INTM551190](#) for an example where a payment is made to reduce the interest rate due or [INTM551260](#) where a payment is made to cancel a loan) or the release from all or some of its terms (see [INTM551200](#) for an example).

# **INTM551022: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition B**

## **Condition B**

Condition B of s259CA TIOPA 2010 requires

- the payer to be within the charge to UK corporation tax for a relevant payment period, or
- a payee to be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period.

The relevant payment period is the taxable period of the payer in which an amount may be deducted, in relation to the payment or quasi-payment.

# **INTM551023: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition C**

## **Condition C**

Condition C of s259CA TIOPA 2010 requires an objective judgement: is it reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a relevant deduction/non-inclusion mismatch in relation to the payment or quasi-payment?

The test here is whether a relevant deduction/non-inclusion mismatch would arise if Chapter 3 and Chapters 5 to 10 of Part 6A TIOPA 10 (or any equivalent non-UK legislation) did not apply. For example, if Chapter 5 can also apply to the arrangement at issue, then Chapter 3 has priority, because counteraction under Chapter 3 is given priority over all other chapters except Chapter 4, (S259A(20)(b)).

In determining whether Condition C is satisfied, it is necessary to apply the rules in s259CB to determine whether there is a relevant mismatch (see [INTM551130](#)) and to determine its amount. If there is a mismatch, it will only be subject to counteraction if all four conditions are satisfied.

### **Reasonable to suppose**

There is no definition of the term “reasonable to suppose” in Part 6A. The phrase will take its ordinary meaning. It does not require either party to actually know how the transaction has been treated by the counterparty but only that given the facts and circumstances that it would be reasonable to conclude that a mismatch may or may not arise.

The inclusion of this phrase is intended to assist in the application of Condition C. Parties to the transaction should take all reasonable actions to establish whether a mismatch is likely to arise, taking account of the relevant tax laws of the territories involved. It is not necessary for the parties to await final resolution of the relevant tax returns.

## **INTM551024: Hybrids: Chapter 3 - Financial Instruments: Conditions to be satisfied: Condition D**

### **Condition D**

Condition D is satisfied where one of the following applies –

- a quasi-payment is made where the payer is also the payee, or
- the payer and a payee are related at any time from when the arrangement in connection with the financial instrument is made, to the last day of the payment period, or
- the financial instrument or an arrangement connected with it is a structured arrangement.

A payer may also be a payee in respect of a quasi-payment only where the payee

- is an entity that is not considered to be a separate person from the payer, for example the branch of a company, and
- is an entity that is a separate person from the payer for tax purposes in the payer's jurisdiction, and
- it would be reasonable to expect that entity to have an amount of ordinary income arising as a result of the circumstances giving rise to the quasi-payment.

Related persons are defined at s259NC. More detailed guidance on related persons is at [INTM550580](#), but in broad terms a payer and a payee are related on any day that they are

- in the same control group (as defined at s259NB), or
- one holds a 25% investment in the other, or
- a third person holds a 25% investment in both entities

A financial instrument or arrangement connected with it is a structured arrangement if –

- it is designed to secure a relevant mismatch within Case 1 or Case 2, or

- under the terms of the instrument or arrangement the economic benefit of the mismatch is shared between the parties to that instrument or arrangement, or
- the terms of the instrument or arrangement otherwise reflect that the mismatch was expected to arise.

For example, both parties must be aware that the instrument or arrangement may create a relevant mismatch and either it is designed to achieve that (irrespective of whether it has also been designed to achieve commercial or other objectives) or a reasonable person would presume that the benefit of the possible tax saving has been shared between the relevant parties.

Where it can be shown that the pricing resulting in any tax saving was derived from factors unconnected to the possible mismatch then there will not be a structured arrangement, unless it is reasonable to suppose that it was still designed to secure it, irrespective of whether both parties intended to share in that saving.

If a product is targeted at a subset of taxpayers who are likely to benefit from such a mismatch, then irrespective of whether the product is also more widely available to other taxpayers, who would not benefit from the mismatch, the arrangement or instrument would be caught.

## **INTM551030: Hybrids: Chapter 3 - Financial Instruments: Extent of the mismatch**

If conditions A to D of s259CA TIOPA 2010 are satisfied the next step is to establish the extent of any hybrid or other impermissible mismatch under Chapter 3, Part 6A of TIOPA 2010.

S259CB defines a hybrid or other impermissible mismatch as a mismatch within

- Case 1, or
- Case 2, or
- both Case 1 and Case 2.

It is necessary to apply S259CB to determine whether there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch, which in turn determines whether condition C is satisfied – see [INTM551023](#).

[INTM551031: Hybrids: Chapter 3 - Financial Instruments: Extent of the mismatch: Case 1](#)

[INTM551032: Hybrids: Chapter 3 - Financial Instruments: Extent of the mismatch: Case 2](#)

# **INTM551031: Hybrids: Chapter 3 - Financial Instruments: Extent of the mismatch: Case 1**

Case 1 deals with deductions arising from a payment or quasi-payment under or in connection with a financial instrument where

- the deduction exceeds the total amount of ordinary income arising to payees, and
- all or part of that excess arises by reason of the terms or features of the financial instrument.

## **Reason for the excess- meaning of terms**

The legislation requires us to consider if, the terms or any other feature of the financial instrument been different, would the excess of the deduction above the ordinary income have been less. If so then, to that extent, it is a hybrid or otherwise impermissible deduction/non-inclusion mismatch.

Where Case 1 applies the impermissible mismatch is the amount of that excess which is attributable to the terms, or any feature, of the financial instrument.

There may be circumstances where only part of the excess is so attributable, with the balance arising for different reasons, and in that case only the part so attributed will satisfy this condition - see the example at [INTM551300](#) where part of the mismatch is attributable to differences over the characterisation of a finance return but the balance is attributable to one of the parties being a share trader (and the mismatch would have arisen regardless of the instrument's attributes).

## **Reason for the excess- any other feature**

The addition of the phrase 'or any other feature' to s259CB(2) widens the scope of Case 1, bringing within it, for example, mismatches that arise by reason of the financial instrument being treated in a more beneficial manner by reason of the relationship between the relevant parties (see the examples at [INTM551110](#), [INTM551150](#), and [INTM551200](#)).

## **Exclusion for specified Loan Relationship debt relief provisions**

There is an exclusion to the extent the excess arises by reason of a relevant debt relief provision, as defined in s259CC(3), which generally respects loan relationship provisions specifically introduced to permit mismatches. These

are limited to circumstances such as genuine distress situations, where the object is to not further burden a debtor that is already genuinely struggling financially or to discourage rescue situations. See CFM35370 for more specific details.

## **Exclusion for excess attributable to a relevant investment fund**

The legislation excludes any element of the excess which arises as a result of the payee being a relevant investment fund, which is defined in s259NA. This includes certain open-ended investment companies, authorised unit trusts and certain offshore funds.

## **What if the mismatch arises for several reasons?**

Where the mismatch arises for several reasons and would have arisen regardless of the terms, or any other feature, of the financial instrument then providing it would also have arisen by reason of the terms or features, it will satisfy the requirement.

However if the terms of the instrument achieve a commercial effect, but a mismatch arises only because of the combination of those terms with a particular fact pattern of the counterparty, the mismatch cannot be attributed to specific terms of the instrument.

### **Relevant assumptions**

A relevant mismatch will also be taken to arise by such reasons if it contains what the UK considers hybrid characteristics. These are determined by making relevant assumptions.

The relevant assumptions ask whether the terms or any other feature of the financial instrument are such that they would have created a 'hybrid or otherwise impermissible deduction/non-inclusion mismatch' if the payee did not benefit from a beneficial tax treatment

The relevant assumptions are:

- If the payee is not within the charge to tax as it benefits from an exclusion, immunity or relief ('however described') then assume that it does not so benefit and establish whether a mismatch would still have arisen.

Examples of such entities are exempted charitable corporations or companies benefitting from sovereign exclusion.

- Where the payment or quasi-payment is not made in connection with a business carried on by the payee in the relevant jurisdiction,



then assume it is so made and ask whether a mismatch would have arisen.

For example, territorial tax regimes do not subject a resident to tax on receipts not in connection with a business carried on in their jurisdiction.

- Where the payee is not within the charge to tax in any territory, either as a resident or through a permanent establishment, then assume it is UK tax resident and that the payment or quasi-payment is made in connection with a business carried on in the UK and ask whether a mismatch would have arisen.

An example of such an entity is one resident in a territory which has no equivalent to UK IT/CT.

### **Differences in valuation**

If the mismatch is not attributable to the terms, or any other feature, of the financial instrument then it will not be caught (subject to the sections below where it may be attributable to several reasons or where it is taken to arise by virtue of a relevant assumption).

This could be where the mismatch arises due a difference of opinion on the value of shares to be received on the maturity of a convertible loan note, as opposed to a situation where the mismatch arises as a result of attributing different valuations to an equity element created by inserting an option to convert before maturity (see the example at [INTM551180](#)).

## **INTM551032: Hybrids: Chapter 3 - Financial Instruments: Extent of the mismatch: Case 2**

Case 2 deals with ordinary income arising from a payment or quasi-payment under or in connection with a financial instrument where

- the income is under-taxed, and
- the under-taxed amount is wholly or partly attributable to the terms or features of the financial instrument.

A similar exclusion in relation to excesses attributable to a relevant investment fund applies as for Case 1, and is outlined in [INTM551031](#). Likewise, [INTM551031](#) also considers the interpretation of the term 'or any other feature'.

If the mismatch arises for several reasons and would have arisen regardless of the terms, or any other feature, of the financial instrument then providing it would have arisen by reason of the terms or features it will satisfy the requirement.

Where Case 2 applies, the amount of the impermissible mismatch is calculated by applying the following formula to each under-taxed amount –

$$\frac{(UTA \times (FMR - R))}{FMR}$$

Where -

UTA is the under-taxed amount

FMR is the payee's full marginal tax rate for the permitted taxable period, as a %

R is the highest rate at which tax is charged on the profits that are under-taxed, as a %, taking into account the effect of any credit for underlying tax on a just and reasonable basis.

For the purposes of establishing the under-taxed amount we ignore withholding tax.

The full marginal tax rate is the highest rate that could be charged on the taxable profits of that payee on finance related income. It does not include a higher tax rate that may be imposed under the Diverted Profits Tax.

The 'under-taxed amount' is the relevant proportion of ordinary income that is subject to tax at a rate lower than the 'full marginal tax rate'.

The highest rate at which tax is charged recognises both income and capital taxes corresponding to the charge that would be imposed under the UK's income tax, capital gains tax or corporation tax regime.

### **Illustration of calculation**

Consider a payee that would ordinarily be subject to tax at 40% on their finance income but who treats the relevant receipt as proceeds from a capital asset, which is eligible for a lower tax rate and other relief. After taking into account the relevant deductions and reliefs, available to be offset under that capital gains taxation regime (including, where relevant, taper, indexation or other such reliefs), they are effectively subject to tax at a rate of 10%, then:

- 'UTA' is the relevant gross proceeds amount
- 'FMR' is 40%, and
- 'R' is 10%

Effectively only 25% of the receipt has been fully included as ordinary income, and 75% is therefore treated by the rules as not-included.

There are examples illustrating this point further at [INTM551120](#), [INTM551210](#) and [INTM551300](#).

## **INTM551033: Hybrids: Chapter 3 - Financial Instruments: Timing – permitted taxable period**

If an amount of ordinary income does arise to the payee, but in a period later to that corresponding to the period within which a deduction is claimed by the payer, then the legislation will not permit a deduction unless that delay is 'just and reasonable'. This is subject to a 12 month "safe harbour" period.

The safe harbour period recognises the timing delay if the payee includes the ordinary income in a period beginning at any time before the end of 12 months after the end of the payment period.

Just and reasonable is not a defined term and therefore takes its ordinary meaning. It asks what is fair, sensible and appropriate depending on the facts, circumstances and the non-tax commercial drivers.

If a receipt is disallowed then the deduction will only be denied under the counteractions below until the relevant corresponding income has been brought into charge. A deduction will then be allowed to the payer for the accounting period in which the relevant payee taxable period ends (s259LA). Effectively the disallowed deduction is carried forward until it is matched against the period in which the relevant income is brought into charge.

## **INTM551040: Hybrids: Chapter 3 - Financial Instruments: Counteraction**

Action to counter the hybrid or other impermissible mismatch (arising from either Case 1 or Case 2) depends on whether the payer, payee or both are within the charge to corporation tax in the UK.

Where there is a mismatch between a corporate and non-corporate the counteraction can only be applied to the corporate.

If the payer is within the charge to corporation tax in the UK for the payment period, S259CD applies. In those cases the payer's claim for a deduction from income is reduced by an amount equal to the hybrid or other impermissible mismatch.

A payment period is the taxable period of the payer in which the deduction for the payment or quasi-payment is made.

If a payee is within the charge to corporation tax in the UK for an accounting period falling wholly or partly within the payment period, S259CE may apply. Where this section applies, the relevant amount or the payee's share of the relevant amount is treated as taxable income of the payee, chargeable under Chapter 8 of Part 10 of CTA 2009.

This is the case even if the payer is loss-making and is unlikely to be able to utilise those losses in the future.

In cases where

- the primary counteraction under s259CD has been applied, or
- an equivalent non-UK provision to the primary counteraction under s259CD has been applied and fully counteracts the hybrid or other impermissible mismatch,

then there will be no further counteraction.

The mismatch is not fully counteracted if the equivalent non-UK provision does not reduce the amount of the deduction by the full amount of the mismatch as quantified under s259CB. If that is the case then s259CE will only apply to the extent that it has not been fully counteracted.

## **INTM551050: Hybrids: Chapter 3 - Financial Instruments: Overseas counteraction where s259CD would apply**

### **The primary response**

If the UK is the payer jurisdiction the UK will deny the deduction.

An exception to this is where the overseas counteraction is equivalent to our rules at sections 931B(c) and 931D(c) Corporation Taxes Acts 2009, which remove an exemption on the taxation of distributions where a deduction is allowed to a resident of any territory in respect of that distribution.

Recognition of any overseas counteractions, other than under a rule equivalent to s259CE, will need to be considered by the Foreign Profits Team in CTIS.

## **INTM551090: Hybrids: Chapter 3 - Financial Instruments: Example**

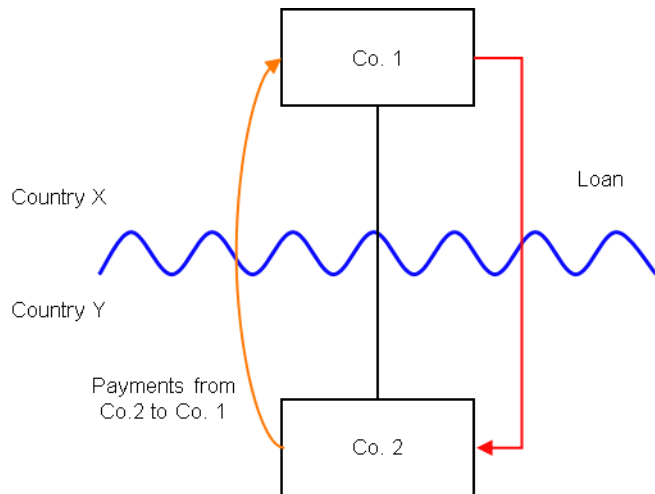
### **General comment on the examples**

A number of scenarios are illustrated because they correspond to examples included in the Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements published by the Organisation for Economic Cooperation and Development ("OECD") on 5 October 2015. Although they illustrate scenarios that could lead to a mismatch where a financial instrument issued by a company in one tax jurisdiction is held by a company in another, they may not give rise to a mismatch where one of the jurisdictions is the UK, as a result of existing rules.

For instance, a UK tax exemption for distributions received under Part 9A CTA 2009 will not apply where the dividend is tax-deductible to the issuer – Section 931B(c) or 931D(c) CTA 2009.

Nevertheless, the examples are included to demonstrate the principles underlying the relevant parts of the hybrid and other mismatch legislation.

## INTM551100: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment - Debt/equity hybrid



### Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X, which owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but
- the terms of the loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements

Under the laws of Country Y the loan is treated as a debt instrument, and as such the payments of interest under the Loan are deductible in calculating Co. 2's ordinary income for a taxable period.

Under the laws of Country X the loan is treated as an equity instrument (i.e. shares), and as such the payments of interest under the loan are treated as dividends. Country X exempts dividends received from a foreign company where the recipient controls the payer. If the instrument had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts.

The payee is not a relevant investment fund as defined in s259NA.



The loan does not qualify as a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 SI 2013/3209). If it did, it would not be a financial instrument - s259N(3)(b).

## **Applying the tests in s259CA TIOPA 2010**

### **Condition A: Are the payments of interest made under, or in connection with, a financial instrument?**

The payments (defined in s259BB) of interest are made in satisfaction of the obligations arising under the loan, which would be defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N. Condition A is therefore satisfied.

### **Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B will be satisfied.

If the UK is neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required.

### **Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to these payments?**

The background suggest it is reasonable to suppose that Country Y will allow Co. 2 a deduction (the relevant deduction) for the payment of interest against its ordinary income. It is also reasonable to suppose that, by reason of the terms of the loan, Country X will not require Co. 1 to bring the corresponding receipt into tax as ordinary income.

Therefore Case 1, as defined in s259CB(2), applies to characterise the payment as a “hybrid or otherwise impermissible deduction/non-inclusion mismatch”, in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arises to the payee in the permitted taxable period, and all or part of that excess arises by reason of the terms of the financial instrument.

Note: It may be that Country X is the UK or, like the UK, has adopted a rule that denies an exemption to Co. 1 for dividends received that have not borne tax at the entity level, or restricts that exemption. The relevant UK rules are found at sections 931B(c) and 931D(c) Corporation Taxes Acts 2009.

To the extent that the Country X provision’s effect is to include that receipt as ordinary income of Co. 1 then, to that extent, it will not be treated as a

'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.  
See [INTM551050](#) for more details.

The UK's counteractions under this legislation act alongside the UK's other domestic rules. Examples of the type of rules that might be applicable would be dividend exemption denial, Transfer Pricing, the Group Mismatch legislation or the Unallowable Purpose Loan Relationship rule.

**Condition D: Are the two companies related or is the loan, or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies satisfy the requirements of s259NC TIOPA 2010, and therefore Condition D is satisfied.

There is therefore no need to consider whether the arrangement is also a structured arrangement.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', the relevant counteractions will need to be considered.

**Counteraction**

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

**Primary Response**

Where the UK is in the position of Country Y (the payer jurisdiction) s259CD TIOPA 2010 will apply and Co. 2's allowable deductions in relation to the payments of interest must be reduced to the extent that the deduction is a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.

In this example Country X exempts the receipt from tax, therefore the excess is the entire amount and none of the deduction will be allowed.

If Country X had subjected the receipt to a rate of taxation lower than the full marginal rate for interest income, then the deduction will be disallowed by an amount as quantified under s259CB (9) TIOPA 2010.

**Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

## **Secondary Response**

Where the UK is in the position of Country X (the payee jurisdiction) and, under the law of Country Y, the deduction to Co. 2 has been fully counteracted under either s259CD a provision equivalent to the counteraction at s259CD, then no further action will be taken by the UK.

If however under the law of Country Y the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully counteracted to disallow the entire deduction then s259CE TIOPA 2010 will apply and the UK will counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' by including that amount as income arising for the counteraction period.

Where the UK is in the position of Country X then the UK legislation should operate to make the distribution receipt either wholly taxable or wholly exempt – it would not treat it as partially exempt.

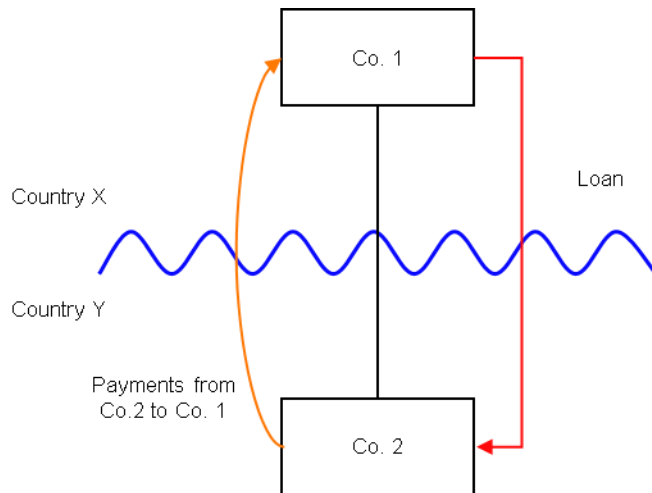
Additionally section 931D(c) or section 931B(c) CTA 2009 would operate in cases where a deduction has been allowed in Co. 2 to require the receipt to be brought into charge (HMRC International Manual INTM652030 refers). Where this has occurred it would take precedence over the counteractions below as there would be no remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' to be addressed.

Where the UK is in the position of both Country X and Country Y (i.e. where the transaction is not cross-border but wholly domestic and if it is assumed that UK law would otherwise permit a mismatch) any counteraction will be applied to the payer. S259CD takes priority over s259CE by virtue of s259CE(1)(b)(i). D

## **Reasonable Supposition**

Where any reasonable suppositions have been made in applying the tests above, and those suppositions turn out to be mistaken or cease to be reasonable, then s259L enables just and reasonable consequential adjustments to be made (subject to any time limits).

## INTM551110: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment - Partial exemption



### Background

- Co. 2 is a company resident in Country Y.
- Co. 1 is a company resident in Country X, which owns all the shares in Co. 2.
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.

Under the laws of Country Y the Loan is treated as a debt instrument, and as such the payments of interest under the Loan are deductible in calculating Co. 2's taxable profit for a taxable period.

Under the law of Country X the Loan is treated as an equity instrument (i.e. shares), and so the sums received under the Loan are treated as dividends.

Country X partially exempts dividends received from foreign companies where the recipient controls the payer. The exemption applies to 90% of the dividend received. Co. 1 benefits from this exemption on receipt of the payment due to Country X's treatment of the Loan.

If the Loan had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts.

The payee is not a relevant investment fund as defined in s259NA.

The loan does not qualify as a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209). If it did, it would not be a financial instrument - s259N(3)(b).

## **Analysis - Applying the tests in s259CA TIOPA 2010**

### **Condition A: Are the payments of interest made under, or in connection with, a financial instrument?**

The payments (defined in s259BB) of interest are made in satisfaction of the obligations arising under the Loan, which would be defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N. Condition A is therefore satisfied.

### **Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

If Co. 1 and Co. 2 were both within the charge to corporation tax then, as both payer and Payee Company are chargeable to CT, Condition B would be satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied as neither Co. 1 nor Co. 2 will be within the charge to corporation tax. No further analysis is required.

### **Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

The background above, suggest that it is reasonable to suppose Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income, as interest payments are usually an allowable deduction. It is also reasonable to suppose that Country X will not require Co. 1 to bring the entire corresponding receipt into tax as ordinary income due to the payment being treated as a partially exempt equity receipt.

Therefore, Case 1 as defined in s259CB (2) applies to create a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms of the financial instrument – being the interaction of the terms of the loan and the recognition of the relationship between Co. 1 and Co. 2 in Country X.

This is a case of a mismatch of amounts (case 1) rather than an undertaxed mismatch (case 2) as 90% of the receipt has not been brought in as ordinary income, but the remaining 10% has been fully included.

If instead Country X had brought the entire amount into charge as ordinary income but subjected it to a tax rate that was lower than that which would have been imposed if it had been treated as finance income, Case 2 would apply. (See example at [INTM551120](#))

**Note:**

Where the UK is in the position of Country X then the UK legislation should operate to make the distribution receipt either wholly taxable or wholly exempt – it would not treat it as partially exempt.

Additionally section 931D(c) or section 931B(c) CTA 2009 would operate in cases where a deduction has been allowed in Co. 2 to require the receipt to be brought into charge (HMRC International Manual INTM652030 refers). Where this has occurred it would take precedence over the counteractions below as there would be no remaining ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ to be addressed.

**Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies satisfy s259NC TIOPA 2010, and therefore Condition D is satisfied.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, the relevant counteractions need to be considered.

**Counteraction**

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both). The following counteractions will take effect on the basis that Country X has not already restricted its partial exemption under other legislative provisions.

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

**Primary Response**

Where the UK is in the position of Country Y (the payer jurisdiction) then s259CD TIOPA 2010 will apply and Co. 2’s allowable deduction in relation to the payments of interest must be reduced by the amount of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’. In this case, that is equal to the amount that is fully exempt from tax as a result of the partial exemption of dividend income under Country X’s laws.

As the dividend received by Co. 1 is treated by Country X as exempt for 90% of the receipt then only the remaining 10% of the receipt is being taxed at the full marginal rate in Country X. The application of the s259CD TIOPA 2010 will limit the allowable deduction in Co. 2 to the amount taxed in Co. 1 in Country Y (equal to 10% of the dividend received). Therefore only 10% of the deduction is allowable in Co. 2 and the remaining 90% will be disallowed.

**Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

**Secondary Response**

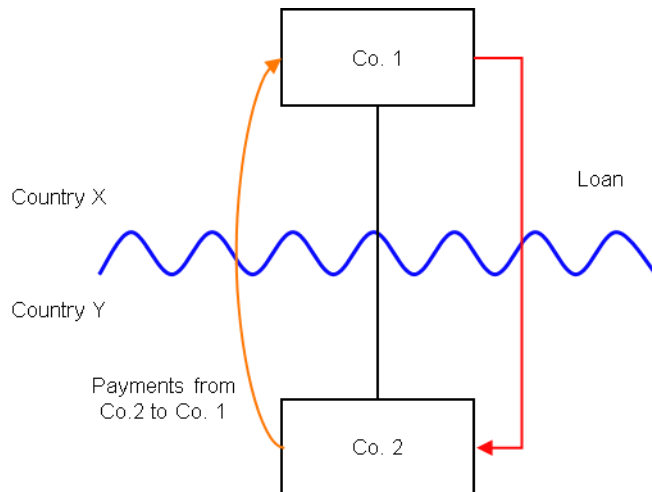
The following will only apply where, exceptionally, the outcomes detailed under Condition C above have not taken precedence over these provisions.

Where the UK is in the position of Country X (the payee jurisdiction) then if, under the law of Country Y, the deduction to Co. 2 has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010, then no further action will be taken by the UK.

If however, under the law of Country Y, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully addressed, then s259CE TIOPA 2010 will apply and the UK will counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' by including that amount as income arising for the counteraction period.

Where the UK is in the position of both Country X and Country Y. (i.e. the transaction is not cross-border) then, to the extent that other UK domestic law would permit such a mismatch section259CD, denial of a deduction, will always apply in priority to s259CE. This is as a result of s259CE(1)(b)(i) which dis-applies the section if s259CD applies giving denial of a deduction to the payer priority over bringing amounts into account in the hands of the payee.

## INTM551120: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment – payee is under-taxed



### Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.

Under the laws of Country Y the Loan is treated as a debt instrument, and as such the payments of interest under the Loan are deductible in calculating Co. 2's ordinary income for a taxable period.

Under the law of Country X the Loan is treated as an equity instrument (i.e. as shares), and so the payments of interest under the Loan are treated as dividends.

Country X taxes dividends from wholly owned subsidiaries at a lower rate than it taxes interest.

If the instrument had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts at the normal rate applicable to ordinary income.

The payee is not a relevant investment fund as defined in s259NA.



The loan does not qualify as a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209). If it did, it would not be a financial instrument - s259N(3)(b).

## **Analysis - Applying the tests in s259CA TIOPA 2010**

Do the interest payments satisfy the relevant conditions and thus fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Are the payments of interest made under, or in connection with, a financial instrument?**

The payments (defined in s259BB) of interest are made in satisfaction of the obligations arising under the Loan, which would be defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N. Condition A is therefore satisfied.

### **Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

In the event the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

In the event the UK is country X, Co. 1 is the payee and is within the charge to corporation tax.

Condition B will therefore be satisfied provided one of the above circumstances is satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax, then condition B would be satisfied as both payer and payee company are within the charge to corporation tax.

### **Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

The above background suggest that it is reasonable to suppose that Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income, as interest payments are an allowable deduction. It is also reasonable to suppose that Co. 1 will treat the receipt as dividend income, chargeable to tax at the lower rate for dividends.

This reduced rate is less than the highest rate applicable to income arising from a financial instrument (full marginal rate).

Therefore, Case 2 as defined in s259CB (7) applies to create a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that there is an amount of ordinary income that arises, by reason of the payment, to the payee for a permitted taxable period, and is under taxed by reason of the terms or other feature of the financial instrument – being a combination of the terms of the loan and the recognition of the relationship between Co. 1 and Co. 2 in Country X

**Note:** Where the UK is in the position of Country X then the UK legislation may operate to make the distribution receipt either wholly taxable or wholly exempt – it would not treat it as partially exempt.

Additionally section 931D(c) or section 931B(c) CTA 2009 would operate in cases where a deduction has been allowed in Co. 2 to require the receipt to be brought into charge (HMRC International Manual INTM652030 refers). Where this has occurred it would take precedence over the counteractions below as there would be no remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' to be addressed.

**Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies satisfy the requirements to be considered within s259NC TIOPA 2010.

## Conclusion

All the conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', and the relevant counteractions need to be considered.

## Counteraction

Co. 1 in Country X will have been charged a lower rate applicable to dividend on the receipt.

The amount of the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' is calculated by means of the formula in s259CB (8) TIOPA 2010 -

$$\frac{UTA \times (FMR - R)}{FMR}$$

Where:

- UTA is the under-taxed amount. This is the amount of dividend charged at a reduced rate in Country X.

- FMR is the payee's full marginal rate (expressed as a %) for the permitted taxable period in which the under-taxed amount is included in taxable profit. This is the highest rate which would have been charged on income from a financial instrument in Country X.
- R is the rate (expressed as a %) at which the relevant tax is charged on the ordinary income in which the under taxed amount is included. This is the lower rate being applied to the dividend income.

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

### **Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

#### **Primary Response**

Where the UK is in the position of Country Y (the payer jurisdiction), s259CD TIOPA 2010 will apply. Co. 2's allowable deduction in relation to the payments of interest must be reduced by an amount equal to the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.

The 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' is calculated by using the formula above. This amount is the amount disallowed in Co. 2 by s259CC.

### **Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

#### **Secondary Response**

The following will only apply where, exceptionally, the outcomes detailed in the note under Condition C above have not taken precedence over these provisions.

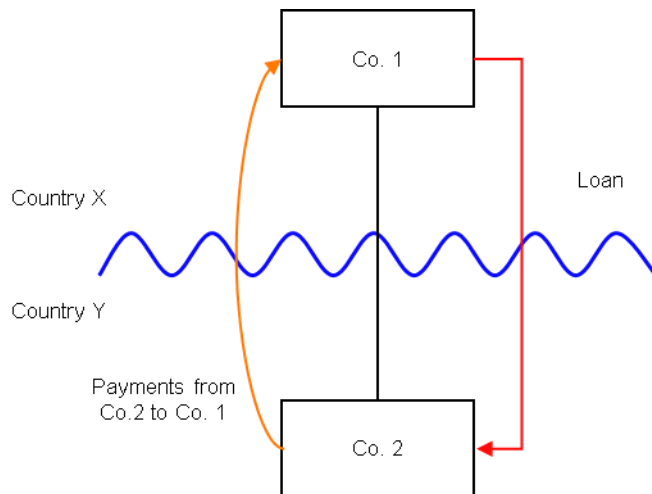
Where the UK is in the position of Country X (the payee jurisdiction) then if (under the law of Country Y) the deduction to Co. 2 has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010, then no further action will be taken by the UK.

If however, under the law of Country Y, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully addressed, then s259CE TIOPA 2010 will apply and the UK will counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' by including that amount as income arising for the counteraction period.

Again, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' is calculated by using the above formula.

## INTM551130: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment – payee has no tax jurisdiction

**Note.** Under existing UK corporate tax law a mismatch of the type illustrated here should not arise. The example is included to illustrate how Part 6A would apply in this hypothetical scenario.



### Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
- Co. 1 lends money to Co. 2 on arm's length terms ('the Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.

Applying the tax laws of Country Y to Co. 2 the Loan is treated as a debt instrument, and as such the payments of interest under the Loan is deductible in calculating Co. 2's ordinary income for a taxable period.

Country X does not tax income, profits or gains and Co. 1 does not have a taxable presence in any other jurisdiction.

Had Co. 1 been a company resident in Country Y then it is likely the terms of the instrument would lead to be it being characterised as an equity instrument, in the hands of the holder – this could be by some interaction between its terms and relationship.

Co. 1's receipt of the interest payment is not subject to tax as income, profit or gains.

The payee is not a relevant investment fund as defined in s259NA, and neither does the excess arise by reason of a relevant debt relief provision as listed in s259CC.

The loan does not qualify as a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209). If it did, it would not be a financial instrument - s259N(3)(b).

## **Analysis - Applying the tests in s259CA TIOPA 2010**

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Are the payments of interest made under, or in connection with, a financial instrument?**

The payments (defined in s259BB) of interest are made in satisfaction of the obligations arising under the Loan, which would be defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N. Condition A is therefore satisfied.

### **Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

The background above suggests the UK cannot be Country X, as the UK taxes income, profits and gains. Where the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B will therefore be satisfied in this example only where the UK is Country Y, the payer jurisdiction.

### **Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

The background above requires that it is reasonable to suppose Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income as interest payments are usually an allowable deduction. As Country X does not tax income, profits or gains, it is also reasonable to suppose that Co. 1 is not required to bring the corresponding receipt into tax as ordinary income.

However Case 1, as defined in s259CB (2), includes a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' where the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and

requires that all or part of that excess arises by reason of the terms, or any other feature, of the financial instrument. As there is no variation of the terms, or any other feature, of the Loan which would result in enhanced ordinary income within Co. 1, then this requirement is not satisfied.

However, we need to apply the relevant assumption at s259CB(5)(c), by virtue of s259CB(4), as Co. 1 is not within the charge to a tax under the law of any territory either as a resident or through a permanent establishment. We therefore need to test whether the mismatch would still have arisen after making the assumption that Co. 1 is a company that is resident in Country Y (the UK) for tax purposes, and carries on a business here in connection with which the payment is made. If a mismatch would still have arisen then it is to be treated as arising by reason of the terms, or any other feature, of the Loan.

Furthermore, once Co. 1 is assumed to be a UK resident s259CB(6) requires that certain other rules should be disregarded for the purposes of testing whether the mismatch would still have arisen. The disregarded provisions include the unallowable purpose rules, the transfer pricing rules as well as Part 6A itself.

Applying the background in this hypothetical example, had Co. 1 been UK resident, it is assumed that the receipt would also have been treated as a distribution, and the return on it non-taxable, by reason of a term or feature in the Loan, and a mismatch would have arisen. Therefore the rules recognise that there is hybridity in the financial instrument which is targeted by the legislation.

**Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies are related within s259NC TIOPA 2010 and therefore Condition D is satisfied.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', the relevant counteractions need to be considered.

**Counteraction**

A counteraction under these provisions will only apply where the UK is in the position of the payer jurisdiction.

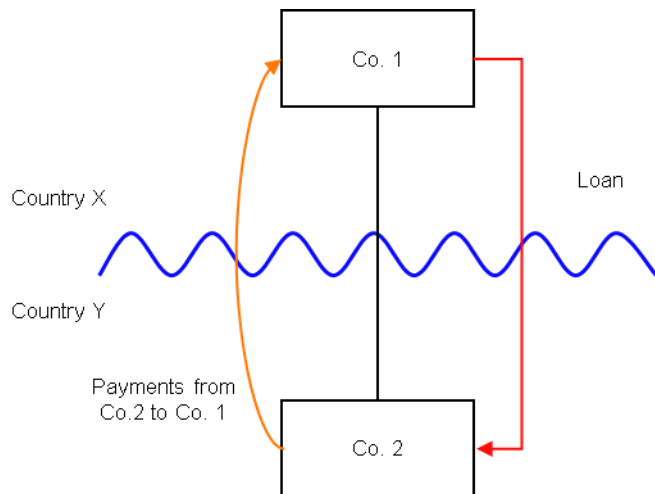
**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

Where the UK is in the position of Country Y (the payer jurisdiction) then, in this hypothetical scenario, s259CD TIOPA 2010 will apply and Co. 2's allowable deduction in relation to the payments of interest must be reduced by

the amount of the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'. In this case, that is equal to the amount that is not chargeable to tax as a result of the Country X not charging tax on income, profits or gains.

## INTM551140: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment – payee in territorial tax regime

**Note.** Under existing UK corporate tax law, a theoretical UK/UK mismatch of the type illustrated here should not arise. The example is included to illustrate how Part 6A would apply in this hypothetical scenario.



### Background

- Co. 1 is a company resident in Country X, and owns all the shares in Co. 2.
- Co. 2 is a company resident in Country Y.
- Co. 1 lends money to Co. 2 on arm's length terms, but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.

Applying the tax laws of Country Y to Co. 2 the Loan is treated as a debt instrument, and as such the payment of interest under the Loan is deductible in calculating Co. 2's ordinary income for a taxable period.

Country X administers a territorial tax system and therefore does not tax income unless it has a domestic source.

Had Co. 1 been a company resident in Country Y then it is assumed to be likely the terms of the instrument would lead to be it being characterised an equity instrument, in the hands of the holder – this could be by some interaction between its terms and relationship.



Co. 1's receipt of the interest payment is not subject to tax as income, profit or gains because it does not have a domestic source from Country X's perspective.

The payee is not a relevant investment fund as defined in s259NA.

The loan does not qualify as a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209). If it did, it would not be a financial instrument - s259N(3)(b).

## **Analysis - Applying the tests in s259CA TIOPA 2010**

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Are the payments of interest made under, or in connection with, a financial instrument?**

The payments (defined in s259BB) of interest are made in satisfaction of the obligations arising under the Loan, which would be defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N. Condition A is therefore satisfied.

### **Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

The UK cannot be Country X, as it does not operate a pure territorial tax system.

Where the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B will therefore be satisfied only where the UK is the payer jurisdiction.

### **Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

The background above require it to be reasonable to suppose Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income, as interest payments are usually an allowable deduction.

However, as Country X operates a pure territorial system and does not tax foreign source income, profits or gains, the payment received on the financial instrument issued by Co 2 will not be taxable, irrespective of whether the instrument is classified as debt or equity. Accordingly, it is reasonable to

suppose that Co. 1 is not required to bring the corresponding receipt into tax as ordinary income.

It is also necessary to consider the position making the relevant assumptions in s259(5).

As County X is not a no tax jurisdiction, due to it taxing income arising from a domestic source, it is not necessary to make the assumption in subsection (5)(c) that Co. 1 is resident in the UK. Thus, the analysis is not the same as in the example at [INTM551130](#).

Co 1 is not benefitting from any special exemption under the law in Country X and it makes no difference to its county X tax position whether or not the return on the security issued by Co. 2 is held in connection with a business carried on in Country X. So subsections 5(a) and (b) also do not alter the analysis. It is thereby sufficient to consider only Co 1's actual tax position in Country X.

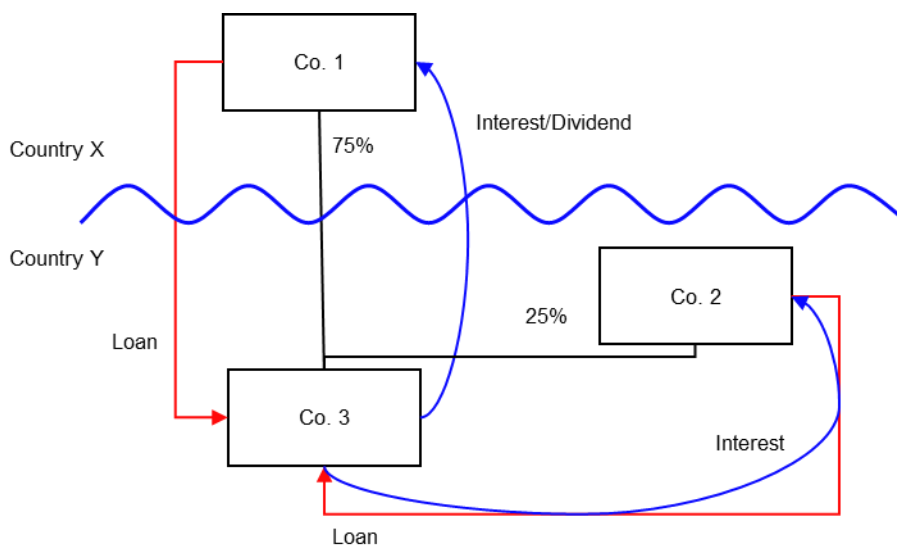
Case 1, as defined in s259CB (2), includes a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' where the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, but requiring that all or part of that excess arises by reason of the terms, or any other feature, of the financial instrument. As there is no variation of the terms, or any other feature, of the Loan which would result in enhanced ordinary income within Co. 1, then this requirement is not satisfied.

The mismatch is solely in relation to the nature of the tax regime in Co. 1's territory of residence under which it is exempt on foreign income from any source.

It follows that Condition C is not satisfied, and this mismatch is beyond the scope of these rules.

## INTM551150: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment – debt recharacterised as equity

**Note.** Under existing UK corporate tax law, a mismatch should not arise where Country X is the UK, because of the impact of other domestic law. The example is included to illustrate how Part 6A would apply in this hypothetical scenario.



### Background

- Co. 3 is resident in Country Y.
- Co. 2 owns 25% of the equity in Co. 3, and is also resident in Country Y.
- Co. 1 owns 75% of the equity in Co. 3, but is resident in Country X.
- Co. 3 needs additional debt financing, and Co. 1 and Co. 2 agree to fund this in proportion to their shareholding in Co. 3 ('the Loans').

Country Y treats the Loans as debt instruments: Co. 3 claims a deduction for the relevant interest payments and Co. 2 includes its receipts in its tax return.

As the Loans are established by reference to the equity held, Country X is assumed to treat the Loans as equity and interest payments as returns on equity.

The "dividend" received is exempt from tax in Country X.

The payee is not a relevant investment fund as defined in s259NA.

## **Analysis - Applying the tests in s259CA TIOPA 2010**

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Are the payments of interest made under, or in connection with, a financial instrument?**

All payments (defined in s259BB) of interest in this example are made in satisfaction of the obligations arising under the Loans, which would be defined as financial instruments for the purposes of UK GAAP, and therefore fall within the definitions provided in s259N. Condition A is therefore satisfied.

### **Condition B: Is Co. 1 or are Co. 2 and Co. 3 within the charge to corporation tax for a relevant payment period?**

For the purpose of this example we are considering the situation in both cases i.e. where the UK is in the position of Country X or Country Y (according to this example, the transactions between Co. 2 and Co. 3 will be wholly domestic transactions). Therefore Condition B will be satisfied.

If the UK was neither in the position of Country X nor Country Y then this condition would not be satisfied and no further analysis is required.

### **Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to these payments?**

The background suggest it is reasonable to suppose that Country Y will allow Co. 2 a deduction (the relevant deduction) for the payment of interest against its ordinary income. It is also reasonable to suppose that, by reason of a feature of the Loans (the relationship and proportionality to the relevant shareholding interests), Country X will not require Co. 1 to bring the corresponding receipt into tax as ordinary income.

Therefore, Case 1 as defined in s259CB(2) applies to create a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms or any other feature of the financial instrument.

Note: Where Country X is the UK, it should be noted that even if the financial instrument fell to be treated as equity for tax purposes, s931B(c) or 931D(c) CTA 2010 would deny an exemption to Co. 1 for distributions received that are tax-deductible to the payer. In this hypothetical scenario, designed to illustrate the principles underlying Part 6A TIOPA 2010, it is assumed that, but for Part 6A, the instrument would be treated as equity and that the payments received would not be subject for CT.

Where Country Y is the UK and Country X has adopted a similar rule, which denies an exemption to Co. 1 for dividends received that have not borne tax at the entity level, or restricts that exemption then to the extent that this provision's effect is to include that receipt as ordinary income of Co. 1 it will be recognised as included and will not be treated as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'

**Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?**

Although neither Co. 1 nor Co. 2 owns all the shares in Co. 3 the companies are related as the 25% investment condition within s259NC TIOPA 2010 is satisfied. Therefore Condition D is satisfied. There is no need to consider the remaining parts of the condition.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', the relevant counteractions therefore need to be considered.

**Counteraction**

The appropriate counteraction to counteract this mismatch will depend upon whether the UK is in the position of Country X or Country Y.

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

**Primary Response**

According to the background, the payment of the interest from Co. 3 to Co. 2 (all within Country Y) does not give rise to a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' as an interest payment is matched with corresponding ordinary income.

With regard to the payment of interest between Co. 3 and Co. 1 then as Country X treats the payment received by Co. 1 as a dividend, it is reasonable to suppose a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' will arise to the extent of the relevant payment.

Where the UK is in the position of the payer jurisdiction (i.e. Country Y), then s259CD will apply and Co. 3's allowable deduction in relation to the payments of interest will be restricted in proportion to the amounts payable to Co. 1 (which is treated as exempt from taxation under Country X's laws). From the background this is likely to therefore result in a denial of 75% of the relevant deduction, being 100% of the Loan payable to Co. 1.

**Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

In this hypothetical example, where the UK is in the position of a payee jurisdiction (i.e. Country X, but not, in this example, also a payer jurisdiction) it is assumed that the receipt is regarded as an equity dividend in nature and that, but for Part 6A, the dividend would be exempted from tax, therefore s259CE TIOPA 2010 must be considered.

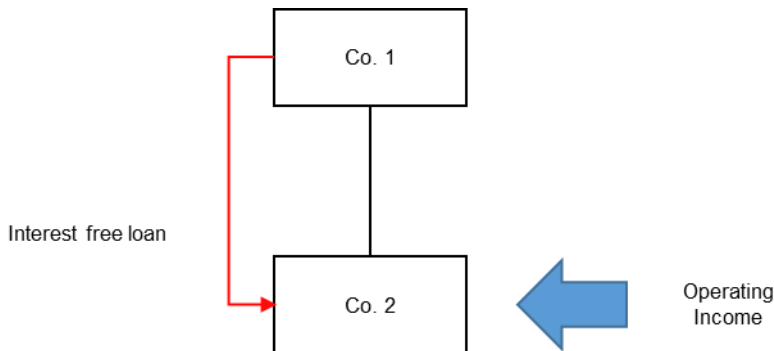
If, by reference to the law of Country Y, the deduction for the interest/ dividend paid by Co. 3 and received by Co. 1, has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010 then no further action will be required in the UK.

If however, Country Y has not fully addressed the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', then s259CE TIOPA 2010 will apply and the UK should counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', as quantified by s259CE(6) TIOPA 2010, by including that amount as income arising for the counteraction period.

If for example, Country Y only allowed Co. 3 a deduction for 50% of the total interest payable on the loan, then s259CE would be applied in the UK to treat the balance of 25% received by Co. 1 as income arising for the counteraction period.

## INTM551160: Hybrids: Chapter 3 - Financial Instruments: Example: Interest free loan – deemed discount

Note - the accounting and tax treatment shown here is hypothetical being designed to illustrate the principles underlying the legislation



### Background

- Co. 1 is a company resident in the UK
- Co. 1 establishes a subsidiary, Co. 2, also in the UK
- Co. 1 provides Co. 2 with capital of 40, which consists of 5 share capital and 35 interest-free loan (the 'Loan')
- The Loan is repayable in full at the end of the five years
- The Loan is treated as a debt instrument under the laws of the UK

For the purposes of the examples it is assumed that applying local GAAP, which is assumed to be respected for tax, Co. 2 is required to split an interest free loan from its parent company (Co. 1) into two separate components:

- a loan of principal amount 35, which Co. 2 is treated as having issued to Co. 1 at a discount of 10, such that its initial carrying value is 25, and
- a deemed equity contribution equal to the amount of that discount (10).

The amount that Co. 2 treats as due for the interest free loan is based on an arm's length valuation.

The payee is not a relevant investment fund as defined in s259NA

Co. 2 – Assets, Liabilities and Equity

Assets – Fixed assets	40
Liabilities – Shareholder loan	(25)
Equity:	
Share capital	5
Other equity	10

Table 1

As is detailed in Table 1 above, Co. 2 has treated the interest free sum of 35 as an equity contribution of 10 and a loan whose initial carrying value is 25. In each accounting period Co. 2 will be required to accrue a portion of the deemed discount on the loan as an expense for accounting purposes and to treat this expense as funded out of Co. 1's deemed equity contribution.

Table 2 below provides a simplified illustration of how Co. 2 might account for the accrued liability under the shareholder loan as at the end of Year 1.

Co. 2 – Assets, Liabilities and Equity	Co. 2 – Income
<b>Asset 45</b>	<b>Income Tax Cash</b>
Current assets (cash) 5	Operating income 5 5
Fixed assets 40	<b>Expenditure</b>
<b>Liabilities 27</b>	Accrued liability on (2)
Shareholder loan 27	shareholder loan
<b>Equity 22</b>	<b>Net return 3</b>
Share Capital 5	
Other Equity 8	

Table 2



In this case Co. 2 treats the deemed discount as accruing at the implied internal rate of return of 8.0%, so at the end of Year 1 the shareholder Loan is recorded on the balance sheet as 27 (an increase of 2).

'Other equity' has subsequently been reduced by the 2, taken to the shareholder loan as the interest expense, and then increased by the 5, being the operating income received during the period.

For the purposes of this example, it is assumed that UK tax law permits this deemed increase in liabilities to be treated as a current expense in Year 1 so that, as Co. 2 has operating income of 5 in that year, its accounts show a net return of only 3.

Applying the same accounting treatment in each of the following years will permit the entire discount to be expensed over the life of the Loan so that, at maturity, the shareholder Loan will be recorded on the company's balance sheet at its face value (35).

Co. 1 adopts different accounting standards from Co. 2 and under those standards it is not required to bifurcate the interest free Loan into equity and debt components.

Accordingly the accrued liability recorded in Co. 2's accounts in each year is not recognised as income by Co. 1.

On repayment of the loan the entire amount paid by Co. 2 is simply treated as a non-taxable return of loan principal.

## **Analysis - Applying the test in s259CA TIOPA 2010**

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

**Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?**

The Loan would be defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N TIOPA 2010.

Co. 2 may claim a deduction against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it adopted the same accounting approach as Co. 2 – an assumption required by s259BB(4)(b). Therefore the accrued expense satisfies the definition of a quasi-payment within s259BB (2) TIOPA 2010.

Condition A is therefore satisfied.

**Condition B: Is Co. 1 or Co. 2 within the charge to corporation tax?**

As both Co. 1 and Co. 2 are resident in the UK, Condition B is satisfied.

**Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this quasi-payment?**

Given the background and assumed tax treatment above, it is reasonable to suppose the UK will permit Co. 2 a deduction (relevant deduction) for the accrued obligation under the loan against its ordinary income. It is also reasonable to suppose that the UK will not require Co. 1 to bring the corresponding amount into tax as ordinary income.

Therefore Case 1, as defined in s259CB (2), applies to characterise the quasi-payment as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the quasi-payment, arise to Co. 1 in the permitted taxable period, and all or part of that excess arises by reason of the terms or any other feature of the financial instrument – the mismatch arises because of the loan being interest free and between related parties.

Note: It is likely in this case that the Group Mismatch Scheme rules will also apply to address the mismatch (CFM77500 refers), the unallowable purpose loan relationship rules or even possibly the transfer pricing rules.

**Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies are related as the conditions within s259NC TIOPA 2010 are satisfied. Therefore Condition D is satisfied and there is no need to consider the other parts of the condition.

**Conclusion**

All the conditions are satisfied to characterise the arrangement involving the accruals of interest under the Loan as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', and the relevant counteractions need to be considered.

**Counteraction**

Although normally, the counteraction applied will depend on whether the legislation is being applied to Co. 1 or Co. 2, in this case (where both companies are in the UK):

**Counteraction to Co. 2 (the payer) (under s259CD TIOPA 2010)**

**Primary Response**

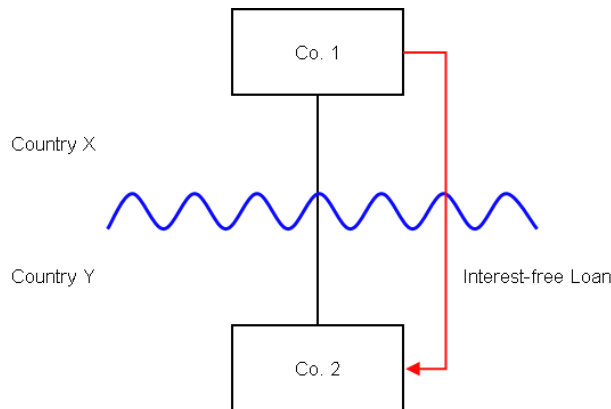
The deductions claimed would be disallowed in Co. 2.

**Counteraction to Co. 1 (the payee) (under s259CE TIOPA 2010)**

**Secondary Response**

As both companies are UK resident, both payer and payee are UK resident and therefore the primary counteraction under s259CD TIOPA 2010 would always apply, with the result that the mismatch would be counteracted in Co. 2.

## INTM551170: Hybrids: Chapter 3 - Financial Instruments: Example: Interest-free loan – deemed interest



### Background

- Co. 1 is resident in Country X
- Co. 1 owns 100% of the equity in Co. 2
- Co. 2 is resident in Country Y
- Co. 1 provides Co. 2 with an interest free loan (the 'Loan'), which is repayable in full at the end of the five years.

The law of Country Y allows Co. 2 to claim a deduction for tax purposes for the deemed interest it would have paid to Co. 1 at a market rate. It does not re-characterise the Loan to treat an element of it as relating to a discount.

Under the law of Country X, due to the relationship between the relevant parties, the Loan is treated as an equity instrument and there is no corresponding interest imputed in that country. The entire value of the Loan on repayment is treated as a return of capital.

Had Co. 1 been resident in Country Y it would have had a corresponding taxable receipt imputed on it.

The payee is not a relevant investment fund as defined in s259NA.

### Analysis - Apply the tests in s259CA

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrids and Other Mismatches from Financial Instruments rules?

**Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?**

The Loan satisfies the definition of a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N TIOPA 2010.

Co. 2 may claim a deduction against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it adopted the same accounting approach and been within the charge to tax in Country Y. Therefore the accrued expense satisfies the definition of a quasi-payment within s259BB (2) TIOPA 2010.

However, as the deduction is deemed to arise to Co. 2 for tax purposes we need to consider if s259BB (3) exempts it from being treated as a quasi-payment. In this situation the Loan represents the existence of economic rights between Co. 1 and Co. 2. The relevant deduction would not have arisen if it were not for the circumstances under the Loan existing. As such it is a quasi-payment.

Condition A is therefore satisfied.

Note: Were the situation instead that had Co. 1 been resident in Country Y then Co. 2 would not have been permitted a deduction for the deemed interest (i.e. it was relief only permitted for overseas investments), and as such Co. 2 would still not have been required to bring in a corresponding tax receipt, then the requirements for the deemed interest to be treated as a taxable receipt would not have been satisfied.

**Condition B: Is Co. 1 or Co. 2 within the charge to corporation tax?**

If the UK is Country X or Country Y, Condition B will be satisfied.

As the background stipulate that Co. 1 would have brought in a corresponding receipt into account as ordinary income if it had been resident in Country Y, then this cannot be a wholly domestic transaction.

If the UK is neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required.

Note: It is unlikely that the UK would be in the position of Country Y as under current law, deductions are not given for deemed interest payments unless the Country X had made a transfer pricing adjustment to impute agreement and an adjustment is due under the mutual agreement provisions of a tax treaty. That is a different scenario and one where no mismatch arises...

**Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this quasi-payment?**

Given the background above, it is reasonable to suppose the Country Y will permit Co. 2 a deduction (relevant deduction) for the deemed interest arising on the loan against its ordinary income. It is also reasonable to suppose that Country X will not require Co. 1 to bring the corresponding amount into tax as ordinary income.

Therefore Case 1, as defined in s259CB (2), applies to characterise the quasi-payment as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the quasi-payment, arise to Co. 1 in the permitted taxable period, and all or part of that excess arises by reason of the terms or any other feature of the financial instrument – the mismatch arises both because of the loan being interest free and between related parties.

**Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies are related as the conditions within s259NC TIOPA 2010 are satisfied. Therefore Condition D is satisfied and there is no need to consider the other parts of the condition.

**Conclusion**

All the conditions are satisfied to characterise the arrangement involving the accruals of interest under the Loan as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, and the relevant counteractions need to be considered.

**Counteractions**

The appropriate counteraction to counteract this mismatch will depend upon whether the UK is in the position of Country X or Country Y.

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

**Primary Response**

Where the UK is in the position of Country Y (the payer jurisdiction), s259CD TIOPA 2010 will apply. Co. 2’s allowable deduction in relation to the relief for deemed interest must be reduced by an amount equal to the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’. This will be the entire amount.

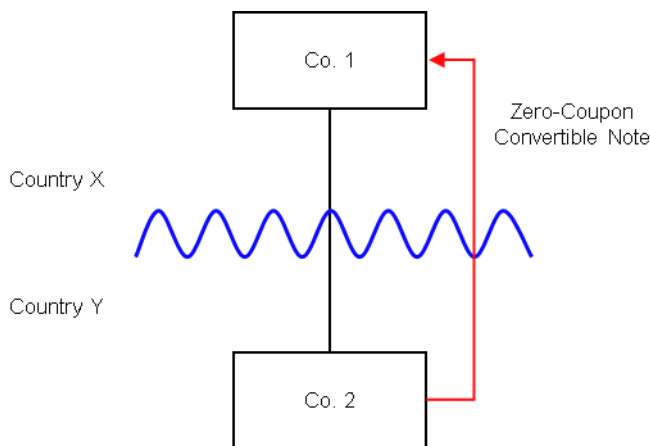
**Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

**Secondary Response**

Where the UK is in the position of Country X (the payee jurisdiction) then if (under the law of Country Y) the deduction to Co. 2 has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010, then no further action will be taken by the UK.

If however, under the law of Country Y, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully addressed, then s259CE TIOPA 2010 will apply and the UK will counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' by including that amount as income arising for the counteraction period.

## INTM551180: Hybrids: Chapter 3 - Financial Instruments: Example: Convertible note – Valuation of discount



### Background

- Co. 1 is resident in Country X and owns all the shares in Co. 2
- Co. 2 is resident in Country Y.
- Co. 1 subscribes for a five year zero-coupon convertible note (the 'Note') with a principal amount of 100.
- The Note can be converted into shares of Co. 2 at the option of Co. 1.

The laws under both Country X and Country Y bifurcate the Note for tax purposes, treating it as being issued at a discount. This discount is treated as deductible by Co. 2 and is included in ordinary income by Co. 1.

Country Y treats Co. 1 as having paid 80 for the Note and 20 for the share option, which it is therefore entitled to accrue as a deduction for tax purposes over the term of the Note.

(It is assumed that the discount of 20 recognised in the accounts of Co. 2 does not represent an internal rate of return in excess of an arm's length amount and that Country Y would therefore not be entitled to make a transfer pricing adjustment to reduce the assumed discount.)

Country X adopts the same tax treatment but treats Co. 1 as having paid 90 for the Note and 10 for the share option, which it brings in as ordinary income spread over the term of the Note.

The payee is not a relevant investment fund as defined in s259NA.



## **Analysis - Applying the tests in s259CA TIOPA 2010**

Do the interest accruals satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?**

The Note is defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N TIOPA 2010.

Although there are no actual payments of interest in the intervening years until maturity, Co. 2 may claim a deduction against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it adopted the same accounting approach (which in this case it actually has).

The deduction is deemed to arise to Co. 2 for tax purposes and the accrued interest arises from an actual transfer of economic rights (being part of the principal amount of 100)

Therefore the accrued expense satisfies the definition of a quasi-payment within s259BB (2) TIOPA 2010.

Condition A is therefore satisfied.

### **Condition B: Is either Co. 2 or Co. 1 within the charge to corporation tax for a relevant payment period?**

If the UK is Country X, Co. 1 as the payee, will be within the charge to corporation tax.

If the UK is Country Y, Co. 2 as the payer, will be within the charge to corporation tax.

Condition B will therefore be satisfied in both scenarios.

If Co. 1 and Co. 2 were both within the charge to corporation tax then, as both payer and payee are within the charge to corporation tax, Condition B would be satisfied.

If the UK is neither Country X nor country Y then this condition would not be satisfied and no further analysis is required.

### **Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

Given the background above, it is reasonable to suppose that if country Y is the UK, it will permit Co. 2 a deduction (relevant deduction) of 20 for the

accrued obligation under the Loan against its ordinary income. It is also reasonable to suppose that the UK will not require Co. 1 to bring more than 10 into tax as ordinary income. The deductions of 20 therefore exceed the 10 included as a receipt.

The different valuation applied to the share option by Country X and Country Y determines the characterisation of the difference between 10 and 20 (or 90 and 80); this difference is debt from the perspective of Country Y, but equity from the perspective of Country X.

In the example here where the option to convert early does create both a finance and an equity element, the split between them is being measured differently by both parties which therefore directly determines the character of 10 out of the quasi-payment made by Co. 2.

Therefore, Case 1 as defined in s259CB (2) applies to create a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the quasi-payment, arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms of the financial instrument.

Condition C is therefore satisfied.

**Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies are related as the conditions within s259NC TIOPA 2010 are satisfied. Therefore condition D is satisfied. There is thus no need to consider any other part of the condition.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', the relevant counteractions need to be considered.

**Counteractions**

The counteraction applicable will depend on whether the UK is in the position of Country X and Country Y (or both).

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

**Primary Response**

Where the UK is in the position of the payer jurisdiction (i.e. Country Y) then s259CD TIOPA 2010 will apply to the extent of the 'hybrid or otherwise

impermissible deduction/ non-inclusion mismatch' allocated to each period. This will be the case for each of the 5 years of the Note, provided it is not converted.

Assuming that Co. 2 accrues the discount over the 5 years and, for simplicity that the payment period coincides with their accounting period and that the Note is not converted then Co. 2's deductions will be restricted by an amount equal to the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in each accounting period until maturity - in this case 10 attributed to periods in accordance with the difference between the amounts that would accrue in each period on discounts of 10 and of 20 (most likely computed using the implied internal rates of return). This will be the excess attributable to that period for the purposes of s259CB (2) TIOPA 2010.

### **Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

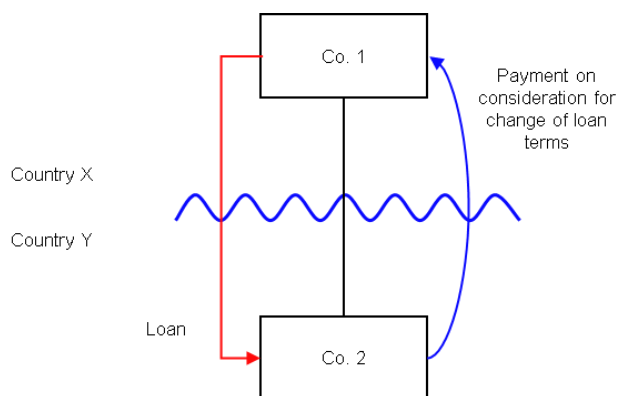
#### **Secondary Response**

As the UK is in the position of Country X (the payee jurisdiction) if, under the law of Country Y, the deduction in Co. 2 has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010, then no further action will be taken by the UK.

If however, under the law of Country Y, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully addressed then s259CE TIOPA 2010 will apply and the UK will counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' by including that amount as income arising for the counteraction period.

This will be computed in a similar manner to that outlined in the counteraction at s259CD TIOPA 2010 above if Co. 1 also recognises the discount on a straight line basis over the 5 years, that the payment period coincides with their accounting period and that the Note is not converted.

## INTM551190: Hybrids: Chapter 3 - Financial Instruments: Example: Payment to modify debt instrument



### Background

- Co. 1 is resident in Country X.
- Co. 2 is resident in Country Y.
- Co. 2 borrows money from its immediate parent Co. 1 (the 'Loan').
- The Loan has a 5 year term and pays a high fixed rate of interest (but not in excess of an arm's length rate at the time the loan was advanced).
- Co. 2 makes a one off arm's length payment to Co. 1 in consideration for Co. 1 agreeing to lower the interest rate on the Loan.
- Country Y permits Co. 2 a deduction for this payment (either when made or spread over the remaining life of the loan).
- The effect is to reduce the value of the loan as recorded in Co. 1's accounts.
- Co. 1 is not required to bring the receipt in as Ordinary Income as Country X does not subject to tax amounts attributable to a surrender of rights.
- The payee is not a relevant investment fund as defined in s259NA.

### Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest accruals satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

**Condition A: Are there payments made under, or in connection with, a financial instrument?**

The one off payment is considered a payment under s259BB (1) TIOPA 2010, being a transfer of money or money's worth in relation to which an amount (relevant deduction) may be deducted in calculating Co. 2's ordinary income for a taxable period.

It is made under the terms of the Loan, which would be defined as a financial instrument for the purposes of the definitions provided in s259N TIOPA 2010, as it is a release from an obligation to make certain payments under the loan.

This therefore satisfies condition A.

**Condition B: Is either Co. 1 or Co. 2, within the charge to corporation tax for a relevant payment period?**

Where the UK is country X, Co. 1 is a payee and will be within the charge to corporation tax.

Where the UK is Country Y, Co. 2 is the payer and will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax then, as both payer and payee are within the charge to corporation tax, Condition B would be satisfied.

Condition B will therefore be satisfied providing one of the above scenarios is satisfied.

If the UK is neither represented as Country X nor Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

**Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

Case 1 as defined in s259CB (2) applies to create a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms of the financial instrument - in this case the Loan.

It is by reason of the adjustment to the terms of the loan that the Country characterises the payment differently. If either the terms had not been adjusted, or the provisions within the Loan did not allow for such an

adjustment, then it would not be characterised as a surrender of rights and the mismatch would not have arisen.

Condition C is therefore satisfied.

As none of the consideration for agreeing to change the terms of the Loan is included in the ordinary income of Co. 1 then the extent of the mismatch is the entire relevant deduction.

**Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2, the companies satisfy the requirements within s259NC TIOPA 2010 to be considered related. Therefore condition D is satisfied. There is thus no need to consider any other part of the condition.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' the relevant counteractions need to be considered.

**Counteractions**

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y (or both).

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

**Primary Response**

Where the UK is in the position of the payer jurisdiction (i.e. Country Y) then s259CD TIOPA 2010 will apply and Co. 2's allowable deduction, in relation to the consideration amount for the change in the terms of the Loan, must be reduced by the amount of the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'. In this case the entire amount will be disallowed (spread between periods, if appropriate, to reflect its accounting treatment).

Note: If Country X had been required to treat some or all of the receipt as within the charge to tax as ordinary income at the end of the Loan term then if the delay is deemed just and reasonable then the deduction is not countered.

If it is not deemed just and reasonable then s259CD would still apply to deny the deduction, however s259LA may subsequently apply.

Where an amount of ordinary income ("the late income") arises by reason of the payment, but not as a consequence of any provision of this Part or any equivalent provision of the law of a territory outside the United Kingdom to a payee for a taxable period ("the late period") that is not a permitted taxable

period, then s259LA may apply to allow a deduction for an amount equal to the late income in the accounting period in which the late period ends. The deduction will be included at Step 2 of section 4(2) CTA 2010.

**Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

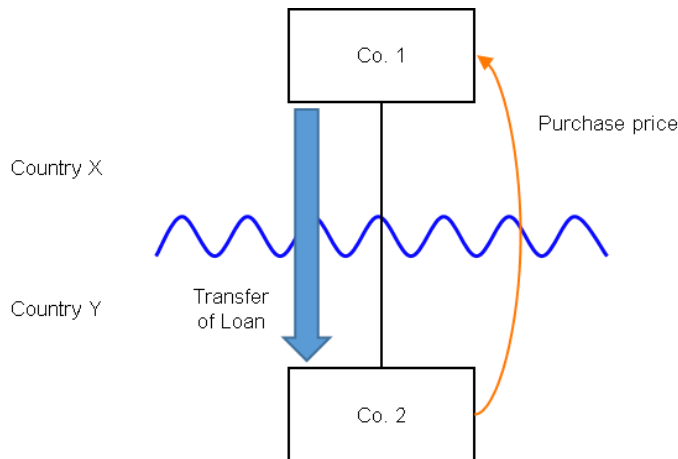
**Secondary Response**

As the UK is in the position of the payee jurisdiction (i.e. Country X) and it is assumed that, under the UK tax law applicable at the time, the payment received would not be taxed, then if, under the law of Country Y, the deduction in Co. 2 has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010, then no further action will be taken by the UK.

If, however, under the law of Country Y the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully counteracted then s259CE TIOPA 2010 will apply and the UK will counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' by including that amount as income arising for the counteraction period.

Where the UK is in the position of both Country X and Country Y i.e. the transaction is not cross border, and hypothesising that UK tax law otherwise permitted such a mismatch, counteraction will be to the position of Co.2 by means of denial of a deduction this would leave no amount to be counteracted under s259CE as regards Co.1.

## INTM551200: Hybrids: Chapter 3 - Financial Instruments: Example: Release of debt obligation



### Background

- Co. 1 is resident in Country X.
- Co. 2 is resident in Country Y.
- Co. 2 borrows money from its immediate parent Co. 1 (the 'Loan').
- The Loan has a 5 year term and pays a normal rate of interest.
- Co. 2 gets into financial difficulties and is unable to make payments of interest and principal of the Loan.
- Co. 1 agrees to forgive the Loan and releases Co. 2 from the obligation to make further payments of principal and accrued interest. Country X permits Co. 1 a deduction for the reduction in value of this asset.
- Due to the relationship between Co. 1 and Co. 2, Country Y recognises the release as an equity contribution.
- The amount of debt forgiven is treated as deductible under Country X law but is not treated as income under Country Y law.

### Analysis – Applying the tests in s259CA TIOPA 2010

Do the payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?



**Condition A: Is there a payment or quasi-payment made under, or in connection with, a financial instrument?**

The forgiveness is considered a payment under s259BA (1) TIOPA 2010, the contractual release being a transfer of money's worth directly from Co. 1 (the payer) to Co. 2 in relation to which an amount (relevant deduction) may be deducted in calculating Co. 1's ordinary income for a taxable period.

The forgiveness would satisfy the requirements to be a quasi-payment. Co. 1 may claim a deduction and it would be reasonable to expect Co. 2 to bring in a corresponding receipt if it were also resident in Country X and adopted the same approach to accounting as Co. 1. It would be unusual for a county to allow such a mismatch in domestic transactions.

The quasi-payment, is made in connection with the Loan, which would be defined as a financial instrument for the purposes of the s259N TIOPA 2010.

Condition A is therefore satisfied.

**Condition B: Is either Co. 1 or Co. 2, within the charge to corporation tax for a relevant payment period?**

If UK is Country X, Co. 1 is a payer and will be within the charge to corporation tax.

If the UK is Country Y, Co. 2 is the payee and will be within the charge to corporation tax.

Condition B will therefore be satisfied providing one of the above scenarios is satisfied.

If the scenario is such that the UK is neither represented as Country X nor Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax, then Condition B would also be satisfied, however as stated above it would be unusual for the UK legislation to allow such a domestic mismatch – the Group Mismatch rules are likely to also apply.

**Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

The relevant deduction identified in Condition A, and arising to Co. 1, exceeds the amount included in the ordinary income of Co. 2. Therefore, Case 1 as defined in s259CB (2) applies to create a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment,

arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms or feature of the financial instrument – in this case it is the relationship between the parties that allows Co. 2 to recognise it as an equity contribution as opposed to a finance return.

Condition C is therefore satisfied.

As none of the consideration for agreeing to change the terms of the Loan is included in the ordinary income of Co. 2 then the extent of the mismatch is the amount of the relevant deduction.

**Condition D: Are the two companies related, or is the Loan or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies are related as the requirements within s259NC TIOPA 2010 are met, and therefore condition D is satisfied. There is thus no need to consider any other part of the condition.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' the relevant counteractions need to be considered.

**Counteraction**

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y (or both).

**Counteraction where the UK is in the position of Country X (the payer jurisdiction)**

**Primary Response**

Where the UK is in the position of the payer jurisdiction (i.e. Country X) then s259CD TIOPA 2010 will apply and Co. 1's allowable deduction, in relation to the deduction claimed for the release of the Loan, must be reduced by the amount of the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'. In this case the entire amount will be disallowed.

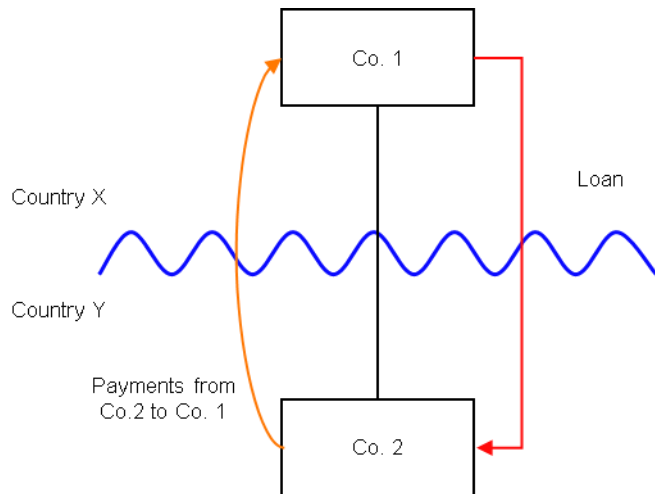
**Counteraction where the UK is in the position of Country Y (the payee jurisdiction)**

**Secondary Response**

As the UK is in the position of the payee jurisdiction (i.e. Country Y) then if, under the law of Country X, the deduction in Co. 1 has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010 then no further action will be taken by the UK.

If however, under the law of Country X, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully addressed then s259CE TIOPA 2010 will apply and the UK will counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' by including that amount as income arising for the counteraction period.

## INTM551210: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment with underlying foreign tax credit



### Background

- Co. 2 is a company resident in Country Y.
- Co. 1 is a company resident in Country X, which owns all the shares in Co. 2.
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.
- The loan does not qualify as a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 SI 2013/3209). If it did, it would not be a financial instrument - s259N(3)(b).
- Under the laws of Country Y the Loan is treated as a debt instrument, and as such the payments of interest under the Loan are deductible in calculating Co. 2's ordinary income for a taxable period.
- Under the law of Country X the Loan is treated as an equity instrument (i.e. shares), and as such payments under the Loan are treated as dividends. Country X taxes dividends at the same rate as any other income received from a financial instrument but allows for a foreign tax credit, to reflect the underlying foreign tax suffered on profits from which a dividend was paid.

- The tax credit provided to Co. 1 by Country X results from the characterisation of the income as a dividend. If the instrument had been treated as a debt instrument in Country X then Co. 1 would be taxable on those receipts at the full marginal rate for ordinary income, without the benefit of the foreign tax credit.

## **Analysis - Applying the tests in s259CA TIOPA 2010:**

Do the interest payments satisfy the relevant conditions to fall within the scope of the financial instruments mismatch arrangements rules?

### **Condition A: Are the payments made under, or in connection with, a financial instrument?**

The payments are made in satisfaction of the obligations arising under the Loan, which would be defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N. Condition A is therefore satisfied.

### **Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

In the event the UK is country X, Co. 1 is the payee and is within the charge to corporation tax.

In the event the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B will therefore be satisfied providing either of the above is satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax, as both payer and payee company are within the charge to corporation tax, Condition B would be satisfied.

Note: Under current UK tax law, a mismatch should not arise where Country X is the UK.

### **Condition C: Is it reasonable to assume that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

Given the background above, it is reasonable to assume Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income, as interest payments are usually an allowable deduction. It is also reasonable to assume that Co. 1 will treat the receipt as dividend income

chargeable to tax at the full marginal rate, but with the benefit of a foreign tax credit. As this tax credit reduces the effective tax suffered below that which would be payable at the full marginal rate applicable to ordinary income, by reason of a credit that applies specifically to this receipt, there is a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.

As such, there is a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' which is attributable to a term or feature of the Loan – it would not be treated as equity if the relationship between the parties was different, or if the debt was not subordinated.

Condition C is therefore satisfied.

**Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the requirements of S259NC are met, therefore Condition D is satisfied. There is no need to consider the remaining parts of the condition.

**Conclusion**

All the conditions are satisfied to characterise the arrangement involving the payment of interest under the Loan as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' and the relevant counteractions therefore need to be considered.

**Counteractions**

The extent of the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' is calculated by means of the formula in s259CB(11) TIOPA 2010, which is as follows:

$$\frac{UTA \times (FMR - R)}{FMR}$$

Where:

- UTA is the under-taxed amount. This is the amount of dividend benefitting from the underlying foreign tax credit.
- FMR is the payee's full marginal rate (expressed as a %) for the permitted taxable period in which the under-taxed amount arises. This is the highest rate which would have been charged on taxable profits of the payee which include ordinary income that arises from, or in connection with, a financial instrument. Under the background of this example it would equate to the rate that would be applied to the dividend in the absence of any foreign tax credit.

- R is the highest rate (expressed as %) at which tax is charged on the taxable profits in which the under-taxed amount is included, taking into account the effect of any credit for underlying tax.

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

### **Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

#### **Primary Response**

Where the UK is in the position of Country Y (the payer jurisdiction) then s259CD TIOPA 2010 will apply. Co. 2's allowable deduction in relation to the payments of interest must be reduced by an amount equal to the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', calculated according to the equation above.

### **Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

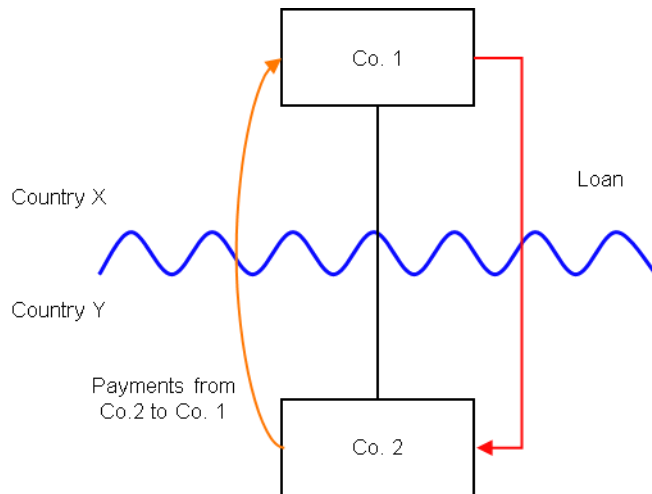
#### **Secondary Response**

Where the UK is in the position of Country X (the payee jurisdiction) then if, under the law of Country Y, the deduction to Co. 2 has been fully counteracted under the provision equivalent to the counteraction at s259CD TIOPA 2010, then no further action will be taken by the UK.

If however, under the law of Country Y, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully addressed, then s259CE TIOPA 2010 will apply and the UK must counteract the remaining 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' (as quantified by the equation above from s259CB(11) TIOPA 2010) by including that amount as income arising for the counteraction period.

This will include the situation where the UK is in the position of both Country X and Country Y. i.e. the transaction is not cross border. To the extent the counteraction at s259CD TIOPA 2010 has not fully addressed the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' then the counteraction at s259CE TIOPA 2010 will be applied to Co. 1. As noted above it is possible that the Group Mismatch rules would also apply in a purely domestic transaction to counter any mismatch.

## INTM551220: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment to a charity



### Background

- Co. 2 is a company resident in Country Y
- Co. 1 is a company resident in Country X, which owns all the shares in Co. 2
- Co. 1 is a registered charity in Country X.
- Co. 1 lends money to Co. 2 on arm's length terms (the 'Loan'), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.
- Under the laws of both Country X and Y, the Loan is treated as a financial instrument.
- Under the laws of Country Y the payments of interest under the Loan are deductible in calculating Co. 2's ordinary income for a taxable period
- Under the laws of Country X Co. 1 is exempt from tax generally by reason of being a registered charity
- In the absence of that exemption Co. 1 would still not be taxable upon the receipts as the Loan would be treated as an equity instrument (i.e. shares), and as such the payments of interest under the Loan are



treated as dividends. Country X usually exempts dividends received from a foreign company where the recipient controls the payer.

- If the instrument had been treated as a debt instrument in Country X then ordinarily a non-charity would be taxable on those receipts.
- The payee is not a relevant investment fund as defined in s259NA

### **Analysis - Applying the tests in s259CA TIOPA 2010:**

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

#### **Condition A: Are the payments made under, or in connection with, a financial instrument?**

- The payments of interest are made in satisfaction of the obligations arising under the Loan, which would be defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in S259N.
- Condition A is therefore satisfied.

#### **Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

For the purpose of this example we are considering the situation in all cases i.e. where the UK is in the position of Country X, Country Y or both (i.e. a wholly domestic transaction). Therefore Condition B will be satisfied.

If the UK was neither in the position of Country X nor Country Y then this condition would not be satisfied and no further analysis is required.

Note: If the UK were in the position of both payer and payee (i.e. a wholly domestic transaction) then it is likely that the denial of distribution exemption rules would also apply to address the mismatch.

#### **Condition C: Is it reasonable to suppose that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to these payments?**

The background suggest it is reasonable to suppose that Country Y will permit Co. 2 a deduction (the relevant deduction) for the payment of interest against its ordinary income. It is also reasonable to suppose that Country X will not require Co. 1 to bring the corresponding receipt into tax as ordinary income.

Case 1, as defined in s259CB (2), qualifies a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' where the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason

of the payment, arise to each payee in the permitted taxable period, but requiring that all or part of that excess arises by reason of the terms, or any other feature, of the financial instrument. As Co. 1 is not subject to tax on its receipts there is no variation of the terms, or any other feature, of the Loan which would result in enhanced ordinary income within Co. 1, then this requirement is not satisfied.

However, we need to apply the relevant assumption at s259CB(5)(a), by virtue of s259CB(4), as Co. 1 is not within the charge to a tax under the law of any territory because it benefits from an exemption by reason of being a registered charity. We therefore need to test whether the mismatch would still have arisen after making the assumption that Co. 1 does not benefit from such an exemption. If a mismatch would still have arisen then it is to be treated as arising by reason of the terms, or any other feature, of the Loan.

Applying the background in this specific example then had Co. 1 not benefitted from the 'registered charity' exemption the receipt would not have been brought in as ordinary income as it would have been treated as equity, by reason of a combination of the term of the Loan and the relationship between the parties. A mismatch in the full amount of the deduction would still have arisen. Therefore the rules recognise that there is hybridity in the financial instrument which is targeted by the legislation

As such Condition C is satisfied.

**Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?**

As Co. 1 owns all the shares in Co. 2 the companies are related within s259NC TIOPA 2010 and therefore Condition D is satisfied.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', the relevant counteractions need to be considered.

**Counteraction**

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

**Primary Response**

Where the UK is in the position of Country Y (the payer jurisdiction) then s259CD TIOPA 2010 will apply and Co. 2's allowable deduction in relation to the payments of interest must be reduced by the amount of the 'hybrid or

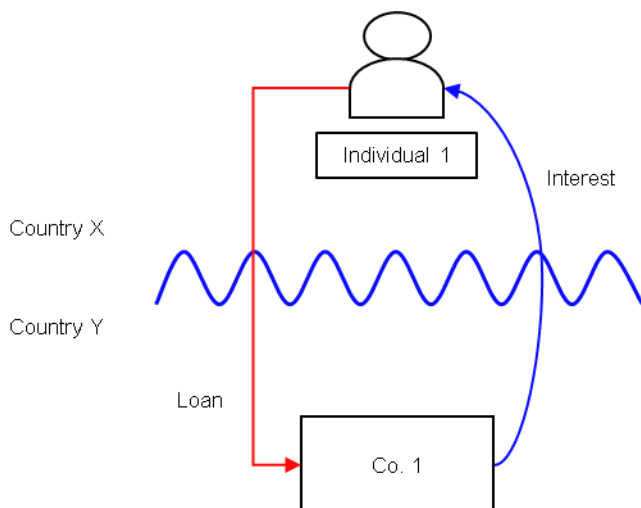
otherwise impermissible deduction/ non-inclusion mismatch'. In this case, that is equal to the full amount of the deductions.

**Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

**Secondary Response**

Where the UK is in the position of Country X (the payee jurisdiction) then it is unlikely there will be a counteraction. Although the counteraction requires a receipt to be brought into charge this will not override the relief provided to registered charities that exempt them from taxation upon their income.

## INTM551240: Hybrids: Chapter 3 - Financial Instruments: Example: Interest payment to a person holding instrument through tax exempt accounts (e.g. ISAs)



### Background

- Co. 1 is resident in Country Y.
- Individual 1 is resident in Country X and, except as specified below, there is no other relationship between the parties.
- Individual 1 subscribes for a bond issued by Co. 1 that pays regular interest.
- The bond is treated as a debt instrument under the laws of Countries X and Y.
- Co. 1 is entitled to a deduction for the interest payments and these payments would usually be treated as ordinary income in Country X.
- In this case, the bond is held by Individual 1 through a tax exempt personal savings account that entitles the individual to an exemption on any income and gains in respect of qualifying investments held in the account. To be eligible as a 'qualifying investment' they must be stocks and shares listed or traded on a recognised stock exchange, akin to a UK ISA.
- The savings account is only available to individuals and there are limits on the amount of assets that can be put into the account.

## **Analysis – Applying the test in s259CA TIOPA 2010:**

Do the interest payments satisfy the relevant conditions to fall within the scope of Chapter 3 of the Hybrid and Other Mismatches from Financial Instruments rules?

Individuals are not subject to a response under these rules, so the counteraction response within S259CE would not be applicable. However, S259CD could apply to restrict the deductions arising to Co. 1.

### **Condition A: Are the payments made under, or in connection with, a financial instrument?**

Transfers of money are made under the bond, which would be defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N TIOPA 2010.

Condition A is therefore satisfied.

### **Condition B: Is either Co. 1 or Individual 1 within the charge to corporation tax for a relevant payment period?**

If the UK is in the position of Country Y then Co. 1 will be within the charge to corporation tax, therefore this condition would be satisfied.

If the UK is Country X, then the condition will not be satisfied as no relevant entity would be within the charge to corporation tax.

Condition B will only therefore be satisfied if the UK is in the position of Country Y.

### **Condition C: Is it reasonable to assume that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?**

Given the background above, it is reasonable to assume the UK will permit Co. 1 a deduction (relevant deduction) for the regular interest payments under the bond against its ordinary income. It is also reasonable to assume that Country X will not require Individual 1 to bring the entire corresponding receipt into tax as ordinary income.

For an impermissible mismatch to occur either Case 1 at s259CB(2) or Case 2 at s259CB(7) must apply. Case 2 is not relevant in this example, as there is no under-taxed amount. Case 1 is not satisfied as when considering the relevant assumptions at s259CB(5), the mismatch does not occur by reason of the terms, or any other feature, of the financial instrument, but rather because of unilateral relief granted by Country X to Individual 1 for investments that are held within a specified account.

To be eligible as a 'qualifying investment' the financial instruments must be stocks and shares listed or traded on a recognised stock exchange. Even if being so quoted could be regarded as a feature of the financial instrument, that feature on its own is not enough for a mismatch to arise. It is necessary that the individual conforms with the entirety of the requirements for ISA treatment to apply before non-taxation applies. Accordingly, the mismatch does not occur by reason of the terms, or any other feature, of any particular financial instrument within the ISA account.

As such, there is no 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.

**Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?**

Although the parties are not related it is reasonable to suppose that the financial instrument was designed to secure the mismatch, by reason of designing it in such a manner that individuals in the UK would be able to benefit from the preferential treatment. This would be the case even if persons unable to benefit from the mismatch were also able to acquire those instruments.

However, as the mismatch is not a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' this condition is not satisfied.

**Conclusion**

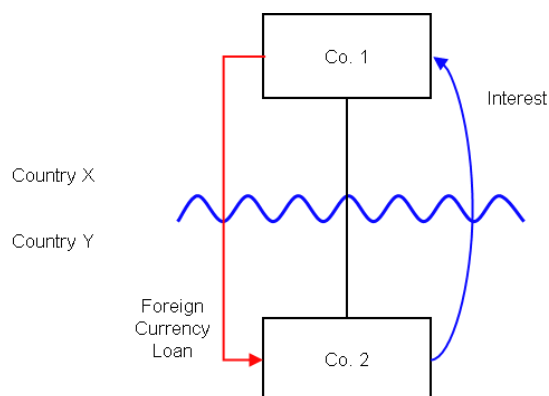
As Condition C is not satisfied (and by extension Condition D) there can be no counteraction under Chapter 3 and there is no need to consider further.

**Application to similar circumstances**

The analysis provided above in respect of tax exempt accounts would also be applicable in relation to any other mismatches where the mismatch arises because of unilateral relief granted by Country Y (for example, in the case of the issuance of Excluded Indexed Securities (EIS) which are designed to meet the requirements of section 433 ITTOIA 2005). The statutory treatment of EIS generally produces a capital return for individual investors.

In such circumstances, for an impermissible mismatch to occur either Case 1 at s259CB(2) or Case 2 at s259CB(7) must apply. Case 2 is not relevant in this example, as there is no under-taxed amount. Case 1 is not satisfied as, when considering the relevant assumptions at s259CB(5), there would not be a mismatch if the issuance did not benefit from the EIS requirements of s433 ITTOIA 2005. The mismatch therefore does not occur by reason of the terms, or any other feature, of the financial instrument,

## INTM551250: Hybrids: Chapter 3 - Financial Instruments: Example: Foreign exchange differences on a debt instrument



### Background

- Co. 1 is resident in Country X.
- Co. 1 owns all the shares in Co. 2, which is resident in Country Y.
- Both Co. 1 and Co. 2's functional currency for accounting purposes is that of the official currency in its country of residence, which is Currency X and Currency Y respectively
- Co. 1 provides Co. 2 with a loan on normal commercial terms (the 'Loan'). Interest is payable every year in arrears at the market rate and the principal is payable at maturity.
- The loan is treated as a debt instrument under the laws of both Country X and Country Y and they take a consistent position on the character of the payments made. The interest payable on the Loan is deductible in Country Y and included in ordinary income under the laws of Country X.
- The interest and principal under the Loan are payable in Currency X, the official currency of Country X.
- The value of Currency X (the official currency of Country X) strengthens in relation to Currency Y while the Loan is still outstanding so that the measure of the principal amount outstanding under the Loan as expressed in Currency Y increases during its taxable period. Accordingly, as Co 2's functional currency is Currency Y, it recognises in its accounts an exchange loss for the period.

- Under the Country Y law, Co. 2 is entitled to a deduction for this exchange loss
- There is no similar adjustment required under Country X law and neither exchange gain nor loss is recognised in profit or loss in Co. 1's accounts, as its functional currency is the same as that of the Loan - currency X.

## Analysis:

Do the interest payments satisfy the relevant conditions to fall within the scope of Chapter 3 of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?**

The loan, which would be defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N TIOPA 2010. Interest is payable on the loan, so the interest is a payment.

Condition A is therefore satisfied in respect of the interest payments.

Consideration then needs to be given to whether the exchange loss on the loan principle constitutes a quasi-payment i.e. would it be reasonable to expect an amount of ordinary income to arise to Co. 1 under these circumstances if it was resident in Country Y and adopted the same approach to accounting :

- (i) Where Country Y is the UK, the exchange loss is not considered to be a quasi-payment – see [INTM551013](#).
- Whether an exchange gain or loss arises depends on the functional currency of the company. Even if two companies adopt the same approach to accounting, the functional currency of a company is fact-dependent and usually determined by the currency of the primary economic environment in which the entity operates.
- The UK allows companies to prepare their accounts in their functional currency and therefore were Co. 1 resident in the UK it would still be permitted to prepare its accounts in Currency X, and no foreign exchange gain would arise.
- (ii) If Country Y is not the UK, requires exchange differences to be computed by reference to its official currency and always takes exchange differences on loans into account then there would be a quasi-payment. quasi-payment



- It would be reasonable to expect that if Co. 1 was resident in Country Y it would also be required to compute exchange differences on the Currency X denominated debt by reference to Currency Y, and therefore would recognise a corresponding exchange gain in its ordinary income.

Condition A is therefore also satisfied in respect of the exchange loss quasi-payment, where the UK is in the position of Country X.

**Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

In the event the UK is Country X, Co. 1 is a payee and is within the charge to corporation tax.

In the event the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B will therefore be satisfied providing either of the above scenarios is satisfied.

If the scenario is such that the UK is neither represented as Country X nor Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If the UK was in the position of both Country X and Country Y then this condition would also be satisfied. Given the background this is unlikely to occur unless one of the companies prepares their accounts in a currency other than UK sterling.

**Condition C: Is it reasonable to assume that there would be a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

No mismatch arises in respect of the interest payment, so condition C is not satisfied as regards interest.

However, although the UK (Country X) does not require Co. 1 to bring into receipt a corresponding amount characterised as a 'foreign exchange movement' in respect of this movement in the value of the principle it does require Co. 1 to recognise the amount by virtue of bringing into account the value of the principle in the stronger currency.

If we assume that when the Loan was entered into it was quantified as X10 (10 in currency X) and Y20 (20 in currency Y), then if during the period the value of currency Y falls such that the equivalent of X10 now becomes Y20 the value of the Loan principal is still X10, independently of which currency you translate it to. In absolute terms there is no mismatch.

Gains and losses that result from converting foreign exchange into local or functional currency are attributable to the way jurisdictions measure the value of money rather than the value of the payment.

The legislation requires there to be a comparison between the relevant deduction against the ordinary income. In this case whether we quantify the deduction and income in Currency X or Currency Y, than they are equal. There is no requirement to quantify the relevant amounts in a specific currency.

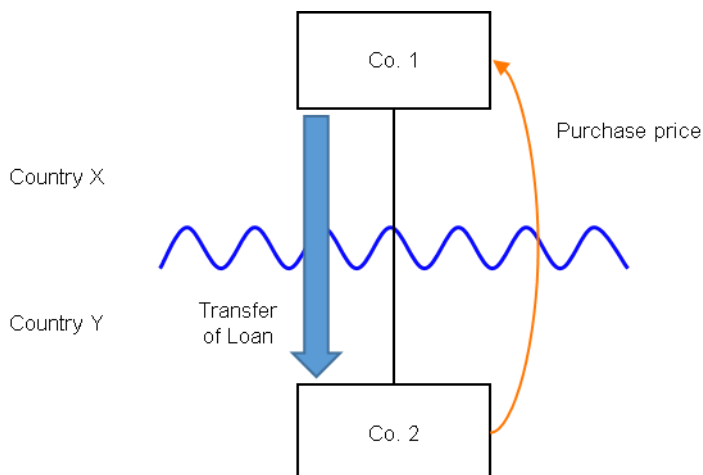
Therefore the foreign exchange movement will not give rise to a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' provided the proportion of the interest and principal payable under the Loan is the same under the laws of both jurisdiction.

Condition C is therefore not satisfied.

### **Conclusion**

There is no hybrid or otherwise impermissible deduction/non-inclusion mismatch to counteract.

## INTM551260: Hybrids: Chapter 3 - Financial Instruments: Example: Payment for cancellation of a financial instrument



### Background

- Co. 1 is resident in Country X.
- Co. 1 owns 100% of the equity of Co. 2, which is resident in Country Y.
- Co. 2 has borrowed money from Co. 1 (the 'Loan'), but now acquires that Loan at a premium, effectively cancelling the Loan.
- Under the law of Country Y, Co. 2 treats the premium as deductible expenditure
- The receipt of the premium received by Co. 1 in Country X is treated as a gain on the disposal of the Loan.

### Analysis – Applying the tests in s259CA TIOPA 2010

Does the payment satisfy the relevant conditions to fall within the scope of the hybrid or other mismatches arising from financial instruments rules?

#### **Condition A: Is the payment of the premium made under, or in connection with, a financial instrument?**

Although the payment represents the acquisition cost of an instrument, as it has the effect of cancelling Co.2 's indebtedness under the instrument, it is considered to be made in connection with a financial instrument as it discharges Co. 2's obligations under the loan. The Loan described would fall under the definition of a financial instrument for the purposes of UK GAAP. The transfer of the financial instrument is not a hybrid transfer arrangement

within the meaning given by s259DB and so is dealt with under the financial instrument provisions – s259N(3)(a). Condition A is therefore satisfied.

**Condition B: Is Co. 2 or Co. 1 within the charge to corporation tax for a relevant payment period?**

If the UK is country X, Co. 1 is a payee and is within the charge to corporation tax.

If the UK is Country Y, Co. 2 is a payer and is within the charge to corporation tax.

Condition B will therefore be satisfied in either of the situations above.

Note: The basic provisions of the Loan Relationship legislation (at CTA09/s307) would usually apply where the UK is in the position of Country X to ensure that the amounts are brought into account. However where this is not the case, possibly because the Loan satisfies the definition of a financial instrument for the purposes of UK GAAP but does not fall within the definition of a loan relationship or related transaction within CTA09/Part 5, then there may be a mismatch as reflected here.

**Condition C: Is it reasonable to assume that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?**

Given the background above, it is reasonable to assume Country Y will permit Co. 2 a deduction (relevant deduction) equal to the payment of the premium against its ordinary income.

If (as is stated in the background) Country X treats the receipt as a gain on the disposal of the loan, there will be a mismatch if either none of the receipt will be taxed as ordinary income or it will be taxed at lower rate (i.e. under-taxed).

If Country X subjects the receipt to tax on capital then it will not be treated as included in ordinary income, however credit for the tax suffered may be given when determining the extent of under-tax.

In either of these circumstances, Condition C would be satisfied.

**Condition D: Are the two companies related or is there a structured arrangement?**

As Co. 1 owns 100% of the equity in Co. 2, the companies are related within the definition at s259NC and Condition D is satisfied.

## **Conclusion**

As Conditions A to D are satisfied, there is a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.

## **Counteraction**

The appropriate response to counteract this mismatch will depend upon whether the UK is in the position of Country X or Country Y.

### **Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

#### **Primary Response**

If the UK is Country Y, s259CD will apply and the UK will deny the deduction for the premium paid by Co. 2 to the relevant extent necessary to address the mismatch.

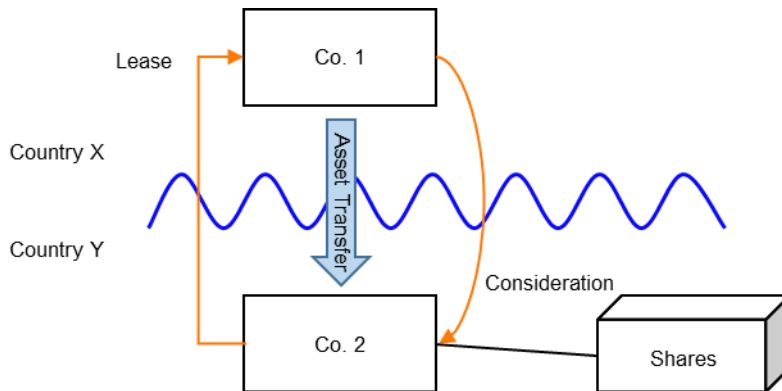
### **Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

#### **Secondary Response**

If the UK is Country X, the counteraction will depend on whether or not the deduction has been fully counteracted under a provision equivalent to s259CD in Country Y. If so, no further action will be taken by the UK.

If however, under the law of Country Y, the 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' has not been fully counteracted, then s259CE will apply and the UK will counteract the remaining mismatch by including that amount as income arising for the counteraction period.

## INTM551270: Hybrids: Chapter 3 - Financial Instruments: Example: Consideration for the purchase of a trading asset



### Background

- Co. 1 is resident in Country X.
- Co. 2 is resident in Country Y.
- Co. 1 transfers shares to Co. 2, who pays fair market value for the shares.
- The share transfer occurs on the same day as the payment.
- Co. 2 acquires the shares as part of its activities as a trader and will be able to include the purchase price as expenditure when calculating any taxable gains/loss on the disposal of the shares.

### Analysis – Applying the rules in s259CA TIOPA 2010

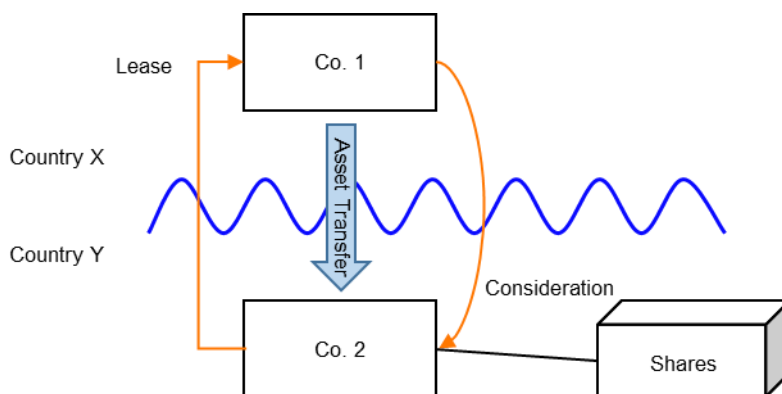
The asset sale agreement is not a financial instrument as it does not fall within any of the definitions provided in s259N. Although shares are included, an agreement to acquire them will only be a financial instrument if it satisfies one of the tests in s259N, for instance that amounts are brought into account in respect of it under Part 6 CTA 2010 – see s259N(1)(b). That is not the case here.

This transaction does not fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules. Note that if a substitute payment is made in connection with the transfer, Chapter 4, Hybrid transfers may be in point.

## INTM551280: Hybrids: Chapter 3 - Financial Instruments: Example: Interest component of the purchase price of shares

This example looks at situations where a company transfers shares to a related company in exchange for payment. This payment is deferred and interest is applied to the unpaid amount.

The example considers whether the interest element of the payment falls within the Hybrid and Other Mismatches from Financial Instruments rules, and how it should be treated.



### Background

- Co. 1 is a company resident in Country X.
- Co. 2 is a related company, resident in Country Y.
- Co. 1 transfers shares to Co. 2, which pays market value for the shares (subject to a price adjustment for the consideration being deferred).
- The consideration given for the shares is deferred for a year. The purchase price is fair market value on the date of the agreement plus an amount equal to a market rate of interest on the unpaid purchase price.
- Under the laws of Country Y, Co. 2 is allowed to treat the interest portion of the purchase price as a separate deductible expense for tax purposes.
- Under the laws of Country X, Co. 1 treats the entire purchase price (including the interest element) as consideration for the transfer of the asset. This is not a trading asset of Co. 1 and therefore does not bring the receipt in as ordinary income.
- The payee is not a relevant investment fund as defined in s259NA

## **Analysis – Applying the tests in s259CA TIOPA 2010**

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Are the payments or quasi-payments made under, or in connection with, a financial instrument?**

The underlying shares may satisfy the definition to be considered a financial instrument but Chapter 3 can only be applied where a payment or quasi-payment is made under or in connection with a financial instrument. The purchase price is clearly not made under the instrument and is made in connection with the transfer agreement, as against the shares themselves.

Turning to the transfer agreement, it should be treated as a financial instrument in the following circumstances:

- It would be treated as a financial instrument under UK GAAP – s259N(2); or
- If it is assumed that a party to the contract is subject to corporation tax, profits or losses would be taken into account under part 6 CTA 2009 – s259N(1)(b)
- (Any other subsections of s259N are not likely to apply)
- Where country X is the UK, it is likely that s480 CTA 2009 would be in point and the UK would tax the in-substance interest under Part 6 CTA. This would mean that the agreement is a financial instrument, but does not fit the fact pattern described.
- Where country X is the UK, but s480 is not in point (as stated in the background of this example) and the UK does not otherwise tax the return, Condition A is only satisfied if the agreement is accounted for as a financial instrument and Country Y allows a tax deduction for a payment or quasi-payment representing the in-substance interest. Given the background above, that the UK recognises it as an acquisition cost, it is unlikely it is regarded as a financial instrument unless it falls within the definition of such under UK GAAP, which is wider than Part 5 and Part 7 CTA 2009.

Chapter 3 could be in point where the UK is country Y, the agreement is a financial instrument under UK GAAP and the UK gives a tax deduction for the in-substance interest.



**Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?**

In the event the UK is country X, Co. 1 is the payee and is within the charge to corporation tax.

In the event the UK is Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B will therefore be satisfied providing either of the above is satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax, as both payer and payee company are within the charge to corporation tax, Condition B would be satisfied.

**Condition C: Is it reasonable to assume that there is, or will be, a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

Co. 2 receives an allowable deduction for the interest expense, while Co. 1 does not include the corresponding receipt as ordinary income. Therefore, Case 1 as defined in s259CB (2) applies to create a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch', in that the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment, arise to each payee in the permitted taxable period, and all or part of that excess arises by reason of the terms of the financial instrument – in that it is part of an asset sale agreement and therefore characterised differently in Country X.

Condition C is satisfied.

**Condition D: Are Co. 1 and Co. 2 related or is the financial instrument, or any arrangement connected with it, a structured arrangement?**

Co. 1 and Co. 2 are related within the definition at s259NC, and so the condition is satisfied.

**Conclusion**

Where the UK is in the position of Country Y all the conditions are satisfied to characterise the arrangement involving the payment of interest as a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' and the relevant responses therefore need to be considered.

## **Counteractions**

The response will only apply where the UK is in the position of Country Y.

### **Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

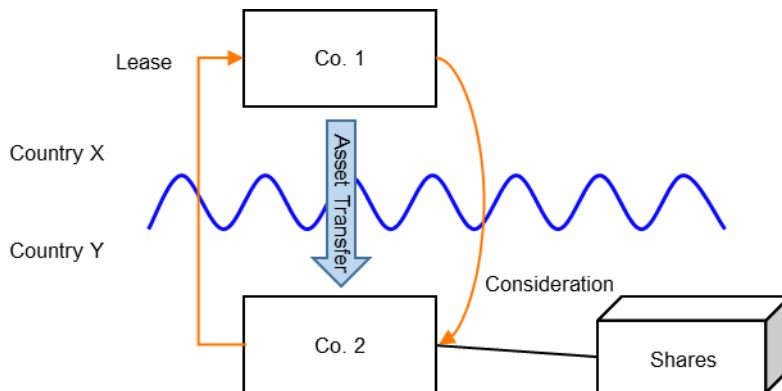
Where the UK is in the position of Country Y (the payer jurisdiction) then s259CD will apply and Co. 2's allowable reductions in relation to the payments of interest must be reduced to the extent that the deduction is a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch'.

In this example Country X exempts the receipt from tax as it is treated as part of the purchase price of the transferred shares. Therefore, none of the finance related deduction will be allowed.

## INTM551300: Hybrids: Chapter 3 - Financial Instruments: Example: Interest paid on the purchase of shares from a share trader

This example looks at situations where a company transfers shares to a related company in exchange for payment. The company selling the shares is a share trader. The payment is deferred and interest is applied to the unpaid amount.

The example seeks to demonstrate both that the cost of the shares should be allowed as a deduction in computing the share trader's profits and that if the interest expense is brought into charge at the full marginal rate, albeit in a different character, there will be no 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' to be counteracted under the Hybrid and Other Mismatches from Financial Instruments rules.



### Background

- Co. 1 is a share trader and resident in Country X.
- Co. 2 is resident in Country Y and is related to Co. 1.
- Co. 1 transfers shares to Co. 2, which pays market value for the shares (subject to a price adjustment for the consideration being deferred).
- The consideration given for the shares is deferred for a year. The purchase price is fair market value on the date of the agreement plus an amount equal to a market rate of interest on the unpaid purchase price.
- Under the laws of Country Y, Co. 2 is allowed to treat the in-substance interest portion of the purchase price as a separate deductible expense for tax purposes. Co. 2 is not a share trader and is therefore not able to claim a deduction for the cost of the shares acquired.

- Under the laws of Country X, Co. 1 treats the entire purchase price (including the interest element) as consideration for the transfer of the asset. However, as it is a share trader, Co. 1 is required to bring the entire amount of the payment into account as ordinary income when computing its taxable profits.

## **Analysis - Applying the tests in s259CA TIOPA 2010**

Do the interest payments satisfy the relevant conditions to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

### **Condition A: Is there a payment made under, or in connection with, a financial instrument?**

The definition of a 'financial instrument' within s259N TIOPA 2010 includes anything else that 'has the meaning that it has for UK generally accepted accounting practice'. Therefore if the UK is in the position of Country X then it can usually be supposed that UK generally accepted accounting practice has determined the agreement to be merely a transfer of the asset, and therefore not a financial instrument.

Contrary to this, if the UK is in the position of Country Y then it can usually be supposed that UK generally accepted accounting practice has determined the agreement to include an element of finance, and therefore it is a financial instrument.

The general positions are therefore that Country X will not recognise the instrument as a financial instrument but Country Y will.

Condition A will therefore only be satisfied if the UK is in the position of Country Y.

Note: It is unlikely that the UK would not recognise the interest portion of the purchase price as a credit subject to tax under the Loan Relationship rules, therefore it is unlikely that in an example like this the UK would ever be in the position of Country X.

### **Condition B: Is the payer or payee within the charge to corporation tax for a relevant payment period?**

In the event the UK is in the position of Country X, Co. 1 is the payee and is within the charge to corporation tax.

In the event the UK is in the position of Country Y, Co. 2 is the payer and within the charge to corporation tax.

Condition B will therefore be satisfied providing either of the above is satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied and no further analysis is required as neither Co. 1 nor Co. 2 will be within the charge to corporation tax.

If Co. 1 and Co. 2 were both within the charge to corporation tax, as both payer and payee company are within the charge to corporation tax, Condition B would be satisfied.

**Condition C: Is it reasonable to assume that there is, or will be, a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' in relation to this payment?**

The payment is made up of two distinct and separable elements: the payment for the shares and the payment of interest.

The separate and identifiable payment for the shares will not result in a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' as Country Y will not permit a deduction for the cost of the shares in calculating Co. 2's trading profits, as it is not a share trader.

The interest payment also does not result in a 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' because the relevant deduction does not exceed the amounts of ordinary income arising to each payee for the permitted taxable period. Co. 2 has benefitted from a deduction in Country Y, but it is reasonable to assume that the corresponding receipt has been taxed in Country X as ordinary income – it is income that has been brought into charge by Country X under a tax corresponding to the UK's charge to corporation tax on income.

Although Co. 1 does bring an amount into receipt otherwise as finance income, the definition of Ordinary Income at s259BC does not require it to be recognised as a finance return.

As the rate charged on that element of Ordinary Income is not lower than that charged in Country X on all ordinary income arising from financial instruments, it is not under-taxed for the purpose of Case 2.

There is therefore no 'hybrid or otherwise impermissible deduction/ non-inclusion mismatch' as this condition is not satisfied.

## **INTM552000: Hybrids: Chapter 4 - Hybrid transfers: contents**

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## **INTM552010: Hybrids: Chapter 4 - Hybrid transfers: Overview**

Chapter 4 of Part 6A addresses deduction non-inclusion mismatches that arise from payments or quasi-payments involving hybrid transfers. A hybrid transfer arrangement is an arrangement for the transfer of a financial instrument (s259N TIOPA 2010 provides a wide definition for these rules which includes shares). Specifically included within the definition of a targeted hybrid transfer arrangement are Repos (see [INTM552040](#)) and stock lending arrangement (see [INTM552050](#)).

Chapter 4 follows the general structure adopted for each Chapter in Part 6A.

Firstly, the 5 conditions to be met for the Chapter to apply are set out by s259DA. These conditions are covered in INTM552020 to INTM552140.

If all five conditions are met, including that it is reasonable to suppose that there is a hybrid transfer D/NI mismatch falling within one of the two Cases contained in s259DC (see [INTM552100](#)), then this section also determines the extent of the mismatch. Unless the financial trader exclusion provided by s259DE applies (see [INTM552170](#)), the appropriate counteraction is determined by the application of s259DF. Where there is a deduction non-inclusion mismatch, it is counteracted by altering the corporation tax treatment of either the UK payer or UK payee.

This Chapter also sets out what is meant by a hybrid transfer arrangement.



## **INTM552020: Hybrids: Chapter 4 - Hybrid transfers: The five conditions**

S259DA TIOPA 2010 sets out, the five conditions, A to E which must be met if this Chapter is to apply. All conditions must be met for a deduction/non-inclusion mismatch counteraction to be appropriate.

[INTM552030: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A](#)

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## **INTM552030: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A**

Condition A is met if there is a hybrid transfer arrangement in relation to an underlying financial instrument.

A hybrid transfer arrangement is an arrangement for the transfer of a financial instrument (widely defined in s259N TIOPA 2010 and including shares), which is termed the 'underlying instrument', the characteristics of which can create targeted deduction non-inclusion mismatches.

Financial instruments can result in hybrid mismatch arrangements where they are treated as a transfer of ownership of an asset for one jurisdiction's tax rule, but not for the tax purposes of another jurisdiction. A difference in which person is recognised as the beneficial owner, can lead to differences in characterisation of the financial instrument. This asymmetry can create deduction non-inclusion mismatches.

Specifically included within the definition of a targeted hybrid transfer arrangement are Repos (see [INTM552040](#)) and stock lending arrangement (see [INTM552050](#)). These are not defined terms and take their normal commercial meanings.

The definition of a hybrid transfer arrangement also includes any other arrangement that relates to the transfer of a financial instrument (the underlying instrument), providing that either:

- the dual treatment condition ([INTM552060](#)) is met in relation to the arrangement, or
- a substitute payment ([INTM552070](#)) could be made under the arrangement.

Only one of these conditions needs to be met for this arrangement to fall within the definition of a hybrid transfer arrangement.

There can, however be no mismatch to counteract unless the dual treatment condition is satisfied or a substitute payment is actually made. The mismatch may also be specifically excluded under the financial trader exclusion rule in s259DE TIOPA 2010 (see [INTM552170](#)).

### **Novations and other indirect transfers**

S259DB(6) TIOPA 2010, provides an extended definition of transfer in respect of any other arrangement. This is intended to include, but is not restricted to, novations of a financial asset or liability. A novation is a legal term where there is a substitution of a new obligation for the one that previously existed.

For example, where there is a transfer from P to Q, even if the original financial instrument held by P ceases to exist, so long as Q comes to have substantially the same rights or obligations in respect of a financial instrument as P had under the original instrument this would be treated as a transfer.

[INTM552040: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: What are repos?](#)

[INTM552050: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: What are stock lending arrangements?](#)

[INTM552060: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: Dual condition treatment](#)

[INTM552070: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: Substitute payments](#)

## **INTM552040: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: What are repos?**

A Repo is a type of in-substance lending (see CFM46100). In its simplest form, the in-substance borrower transfers a security (referred to in the legislation as the underlying financial instrument) to an in-substance lender at a price, say £100. It agrees to repurchase the same security (or an identical security) at a fixed future date at an agreed higher price, say £101. Economically this is equivalent to a loan of £100 secured on the transferred securities, bearing an interest-like funding cost of £1.

There are many variations on the theme. For instance:

- The prices could be set in any currency (but the same currency for both sale and repurchase).
- There may be flexibility as to the relevant dates and the repurchase price may be fixed by a formula, essentially the accretion of interest over time on the original transfer price.
- There may be some flexibility as to the nature of the securities to be redelivered; they may be the actual securities delivered or there may be flexibility for the in-substance lender to deliver securities similar, but not necessarily identical, to the original securities, with the same value as the securities originally transferred.

Adjustments may need to be made if interest or dividends become payable on the underlying securities in the interim. The in-substance lender may be required to make a substitute payment (see [INTM552070](#)) to recompense the in-substance borrower for the actual dividend received, or the repurchase price may be reduced.

For example:

- Securities are transferred from Co. 1 (the in-substance borrower) to Co. 2 (the in-substance lender) for £100, under an arrangement such that Co. 1 will repurchase them for £101 in 4 months
- During this period Co. 2 becomes entitled to an interest payment of £4 on the underlying securities.

Co. 2 may be obliged to either make a substitute payment of £4 to Co. 1 or to reduce the repurchase price payable by Co. 1 at the end of the period from £101 to £97.

If Co. 1's jurisdiction treats the arrangement as a secured borrowing, it would be expected to treat the in-substance borrower as if it had received the interest of £4 on the underlying financial instrument and as having incurred a funding cost of £1 on the repo. Co. 2 may be required to replicate this treatment or it may be treated as having acquired securities for £100 and sold them for £101, giving a capital gain of £1.

## **INTM552050: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: What are stock lending arrangements?**

In a commercial stock lending transaction (see CFM74100) there is normally a party that has a need of securities, for instance to deliver to satisfy a sales contract it has previously entered into. The original holder of the securities transfers them to the stock borrower, but no price is specified. However, the stock borrower is obliged to transfer them (or identical securities) back at a later date.

In the interim the stock borrower lodges collateral with the stock lender and will normally pay a fee to the stock lender, sometimes by allowing the stock lender to retain part of the return on the collateral (a collateral rebate) e.g. where the collateral is a security the stock lender may be allowed to retain any interest payments in the interim.

If there is no collateral, this could be a sign of an uncommercial possibly tax-driven arrangement.

If the collateral is cash, a stock loan can be very similar to a repo in its economic effects. The stock lender transfers securities and gets them back later. It gets the cash collateral, which it can use in its business. It pays over an interest return on the cash collateral and returns the cash principle at the end. In this example the stock lender is in the same position as the in-substance borrower in a repo.

It is less likely, however, that this type of arrangement will lead to the dual treatment condition being satisfied, as the amount paid over is interest and is less likely to give rise to mismatching tax treatment than the price differential on a repo.

In stock lending, as under repos, a transaction may extend over a dividend or interest record date. The stock borrower will typically be obliged to make a substitute payment to the stock lender. A payment may also arise from the lender to the borrower on the securities posted as collateral. The stock lender would normally pay this over to the stock borrower, so substitute payments could flow in both directions, although they could be netted.

## **INTM552060: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: Dual condition treatment**

The dual condition treatment is satisfied if the arrangement involves a transfer, or a series of transfers, of a financial instrument, which gives rise to a financing expense in the jurisdiction of the company that incurs the funding cost (the in-substance borrower), but the tax jurisdiction of the counterparty (the in-substance lender) does not recognise it as a lending transaction and therefore does not tax the corresponding financing return in full as ordinary income.

Such transactions tend to be built around the concept of a “repo” arrangement. This involves the transfer of a financial instrument by the transferor for a price. The instrument is then transferred back later at a predetermined or pre-determinable higher price. The price differential is the funding cost to the transferor and will be higher for a longer term repo than a shorter term one. The financial instrument transferred may be plain shares, with no inherent hybridity characteristics.

Repo transactions are very common in the financial markets and play a vital role in maintaining liquidity. The great majority of transactions do not create deduction/non-inclusion mismatches, as they are treated for tax purposes as financing or financial trading transactions from the perspective of both parties.

However, there can be mismatches where the transferor treats the transaction in line with its substance, as equivalent in substance to a transaction for the lending of money, but the transferee may in fact treat it in line with its form, as an acquisition and subsequent disposal. If the transferee taxes capital transactions in a more favourable manner than finance transaction then this will create a mismatch.

## **INTM552070: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition A: Substitute payments**

A substitute payment is defined in s259DB(5) TIOPA 2010. In order to satisfy the definition there must be a payment or benefit received.

The benefit received covers indirect methods of transferring value such as the use of a loan waiver. The amount must be representative of a return of any kind on the underlying instrument. Accordingly, it need not be the same as a gross dividend or interest payment, because withholding tax effects, etc. may have an impact.

Finally the payment or benefit must go to some person other than the actual holder of the underlying financial instrument.

A substitute payment may become payable where an economic owner of securities is deprived of a dividend or interest payment that would be expected to arise to it as economic owner of the asset. This may arise because the economic owner has lent the security under a repo or stock loan arrangement and expects the security to be transferred back at a later date, and during this period a dividend is paid.

If a repo (see [INTM552040](#)) or stock loan (see [INTM552050](#)) extends over the record date (the date which determines to whom the dividend or interest on the underlying instrument will be paid) the registered holder (the transferee) of the securities on that date is entitled to the interest or dividend. Commonly, under the terms of the stock lending or repo arrangement, the transferee will be required to compensate the original transferor by means of a substitute payment.

The substitute payment will not necessarily be of the same amount as the gross interest or dividend. For example, if a dividend of 100, payable to the original holder of the shares, would normally be paid subject to a withholding tax of 15%, due to the jurisdiction of residence of the issuer of the security, the substitute payment might be reduced to 85.

In addition as stock lending or repo transactions might be used to position securities, over the record date, in a jurisdiction that minimised the withholding tax, the substitute payment might be some amount in-between 85 and 100, sharing the benefit between the parties. This is a form of tax arbitrage, but not one that is countered by these rules which only counter deduction/non-inclusion mismatches.

A substitute payment may give rise to a mismatch. For example the transferor's jurisdiction may treat a substitute payment as if it were a real



dividend and exempt it from tax or otherwise allow favourable tax treatment. However, the payer's jurisdiction may allow a tax deduction for the payment.

This type of mismatch is instant, arising from the payment, and it does not reflect the duration of the transaction.

Substitute payments are very common in the financial markets. There may be a chain of substitute payments, for instance if shares are lent to an intermediary, and then on-lent to a further party who sells into the market intending to repurchase similar shares in the market at a later date.

Substitute payments are not limited to those made in stock lending and repo arrangements extending over a record date. For example, a company might enter into a contract to sell securities cum dividend (i.e. including the right to the dividend) but for some reason, perhaps because of a delay in delivery resulting from a failed trade, title to the securities might not pass until after the record date for the dividend or interest in question; the securities are thus delivered ex-dividend. Typically the sales contract will require the vendor to make a substitute payment to the purchaser in such circumstances – thus the substitute payment is made in reverse by the transferor to the transferee.

A failed delivery that gives rise to a substitute payment, whether unintended or deliberate, falls within s259DB(2)(c) as an example of any other arrangement.

## **INTM552080: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition B**

Condition B is met if a payment or quasi-payment is made under or in connection with the hybrid transfer arrangement itself, or the underlying instrument.

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person who makes the transfer. A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply.

See [INTM550530](#) for more detail on quasi-payments.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments where the circumstances giving rise to the deduction do not involve economic rights between the payer and a payee.

Where the dual treatment condition is satisfied in respect of funding expense mismatches (see [INTM552060](#)) the mismatch will normally concern a quasi-payment and the mismatch will be the amount of the relevant deduction (see [INTM550530](#)) for the funding cost under the hybrid transfer arrangement.

The quasi-payment may reflect the effects of a number of payments, for example the sale and repurchase costs of the security and any interest, dividend and substitute payments received, paid, or forgone.

For example, Co. 1 may loan shares to Co. 2 for principle of 100. The shares may be repurchased in 12 months for 101, and in the interim a distribution on the shares of 3 may be retained by Co. 2. Co. 2 may also be required to pay a fee of 2 for the share loan. Co. 1 will effectively have paid 104 (the 101 repurchase price plus the distribution of 3 foregone) and received 2 for the fee. Co. 1 may therefore be claiming a finance cost of 2 for the use of the 100

principle for those 12 months. It would be reasonable to expect Co. 2 to return a corresponding 2 as ordinary income if it were resident in the same country as Co. 1 and adopted the same approach to accounting, therefore the 2 represents a quasi-payment.

The focus of the concern is whether fully taxed ordinary income arises to the counterparty that corresponds to the funding expense deducted. In the case of such funding arrangements, once the funding cost is identified, it is not necessary to further test the individual components of the overall transfer arrangements.

In the case of substitute payment mismatches (see [INTM552070](#)) it is a payment being the substitute payment or some other benefit given in respect of a substitute payment where this is not cash.

## **INTM552090: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition C**

Condition C requires that at least one party of the arrangements is within the charge to CT.

This means that

- the payer to be within the charge to UK corporation tax for a relevant payment period, or
- a payee to be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period.

The relevant payment period is the taxable period of the payer in which an amount may be deducted for a payment or quasi-payment.

## **INTM552100: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition D**

Condition D requires that it would be reasonable to conclude that a hybrid transfer deduction/non-inclusion mismatch would arise, disregarding the effects of the UK's 'Hybrid and Other Mismatches' legislation or similar rules in the counterparty jurisdiction. This is set out in s259DC TIOPA 2010.

There are two types of hybrid transfer deduction/non-inclusion mismatches:

- Case 1 (s259DC(2)) arises where deductions exceed ordinary income
- Case 2 (s259DC(5)) is where ordinary income arises, but at a rate lower than that the highest rate which could be charged on ordinary income arising from a financial instrument.

In broad terms, ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income is in s259BC TIOPA 2010 and the concept is discussed further at [INTM550540](#).

Any excess is disregarded if it arises because of the financial trader exclusion see (see [INTM552170](#)) or because the payee is a relevant investment fund (see [INTM552210](#)).

[INTM552110: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition D: Case 1](#)

[INTM552120: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition D: Case 2](#)

[INTM552130: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition D: Foreign exchange differences](#)

# **INTM552110: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition D: Case 1**

## **Case 1 – deductions exceed ordinary income**

For case 1 the requirements are that the relevant deduction exceeds the total amounts of ordinary income arising by virtue of payments or quasi-payments for a permitted taxable period and all or part of that excess arises (s259DC(7) TIOPA 2010) because either:

- the dual treatment condition is satisfied in respect of an arrangement under which a payment or quasi-payment is made, or
- because the payment or quasi-payment is a substitute payment.

If the excess would have been reduced had the arrangement not contained those relevant characteristics then it will satisfy the requirements to be characterised as a hybrid transfer deduction/non-inclusion mismatch.

It does not matter if excess could also have arisen for some other reason as well.

- To the extent that the excess has not already been characterised as a hybrid transfer deduction/non-inclusion mismatch it will be treated as such if, upon making the relevant assumptions as below, the excess could have arisen by reason of those relevant characteristics (i.e. the satisfaction of the dual treatment condition or that the payment or quasi-payment is a substitute payment).
- If there are multiple payees, each payee is tested separately, making the relevant assumptions (see below) as regards each payee as required.

### **The relevant assumptions**

In relation to each payee, the relevant assumptions concern its actual or hypothetical tax treatment. The assumptions are as follows –

- if the payee is not within the charge to tax in a payee jurisdiction because of an exclusion, immunity, exemption or relief under that law, the exclusion, etc. is assumed not to apply
- if a payment or quasi-payment is not chargeable to tax in a “payee jurisdiction” because it is not made in connection with the payee’s business in that jurisdiction, it is assumed that it is made in connection with such a business

- if the payee is not liable to tax in any jurisdiction by virtue of residence there or carrying on business through a permanent establishment, then a hypothetical UK tax treatment must be considered.

A payee jurisdiction is one in which the payee is resident for tax purposes, or has a permanent establishment – s259BB(9) TIOPA 2010.

If no jurisdiction applies a tax charge, either because there is no tax system, or because there is a zero rate, the payee is assumed to be subject to UK tax, but with the following provisions disregarded (by virtue of s259DB(4a), the Hybrid and Other Mismatches provisions themselves, transfer pricing (Part 4 TIOPA 2010), the worldwide debt cap (Part 7 TIOPA 2010) and the loan relationships unallowable purposes rules (s441 CTA 2009).

The effect of making these assumptions is that if there is no tax on the payee for some other reason, a mismatch can still be identified and counteracted where there is no other legislative reason not to do so – such as the payee being a relevant investment fund (see [INTM552210](#))

### **Case 1 – permitted taxable period**

The permitted taxable period (in which ordinary income arises to a payee) is defined in s259DD(2). It includes a period that begins before the end of 12 months before the payer's taxable period (under its tax law). This will include a coincident period or an earlier period.

Further if a claim is made and it is just and reasonable that ordinary income might arise in a later period rather than earlier, that later period.

This should be intended to ensure that inappropriate mismatches arising from differences in the timing of deduction or inclusions of ordinary income, for example cases where timing is determined by accounting and different accounting methods apply to payer and payee (providing that the same total amounts are taken into account over the lifetime of the hybrid transfer). There is further comment on the permitted taxable period in the context of financial instruments at [INTM551033](#).

## **INTM552120: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition D: Case 2**

### **Under-taxed amounts**

In case 2 mismatches, ordinary income does arise to the payee in respect of a hybrid transfer, but the income in question represents under-taxed amounts for a permitted taxable period.

Similar to Case 1, the amounts must be under-taxed for one of the reasons set out in s259DC(7) TIOPA 2010, that is because either:

- the dual treatment condition is satisfied in respect of an arrangement under which a payment or quasi-payment is made, or
- because the payment or quasi-payment is a substitute payment.

If the amount of relevant under-taxed income would have been reduced had the arrangement not contained those relevant characteristics then it will satisfy the requirements to be characterised as a hybrid transfer deduction/non-inclusion mismatch.

Ordinary income is under-taxed if the highest rate at which the payee is taxed on such income is less than the payee's full marginal rate, taking into account, on a just and reasonable basis, any credit for underlying tax on profits used wholly or partly to fund the payment.

This full marginal rate is the highest rate at which the taxpayer would be taxed on ordinary income arising from a financial instrument (s259DD(4)).

The "highest rate" of tax referred to is the effective rate after taking into account underlying tax credit relief, assuming no other reliefs are also applied to that income.

For example, under a complex repo arrangement, the temporary holder of share receives a taxable dividend payment in respect of which underlying tax credit relief can be claimed. That dividend, or rather the quasi-payment reflecting the financing return on the repo, of which the dividend forms a part, will be an under-taxed amount due to the underlying tax credit. (See example at [INTM552530](#)).



## **INTM552130: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition D: Foreign exchange differences**

A foreign exchange loss does not give rise to a Case 1 or 2 hybrid transfer deduction/non-inclusion mismatch. It is not within the scope of the rules.

An example of a transaction to which the dual treatment condition in s259DA(4) TIOPA 2010 might apply is a repo (see [INTM552040](#)).

It is quite possible that the in-substance borrower on a repo is a UK company with a sterling functional currency, but the sale and repurchase price are denominated in some other currency.

For example, a UK company with a sterling functional currency enters into a euro-denominated repo with a related party. Absent the Hybrid and other Mismatch legislation the UK company would have been entitled (under s551 CTA 2009) to a deduction for both in-substance interest and an exchange loss on a debtor repo denominated in euros. The counterparty is not taxed either on deemed interest or any exchange difference. In this example the counteraction will deny the deemed interest deduction, but not the exchange loss.

The key point as regards the exchange loss is that it should not give rise to a quasi-payment within s259BB(2) TIOPA 2010.

## **INTM552140: Hybrids: Chapter 4 - Hybrid transfers: The five conditions: Condition E**

Condition E identifies three circumstances which would mean that the condition would apply. These are :-

- The payer is also the payee
- The payer and payee are related
- The hybrid transfer arrangement is a structured arrangement.

### **The payer is also the payee**

From a UK tax perspective this circumstance could happen when the transaction takes place within a single entity.

The UK branch of a non-UK company enters into a repo transaction with head office. The UK allows a tax deduction for the funding cost under the repo, giving rise to a quasi-payment.

The branch is the payer and head office is the payee and head office is not regarded as a distinct and separate person from the branch for the purposes of UK corporation tax. Both are parts of a single taxable company, even though the UK taxed only profits attributable to the UK permanent establishment, the branch.

If the head office jurisdiction takes a different approach and for tax purposes treats the UK branch as if it were a separate entity, (the scenario imagined in s259BB(7) TIOPA 2010) and the foreign jurisdiction does not tax the corresponding financing income as ordinary income, then the counteraction may apply.

### **The payer and payee are related**

This circumstance is satisfied where the payer and payee are related at any time in the period beginning with entry into the hybrid transfer arrangement and ending on the last day in the payment period. This is the last day of the tax period in the payer's tax jurisdiction in which the payer gets a tax deduction giving rise to a quasi-payment (or makes a payment).

The meaning of related party is set out in s259NB TIOPA 2010, see [INTM550580](#)

Where the payer of a substitute payment is a financial trader, entitled to a tax deduction for the payment in computing trading profits, the related party

circumstance on its own is insufficient to lead to counteraction, see [INTM552170](#).

## **The hybrid transfer is a structured arrangement**

The definition of a structured arrangement is found in s259DA(7) TIOPA 2010. See [INTM552150](#) for further details.

## **INTM552150: Hybrids: Chapter 4 - Hybrid transfers: Structured arrangements**

The concept of a structured arrangement is relevant in two contexts.

It determines whether there is sufficient connection to satisfy Condition E for the Hybrid Transfer chapter to apply, and in the case of a substitute payment made by a financial trader, the financial trader exemption will not apply in the case of a structured arrangement, see [INTM552170](#).

An arrangement is a structured arrangement if it is reasonable to suppose that

- it is designed to secure a hybrid payer deduction/non-inclusion mismatch, or
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or
- the terms of the arrangement otherwise reflect an expected mismatch.

An arrangement may be designed to secure a commercial or other objective, and yet also still secure a hybrid payer deduction/ non-inclusion mismatch. When considering this issue the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch.

See [INTM551024](#) for further commentary on structured arrangements as they apply to financial instruments.

## **INTM552160: Hybrids: Chapter 4 - Hybrid transfers: The extent of a mismatch**

Where case 1 applies, the extent of the mismatch is simply the excess of the deductions over the amounts treated as ordinary income by the payees, making all the necessary assumptions.

Where case 2 applies the calculation of under-taxed amounts has two stages. First it is necessary to identify the under-taxed amounts. Then for each amount a simple formula is applied to each under-taxed amount:

$$\frac{(UTA \times (FMR - R))}{FMR}$$

Where -

UTA is the under-taxed amount

FMR is the payee's full marginal tax rate for the permitted taxable period, as a %

R is the highest rate at which tax is charged on the profits that are under-taxed, as a %, taking into account the effect of any credit for underlying tax on a just and reasonable basis.

For the purposes of the establishing the undertaxed amount we ignore withholding tax.

The full marginal tax rate is the highest rate that could be charged on the taxable profits of that payee on finance related income. It does not include a higher tax rate that may be imposed under the Diverted Profits Tax.

The under-taxed amount is the relevant proportion of ordinary income that is subject to tax at a rate lower than the full marginal tax rate.

The highest rate at which tax is charged (R) recognises both income and capital taxes corresponding to the charge that would be imposed under the UK's income tax, capital gains tax or corporation tax regime.

### **Repo, UK Payer, dual treatment condition satisfied, counterparty entitled to underlying tax credit relief**

An example of an under-taxed amount arises where the non-UK party to a repo (under which the UK party is the in-substance borrower) is subject to tax on the return on the repo, but as a capital gain subject to less than the non-UK payee's full marginal rate on ordinary income.

The UK company is entitled to a deduction for deemed interest of 80.

In this example, the normal corporate income tax rate (the full marginal rate) is 30% but capital gains are taxed at 18% (ignoring indexation or any other computational adjustments of the gain).

Applying the formula

$$\frac{(UTA \times (FMR - R))}{FMR}$$

UTA is 80, the under-taxed amount

R is 18%, the rate actually suffered on the amount

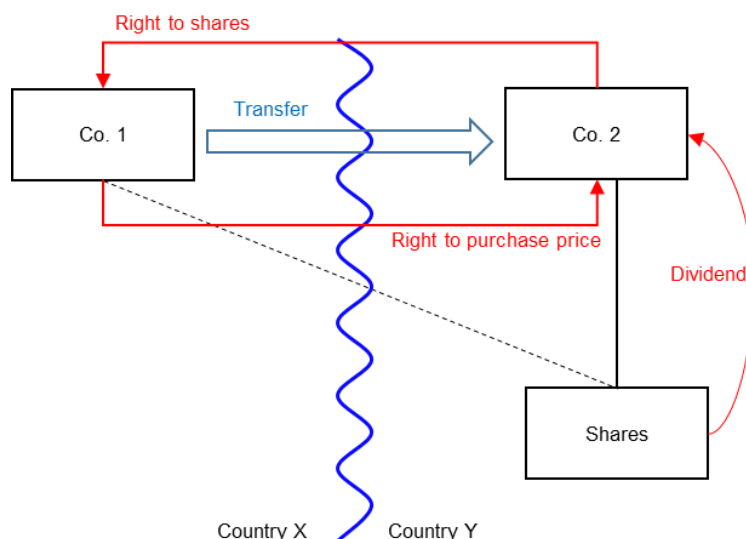
FMR is 30%, being the full marginal rate

The deduction denied would be:

$$80 \times (30\% - 18\%) \div 30\% = 32.$$

The UK company's deduction for deemed interest would be restricted by 32: from 80 to 48.

**Example illustrating under-taxed amount: Repo, UK payer, dual treatment condition satisfied, counterparty entitled to underlying tax credit relief**



A UK payer (Co. 1) sells shares to a counterparty (Co. 2) under a repo.

Co. 1 gets a deduction for a financing cost of 80 under the repo, which is equal to a dividend retained by the repo counterparty (a net-paying repo).

The sale and repurchase prices are equal once the dividend retained by the counterparty (Co. 2) is deducted from the purchase price (i.e. the finance cost = the expected distribution).

It is also assumed that the dividend is paid out of profits which have suffered tax in the share issuer's source jurisdiction of 20%.

The normal rate of tax on financing income on Co. 2 would be 30%. But it is able to treat the dividend retained as gross income of 100. Its gross tax liability would be 30, but this is reduced by credit for underlying tax of 20, leaving net tax of 10 payable. (It is assumed that no withholding tax arises.)

As there is only the one payer the under-taxed amount is 80, which is an amount equal to Co. 1's tax deduction.

Position of counterparty Co. 2:

- Co. 2's financing income from the hybrid transfer is 80 (the ordinary income that would be expected to be received under the repo is equal to the cash dividend received)
- The maximum rate of tax on that income (or at least the cash dividend) is  $10/80 = 12.5\%$ . This compares with a normal rate of tax (and FMR in the formula) on financing income of 30%. So R equals 12.5%.

The tax saved by Co. 2 as compared with the return on a conventional loan to Co. 1 is  $80 \times (30\% - 12.5\%) = 14$ . This is reconciled as 24 tax at 30%, on normal loan interest of 80, less 10, the net tax under the net-paying repo.

Applying the formula, the amount of the deduction/non-inclusion mismatch is:

$$\frac{(UTA \times (FMR - R))}{FMR}$$

Where -

UTA is 80, the under-taxed amount

R is 12.5%, as determined above

FMR is 30%, being the payee's full marginal rate

The deduction denied would be 46.67 calculated as below

$$\frac{80 \times (30\% - 12.5\%)}{30\%}$$

This is the tax saving to Co. 2 of 14, divided by its full marginal rate of tax, 30%, to give the measure of a notional non-inclusion that would provide the same tax-saving.

The primary counteraction, see [INTM552220](#), is to deny the UK payer (Co. 1) a deduction of the same amount, 46.67.

Co. 1 is therefore only able to deduct 33.33 of its repo interest expense of 80.



## **INTM552170: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion**

The financial trader exclusion (FTE), in s259DE TIOPA 2010, relates solely to hybrid transfer deduction/non-inclusion mismatches arising from a payment or quasi-payment that it is a substitute payment.

Substitute payments are very commonly made in commercial financial transactions, it is common for there to be chains of substitute payments, some between related parties and if a transaction under which a substitute payment is made is looked at narrowly, a deduction non-inclusion mismatch arises. But if the entirety of the chain of transactions giving rise to the payment is considered there is usually no mismatch.

At the beginning of the chain of transactions there is a real non-deductible dividend and at the end a substitute payment treated as a tax exempt dividend. Providing the financial trader brings all expenses and receipts into account in trading taxable profits, for example by being subject to tax on a dividend or substitute payment received, the financial trader gains no tax benefit. For this reason, in the Hybrid Transfers Chapter there is a special rule, the financial trader exclusion which can apply to deduction/non-inclusion mismatches that arise because a financial trader can deduct the cost of the substitute payment in computing profits.

The purpose of the financial trader inclusion is two-fold:

- to prevent inappropriate counteraction of mismatches, and
- to ease the compliance burden imposed on financial traders

This exclusion provides that excesses of deductions over inclusions, or under-taxed amounts, within the exclusion are not taken into account in computing the extent of a hybrid transfer deduction/non-inclusion mismatch under s259DC TIOPA 2010 (see [INTM552100](#)).

It does not apply to the class of transactions where the dual treatment condition is satisfied that is in-substance lending mismatches, see [INTM552060](#).

The illustration below shows that where the deduction is claimed by a financial trader, viewed in the whole there is no actual deduction/non-inclusion mismatch.

### **Illustration – bank acts as stock lending intermediary**

An investment entity (not a financial trader) which is a member of a group wishes to earn a stock lending fee by lending shares in the market. Its sister

company, a UK bank, has many clients that may wish to borrow the shares and acts as an intermediary - on-lending the shares to its client.

The stock loan extends over the record date for payment of a dividend. Accordingly the client makes a substitute payment to the bank which in turn makes a substitute payment to its sister investment company.

Looking at the overall transaction, the issuer of the underlying instrument (the shares) makes a dividend payment which is not tax-deductible.

The 3rd party client receives a dividend which is not taxable (for example because of participation exemption) and makes a non-deductible substitute payment to the UK bank which is tax neutral for the client.

The UK bank receives a substitute payment, which is taken into account in computing its tax liability.

The UK bank makes a deductible substitute payment to its sister investment company, which is not taxed on it as the payment is treated as a real tax-exempt dividend.

Overall there are:

- two non-deductible payments, by the issuer and the client,
- two non-taxable receipts, to the client and the investment company,
- and additionally one taxable receipt and one tax deductible payment to the UK bank.

Therefore it is tax-neutral.

Two entities may benefit from a participation exemption relating to the same dividend, but providing the client does not get a tax deduction for its substitute payment the position is neutral.

[INTM552180: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition A](#)

[INTM552190: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition B](#)

[INTM552200: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition C](#)

## **INTM552180: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition A**

Three conditions, A to C, must be satisfied in order for the financial trader exclusion to apply.

Condition A (s259DE(3) TIOPA 2010) is that:

- A mismatch arises from a payment or quasi-payment that is a substitute payment. In the illustration in [INTM552170](#) the substitute payment is made to the sister investment entity.
- The payment is treated by a person in a manner that reflects the facts that the substitute payment is representative of the underlying return (the underlying shares). In the illustration in [INTM552170](#) the person is the stock loan counterparty. This is the case because the substitute payment received is treated for taxable purposes in the same manner as a real dividend on the stock-lent shares.
- The substitute payment is brought into account in computing the taxable profits of a financial trader. In the illustration in [INTM552170](#) this is the UK bank who is the financial trader.

## **INTM552190: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition B**

Three conditions, A to C, must be satisfied in order for the financial trader exclusion to apply.

Condition B (s259DE(4) and (5)) is that the financial trader brings associated payments into account.

These are payments that are received by, or made by, the financial trader and relate to the underlying instrument or an arrangement that relates to the underlying instrument.

In the illustration in [INTM552170](#), the dividend on the shares borrowed, if actually received by the UK bank would be an associated return, as would the UK bank's return on some other transaction it enters into relating to the shares borrowed. Here the UK bank is trading the value of the dividend received forms part of its trading income but it is also allowed as a deduction the substitute payment made to the investment company who is the lender of the shares.

## **INTM552200: Hybrids: Chapter 4 - Hybrid transfers: The financial trader exclusion: Condition C**

Three conditions, A to C, must be satisfied in order for the financial trader exclusion to apply.

Condition C (s259DE(6)) has two legs which must both apply:

- The return on the underlying security must not be one to which Chapter 3 of the UK Hybrid and Other Mismatches provisions, nor an equivalent foreign provision, would apply. This counters the use of hybrid transfers as a means to avoid counteraction on the underlying instrument
- The hybrid transfer arrangement giving rise to the substitute payment is not a structured transaction. Structured payments are referred to in [INTM552150](#).

### **UK Hybrid and Other Mismatches Provisions and Equivalent Foreign Provision**

The example in [INTM552580](#) looks at the situation where equivalent foreign provisions to the UK hybrid and other mismatches provisions deny the financial trader exclusion. In this case we have L Co which is resident in country L which holds shares in I Co which is resident in country I. L Co lends the stock in I Co to U Co which is resident in the UK. U Co is a financial trader and it uses the borrowed stock as part of its trade to sell these shares short. (The repurchase price is expected to be less than the sale price allowing a profit on the transaction.)

In this example U Co, L Co and I Co are related parties. Country I allows a deduction for dividends paid. However it also has equivalent hybrid and other mismatches provisions. These provisions act to deny a deduction for dividends paid in country I if the payment is made to a related party. This means that if a dividend were paid direct from I Co to L Co then the deduction in I Co would be denied.

In the example the dividend is paid from I Co to U Co followed by a substitute payment to L Co. Here the deduction from I Co is allowed. However because the direct payment of the underlying return from I Co to L Co would trigger the equivalent foreign hybrids and mismatches provisions in Country I then under condition C the financial trader exclusion is not allowed. As shown in this example this satisfies the conditions for there to be a hybrid transfer deduction/non inclusion mismatch and a counteraction is required.

### **Structured Transactions**

The example in [INTM552570](#) shows condition C is failed because the hybrid transfer arrangement giving rise to the substitute payment is a structured transaction. This is because the transaction was structured giving rise to taxable benefits both to L Co and U Co and both the deductibility of the substitute payment paid by U Co and the non-taxation of the receipt of the substitute payment to L Co are critical to the design of the arrangement.

## **INTM552210: Hybrids: Chapter 4 - Hybrid transfers: Payments to relevant investment funds**

S259DC(9) TIOPA 2010 provides that a hybrid transfer deduction/non-inclusion mismatch is disregarded if, or to the extent that, it arises as a result of the payee being a relevant investment fund. The definition of a relevant investment fund is found in s259NA TIOPA 2010 (see [INTM550580](#)) in essence OEICs, authorised unit trusts and offshore funds that meet the genuine diversity of ownership condition. These entities are in substance transparent to income, where it's taxed (or not taxed in the case of an exempt investor) at the level of the investor.

Unlike the financial trader exclusion this exclusion applies both to substitute payments and to the return on funding transactions on which the dual treatment condition is satisfied – defined in s259DB(4) TIOPA 2010, see [INTM552060](#).

Neither is the exclusion limited to payments and quasi-payments made by financial traders. Where a payment of quasi-payment is to such an investor then, to the extent the excess is attributable to the payee being a relevant investment fund, compliance is simplified because it is not necessary to consider whether there is a related party transaction or whether, for example, the quantum of a substitute payment might be an indicator that there is a structured transaction. A counteraction will not arise.

## **INTM552220: Hybrids: Chapter 4 - Hybrid transfers: Counteraction UK payer**

In a case where the payer is within the charge to UK tax and a counteraction is due because all of the Conditions A to E in s259DA TIOPA 2010 are met, the payer is denied a deduction by s259DF(2) TIOPA 2010 for the deduction/non-inclusion mismatch, computed as at [INTM552160](#).



## **INTM552230: Hybrids: Chapter 4 - Hybrid transfers: Counteraction UK payee**

Counteraction in relation to a UK payee is dealt with in s259DG TIOPA 2010 and occurs only if it is reasonable to suppose that the corresponding payer is not denied a deduction under the UK hybrid mismatch legislation (s259DF TIOPA 2010, see [INTM552220](#)), or an equivalent provision under of another territory, or where the payer counteraction is only partial.

A counteraction is a partial counteraction if some of the hybrid transfer deduction/non-inclusion mismatch, as computed under the UK legislation at s259DC TIOPA 2010 (see [INTM552160](#)), remains deductible even after the equivalent provision has been applied.

If there is only one payee, the entire relevant amount is treated as taxable income of the UK payee for the counteraction period. The relevant amount is the hybrid transfer deduction/non-inclusion mismatch deduction that is not counteracted, or the part of the deduction that is not counteracted.

If there is more than one payee, this amount is apportioned between payees on a just and reasonable basis. This basis takes into account profit sharing arrangements that may exist between payees, to whom amounts that are not taxed as ordinary income arise and to whom under-taxed amounts arise.

The counteraction period in which the income should be included is the accounting period of the payee that coincides with the chargeable period of the payer (under its applicable tax law) or, if there is no such period, the payee's first accounting period that is wholly or partly contained within the payer's chargeable period.

## **INTM552500: Hybrids: Chapter 4 - Hybrid transfers: Examples of arrangements giving rise to mismatches**

These examples, illustrate the types of transaction that would be expected to be liable to counteraction under Chapter 4, Hybrid Transfers, of the Hybrid and Other Mismatches legislation.

[INTM552510: Hybrids: Chapter 4 - hybrid transfers: Example 4.1: Repo transaction creating an in-substance borrowing: No mismatch present.](#)

[INTM552520: Hybrids: Chapter 4 - hybrid transfers: Example 4.2: Repo transaction creating an in-substance borrowing: Mismatch present.](#)

[INTM552530: Hybrids: Chapter 4 - hybrid transfers: Example 4.3: Repo transaction creating an in-substance borrowing: Sharing benefits of different withholding tax rates.](#)

[INTM552540: Hybrids: Chapter 4 - hybrid transfers: Example 4.4: Example of transactions involving substitute payments: Basic pattern – stock loan mismatch created. UK company lends to company in another territory.](#)

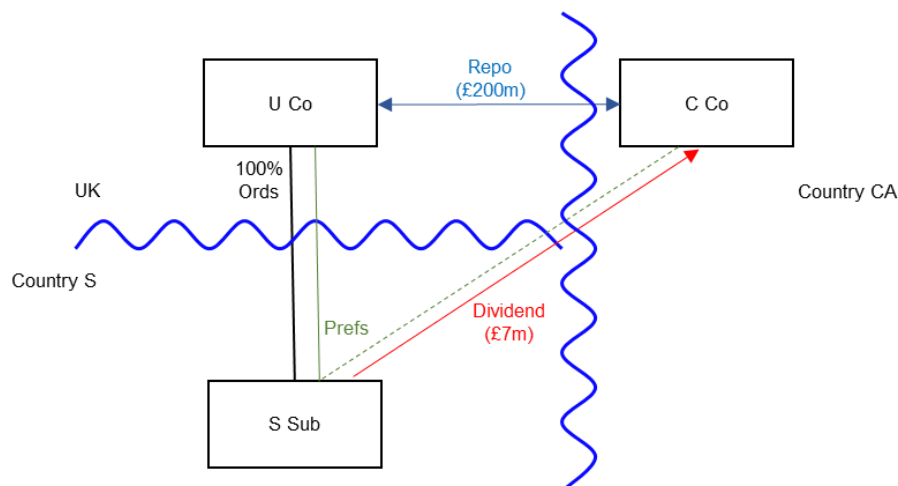
[INTM552550: Hybrids: Chapter 4 - hybrid transfers: Example 4.5: Example of transactions involving substitute payments: Basic pattern – stock loan mismatch created. UK company borrows from company in another territory.](#)

[INTM552560: Hybrids: Chapter 4 - hybrid transfers: Example 4.6: Example of transactions involving substitute payments: Basic pattern – stock loan. Financial trader exemption is allowed.](#)

[INTM552570: Hybrids: Chapter 4 - hybrid transfers: Example 4.7: Example of transactions involving substitute payments: Basic pattern – stock loan. UK is financial trader and substitute payment is made as part of structured arrangement.](#)

[INTM552580: Hybrids: Chapter 4 - hybrid transfers: Example 4.8: Example of transactions involving substitute payment: Basic pattern – stock loan. UK Company is a financial trader. Hybrid or similar rules applying in a foreign jurisdiction.](#)

## INTM552510: Hybrids: Chapter 4 - Hybrid transfers: Example 4.1: Repo transaction creating an in-substance borrowing: No mismatch present



U Co and C Co account for the repo as a loan. There is no hybrid transfer mismatch

### Background

- U Co is resident in the UK.
- U Co has a 100% subsidiary (S sub), which is incorporated and tax resident in Country S. In addition to ordinary shares S Sub has issued to U Co 3.5% fixed rate preference shares carrying 10% of the voting rights (the Prefs).
- U Co sells the entire holding in Prefs for £200m to an unrelated company, C Co - which is resident in Country CA. This is subject to an agreement (the Repo) that it will repurchase the shareholding after 12 months for £200m.
- During the period that C Co holds the Prefs S Sub pays a dividend of £7m to C Co. C Co is not required under the terms of the Repo to make a substitute payment to U Co.
- Company S is not entitled to a tax deduction in Country S in respect of this dividend.
- U Co accounts for the transactions as a borrowing of £200m, secured on the Prefs in S Sub, recognising a financing cost of £7m (being the dividend foregone) as accruing over the 12 month term of the Repo. The UK

permits U Co to deduct the £7m against its ordinary income for tax purposes.

- 3.5% represents an arm's length borrowing cost for U Co.
- Country CA treats the Repo for tax purposes as secured lending and in-substance interest of £7m is taxed as ordinary income at the full marginal rate.

## **Analysis – Applying the tests in s259DA TIOPA 2010**

### **Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

The agreement to sell and then repurchase the Prefs after 12 months for £200m is a repo, therefore this is a hybrid transfer arrangement within the definition in s259DB(2) TIOPA 2010.

Whether the arrangement was a repo would be beyond doubt if the repurchase price is computed by a formula such that the dividend retained by C Co reduced the repurchase price from £207m, which it would otherwise have been, to £200m by the £7m dividend retained.

Condition A is therefore satisfied.

Note: Also, if it were not a repo, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) or the dual treatment condition in s259DB(3)(a) is satisfied.

The Prefs satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

### **Substitute Payment, as defined in s259DB(5):**

In this case the Repo provides for the transfer of the Prefs and the payment of the dividend, made under the Repo, is representative of a return that arises on the Prefs and it is paid to C Co.

U Co is the person to whom the benefit of the dividend payment is given by virtue of it satisfying the finance element of the transaction, and they are a person other than C Co.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).

### **Dual Treatment Condition, as defined in s259DB(4):**

For U Co, the transaction is treated for tax purposes as equivalent in substance to a lending of money at interest and the quasi-payment (interest

accrual) under the Prefs is treated as reflecting this fact, with the dividend representing the finance element. Therefore s259DB(4)(a) is satisfied.

In this example, C Co, is taxed in Country CA on the corresponding return as ordinary income.

Accordingly the dual treatment condition is not satisfied as the requirements of s259DB(4)(b) are not met.

**Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

U Co may claim a deduction for the interest accrual against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to C Co had it adopted the same accounting approach and been within the charge to tax in the UK.

Therefore the accrued interest satisfies the definition of a quasi-payment within s259BB(2) TIOPA 2010 and Condition B is therefore met.

**Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4) is satisfied because U Co is within the charge to corporation tax.

**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

Given the background above it is reasonable to suppose that the UK will permit U Co a deduction (the relevant deduction) for the interest accrual against its ordinary income

In this example C Co is taxed in Country CA on the corresponding return as ordinary income. Accordingly the relevant deduction arising to U Co does not exceed the ordinary income arising to C Co and there is therefore no hybrid transfer deduction/non-inclusion mismatch.

Condition D is therefore not satisfied.

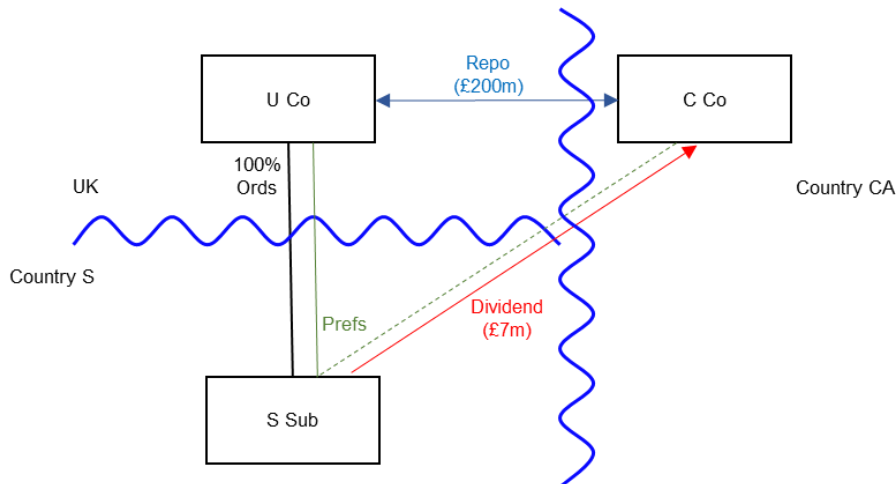
**Conclusion**

As Condition D is not satisfied, there is no need to consider Condition E.

## **Counteractions**

As Condition D is not satisfied in relation to Scenario A there is no hybrid transfer deduction/non-inclusion mismatch and therefore no counteraction under TIOPA10/s259DD.

## INTM552520: Hybrids: Chapter 4 - Hybrid transfers: Example 4.2: Repo transaction creating an in-substance borrowing. Mismatch present



U Co treats transaction as a loan. C Co treats transaction as dividends paid and received. There is a Hybrid Transfer Mismatch which is caught by the rules.

### Background

- U Co is resident in the UK.
- U Co has a 100% subsidiary (S sub), which is incorporated and tax resident in Country S. In addition to ordinary shares S Sub has issued to U Co 3.5% fixed rate preference shares carrying 10% of the voting rights (the Prefs).
- U Co sells the entire holding in Prefs for £200m to an unrelated company, C Co - which is resident in Country CA. This is subject to an agreement (the Repo) that it will repurchase the shareholding after 12 months for £200m.
- During the period that C Co holds the Prefs S Sub pays a dividend of £7m to C Co. C Co is not required under the terms of the Repo to make a substitute payment to U Co.
- Company S is not entitled to a tax deduction in Country S in respect of this dividend.
- U Co accounts for the transactions as a borrowing of £200m, secured on the Prefs in S Sub, recognising a financing cost of £7m (being the dividend

foregone) as accruing over the 12 month term of the Repo. The UK permits U Co to deduct the £7m against its ordinary income for tax purposes.

- 4.0% represents an arm's length borrowing cost for U Co.
- Country CA treats the Repo for tax purposes as a normal acquisition of shares, acquired and sold for £200m, giving rise to no profit or loss. The dividend received is exempted from tax.

## **Analysis – Applying the tests in s259DA TIOPA 2010**

### **Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

The agreement to sell and then repurchase the Prefs after 12 months for £200m is a repo, therefore this is a hybrid transfer arrangement within the definition in s259DB(2) TIOPA 2010.

Whether the arrangement was a repo would be beyond doubt if the repurchase price is computed by a formula such that the dividend retained by C Co reduced the repurchase price from £207m, which it would otherwise have been, to £200m by the £7m dividend retained.

Condition A is therefore satisfied.

Note: Also, if it were not a repo, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) TIOPA 2010 or the dual treatment condition in s259DB(3)(a) is satisfied.

The Prefs satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

### **Substitute Payment, as defined in s259DB(5)**

In this case the Repo provides for the transfer of the Prefs and the payment of the dividend, made under the Repo, is representative of a return that arises on the Prefs and it is paid to C Co.

U Co is the person to whom the benefit of the dividend payment is given by virtue of it satisfying the finance element of the transaction, and they are a person other than C Co.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).



**Dual Treatment Condition, as defined in s259DB(4)**

For U Co, the transaction is treated for tax purposes as equivalent in substance to a lending of money at interest and the quasi-payment (interest accrual) under the Prefs is treated as reflecting this fact, with the dividend representing the finance element. Therefore s259DB(4)(a) is satisfied.

In this scenario Country CA does not reflect the arrangement being regarded as equivalent, in substance, to a transaction for the lending of money at interest but as a generic dividend receipt – which it consequentially exempts from tax. Accordingly the requirements of s259DB(4)(b) are met and the ‘dual treatment condition’ in s259DB(4) is satisfied.

**Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

U Co may claim a deduction for the interest accrual against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to C Co had it adopted the same accounting approach and been within the charge to tax in the UK.

Therefore the accrued interest satisfies the definition of a quasi-payment within s259BB(2) TIOPA 2010 and Condition B is therefore met.

**Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4) is satisfied for because U Co is within the charge to corporation tax.

**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

Given the background above it is reasonable to suppose that the UK will permit U Co a deduction (the relevant deduction) for the interest accrual against its ordinary income.

In this example it is reasonable to suppose that Country CA will not require C Co to bring the corresponding receipt into tax as ordinary income. This is by reason of either the dual treatment condition within s259DB(4) being met or the payment being a Substitute Payment within s259DB(5).

Condition D is therefore satisfied and there is a hybrid transfer deduction/non-inclusion mismatch.

**Condition E: Are U Co and C Co related, or is the arrangement a structured arrangement?**

In this example the features of the design (for instance its elaborate nature, the equality of sale and repurchase price) suggest that the transaction was designed to create a mismatch - in a real scenario other factors such as a reorganisation of the share capital of S Co to facilitate the transaction would reinforce this.

The tax mismatch benefit is priced into the transaction. U co is able to raise funding at a lower rate than under conventional funding, but C Co's post-tax return is more than that from conventional lending. Consequently, this is a structured arrangement as defined in s259DA(7), so condition E is satisfied.

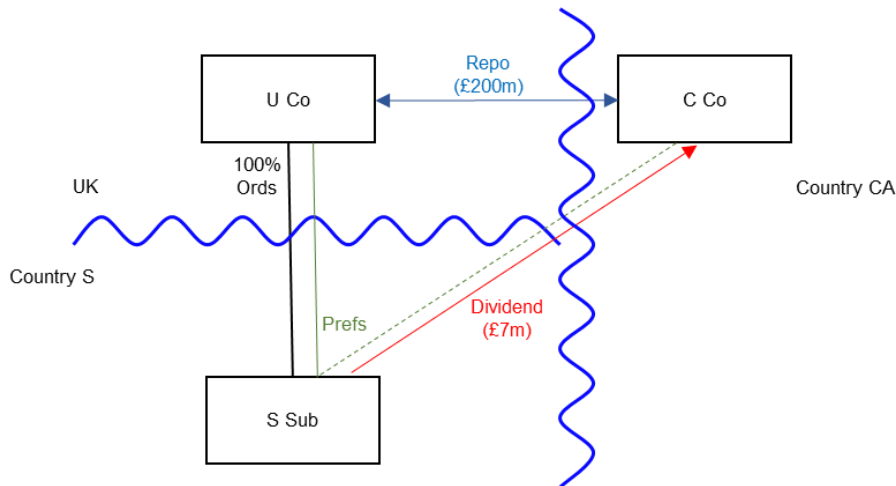
**Conclusion**

All the Conditions are satisfied for there to be a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the relevant deduction.

**Counteraction**

As the UK is only in the position of the payer then the only relevant counteraction is TIOPA10/s259DF. U Co will be denied a deduction against its ordinary income for the entire interest accrual (£7m).

## INTM552530: Hybrids: Chapter 4 - hybrid transfers: Example 4.3: Repo transaction creating an in-substance borrowing: Sharing benefits of different withholding tax rates



In this case underlying tax credits are allowed in Country CA which would not occur if the dividend is paid directly to U Co. Here this benefit is priced into the transaction.

### Background

- U Co is resident in the UK.
- U Co has a 100% subsidiary (S sub), which is incorporated and tax resident in Country S. In addition to ordinary shares S Sub has issued to U Co 3.5% fixed rate preference shares carrying 10% of the voting rights (the Prefs).
- U Co sells the entire holding in Prefs for £200m to an unrelated company, C Co - which is resident in Country CA. This is subject to an agreement (the 'Repo') that it will repurchase the shareholding after 12 months for £200m.
- During the period that C Co holds the Prefs, S Sub pays a dividend of £7m to C Co. C Co is not required under the terms of the Repo to make a substitute payment to U Co.
- Company S is not entitled to a tax deduction in Country S in respect of this dividend.

- U Co accounts for the transactions as a borrowing of £200m, secured on the Prefs in S Sub, recognising a financing cost of £7m (being the dividend foregone) as accruing over the 12 month term of the Repo. The UK permits U Co to deduct the £7m against its ordinary income for tax purposes.
- 3.9% represents an arm's length borrowing cost for U Co.
- Country CA treats the Repo for tax purposes as a normal acquisition of shares, acquired and sold for £200m, giving rise to no profit or loss. The dividend received is taxable as ordinary income, but credit is allowed for the underlying tax levied in Country S on the profits out of which the dividend is paid.

## **Analysis – Applying the tests in s259DA TIOPA 2010**

### **Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

The agreement to sell and then repurchase the Prefs after 12 months for £200m is a repo, therefore this is a hybrid transfer arrangement within the definition in s259DB(2) TIOPA 2010.

Whether the arrangement was a repo would be beyond doubt if the repurchase price is computed by a formula such that the dividend retained by C Co reduced the repurchase price from £207m, which it would otherwise have been, to £200m by the £7m dividend retained.

Condition A is therefore satisfied.

Note: Also, if it were not a repo, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) TIOPA 2010 or the dual treatment condition in s259DB(3)(a) is satisfied.

The Prefs satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

### **Substitute Payment, as defined in s259DB(5)**

In this case the Repo provides for the transfer of the Prefs and the payment of the dividend, made under the Repo, is representative of a return that arises on the Prefs and it is paid to C Co.

U Co is the person to whom the benefit of the dividend payment is given by virtue of it satisfying the finance element of the transaction, and they are a person other than C Co.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).

**Dual Treatment Condition, as defined in s259DB(4)**

For U Co, the transaction is treated for tax purposes as equivalent in substance to a lending of money at interest and the quasi-payment (interest accrual) under the Prefs is treated as reflecting this fact, with the dividend representing the finance element. Therefore s259DB(4)(a) is satisfied.

In this example, whilst Country CA does levy some tax, it does not tax levy tax on C Co on the premise that arrangement is equivalent, in substance, to the lending of money at interest.

Accordingly the requirements of s259DB(4)(b) are met and the dual treatment condition in s259DB(4) is satisfied.

**Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

U Co may claim a deduction for the interest accrual against its ordinary income for the purposes of calculating its taxable profits, and it would be reasonable to expect that an amount of ordinary income would have arisen to C Co had it adopted the same accounting approach and been within the charge to tax in the UK.

Therefore the accrued interest satisfies the definition of a quasi-payment within s259BB(2) TIOPA 2010 and Condition B is therefore met.

**Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4) is satisfied because U Co is within the charge to corporation tax.

**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

Given the background above it is reasonable to suppose that the UK will permit U Co a deduction (the relevant deduction) for the interest accrual against its ordinary income.

In this example it is reasonable to suppose (based on the background above) that although Country CA will require C Co to bring the corresponding receipt into tax as ordinary income it will permit against the charge a credit for underlying tax credit. The taxable profits of C Co are therefore under taxed within the definition in s259DC(9) and this is by reason of either the dual treatment condition within s259DB(4) being met or the payment being a Substitute Payment within s259DB(5).

Condition D is therefore satisfied.

**Condition E: Are U Co and C Co related, or is the arrangement a structured arrangement?**

In this example the features of the design (for instance its elaborate nature, the equality of sale and repurchase price) suggest that the transaction was designed to create a mismatch - in a real scenario other factors such as a reorganisation of the share capital of S Co to facilitate the transaction would reinforce this.

Further the tax mismatch benefit is priced into the transaction: U co is able to raise funding at a lower rate than under conventional funding, but C Co's post-tax return is more than that from conventional lending. Consequently, this is a structured arrangement as defined in s259DA(7), so condition E is satisfied.

**Counteractions**

All the Conditions are satisfied for there to be a hybrid transfer deduction/non-inclusion mismatch, which is calculated by means of the formula in s259DC(12).

This is:

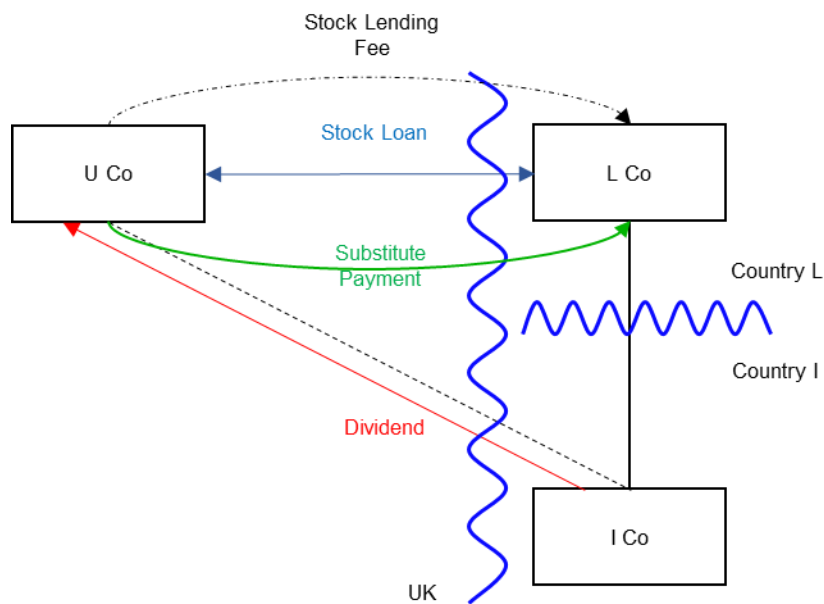
$$\frac{UTA \times (FMR - R)}{FMR}$$

Where:

- UTA is the under-taxed amount. This is the amount of dividend charged at a reduced rate in Country CA.
- FMR is the C Co's full marginal rate (expressed as a %) for the permitted taxable period in which the under-taxed amount is included in taxable profit. This is the highest rate which would have been charged on income from a financial instrument in Country CA.
- R is the rate (expressed as a %) at which the relevant tax is charged on the ordinary income in which the under taxed amount is included. This is the lower rate being applied to the dividend income by reason of the underlying tax credit.

As the UK is only in the position of the payer then the only relevant counteraction is s259DF TIOPA 2010. U Co will be denied a deduction in an amount equal to the hybrid transfer deduction/non-inclusion mismatch. This is calculated by using the above formula.

## INTM552540: Hybrids: Chapter 4 - hybrid transfers: Example 4.4: Examples of transactions involving substitute payments: Basic pattern – stock loan mismatch created. UK company lends to company in another territory



An example of a stock loan that is designed to create a hybrid transfer mismatch

### Background

- U Co is resident in the UK
- L Co is tax resident and incorporated in Country L. At the beginning of the transaction it holds shares in I Co which is tax resident and incorporated in Country I.
- L Co enters into a stock lending transaction with U Co.
- L Co transfers its shares in I Co to U Co.
- Under the agreement for this transaction after 24 days U Co will transfer the same or identical shares back to L Co. In this period U Co provides collateral (cash or high grade securities). This collateral will be transferred back with any return made on the securities or interest due on cash when shares are returned.

- U Co pays stock lending fee to L Co.
- The record date falls during the 24 day period for the I Co shares. L Co does not receive this dividend.
- Under the terms of the stock lending agreement U Co is required to make a substitute payment (manufactured dividend) to L Co. This is related to the amount of the dividend received for the I Co shares but not necessarily the same.
- U Co holds the stock on the record date and receives the actual dividend for the I Co Shares.
- U Co is not taxed on this actual dividend received.
- U Co can claim a taxable deduction on the substitute payment it made to L Co.
- L Co is taxed in country L as it still held the shares when the dividend was received. It treats the substitute payment as a non-taxable dividend.

## **Analysis – Applying the tests in s259DA TIOPA 2010**

### **Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

This is a stock lending arrangement which is in the meaning of hybrid transfer arrangement under s259DB(2) TIOPA 2010. Condition A is therefore satisfied.

Note: Also, if it were not defined as a stock lending arrangement, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) or the dual treatment condition in s259DB(3)(a) is satisfied.

The shares that are part of the stock lending transaction could satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010 depending on the type of share being lent, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

### **Substitute Payment, as defined in s259DB(5)**

In this case the agreement in the stock lending transaction requires U Co to make a substitute payment to L Co when U Co receives the actual dividend from I Co. Under s259DB(5) there is an amount paid which is representative of the dividend received on the shares and this amount is paid to L Co who is someone who did not receive the actual dividend.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).



**Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

It has been established for Condition A that there is a hybrid transfer arrangement in relation to an underlying instrument and that a payment (the substitute payment) has been made in connection with this arrangement. This payment falls into the definition of payment as outlined in s259BB(1) TIOPA 2010. Condition B is therefore satisfied.

**Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4)(a) is satisfied for because U Co is within the charge to corporation tax. Condition C is therefore satisfied.

**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

The deduction for the substitute payment is allowed in the UK but the receipt of the substitute payment is treated as a non-taxable dividend in country L. This is a Case 1 Hybrid transfer deduction/non-inclusion mismatch as defined in s259DC(2). Condition D is therefore satisfied.

**Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?**

For condition E to be in point for this example s259DB(6)(c) has to be considered. U Co gets the benefit of a deduction for the substitute payment. There is also a stock lending fee that U Co pays to L Co. This means that the mismatch will be priced into the stock lending arrangement so it will fall into the definition of structured arrangement as defined in s259DB(7). Condition E is therefore satisfied.

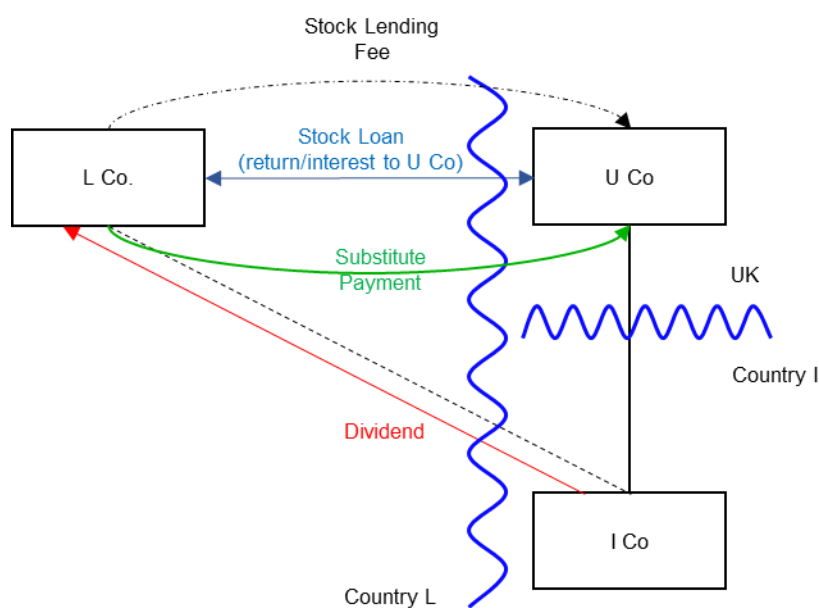
**Conclusion**

All the Conditions are satisfied for there to be a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the deduction for the substitute payment.

**Counteraction**

As the UK is only in the position of the payer then the only relevant counteraction is s259DF TIOPA 2010. U Co will bring the amount of the substitute payment as taxable income because it will be denied the deduction for the substitute payment.

## INTM552550: Hybrids: Chapter 4 - hybrid transfers: Example 4.5: Examples of transactions involving substitute payments: Basic pattern – stock loan mismatch created. UK company borrows from company in another territory



Here this has the same background as the previous example but in this case the positions of U and L are reversed with U being the stock lender.

### Background

- U Co is resident in the UK. At the beginning of the transaction it holds shares in I Co which is tax resident and incorporated in Country I.
- L Co is tax resident and incorporated in Country L.
- U Co enters into a stock lending transaction with L Co.
- U Co transfers its shares in I Co to L Co.
- Under the agreement of this transaction after 24 days L Co will transfer the same or identical shares back to U Co. In this period L Co provides collateral (cash or high grade securities). This collateral will be transferred back with any return made on the securities or interest due on cash when shares are returned.

- L Co pays stock lending fee to U Co.
- The record date falls during the 24 day period for the I Co shares. U Co does not receive this dividend.
- Under the terms of the stock lending agreement L Co is required to make a substitute payment (manufactured dividend) to U Co. This is related to the amount of the dividend received for the I Co shares but not necessarily the same.
- L Co holds the stock on the record date and receives the actual dividend for the I Co Shares.
- L Co is not taxed on this actual dividend received.
- L Co can claim a taxable deduction for substitute payment made to U Co
- U Co is taxed in the UK as it still held the shares when the dividend was received It treats the substitute payment as a non-taxable dividend. Under s814D(2) CTA 2010 it is taxed as if it were the real dividend.

## **Analysis – Applying the tests in s259DA TIOPA 2010**

### **Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

This is a stock lending arrangement which is in the meaning of hybrid transfer arrangement under s259DB(2) TIOPA 2010. Condition A is therefore satisfied.

Note: Also, if it were not defined as a stock lending arrangement, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) or the dual treatment condition in s259DB(3)(a) is satisfied.

The shares that are part of the stock lending transaction could satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010 depending on the type of share being lent, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

### **Substitute Payment, as defined in s259DB(5)**

In this case the agreement in the stock lending transaction requires L Co to make a substitute payment to U Co when L Co receives the actual dividend from I Co. Under s259DB(5) there is an amount paid which is representative of the dividend received on the shares and this amount is paid to L Co who is someone who did not receive the actual dividend.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).

**Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

It has been established for Condition A that there is a hybrid transfer arrangement in relation to an underlying instrument and that a payment (the substitute payment) has been made in connection with this arrangement. This payment falls into the definition of payment as outlined in s259BB(1) TIOPA 2010. Condition B is therefore satisfied.

**Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4)(a) is satisfied for because U Co is within the charge to corporation tax. Condition C is therefore satisfied.

**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

The deduction for the substitute payment is allowed in Country L but the receipt of the substitute payment is treated as a non-taxable dividend in the UK. This is a Case 1 Hybrid transfer deduction/non-inclusion mismatch as defined in s259DC(2). Condition D is therefore satisfied.

**Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?**

For condition E to be in point for this example s259DB(6)(c) has to be considered. L Co gets the benefit of a deduction for the substitute payment. There is also a stock lending fee that L Co pays to U Co. This means that the mismatch will be priced into the stock lending arrangement so it will fall into the definition of structured arrangement as defined in s259DB(7). Condition E is therefore satisfied.

**Conclusion**

All the Conditions are satisfied for there to be a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the deduction for the substitute payment.

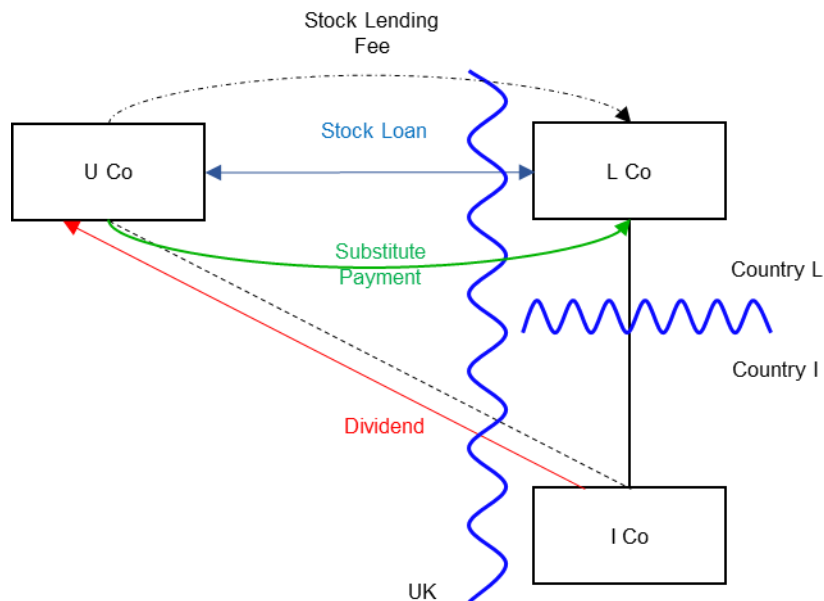
**Counteraction**

This example differs to the previous one in the fact that the payer and payee are reversed. We assume that country L does not have legislation in place similar to the Hybrids or other mismatch rules.

The UK company is in the position of the payee then the only relevant counteraction is s259DG TIOPA 2010. U Co will bring in the amount of the substitute payment received as taxable income in the UK.

## INTM552560: Hybrids: Chapter 4 - hybrid transfers: Example 4.6: Examples of transactions involving substitute payments

### Basic pattern –stock loan. Financial trader exemption is allowed.



In this stock lending arrangement U Co is a financial trader and is a related party of L Co.

### Background

- U Co is resident in the UK. It is a financial trader and all transactions in this arrangement are within its financial trade.
- L Co is tax resident and incorporated in Country L. At the beginning of the transaction it holds shares in I Co which is tax resident and incorporated in Country I.
- U Co and L Co are in the same worldwide group and are related parties.
- L Co enters into a stock lending transaction with U Co.
- L Co transfers its shares in I Co to U Co.
- The stock lending transaction facilitates U Co selling these borrowed shares short. (U Co is expecting the price of the shares to fall after it sells them. Later it will then purchase identical shares so that it can repay the

stock loan to L Co. As the expected repurchase price is lower than the sale price it makes a profit.)

- Under the agreement for this transaction after 24 days U Co will transfer the same or identical shares back to L Co. In this period U Co provides collateral (cash or high grade securities). This collateral will be transferred back with any return made on the securities or interest due on cash when shares are returned.
- U Co pays stock lending fee to L Co.
- The record date falls during the 24 day period for the I Co shares. L Co does not receive this dividend.
- On the record date U Co still holds the shares and has not sold them yet.
- Under the terms of the stock lending agreement U Co is required to make a substitute payment (manufactured dividend) to L Co. This is related to the amount of the dividend received for the I Co shares but not necessarily the same.
- U Co holds the stock when the dividend is paid and receives the actual dividend for the I Co Shares.
- U Co is taxed on the dividend as income in the course of its financial trade.
- U Co can claim a taxable deduction on the substitute payment it made to L Co.
- L Co is taxed in country L as it still held the shares when the dividend was received. It treats the substitute payment as a non-taxable dividend.
- This transaction was not designed to facilitate any tax mismatch and as a consequence this is not priced into the transaction.

## **Analysis – Applying the tests in s259DA TIOPA 2010**

### **Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

This is a stock lending arrangement which is within the meaning of hybrid transfer arrangement under s259DB (2) TIOPA 2010. Condition A is therefore satisfied.

Note: Also, if it were not defined as a stock lending arrangement, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) or the dual treatment condition in s259DB(3)(a) is satisfied.

The shares that are part of the stock lending transaction could satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010 depending on the type of share being lent, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

**Substitute Payment, as defined in s259DB(5)**

In this case the agreement in the stock lending transaction requires U Co to make a substitute payment to L Co when U Co receives the actual dividend from I Co. Under s259DB(5) there is an amount paid which is representative of the dividend received on the shares and this amount is paid to L Co, a person that did not receive the actual dividend.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).

**Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

It has been established for Condition A that there is a hybrid transfer arrangement in relation to an underlying instrument and that a payment (the substitute payment) has been made in connection with this arrangement. This payment falls into the definition of payment as outlined in s259BB(1) TIOPA 2010. Condition B is therefore satisfied.

**Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4)(a) is satisfied for because U Co is within the charge to corporation tax. Condition C is therefore satisfied.

**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

The deduction for the substitute payment is allowed in the UK but the receipt of the substitute payment is treated as a non-taxable dividend in country L. This could be a potential Case 1 Hybrid transfer deduction/non-inclusion mismatch as defined in s259DC(2). However it is noted that U Co is a financial trading company and we have to consider the financial trader exclusion s259DC(9) and s259DE.

The substitute payment is brought in by the financial trader in calculating the profits of its trade. The financial trade also brings in associated payments into accounts. If the dividend payment was made directly from I Co to L Co then the hybrid legislation would not apply nor similar rules in another country. It is made clear that it is not a structured arrangement, the intention of which is to create a mismatch. Therefore the trader exclusion applies. Condition D is therefore not satisfied.

**Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?**

Once condition D is not satisfied Condition E does not need to be considered. However for completeness as U Co and L Co are related s259DA(6)(b) applies so even though the arrangement is not a structured arrangement Condition E still applies.

**Conclusion**

As the financial trader exclusion applies, Condition D is not satisfied and no counteraction is necessary.

**Counteraction**

None.

**Note 1: What if shares are sold cum-dividend and equivalent shares bought ex-dividend**

The background in the example assume that the record date was when U Co held the shares. However as U Co is trading in these shares it is likely that it may not hold the shares on the record date. Here it is assumed U Co delivers the shares, cum dividend (before the record date) to a third party in a normal market sale. It is not known what happens to the shares after that sale. Later, and after the record date, U Co buys equivalent shares from a third party in the market, ex-dividend (after the record date) and delivers these shares to L Co as a repayment of the stock loan.

As part of the stock loan agreement U Co still has to make a substitute payment to related party L Co. This is tax-deductible to UK financial trader U co, but not taxable to lender L Co which benefits from a dividend exemption as if it had received the real dividend. This is still not a structured transaction, and the dividend is not tax-deductible to Company I.

The position of U Co remains the same. Condition D in s259DA(5) is again not satisfied as a result of the financial trader exclusion in s259DC(9) and s259DE.

The key point is that the deduction arises only because of U Co's financial trader status. It is not dependent on matching the tax treatment of U Co on the dividend received and the substitute payment made. U Co is unlikely to be aware of who received the actual dividend on the shares sold and the shares later purchased in the market or how the dividends are taxed. U Co's is taxed on its commercial profits from the trading. Whether shares were bought cum-dividend and purchased ex-dividend will already be recognised in the valuation of the shares and be reflected in the profits of the transaction.



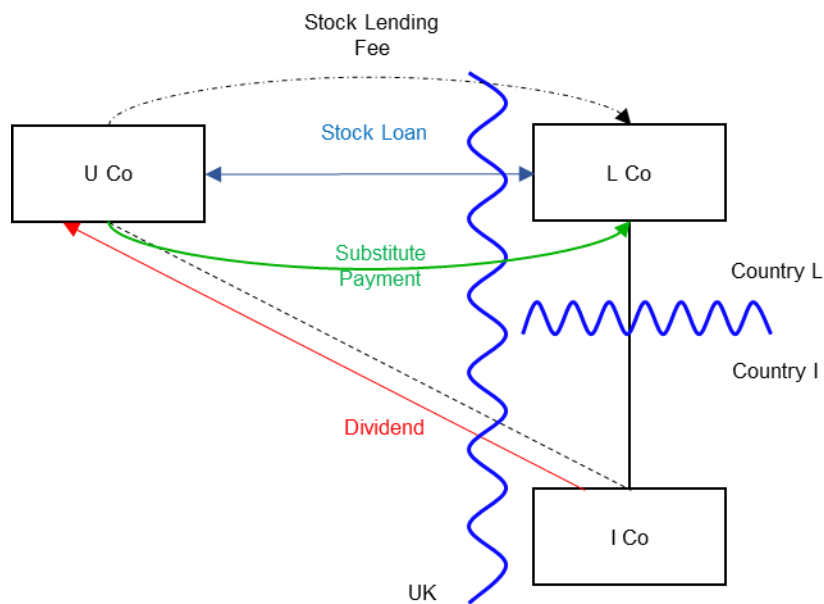
**Note 2: Withholding Tax benefits priced into the arrangement**

This example can present issues where there are different withholding tax rates on dividends paid from Country I to Country L and from Country I to the UK. For example if L Co receives the dividend directly from I Co and a withholding tax rate of 30% is applied. However in this situation U Co is registered holder of the shares on the dividend payment date, I Country dividend withholding tax is for example 15% to the UK. As s822-925 ITA 2007 have been repealed, U Co is not required to withhold UK income tax from the overseas manufactured dividend. Therefore there is a potential benefit in routing the dividend through the UK to Country L as this would allow less withholding tax on the dividend.

It is then assumed that the amount of the substitute payment is such that the withholding tax benefit is split between the parties and on a gross dividend of 100, the substitute payment is, say, 77, more than the 70 that L Co would have receive in respect of a direct dividend, but less than the 85 received by U Co.

The analysis is essentially the same as in the example. So far as the application of the financial trader exclusion is concerned, this is not denied by s259DE(6)(b). There is an economic benefit that is related to the withholding tax treatment that is reflected in the amount of the substitute payment. However this economic benefit does not come from the deduction/non-inclusion mismatch. This type of tax arbitrage is outside the scope of the hybrid and other mismatches provisions.

## INTM552570: Hybrids: Chapter 4 - hybrid transfers: Example 4.7: Example of transactions involving substitute payments. Basic pattern - stock loan. UK is financial trader and substitute payment is made as part of structured arrangement



In this stock lending transaction U Co is a financial trading company and is a related party of L Co. Here the substitute payment made by U Co is part of a structured arrangement.

### Background

- U Co is resident in the UK. It is a financial trader and all transactions in this arrangement are within its financial trade.
- L Co is tax resident and incorporated in Country L. At the beginning of the transaction it holds shares in I Co which is tax resident and incorporated in Country I.
- U Co and L Co are in the same worldwide group and are related parties.
- L Co enters into a stock lending transaction with U Co.
- L Co transfers its shares in I Co to U Co.

- The stock lending transaction facilitates U Co selling these borrowed shares short. (U Co is expecting the price of the shares to fall after it sells them. Later it will then purchase identical shares so that it can repay the stock loan to L Co. As the expected repurchase price is lower than the sale price it makes a profit.)
- Under the agreement for this transaction after 24 days U Co will transfer the same or identical shares back to L Co. In this period U Co provides collateral (cash or high grade securities). This collateral will be transferred back with any return made on the securities or interest due on cash when shares are returned.
- U Co pays stock lending fee to L Co.
- During the 24 day period the record date falls for the I Co shares. L Co does not receive this dividend.
- On the record date U Co still holds the shares and has not sold them yet.
- Under the terms of the stock lending agreement U Co is required to make a substitute payment (manufactured dividend) to L Co. This is related to the amount of the dividend received for the I Co shares but not necessarily the same.
- U Co holds the stock on the record date and receives the actual dividend for the I Co Shares.
- U Co is taxed on the income of the dividend as if it was received in the normal course of its financial trade.
- U Co can claim a taxable deduction on the substitute payment it made to L Co.
- L Co is taxed in country L as it still held the shares when the dividend was received. It treats the substitute payment as a non-taxable dividend.
- This transaction is designed to give rise to an overall tax benefit to the parties taken as a whole and it is critical to the design that both U Co is able to obtain a tax deduction for the substitute payment and L Co is not taxed upon the receipt of the substitute payment.

Analysis – Applying the tests in s259DA TIOPA 2010

**Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

This is a stock lending arrangement which is in the meaning of hybrid transfer arrangement under s259DB(2) TIOPA 2010. Condition A is therefore satisfied.

Note: Also, if it were not defined as a stock lending arrangement, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) or the dual treatment condition in s259DB(3)(a) is satisfied.

The shares that are part of the stock lending transaction could satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010 depending on the type of share being lent, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

**Substitute Payment, as defined in s259DB(5)**

In this case the agreement in the stock lending transaction requires U Co to make a substitute payment to L Co when U Co receives the actual dividend from I Co. Under s259DB(5) there is an amount paid which is representative of the dividend received on the shares and this amount is paid to L Co who is someone who did not receive the actual dividend.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).

**Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

It has been established for Condition A that there is a hybrid transfer arrangement in relation to an underlying instrument and that a payment (the substitute payment) has been made in connection with this arrangement. This payment falls into the definition of payment as outlined in s259BB(1) TIOPA 2010. Condition B is therefore satisfied.

**Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4)(a) is satisfied because U Co is within the charge to corporation tax. Condition C is therefore satisfied.

**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

The deduction for the substitute payment is allowed in the UK but the receipt of the substitute payment is treated as a non-taxable dividend in country L. This could be a potential Case 1 Hybrid transfer deduction/non-inclusion mismatch as defined in s259DC(2). However it is noted that U Co is a financial trading company and we have to consider the financial trader exclusion s259DC(9) and s259DE.

What this example shows clearly is that we have U Co and L Co entering into a structured arrangement. Applying TIOPA 10/s259DE(6)(b) means that the

financial trader exclusion cannot apply despite the fact that the substitute payment is brought into account for determining U Co's taxable profits. As the financial trader exclusion has now been removed there is a definite Case 1 Hybrid transfer deduction/non-inclusion mismatch. Condition D is therefore satisfied.

**Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?**

U Co and L Co are related so s259DA(6)(b) applies. The arrangement is also a structured arrangement so s259DA(7) also applies. Condition E is therefore satisfied.

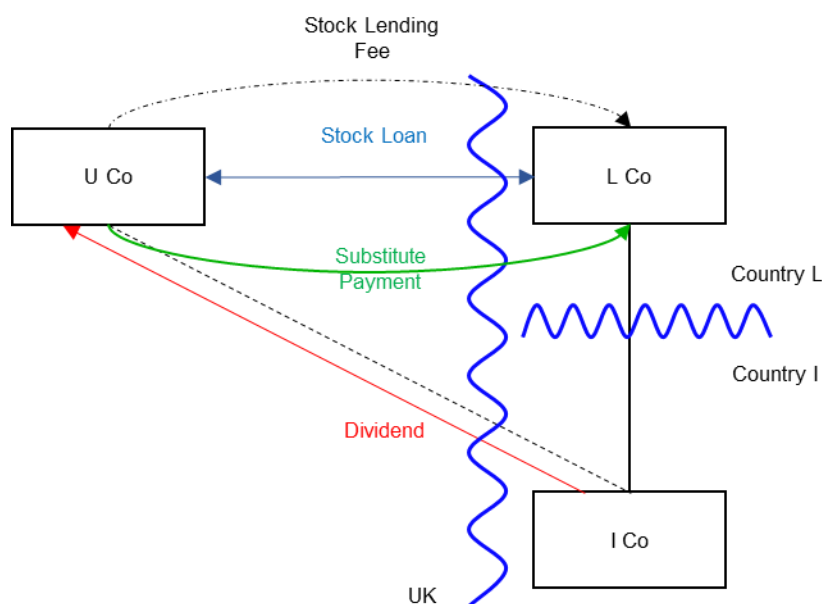
**Conclusion**

All the Conditions are satisfied for there to be a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the deduction for the substitute payment.

**Counteraction**

As the UK is only in the position of the payer then the only relevant counteraction is s259DF. U Co will bring the amount of the substitute payment as taxable income because it will be denied the deduction for the substitute payment.

**INTM552580: Hybrids: Chapter 4 - hybrid transfers: Example 4.8: Examples of transactions involving substitute payments: Basic pattern – stock loan UK Company is a financial trader. Hybrid or similar rules applying in a foreign jurisdiction.**



In this example U Co is a trader but U Co, L Co and I Co are all part of the same worldwide group and therefore related. I Co normally allows a deduction for dividend payments but not to connected parties. Therefore if the dividend payment were made directly to U then their equivalent hybrid mismatch rules would deny the deduction.

**Background**

- U Co is resident in the UK. It is a financial trader and all transactions in this arrangement are within its financial trade.
- L Co is tax resident and incorporated in Country L. At the beginning of the transaction it holds shares in I Co which is tax resident and incorporated in Country I.
- U Co and L Co are in the same worldwide group and are related parties.
- L Co enters into a stock lending transaction with U Co.

- L Co transfers its shares in I Co to U Co.
- The stock lending transaction facilitates U Co selling these borrowed shares short. (U Co is expecting the price of the shares to fall after it sells them. Later it will then purchase identical shares so that it can repay the stock loan to L Co. As the expected repurchase price is lower than the sale price it makes a profit.)
- Under the agreement for this transaction after 24 days U Co will transfer the same or identical shares back to L Co. In this period U Co provides collateral (cash or high grade securities). This collateral will be transferred back with any return made on the securities or interest due on cash when shares are returned.
- U Co pays stock lending fee to L Co.
- During the 24 day period the record date falls for the I Co shares. L Co does not receive this dividend.
- On the record date U Co still holds the shares and has not sold them yet.
- Under the terms of the stock lending agreement U Co is required to make a substitute payment (manufactured dividend) to L Co. This is related to the amount of the dividend received for the I Co shares but not necessarily the same.
- U Co holds the stock on the record date and receives the actual dividend for the I Co Shares.
- U Co is taxed on the income from the dividend as if it was part of their normal finance trade.
- U Co can claim a taxable deduction on the substitute payment it made to L Co.
- L Co is taxed in country L as it still held the shares when the dividend was received. It treats the substitute payment as a non-taxable dividend.
- This transaction was not designed to facilitate any tax mismatch and as a consequence this is not priced into the transaction.
- U Co, L Co and I Co are related parties.
- Country I allows a tax deduction for dividend payments. However Country I has a hybrid mismatch rule similar to s259BA TIOPA 2010.
- The deduction for the dividend in I Co would be denied if it was paid directly to L Co. However if the dividend is paid to U Co and this is brought into account for U Co's finance trade the deduction would still be allowed.

## **Analysis – Applying the tests in s259DA TIOPA 2010**

### **Condition A: Is there a hybrid transfer arrangement in relation to an underlying instrument?**

This is a stock lending arrangement which is in the meaning of hybrid transfer arrangement under s259DB(2) TIOPA 2010. Condition A is therefore satisfied.

Note: Also, if it were not defined as a stock lending arrangement, but was any other arrangement then it may still give rise to a hybrid transfer arrangement if it provided for a transfer of a financial instrument and either a substitute payment was made within s259DB(3)(b) or the dual treatment condition in s259DB(3)(a) is satisfied.

The shares that are part of the stock lending transaction could satisfy the definition of a financial instrument provided in s259N(2) TIOPA 2010 depending on the type of share being lent, being a financial instrument within that meaning for the purposes of UK generally accepted accounting practice.

### **Substitute Payment, as defined in s259DB(5)**

In this case the agreement for the stock lending transaction requires U Co to make a substitute payment to L Co when U Co receives the actual dividend from I Co. Under s259DB(5) there is an amount paid which is representative of the dividend received on the shares and this amount is paid to L Co, who did not receive the actual dividend.

The payment of the dividend is therefore a substitute payment within the definition in s259DB(5).

### **Condition B: Is there a payment or quasi-payment made under, or in connection with, a hybrid transfer arrangement?**

It has been established that from Condition A that there is a hybrid transfer arrangement in relation to an underlying instrument and that a payment (the substitute payment) has been made in connection with this arrangement. This payment falls into the definition of payment as outlined in s259BB(1). Condition B is therefore satisfied.

### **Condition C: Is U Co within the charge to corporation tax for a relevant payment period?**

It is clear that Condition C in s259DA(4)(a) is satisfied because U Co is within the charge to corporation tax. Condition C is therefore satisfied.



**Condition D: Is it reasonable to suppose that there would be a hybrid transfer deduction/non-inclusion mismatch in relation to the quasi-payment?**

The deduction for the substitute payment is allowed in the UK but the receipt of the substitute payment is treated as a non-taxable dividend in country L. This could be a potential Case 1 Hybrid transfer deduction/non-inclusion mismatch as defined in s259DC(2). However it is noted that U Co is a financial trading company and we have to consider the financial trader exclusion s259DC(9) and s259DE.

S259DE(6)(a) denies application of the trader exemption. If the underlying return were to be paid directly from I Co to L Co then the deduction would be denied in I Co by application of an equivalent provision of the hybrid and other mismatch rules. As the financial trader exemption cannot apply then there is a Case 1 Hybrid transfer deduction/non-inclusion mismatch. Condition D is therefore satisfied.

**Condition E: Are U Co and L Co related, or is the arrangement a structured arrangement?**

U Co and L Co are related so s259DA(6)(b) applies. Condition E is therefore satisfied.

**Conclusion**

All the Conditions are satisfied for there to be a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in s259DC(11)) is the full amount of the deduction for the substitute payment.

**Counteraction**

As the UK is only in the position of the payer then the only relevant counteraction is s259DF TIOPA 2010. U Co will bring the amount of the substitute payment as taxable income because it will be denied the deduction for the substitute payment.

**Note 1: Application to structured arrangement**

It should be noted that if U Co and L Co were not related parties, but the stock loan was a structured arrangement (including a wider arrangement also involving I Co, of which a deduction/non-inclusion treatment of the substitute payment was a critical part), the transaction would be an example of the type of arrangement envisaged in [example 4.7](#) and the financial trader exclusion would not apply, this time by virtue of s259DE(6)(a).

**Note 2: What happens if L Co and I Co are not related parties**

It is assumed that this is not a structured arrangement. Country I does allow a tax deduction for the dividend. Country I's financial instrument hybrid mismatch rules follow the same pattern as the UK's Chapter 3, such that the

deduction/non-inclusion mismatch of the payment of a dividend on the I Co shares would not be counteracted unless there is a structured transaction, or I Co and L Co are related.

There would have been no hybrid mismatch counteraction by Country I, if the tax-deductible dividend had been paid directly to L Co. Therefore s259(6)(a) does not deny the financial trader exclusion. As this is not a structured arrangement then the financial trader exclusion now applies. This means that Condition D is now not met so no counteraction is required and the deduction for the substitute payment for U Co is not denied.

## **INTM553000: Hybrids: Chapter 5 - Hybrid payer: contents**

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## **INTM553010: Hybrids: Chapter 5 - Hybrid payer: Overview**

Chapter 5 of Part 6A TIOPA 2010 counters deduction/non-inclusion mismatches that arise from payments or quasi-payments by a hybrid entity payer, either to a connected party, or as part of a structured arrangement, where

- there is an allowable deduction for the payer that exceeds the sum of ordinary income arising to the payee(s) for a permitted taxable period (a deduction/non-inclusion (D/NI) mismatch), and
- all or part of that excess arises because the payer is a hybrid entity.

### **Hybrid entity**

A hybrid entity for the purpose of Chapter 5 of Part 6A TIOPA 10 is defined at s259BE A hybrid entity is an entity that is regarded as a person for tax purposes under the law of any territory, and

- any of the income or profits of the entity are treated by any territory wholly or partly as the income or profits of a different person, or
- the entity is not regarded as a separate person for tax purposes under the law of a different territory.

Whether an entity has the relevant characteristics to be treated as a 'hybrid entity' is discussed at [INTM550560](#).

### **Payments and quasi-payments**

Payments and quasi-payments are discussed at [INTM550530](#).

### **Ordinary income**

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income, and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed at [INTM550540](#).

There are special recognition rules at s259BD in instances of non-inclusion for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign companies (CFC) charge. This is discussed at [INTM550550](#).

## Conditions to be satisfied

Chapter 5 applies where the five conditions (A to E) identified in s259EA TIOPA 2010 are met. These conditions are:

### Condition A

Is there a payment or quasi payment under or in connection with an arrangement?

### Condition B

Does the payer satisfy the definition of being a hybrid entity?

### Condition C

Is either the payer or one of the payees within the charge to UK corporation tax?

### Condition D

Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch if it were not countered by this legislation or equivalent legislation outside the UK?

### Condition E

Are the relevant counterparties part of the same control group, or, if not, is it a structured arrangement?

There is a structured arrangement if it is reasonable to suppose that the arrangement was structured to achieve the mismatch, or that the terms of the arrangement shared the economic benefits of the mismatch, or otherwise reflected the fact that a mismatch was expected to arise.

The mismatch is the amount of the excess which arises by reason of the hybrid payer being a hybrid entity. It does not matter if the excess arises for reasons other than the hybridity of the payer.

## Counteraction

If all 5 conditions are met, the mismatch is countered by either

- denying all or part of the deduction for the taxable period in which it is paid up to the amount of the mismatch, where the payer is within the charge to corporation tax, or
- if no such restriction has been applied, treating the relevant amount of the mismatch, after deducting any income that is also taxed on the payee's

investor (see [INTM553090](#)) as taxable income of the payee, where the payee is within the charge to corporation tax in the UK

## **INTM553020: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied**

The conditions applicable for Chapter 5 of Part 6A TIOPA 2010 are set out at s259EA. For Chapter 5 to apply all of conditions A, B, C, D and E must be met.

[INTM553030: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition A](#)

[INTM553040: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition B](#)

[INTM553050: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition C](#)

[INTM553060: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition D](#)

[INTM553070: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition E](#)



## **INTM553030: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition A**

Condition A of s259EA TIOPA 2010 requires there to be a payment or quasi-payment made under, or in connection with, an arrangement. Definitions of the key terms for this condition are at s259BB.

A payment is any transfer of money or money's worth in relation to which an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person from whom the transfer is made. A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income arising to one or more persons were certain relevant assumptions to apply.

### **Relevant assumptions**

The relevant assumptions when deciding if the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income are –

- if there is any question of whether an entity is separate from the payer, that is to be determined by the law of the payer jurisdiction (this will address situations where the payee jurisdiction does not recognise the payee as a separate entity)
- any payee or potential payee is assumed to have adopted the same accounting approach to those circumstances as the payer,
- any payee or potential payee is assumed to be resident for tax purposes in the payer jurisdiction, and
- any payee or potential payee is assumed to be carrying on a business in the payer jurisdiction and the circumstances giving rise to the payer's deduction arise in connection with that business.

There is nothing to prevent an amount satisfying the definitions of being both a payment and a quasi-payment.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

- Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments where the circumstances giving rise to the deduction do not include economic rights, in substance, existing between the payer and the payee(s).

Condition A also requires that the payment or quasi-payment be made under an arrangement. S259NF contains the definition of an arrangement for the purposes of this legislation and it includes any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

## **INTM553040: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition B**

Condition B of s259EA TIOPA 2010 requires that the payer is a hybrid entity (hybrid payer). S259BE defines a payer as a hybrid entity where the payer is regarded as a distinct and separate person for tax purposes under the law of any territory, but

- any of its income or profits are treated as the income or profits of another person, or
- it is not regarded as a separate person for tax purposes under the law of another country, for example an entity treated as a separate company in one territory, and branch of a different company in another territory.

See [INTM550560](#) for further details on the relevant requirements to satisfy the definition of being a hybrid entity.

## **INTM553050: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition C**

Condition C of s259EA TIOPA 2010 requires:

- the hybrid payer to be within the charge to UK corporation tax for a relevant payment period, or
- a payee to be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period.

The relevant payment period is the taxable period of the payer in which an amount may be deducted in relation to a payment or quasi-payment.

## **INTM553060: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition D**

Condition D of s259EA TIOPA 2010 asks whether it is reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a relevant deduction/non-inclusion mismatch ('hybrid payer deduction/non-inclusion mismatch') in relation to the payment or quasi-payment.

The test is whether a relevant deduction/non-inclusion mismatch would arise if Chapters 5 to 10 of Part 6A TIOPA 10 (or any equivalent non-UK legislation) did not apply.

There is no definition of the term "reasonable to suppose" in Part 6A, so the phrase will take its ordinary meaning. Generally this does not require either party to know how the transaction has in fact been treated by the counterparty, but only that, given the facts and circumstances, it would be reasonable to conclude that a mismatch may arise.

See [INTM553080](#) for the requirements for a deduction/non-inclusion mismatch to be hybrid payer deduction/non-inclusion mismatch.

## **INTM553070: Hybrids: Chapter 5 - Hybrid payer: Conditions to be satisfied: Condition E**

Condition E of s259EA TIOPA 2010 is satisfied where one of the following applies –

- (for a quasi-payment only) - the hybrid payer is also the payee,
- (for a payment or quasi-payment) - the hybrid payer and a payee are in the same control group at any time from when the arrangement is made to the last day of the payment period, or
- (for a payment or quasi-payment) - the arrangement is a structured arrangement.

A hybrid payer may also be a payee in respect of a quasi-payment only where the UK is not the payer jurisdiction, and the payee -see [INTM550530](#).

### **Control groups**

Control groups are defined at s259NB. More detailed guidance on control groups is at [INTM550580](#). A hybrid payer and a payee are in the same control group if:

- they are consolidated for accounting purposes,
- one entity participates directly or indirectly in the management, control or capital of the other,
- a third person(s) participates directly or indirectly in the management, control or capital of each of the entities,
- one entity has a 50% investment in the other, or
- a third person has a 50% investment in each of the entities within a 6 month period.

### **Structured arrangement**

An arrangement is a structured arrangement if it is reasonable to suppose that -

- it is designed to secure a hybrid payee deduction/non-inclusion mismatch, or

- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch regardless of any other objective.

## **INTM553080: Hybrids: Chapter 5 - Hybrid payer: Extent of the mismatch**

If conditions A to E are met, the next step is to establish the extent of any hybrid payer deduction/non-inclusion mismatch for the purposes of Chapter 5, Part 6A of TIOPA 2010.

S259EB defines a hybrid payer deduction/non-inclusion mismatch in relation to a payment or quasi-payment as a mismatch where

- there is an allowable deduction for the hybrid payer that exceeds the sum of ordinary income arising to the payee(s), and
- all or part of that excess arises because the hybrid payer is a hybrid entity.

The legislation asks whether, if the payer had not been a hybrid entity, would the mismatch between the ordinary income of the payee and the allowable deduction of the payer have been reduced or eliminated? If so then, to that extent, it is a hybrid payer deduction/non-inclusion mismatch.

- The amount of hybrid payer deduction/non-inclusion mismatch is the amount of the excess that arises because the hybrid payer is a hybrid entity. In determining whether the mismatch arises from hybridity, it does not matter whether the excess arises for some other reason as well, and this is dealt with by a counter-factual test which asks whether the excess could arise when making the following assumptions –
- If the payee was not within the charge to tax because of an exclusion, immunity, exemption or relief, assume that the payee did not benefit from that exclusion, immunity, exemption or relief, and establish whether a mismatch would still have arisen.
- (Examples of such entities are exempted charitable corporations or companies benefitting from sovereign exemption.)
- If the payment or quasi-payment was not made in connection with a business carried on by the payee in the relevant jurisdiction, then assume it was made in connection with such a business, and ask whether a mismatch would still have arisen
- (For example, some jurisdictions do not tax residents on receipts which arise in connection with a business carried outside that jurisdiction.)

There is no hybrid payer deduction/non-inclusion mismatch where

- there is no excess



- there is an excess, but none of it arises because the payer is a hybrid entity.

## **INTM553090: Hybrids: Chapter 5 - Hybrid payer: Counteraction**

The hybrid payer deduction/non-inclusion mismatch requires either the hybrid payer or the payee to be within the charge to UK corporation tax.

Where the hybrid payer is within the charge to UK corporation tax the legislation provides for a counteraction to reduce or eliminate the allowable deduction available to the hybrid payer. This is discussed at [INTM553100](#).

Where it is the payee that is within the charge to UK corporation tax, and the payer counteraction has not been applied to fully counteract the hybrid payer deduction/non-inclusion mismatch, then an alternative counteraction applies, and requires the payee to bring into charge a relevant amount as income. This is discussed at [INTM553110](#).

Any counteraction may be mitigated if, and to the extent, the payer has dual inclusion income.

### **Dual Inclusion Income**

Dual inclusion income arises during an accounting period to the hybrid payer, in connection with an arrangement, if that income is ordinary income of both

- the hybrid payer for the relevant payment period, and
- an investor in the hybrid payer for a permitted taxable period for the purposes of any tax charged in the investor jurisdiction.

Note that inclusion for the purposes of a charge imposed under another countries controlled foreign company regime is not dual inclusion income, and nor is taxable income of another group company even if it involves the same counterparty jurisdictions.

An investor is defined at s259BE -

- If the payer is a hybrid entity because its income or profits are treated as the income or profits of another person, an investor is any person who is treated as having that income, or
- If the payer is a hybrid entity because it is treated as a distinct and separate person in one territory but treated as a composite part of another person in another territory, then an investor is the person in that other territory.

A permitted taxable period of an investor is a taxable period of that investor which

- begins at any time before the end of 12 months after the end of the accounting period within which the relevant deduction is claimed by the hybrid payer, or
- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

Counteraction to address the hybrid payer deduction/non-inclusion mismatch is considered first in respect of the hybrid payer (the primary counteraction). You should consider the counteraction against the payee(s), (the secondary counteraction) only if the hybrid payer is not within the charge to UK corporation tax.

## INTM553100: Hybrids: Chapter 5 - Hybrid payer: Counteraction: Hybrid payer

The counteraction where the hybrid payer is within the charge to UK corporation tax is set out at s259EC TIOPA 2010.

The counteraction is to deny a deduction for the payment period of the lower of

- the deduction claimed by the hybrid payer in respect of a payment or quasi-payment, and
- the amount of the hybrid payer deduction/non-inclusion mismatch,

unless and to the extent that it is deducted from dual inclusion income ([INTM553090](#)) for the period.

So if the hybrid payer has no dual inclusion income, the relevant amount deducted is reduced by the amount of the restricted deduction.

Any restricted deduction that has been denied is carried forward and may be allowed as a deduction from any dual inclusion income of the hybrid payer arising in future accounting periods.

### Example

The table below shows the position for each accounting period of a hybrid payer within the charge to tax in the UK.

Accounting period	Relevant Deduction	Mismatch amount	Restricted Deduction	Dual inclusion income	Restricted deduction used	Restricted deduction c/f
31/12/17	300,000	200,000	200,000	Nil	Nil	200,000
31/12/18	350,000	300,000	300,000	60,000	60,000	440,000

The relevant deduction of 350,000 in the accounting period ending 31/12/18 has been met by 50,000 of ordinary income in a payee, and therefore the hybrid payer deduction/non-inclusion mismatch is 300,000. There is 60,000 of dual inclusion income in that period therefore 240,000 of the 300,000 mismatch amount will be restricted.

As at 31/12/2018 this hybrid payer has accumulated unused restricted deductions of £440,000 to carry forward and deduct from dual inclusion income arising in later accounting periods.

## **INTM553110: Hybrids: Chapter 5 - Hybrid payer: Counteraction: Hybrid payee**

This counteraction applies to a payee within the charge to UK corporation tax, where all or part of the hybrid payer deduction/non-inclusion mismatch is treated as income for the relevant 'counteraction period' of that payee.

The counteraction at s259ED applies where it is reasonable to suppose that

- there has been no counteraction against the hybrid payer under non-UK legislation equivalent to s259EC, or
- there has been counteraction against the hybrid payer under non-UK legislation equivalent to s259EC, but it does not fully counteract the mismatch.

Where no overseas provision equivalent to s259EC applies, the amount to be counteracted under s259ED is equal to the excess of the hybrid payer deduction/non-inclusion mismatch above the amount of dual inclusion income.

The mismatch is not fully counteracted if, and to the extent, that the hybrid payer has not been denied a deduction equivalent to the amount by which the hybrid payer deduction/non-inclusion mismatch (as quantified by s259EB) exceeds the dual inclusion income (as quantified by s259EC(4)), as outlined in [INTM553100](#).

Where the mismatch has not been fully counteracted by an overseas provision, the amount to be counteracted under Part 6A is the lesser of

- the amount of the mismatch that it is supposed has not been restricted by the equivalent overseas rules, and
- the amount of the relevant deduction that is deducted from income other than dual inclusion income,

after deducting any dual inclusion income.

If there is more than one payee, the relevant amount and any dual inclusion income is apportioned on a just and reasonable basis, particularly taking into account

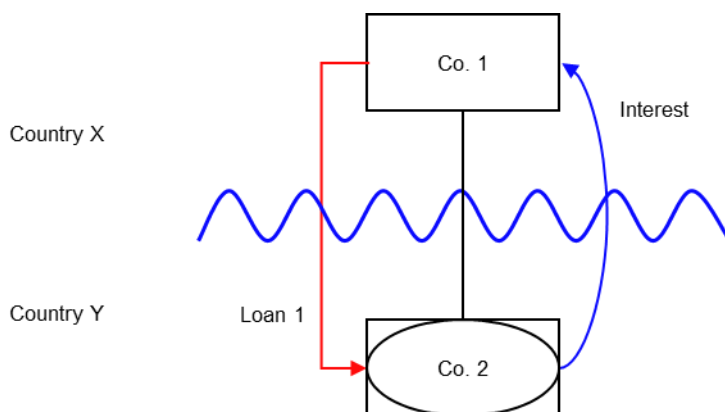
- any profit sharing arrangements between some or all of the payees, and
- payees to whom ordinary income would have been expected to arise, but to whom it did not arise.

For the purposes of these rules, the counteraction period is

- the payee's accounting period where that coincides with the payment period, or
- the first accounting period of the payee that is wholly or partly within the payment period.

Similarly, the payment period is the taxable period of the hybrid payer in which an amount may be deducted for the relevant payment or quasi-payment.

## INTM553200: Hybrids: Chapter 5 - Hybrid payer: Example: Restricted deduction for interest payment



### Background

- Co. 1 is resident in Country X
- Co. 1 establishes Co. 2, which is resident in Country Y
- Country Y treats Co. 2 as a distinct and separate person for tax purpose
- Country X considers Co. 2 to be a branch of Co.1, not a separate entity
- Co. 2 borrows money from Co. 1 on arm's length terms ('Loan 1')
- Country Y allows Co. 2 a deduction for interest payments made under the loan
- Country X does not tax the interest receipt as it considers the loan is an intra-company transaction.

### Analysis - Applying the tests in s259EA TIOPA2010

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

**Condition A: Are the payments made under, or in connection with, an arrangement?**

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan 1), and the payment is made under that arrangement.

Condition A is satisfied.

**Condition B: Is the payer a hybrid entity?**

Country Y regards Co. 2 as a person, separate and distinct from Co. 1 under its domestic tax law. Country X treats the income and profits of Co. 2 as the income or profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE TIOPA 2010, so Condition B is satisfied.

**Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?**

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C can be satisfied only if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y, in this example then condition C cannot be satisfied. It is not necessary to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 (s259K – s259KC) apply.

**Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?**

Given the information provided, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on Loan 1 (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.



**Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?**

Co. 1 and Co. 2 are in the same control group as defined in s259NA. This is sufficient to satisfy Condition E in this example, and you need not go on to consider whether Loan 1 is also a structured arrangement.

In some cases you may want to consider if Loan 1 is a structured arrangement where it is not clear whether any of the control tests are met. In this example, there is insufficient information regarding the terms of the loan to make that determination.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a hybrid payer deduction/non-inclusion mismatch the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the payment of interest by Co. 2 under Loan 1 is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted.

You will also need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income
- You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example, if Co. 2 were not a hybrid entity, a mismatch would not arise. The extent of the mismatch arising by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

**Counteraction**

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

**Primary Response**

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest deductions under Loan 1, per s259EC.

The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods. In this example there is insufficient information to determine whether there is any dual inclusion income.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

### **Secondary Response**

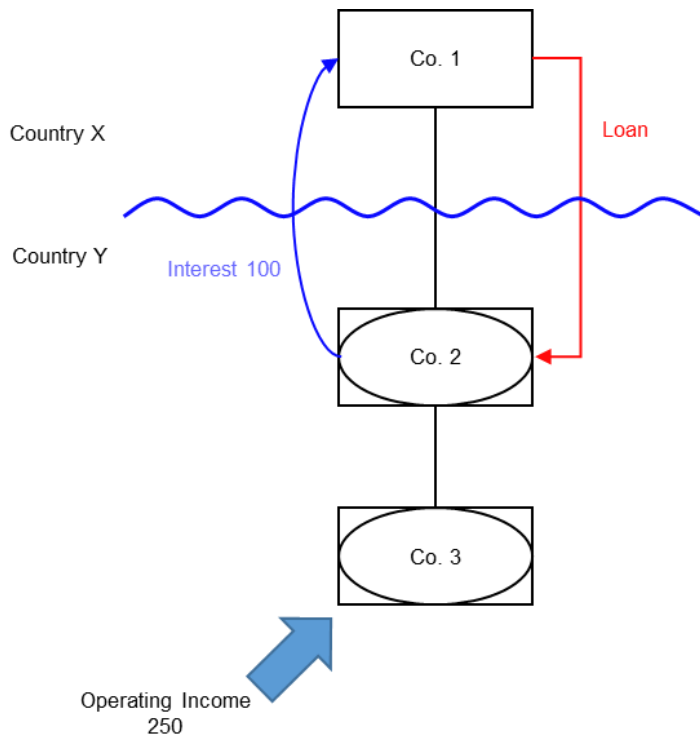
Action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and you conclude that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then you would apply s259ED to treat the entire mismatch as income of the payee.

If you conclude that Country Y has provisions that apply but they do not fully counteract the mismatch then s259ED applies to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

## INTM553210: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income - Operating income in subsidiary of disregarded entity



### Background

- Co. 1 is a company resident in Country X.
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 3 is also resident in Country Y
- Co. 2 owns the entire shareholding of Co. 3
- Co. 3 is also treated as a distinct and separate person for tax purposes under the law of Country Y

- Co. 3 is also a disregarded entity for tax purposes under the law of Country X.
- Co. 2 borrows money from Co. 1 to finance its ongoing operations in Country Y (the 'Loan').
- Country Y allows a deduction for the interest payments made by Co. 2.
- Country X ignores the interest receipt to Co. 1 as it regards Co. 2 as a branch of Co. 1.
- Co. 2 has no operating income during the relevant period but recognises interest expenses of 100 arising on the Loan
- Co. 3 has operating income of 250 in the relevant period, subject to tax at the full marginal rate in Country Y. For the purposes of this example Co. 3 incurs no expenditure in earning this income
- This operating income of 250 is also recognised by Co. 1 and subject to tax at the full marginal rate in Country X
- Co. 2 receives regular distributions from Co. 3, but these are not subject to tax under the domestic legislation of either Country X or Country Y

## **Analysis - Applying the tests in s259EA TIOPA 2010**

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

### **Condition A: Are the payments made under, or in connection with, an arrangement?**

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan), and the payment is made under that arrangement.

Condition A is satisfied.

### **Condition B: Is the payer a hybrid entity?**

Co. 2 is the payer.

Country Y regards Co. 2 as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as a branch of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

**Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?**

The charge to corporation tax is the charge to corporation tax in the UK. In this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

**Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?**

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on the Loan (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

**Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?**

Co. 1 and Co. 2 are in the same control group as defined at s259NA. That is sufficient to satisfy condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the Loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example, there is insufficient information regarding the terms of the loan to make that determination.

## Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payer deduction/non-inclusion mismatch' the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the payment of interest by Co. 2 under the Loan is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted.

You will also need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income

You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

## Counteractions

- The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

### Primary Response

- The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the loan, per S259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and

- was also ordinary income of Co. 1 for the purposes of any tax under the law of Country X

Although the definition of arrangement is drawn widely, it does not include all transactions simply because they fall within the same payment period. In this example Co. 3's operating revenue is not part of the loan arrangements between Co. 2 and Co. 1; it arises from Co. 3's ordinary business activities. It is not dual inclusion income as defined in the legislation.

Additionally, although the operating income is included as ordinary income of Co. 1, Co. 3 is the other party including it as ordinary income, rather than Co 2.

In this example there is no relevant dual inclusion income for the period, so all of Co. 2's interest deduction of 100 is a restricted deduction, and no relief is due.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

### **Secondary Response**

The secondary counteraction is applied to the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and it is reasonable to suppose that Country Y has no provisions that apply to the hybrid payer to counteract the mismatch, then you apply s259ED to treat the entire mismatch as income of the payee, Co. 1.

If you conclude that it is reasonable to suppose that Country Y has provisions that apply but that they do not fully counteract the mismatch, then you apply s259ED to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent is not offset against dual inclusion income).

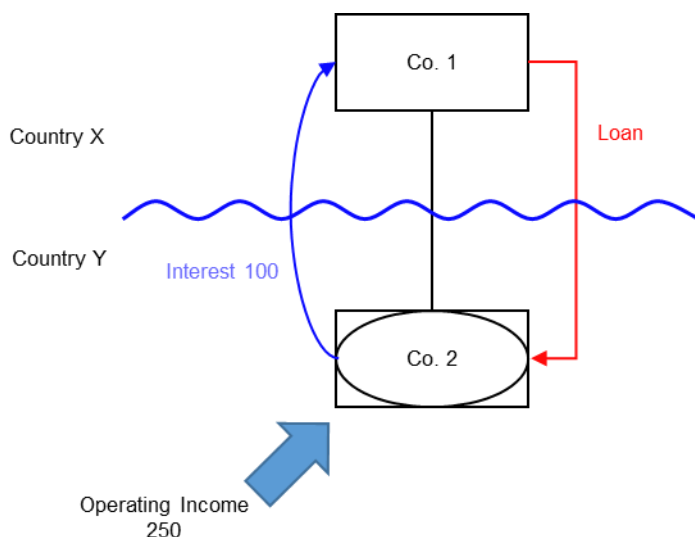
### **Outcome**

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, the amount of the mismatch is 100 and the dual inclusion income is 0, so 100 will be treated as income of Co. 1.





## INTM553220: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income - Operating income



### Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 2 borrows money from Co.1 to finance its ongoing operations (the 'Loan').
- Country Y allows a deduction for the interest payments made by Co. 2.
- Country X ignores the receipt to Co.1 as it recognises Co.2 as a branch of Co.1
- Co. 2 also has operating income of 250 in the relevant period, subject to tax at the full marginal rate in Country Y. For the purposes of this example Co. 2 incurs no expenditure in earning this income.

Note: If Co. 2 did incur expenditure in earning this income, as would be expected, that expenditure should be considered under the Hybrid Entity

Double Deduction rules in Chapter 9, to determine the extent that it gives rise to a hybrid entity double deduction amount.

This operating income of 250 is also recognised by Co. 1 and subject to tax at the full marginal rate in Country X

During the relevant period Co. 2 recognises interest expense of 100 arising on the Loan.

## **Analysis - Applying the tests in s259EA TIOPA 2010**

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

### **Condition A: Are the payments made under, or in connection with, an arrangement?**

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan 1), and the payment is made under that arrangement.

Condition A is satisfied.

### **Condition B: Is the payer a hybrid entity?**

Country Y regards Co. 2 as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as a branch of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

### **Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?**

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

**Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?**

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on the Loan (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

**Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?**

Co. 1 and Co. 2 are in the same control group as defined at s259NA. That is enough to satisfy Condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example there is insufficient information regarding the terms of the loan to make that determination.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payer deduction/non-inclusion mismatch' the relevant counteractions need to be considered.

**Amount of the mismatch**

If conditions A to E are satisfied, the payment of interest by Co. 2 under the Loan is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted in the UK.

You will also need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less

- the amount of that interest payment that Co. 1 includes in its ordinary income

You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

## Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction).

### Primary Response

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the Loan, per s259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and
- was ordinary income of Co. 1 for the purposes of any tax under the law of Country X.

Although the definition of arrangement is wide, it does not include all transactions simply because they fall within the same payment period. In this example Co. 2's operating income is not part of the loan arrangements between Co. 2 and Co. 1: it arises from Co. 2's ordinary business activities. It is not dual inclusion income as defined in the legislation.

Therefore, although Co. 2's operating income is included in the income of Co. 1 and Co. 2 for tax purposes, and so would be ordinary income of both, it does not qualify as dual inclusion income in respect of this loan arrangement.

In this example there is no relevant dual inclusion income for the period, so all of Co. 2's interest deduction of 100 is a restricted deduction, and no relief is due.

**Counteraction where the UK is in the position of Country X (payee jurisdiction)**

**Secondary Response**

The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

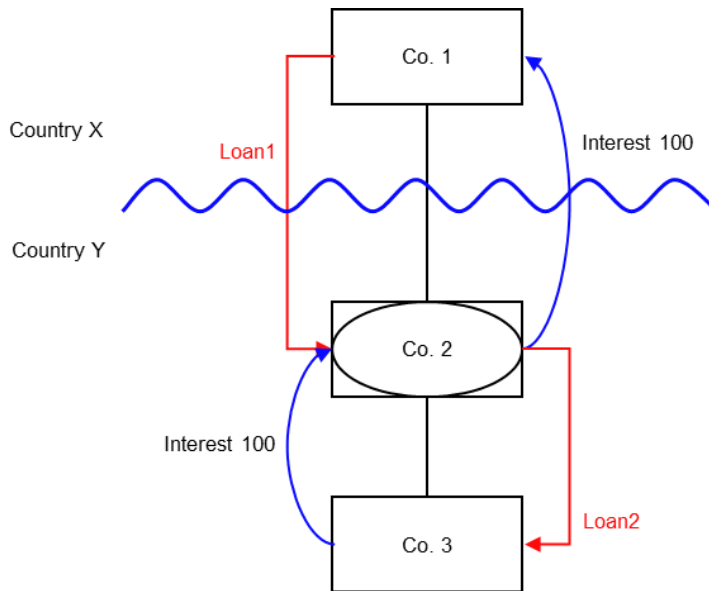
- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and it is reasonable to suppose that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then s259ED should be applied to treat the entire mismatch as income of the payee, Co. 1.

If it is reasonable to suppose that Country Y has provisions that apply, but they do not fully counteract the mismatch, then you apply s259ED to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, the amount of the mismatch is 100 and the dual inclusion income is 0, so 100 will be treated as income of Co. 1.

## INTM553230: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income – Debt passed down to subsidiary



### Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 3 is also resident in Country Y
- Co. 2 owns the entire issued shareholding of Co. 3
- Co. 3 is treated as a separate person for tax purposes under the law of both Country Y and Country X
- Co. 2 borrows money from Co.1 (Loan1)
- Co. 2 is acting as a group treasury company and, as intended, this debt is passed down to Co. 3 at the same interest rate (Loan2) to finance its ongoing operations

- Country Y allows a deduction for the interest payments made by Co. 3 under Loan2
- Country Y allows a deduction for the interest payments made by Co. 2 under Loan1
- Country Y subjects to tax the interest receipt to Co. 2 under Loan2 at the full marginal rate
- Country X ignores the interest receipt to Co.1 under Loan1 as it sees Co.2 as a branch of Co.1
- Country X subjects to tax the interest receipt from Loan2 at the full marginal rate in Country X

## **Analysis - Applying the tests in s259EA TIOPA 2010**

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

### **Condition A: Are the payments made under, or in connection with, an arrangement?**

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (Loan1), and the payment is made under that arrangement.

The arrangement seems to encompass both Loan1 and Loan2, as the background suggests a dependency such that in the absence of Loan2 then Loan1 would not have occurred. However, the relevant payment here is that under Loan1, with the payment under Loan2 to be considered separately.

Condition A is satisfied in respect of Loan1.

Loan2 may itself also be tested to see if it also satisfies the conditions as a separate arrangement. For Loan2 interest is paid by Co. 3 (the payer) to Co. 2 (the payee), assuming that a realistic view of the background does not suggest that Co. 1 is the true payee.

Condition A is satisfied in respect of Loan2.

### **Condition B: Is the payer a hybrid entity?**

For Loan1 Country Y regards Co. 2 (the payer) as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as

an extension of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

For Loan2 Country Y regards Co. 3 (the payer) as a person, separate and distinct from Co. 2. No other jurisdiction is involved.

Co. 3 does not meet the conditions to be a hybrid entity, so Condition B is not satisfied for Loan2. There is no need to consider conditions C to E in respect of Loan2.

**Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?**

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied for Loan1. There would be no need to consider the remaining conditions.

**Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?**

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on Loan1 (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

**Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?**

Co. 1 and Co. 2 are in the same control group as defined at s259NA TIOPA 2010. That is enough to satisfy Condition E in this example, and you need not go on to consider whether Loan1 is a structured arrangement.



In some cases you may want to consider if Loan1 is a structured arrangement where one of the other tests in Condition E is not obviously met. In this example there is insufficient information regarding the terms of the loan to make that determination.

## **Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payer deduction/non-inclusion mismatch' the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the deduction of interest by Co. 2 under Loan1 is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted.

You will need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income
- You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

## **Counteractions**

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

### **Primary Response**

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under Loan1, per 259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and
- was also ordinary income of Co. 1 for the purposes of any tax under the law of Country X.

The background suggest that Loan1 and Loan2 are co-dependent and therefore form part of the same arrangement mentioned in Condition A above. As the ordinary income from Loan2 is included by both Co. 1 and Co. 2 then this satisfies the definition of dual inclusion income.

As the interest receipt on Loan2 equals the interest deduction on Loan1, then Co. 2 will be permitted to retain the deduction to offset against that dual inclusion income. There will therefore be no counteraction.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

### **Secondary Response**

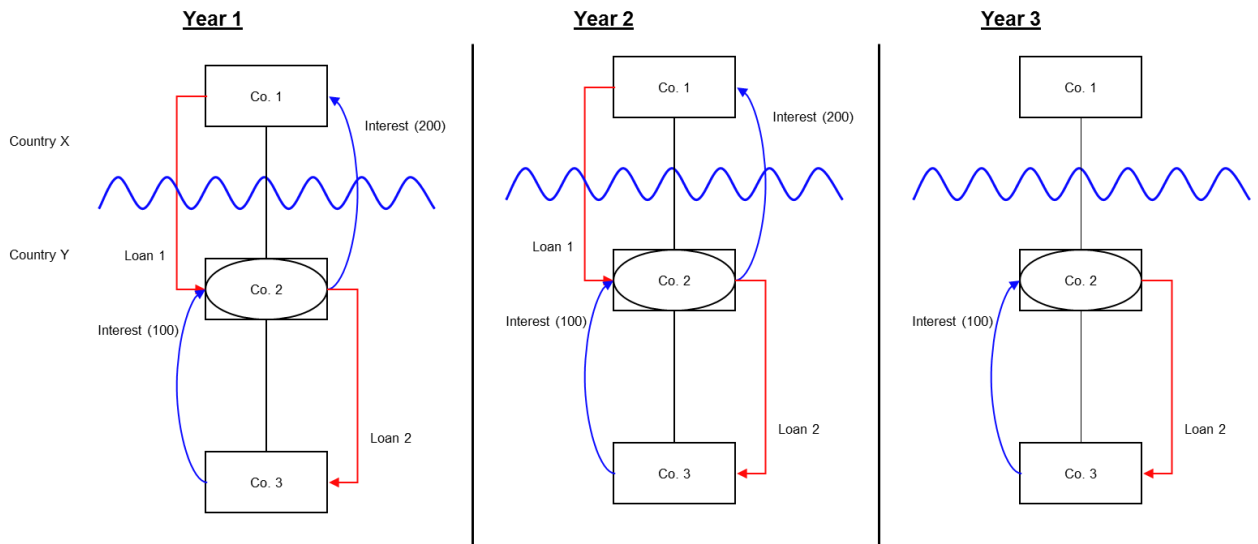
The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, the dual inclusion income established above offsets the hybrid payer deduction/non-inclusion mismatch completely and therefore there is no counteraction.

# INTM553240: Hybrids: Chapter 5 - Hybrid payer: Example: Restricted deduction carried forward



## Background

This continues from the example at [INTM553230](#). All the relevant conditions are satisfied to characterise the deductions claimed under Loan 1 as 'hybrid payer deduction/non-inclusion mismatches' for each payment period, and the income from Loan 2 satisfies the requirements to be considered dual inclusion.

Year 1:

- Co.1 and Co.2 have corresponding payment periods
- the interest payment of 200 under Loan 1 is the restricted deduction
- interest of 100 payable under Loan 2 and is included in the ordinary income of both Co.1 and Co.2.

Year 2:

- the mismatch arising under Loan 1 in Year 2 remains at 200
- 100 is payable under Loan 2 is included in the ordinary income of both Co.1 and Co.2.

Year 3:

- Loan 1 has ceased and there is no longer any mismatch

- 100 is payable under Loan 2 and is included in the ordinary income of both Co.1 and Co.2.

**YEAR 1**

Loan 1:

- 200 paid by Co.2 is a relevant deduction
- The mismatch amount is the excess of the relevant deduction (200) over the amount taxable as income by Co.1 (nil).
- The mismatch is 200.

Loan 2:

- 100 is payable by Co.2
- The receipt of 100 is included as taxable income by both Co.1 and Co.2. 100 and therefore satisfies the definition of dual inclusion income.

Restricted deduction for Co.2 is 200 as this is the relevant deduction (200) capped at the level of the mismatch (also 200). As there is dual inclusion income of 100 we can allow 100 of the restricted deduction against the 100 dual inclusion income.

The restricted deduction carried forward to subsequent period becomes 100 and may be utilised against any future dual inclusion income.

Relevant Deduction	Mismatch amount	Restricted Deduction	Dual inclusion income	Restricted deduction c/f
200	200	200	100	100

**YEAR 2**

- Nothing changes in year 2 in respect of Co.2.
- The restricted deduction brought forward is 100
- The dual inclusion income remains at 100
- The relevant deduction remains at 200
- The mismatch amount also remains at 200.

The restricted deduction of 200 is utilised against the dual inclusion income of 100 so that the restricted deduction carried forward is again 100 and is added to the restricted deduction brought forward from previous payment period.

The total restricted deduction carried forward becomes 200 and may be utilised against any future dual inclusion income.

Relevant Deduction	Restricted deduction b/f	Mismatch amount	Restricted Deduction	Dual inclusion income	Restricted deduction c/f
200	100	200	200	100	200

### YEAR 3

- Loan 1 has ceased so there is no longer a hybrid payer/non-inclusion mismatch
- 100 payable under Loan 2 continues to satisfy the definition of dual income for Co2.

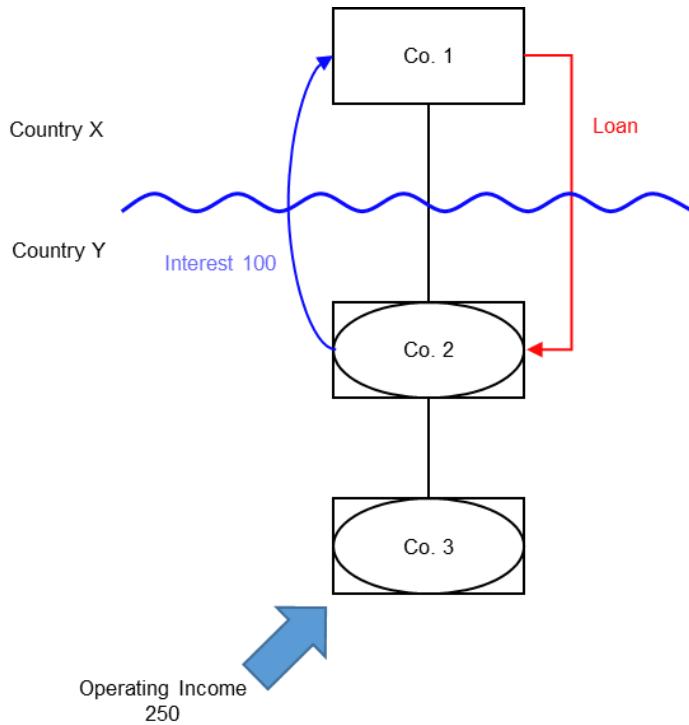
Co2 can utilise 100 of the 200 restricted deduction brought forward against that dual inclusion income.

The remaining 100 would continue to be carried forward to subsequent periods of the hybrid payer and may be utilised against any future dual inclusion income.

Relevant Deduction	Restricted deduction b/f	Mismatch amount	Restricted Deduction	Dual inclusion income	Restricted deduction c/f
nil	200	Nil	Nil	100	100

If Loan 2 ceases in Year 4, so that there is no future dual inclusion income, then the 100 restricted deduction brought forward will no longer be relievable. As the corresponding receipt to Loan1 will remain non-included, this does not create a double taxation issue, and is line with the underlying principles of the rule.

## INTM553250: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income – Debt to fund acquisition of company with operating income



### Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding of Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes under the law of Country Y
- Co. 2 is a disregarded entity for tax purposes under the law of Country X
- Co. 2 borrows money from Co.1 (the 'Loan') to acquire the entire shareholding in Co. 3 from a 3rd party.
- Co. 3 is also resident in Country Y
- Co. 3 is treated as a distinct and separate person for tax purposes in Country Y

- Co. 3 is a disregarded entity for tax purposes under the law of Country X
- Co. 2 has no operating income during the relevant period
- Co. 3 has operating income of 250 in the relevant period, which is subject to tax at the full marginal rate in Country Y
- Co. 2 receives regular distributions from Co. 3, but these are not subject to tax under the domestic legislation of either Country X or Country Y
- Country Y allows a deduction for the interest payments made by Co. 2.
- Country X ignores the receipt to Co.1 as it sees Co.2 as a branch of Co.1
- Country X recognises Co. 3's operating income of 250 as income of Co. 1, which is subject to tax at the full marginal rate in Country X
- During the relevant period Co. 2 recognises interest expenses of 100 arising from the Loan.

## **Analysis - Applying the tests in s259EA TIOPA 2010**

Do the interest deductions satisfy the relevant conditions to fall within the scope of Chapter 5?

### **Condition A: Are the payments made under, or in connection with, an arrangement?**

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (the Loan), and the payment is made under that arrangement.

Note that the purpose of the Loan – to acquire Co.3 – is not part of the arrangement. Co. 2's acquisition of Co. 3, together with the stream of operating income from Co. 3 is not part of the Loan arrangement.

Condition A is satisfied in respect of the Loan.

### **Condition B: Is the payer a hybrid entity?**

Country Y regards Co. 2 (the payer) as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as an extension of Co. 1, and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE, so Condition B is satisfied.

**Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?**

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied for Loan1. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

**Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?**

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on the Loan (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

**Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?**

Co. 1 and Co. 2 are in the same control group as defined at s259NA. That is enough to satisfy Condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the Loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example there is insufficient information regarding the terms of the Loan to make that determination.



## Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payer deduction/non-inclusion mismatch' the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the deduction of interest by Co. 2 under the Loan is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted in the UK.

You will need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income
- You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

## Counteractions

- The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

### Counteraction where the UK is in the position of Country Y (payer jurisdiction)

#### Primary Response

- The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the Loan, per S259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,

- was ordinary income of Co. 2 for corporation tax purposes, and
- was ordinary income of Co. 1 for the purposes of any tax under the law of Country X

Although it is unlikely that the operating income of Co. 3 would be regarded as arising from the Loan, in this example it is not included in the ordinary income of Co. 2. Consequently the operating income of Co. 3 is not dual inclusion income.

In this example there is no relevant dual inclusion income for the period, so all of Co. 2's interest deduction of 100 in respect of Loan1 is a restricted deduction, and no relief is due.

### **Counteraction where the UK is in the position of Country X (payee jurisdiction)**

#### **Secondary Response**

The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

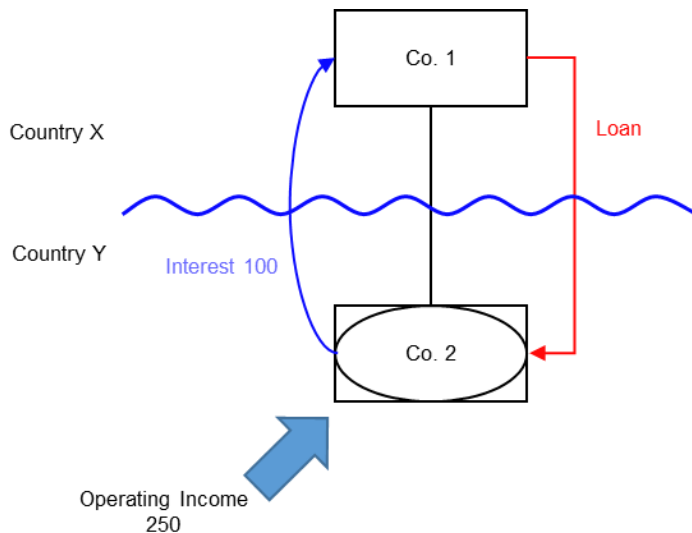
- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and it is reasonable to suppose that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then you apply s259ED to treat the entire mismatch as income of the payee, Co. 1.

If it is reasonable to suppose that Country Y has provisions that apply, but that they do not fully counteract the mismatch, then you apply s259ED to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, the amount of the mismatch is 100 and the dual inclusion income is 0, so 100 will be treated as income of Co. 1.

## INTM553260: Hybrids: Chapter 5 - Hybrid payer: Example: Dual inclusion income – Debt to fund 3rd party acquisition of business with operating income



### Background

- Co. 1 is a company resident in Country X
- Co. 2 is a company resident in Country Y
- Co. 1 owns the entire issued shareholding in Co. 2
- Co. 2 is treated as a distinct and separate person for tax purposes in Country Y
- Co. 2 is a disregarded entity for tax purposes in Country X
- Co. 2 borrows money from Co.1 (the 'Loan') to acquire a business from a 3rd party
- Country Y allows a deduction for the interest payments made by Co. 2
- Country X ignores the receipt to Co.1 as it recognises Co.2 as a branch of Co.1 for tax purposes
- Co. 2 has operating income of 250 during the relevant period only from the new business it used the funds to acquire

- The operating income of 250 is subject to tax at the full marginal rate in Country Y
- Co. 2 incurs no expenditure in earning this income.

Note: If Co. 2 did incur expenditure in earning this income, as would be expected, that expenditure should be considered under the Hybrid Entity Double Deduction rules to determine the extent that it gives rise to a hybrid entity double deduction amount.

This operating income of 250 is also recognised by Co. 1 and subject to tax at the full marginal rate in Country X.

## **Analysis - Applying the tests in s259EA TIOPA 2010**

Do the interest deductions satisfy the relevant conditions for each payment period to fall within the scope of the Hybrid Payer Deduction/Non-Inclusion Mismatches rules?

### **Condition A: Are the payments made under, or in connection with, an arrangement?**

A transaction took place resulting in a transfer of money (the interest payment) directly from Co. 2 (payer) to Co. 1 (payee), which represents a payment.

There is an arrangement (the Loan), and the payment is made under that arrangement.

Note that the purpose of the Loan – to acquire a business – is not part of the same arrangement. Co. 2's acquisition of the business, together with its operation to return a stream of operating income, is not part of the Loan arrangement but is derived from the carrying on an unrelated business. The Loan allowed Co. 2 to benefit from that opportunity, but was not determinate in the generation of those funds.

This should be contrasted with the example at [INTM553230](#) (Dual inclusion income – Debt passed down to subsidiary) where the loan was determinate in providing that future income stream without material further action.

Condition A is satisfied in respect of the Loan.

### **Condition B: Is the payer a hybrid entity?**

Country Y regards Co. 2 (the payer) as a person, separate and distinct from Co. 1. Country X does not recognise Co. 2 as a person, but as an extension of Co. 1 and consequently treats the income and profits of Co. 2 as the income and profits of Co. 1.

Co. 2 meets the conditions to be a hybrid entity as set out at s259BE TIOPA 2010, so Condition B is satisfied.

**Condition C: Is the hybrid payer or a payee within the charge to corporation tax for a relevant payment period?**

The charge to corporation tax is the charge to corporation tax in the UK, so in this example condition C is satisfied if the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then condition C cannot be satisfied for Loan. There would be no need to consider the remaining conditions. In these circumstances you should consider whether the imported mismatch rules in Chapter 11 apply.

**Condition D: Is it reasonable to suppose that there would be a hybrid payer deduction/non-inclusion mismatch in relation to this payment?**

Given the background above, it is reasonable to suppose that, if the hybrids legislation did not apply –

- Co. 2 will deduct an amount from income for the interest paid on the Loan (relevant deduction), and
- Co. 1 will not include the interest received from Co. 2 in its ordinary income.

This mismatch arises as a consequence of the different treatment of Co. 2 for tax purposes in Country X and Country Y, so is directly attributable to the fact that Co. 2 is a hybrid entity. If Co. 2 had been recognised as an entity separate from Co. 1 it is reasonable to suppose that the excess would have been lower, as Co. 1 would have included an amount within ordinary income.

Condition D is satisfied.

**Condition E: Are the payer and payee in the same control group, or is there a structured arrangement?**

Co. 1 and Co. 2 are in the same control group as defined at s259NA TIOPA 2010. That is enough to satisfy Condition E in this example, and you need not go on to consider whether the Loan is also a structured arrangement.

In some cases you may want to consider if the Loan is a structured arrangement where it is not clear whether any of the control tests are met. In this example there is insufficient information regarding the terms of the Loan to make that determination.

## Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payer deduction/non-inclusion mismatch' the relevant counteractions need to be considered.

Amount of the mismatch

If conditions A to E are satisfied, the deduction of interest by Co. 2 under the Loan is a hybrid payer deduction/non-inclusion mismatch, and you will have to consider how it is counteracted in the UK.

You will need to calculate the amount of the mismatch. You begin by quantifying the excess, which in this example is given by

- the amount of Co. 2's deduction from income for the interest paid, less
- the amount of that interest payment that Co. 1 includes in its ordinary income.

You then consider how much of that amount arises because Co. 2 is a hybrid entity. In this example it is clear that the mismatch that arises by reason of Co. 2 being a hybrid entity is the full amount of the interest deduction.

## Counteractions

The counteraction applicable will depend upon whether the UK is in the position of Country X and Country Y.

Counteraction where the UK is in the position of Country Y (payer jurisdiction)

### Primary Response

The primary counteraction is against the hybrid payer.

If the UK is Country Y (the payer jurisdiction) you should restrict the deduction claimed by Co. 2 for interest payments under the Loan, per S259EC. The amount of the restricted deduction may be allowed as a deduction only from dual inclusion income of Co. 2, the hybrid payer. It is set first against dual inclusion income arising in the same accounting period, with unused amounts carried forward to use against dual inclusion income of later accounting periods.

Dual inclusion income is defined at s259EC(4). In this example there would be dual inclusion income only if the income

- arose in connection with the arrangement mentioned in Condition A above,
- was ordinary income of Co. 2 for corporation tax purposes, and

- was ordinary income of Co. 1 for the purposes of any tax under the law of Country X.

Although the definition of arrangement is wide, it is unlikely to include the operating income from the business acquired. That income arose not in connection with the Loan (the arrangement), but in connection with the business activities undertaken. Consequently the operating income arising from the business acquired is not dual inclusion income.

In this example there is no relevant dual inclusion income for the period, so all of Co. 2's interest deduction of 100 in respect of the Loan is a restricted deduction, and no relief is due.

Counteraction where the UK is in the position of Country X (payee jurisdiction)

### **Secondary Response**

The secondary counteraction is against the payee.

In the UK action to counter the mismatch may be taken against the payee only if it is reasonable to suppose that provisions equivalent to s259EC in the payer jurisdiction

- do not apply to counteract the mismatch, or
- do apply but do not fully counteract the mismatch.

In this example, if the UK is Country X and you conclude that it is reasonable to suppose that Country Y has no provisions that apply to counteract the mismatch on the hybrid payer, then you apply s259ED to treat the entire mismatch as income of the payee, Co. 1.

If you conclude that it is reasonable to suppose that Country Y has provisions that apply but that they do not fully counteract the mismatch, then you apply s259ED to treat part of the mismatch as income of the payee, to ensure the hybrid payer deduction/non-inclusion mismatch is fully counteracted (to the extent it is not offset against dual inclusion income).

The amount treated as income of the payee is the amount of the mismatch less any dual inclusion income. In this example, the amount of the mismatch is 100 and the dual inclusion income is 0, so 100 will be treated as income of Co. 1.

## **INTM554000: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Contents**

[INTM554010: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Overview](#)

[INTM554020: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied](#)

[INTM554030: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition A](#)

[INTM554040: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition B](#)

[INTM554050: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition C](#)

[INTM554060: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Extent of the mismatch](#)

[INTM554070: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Counteraction](#)

[INTM554080: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Example](#)



## **INTM554010: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Overview**

Chapter 6 of Part 6A TIOPA 2010 deals with mismatches within a company. The legislation counteracts mismatches involving transfers of money or money's worth from a UK permanent establishment of a company to the company in the parent jurisdiction (normally the head office of that company).

Permanent establishment is defined for the purpose of Part 6A at s259BF as

- a permanent establishment within the corporation tax acts, or
- any similar concept under the law of another territory.

The definition includes specific reference to s1119 of Corporation Tax Act 2010 (CTA 2010). This in turn signposts s1141-1153 of CTA 2010. Detailed guidance on the definition of permanent establishments within the UK is provided at INTM264050. In broad terms, under UK domestic law a non-resident company has a permanent establishment in the UK if the company

- carries on a business wholly or partly through a fixed place of business in the UK, or
- appoints an agent in the UK to act on its behalf and that agent habitually exercises authority to do business on behalf of the company.

Chapter 6 counters mismatches that arise where the permanent establishment in the UK

- makes a transfer of money or money's worth to the company in the parent jurisdiction, or
- is treated for UK corporation tax as if it had made such a transfer.

An example of such a dealing could be where intellectual property owned by a multinational company is exploited by their permanent establishment in the UK, and for which it is deemed appropriate that ownership of that asset is attributable solely to the parent jurisdiction and a fee should be recognised as payable to the parent jurisdiction for that use. This situation will only arise if there is a double taxation agreement in place which contains the new Article 7 (see INTM267100). When tax treaties contain the old Article 7, internal royalties are not recognised. If there is no treaty in place, UK domestic law applies in the same way as old Article 7, and s31 CTA 2009 denies a deduction for royalties paid by the permanent establishment to another part of the same company.

The Chapter applies if conditions A to C are met. The conditions are as follows:

- Condition A – is there a multinational company (see [INTM554030](#))?
- Condition B – is there a relevant permanent establishment deduction (see [INTM554040](#))?
- Condition C – if this legislation or equivalent non-UK provisions did not apply, would the circumstances giving rise to the PE deduction result in increased taxable profits or reduced losses (see [INTM554050](#))?

If all 3 conditions are met then, to the extent of the mismatch (see [INTM554060](#)), it is to be counteracted by denying all or part of the permanent establishment (“PE”) deduction in the UK (see [INTM554070](#)).

## **INTM554020: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied**

The conditions applicable for Chapter 6 of Part 6A TIOPA 2010 are set out at s259FA. For Chapter 6 to apply each of conditions A, B and C must be met.

[INTM554030: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Condition A](#)

[INTM554040: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Condition B](#)

[INTM554050: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Condition C](#)

## **INTM554030: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition A**

Condition A of s259FA TIOPA 2010 requires a company to be a multinational company.

A multinational company is defined by s259FA as a company that is

- resident for tax purposes in a territory outside the UK (the parent jurisdiction), and
- within the charge to corporation tax in the UK because it carries on a business in the UK through a permanent establishment.

Company is not defined in the legislation, so takes its normal meaning under UK law.

## **INTM554040: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition B**

Condition B of s259FA TIOPA 2010 requires there to be a PE deduction.

A PE deduction is defined as an amount that –

- may (in substance) be deducted from income in calculating the profits of the company that are chargeable to corporation tax in the UK, and
- is in respect of a transfer of money or money's worth to the company in the parent jurisdiction - that transfer must either be made, or be (in substance) treated as made, for the purposes of UK corporation tax.

Some allocations of an amount between parties do not reflect a transfer from the PE to the parent jurisdiction. An example of this is a head office recharge. Some of the expenditure incurred by the company will be attributable to the PE. The simple attribution of this expenditure to the PE does not represent a deduction in the PE that is in respect of a transfer of money or money's worth to the parent jurisdiction. In substance, the counterparty to the deduction attributed to the PE is the provider of the goods or services that gave rise to the original expense.

If, however, the head office recharge includes an element representing value provided by the head office to the PE, then this element may be caught. An example would be where it is appropriate to reward the head office for negotiating bulk discounts by coordinating all the acquisitions of the group. In substance, the counterparty to this transaction resulting in the deduction would be the head office.

However, if a PE is permitted a deduction for an item of expenditure attributed to it, but the head office is also able to claim a deduction for the same amount, then the rules within Chapter 10 (Dual Territory Double Deduction Cases) may be at point, as it may constitute a double deduction mismatch within the scope of that Chapter.

## **INTM554050: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Conditions to be satisfied: Condition C**

Condition C of s259FA TIOPA 2010 requires consideration of the circumstances that gave rise to the PE deduction. Condition C is satisfied if, disregarding the provisions of Chapters 6 to 10 of Part 6A, it is reasonable to suppose that those circumstances do not result in either

- an increase in taxable profits of the company for any permitted taxable period, or
- a reduction of a loss made by the company for any permitted taxable period,

for the purposes of tax charged in the parent jurisdiction, or .

- an increase in profits or a reduction of a loss for one or more permitted taxable periods, but the aggregate effect on taxable profits is less than the PE deduction.

The aggregate effect on taxable profits is the sum of

- any increases in taxable profits of the company for the purposes of the related to the PE deduction and
- the amount of any reduction in a loss made by the company.

When calculating the aggregate effect on taxable profits you should take into account only the figures for a permitted taxable period that are in relation to a tax charged in the parent jurisdiction.

The aim is to establish whether the company has reflected a corresponding taxable receipt equal to the amount of the deduction claimed.

A permitted taxable period is a taxable period of the company for the purposes of a tax charged under the law of the parent jurisdiction, that

- begins at any time before the end of 12 months of the end of the accounting period in which the PE deduction falls for the purposes of corporation tax in the UK, or
- begins after that but it is just and reasonable that the circumstances resulting in the PE deduction affect the profits of a later period, and a claim has been made for that period to be a permitted period.

## **INTM554060: Hybrids: Chapter 6 - Transfers by UK permanent establishment of a multinational company: Extent of the mismatch**

If conditions A to C of s259FA are satisfied, the next step is to establish the extent of any excessive PE deduction for the purposes of Chapter 6.

The calculation of the excessive PE deduction will depend on the outcome of Condition C.

If it is concluded that it was reasonable to suppose that there was no increase in taxable profits nor reduction of losses, the excessive PE deduction is the amount of the PE deduction claimed.

If it is concluded that it was reasonable to suppose that there was an increase in taxable profits or a reduction of losses, but that this was less than the PE deduction claimed, then the excessive PE deduction is the PE deduction claimed, less the aggregate effect on taxable profits.

## **INTM554070: Hybrids: Chapter 6 - Transfers by UK permanent establishments of multinational companies: Counteraction**

Action to counter the excessive permanent establishment (PE) deduction is set out at s259FB. There is only one counteraction and it applies where the PE is in the UK. The counteraction works by denying the excessive PE deduction, unless it is deducted from dual income of the company.

Dual inclusion income is the amount arising during an accounting period that is ordinary income (see [INTM553090](#)) of the company for both

- that accounting period for UK corporation tax, and
- a permitted taxable period for the purposes of any tax charged under the law of the parent jurisdiction.

Unlike for a Chapter 3 (Hybrid and other Mismatches from Financial Instruments) counteraction (see [INTM551040](#)), the dual inclusion income does not have to be connected to the circumstances giving rise to the deduction, but includes all income that is included in both jurisdictions.

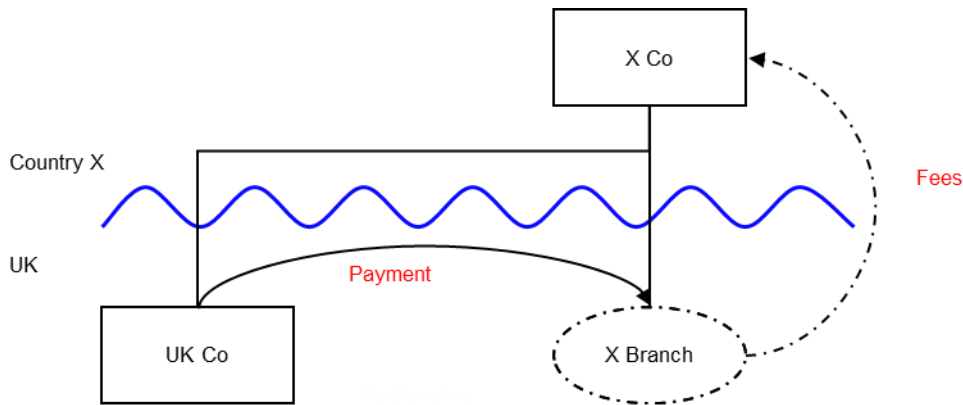
To the extent that the company has dual inclusion income in the accounting period, all or part of the excessive PE deduction may be deducted from that income. Any proportion of the excessive PE deduction that has been denied is carried forward and may be allowed as a deduction from any dual inclusion income of the company arising in future accounting periods.

The company may not benefit from an exclusion such as branch exemption, in relation to profits attributed to the PE, so that it includes the branch's profits within the parent jurisdiction, and the parent jurisdiction may therefore not any recognise any dealings between the head office and the PE. In this case, such dealings may fall within the scope of Chapter 6.

Where the PE is profitable it is unlikely that there will be a counteraction as the relevant dual inclusion income should exceed the PE deduction. However if either the PE is loss-making, or the dual inclusion income does not exceed the deduction (if, for example, some of the income of the PE is not taxable in the parent jurisdiction) then it will only be permitted a deduction for the excess in the parent jurisdiction – it will be denied a deduction for the excess in the UK PE.



## INTM554080: Hybrids: Chapter 6 - Transfers by UK permanent establishments of multinational companies: Example



### Background

- X Co is a non-UK resident company, resident in Country X
- UK Co is a UK resident company that is entirely owned by X Co
- X Co has a UK permanent establishment, X Branch
- The profits of X Branch are taxable in the UK only, as Country X's domestic legislation has an exemption for foreign branches
- UK Co pays fees to X Branch, which are brought into account as income of X Branch in the UK
- The accounts for X Branch show a deduction for the transfer of money or money's worth to X Co
- That transfer to X Co is not brought into account when calculating the profits of X Co under its domestic tax regime.

### Analysis - Applying the tests in s259FA TIOPA 2010

Does the deemed payment by X Branch to X Co satisfy the relevant conditions to fall within the scope of Chapter 6?

#### Condition A: Is the company a multinational company?

X Co is a company resident for tax purposes in a territory outside the UK, Country X. X Co carries on a business in the UK through a permanent

establishment, X Branch, and is within the charge to corporation tax in the UK on the profits attributable to X Branch.

Condition A is satisfied in respect of X Co.

**Condition B: Is there a PE deduction?**

X Branch either makes a transfer of money or money's worth to X Co, or is treated as doing so as it is in recognition of that transfer for which the deduction is permitted. X Branch may deduct that amount from its income when calculating its profits chargeable to corporation tax in the UK.

Condition B is satisfied.

**Condition C: Is it reasonable to suppose that the circumstances giving rise to the PE deduction is not matched by an increase in taxable profits?**

In this example it is reasonable to suppose that the circumstances giving rise to the PE deduction for X Branch in the UK do not result in any increase in the taxable income of X Co in Country X.

Condition C is satisfied.

**Conclusion**

As all the relevant conditions are satisfied the PE deduction is subject to a counteraction under Chapter 6.

**Counteraction**

There is no recognition for the transfer when calculating the profits of X Co. Therefore, the extent of the mismatch, termed the excessive PE deduction, is the entire amount of the PE deduction of X Branch.

The excessive PE deduction may be deducted only from dual inclusion income of X Co. In this example X Co does not have any dual inclusion income, so X Branch cannot deduct any of the excessive PE deduction. The unused deduction is carried forward to subsequent accounting periods, and may be used against dual inclusion income of those periods.

## **INTM555000: Hybrids: Chapter 7 - Hybrid Payee: Contents**

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[INTM555050: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition C](#)

[INTM555060: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition D](#)

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[INTM555095: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Payer](#)

[INTM555100: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Investor in a hybrid payee](#)

[INTM555110: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: LLP is a hybrid payee](#)

[INTM555120: Hybrids: Chapter 7 - Hybrid Payee: Example: Use of reverse hybrid by tax-exempt entity](#)

[INTM555130: Hybrids: Chapter 7 - Hybrid Payee: Example: Payments to reverse hybrid partially excluded](#)

[INTM555140: Hybrids: Chapter 7 - Hybrid Payee: Example: Payment to reverse hybrid caught by CFC regime](#)

## **INTM555010: Hybrids: Chapter 7 - Hybrid Payee: Overview**

Chapter 7 of Part 6A TIOPA 2010 counters mismatches involving payments or quasi-payments ([INTM550530](#)) to a hybrid entity where it is reasonable to suppose the mismatch arises because the entity is a hybrid entity ([INTM550560](#)).

For the Chapter to apply, five conditions, Conditions A to E must be met.

### **Condition A**

Is there is a payment or quasi-payment under or in connection with an arrangement? (see [INTM555030](#))

### **Condition B**

Is the payee a hybrid entity? (see [INTM555040](#))

### **Condition C**

Is either of the following within the charge to UK corporation tax:

- the payer,
- an investor in a hybrid payee, or

Is a hybrid payee an LLP? (see [INTM555050](#))

### **Condition D**

Is it reasonable to suppose that there would be a mismatch arising by reason of a payee being a hybrid entity, if it were not countered by the hybrid mismatch legislation or equivalent legislation outside the UK? (see [INTM555060](#))

### **Condition E**

Are the relevant counterparties within the same control group, or is this a structured arrangement? (see [INTM555070](#))

If all of these conditions are met, then there is a hybrid payee D/NI mismatch if a payment or quasi-payment gives rise to a deduction which exceeds the ordinary income arising to the payee(s) for a permitted taxable period, to the extent that the excess is due to the payee(s) being hybrid entities.

The hybrid mismatch rules do not generally seek to neutralise temporary tax mismatches and so the permitted period for inclusion in ordinary income is a period of 12 months after the end of the taxable period in which the payment was deducted, or such longer time as is claimed as just and reasonable.

Where one of the hybrid payees is either

- resident in a territory which does not impose a tax charge
- or if a permanent establishment, is not charged to tax on its ordinary income, and
- the payment or quasi-payment does not give rise to any CFC charge,

there is provision to establish the extent to which the excess is due to hybridity; the 'relevant amount' of the excess.

## Counteraction

If all 5 conditions are met, then the hybrid payee D/NI mismatch is countered as follows –

- where the payer is within charge to corporation tax, deny a deduction for the amount of the mismatch (see [INTM555095](#)), or
- where an investor in a the hybrid payee is within the charge to corporation tax, and it is reasonable to suppose that there has been no other sufficient counteraction within the Chapter, treat the relevant amount as taxable income of the investor (see [INTM555100](#)), apportioning the income between investors if required, or
- where the hybrid payee is an LLP within the charge to corporation tax, and there has been no other sufficient counteraction within the Chapter, treat the relevant amount as taxable income arising to the LLP (see [INTM555110](#)).

## **INTM555020: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied**

The conditions applicable for Chapter 7 of Part 6A TIOPA 2010 are set out at s259GA. For Chapter 7 to apply each of conditions A, B, C, D and E must be met.

[INTM555030: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition A](#)

[INTM555040: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition B](#)

[INTM555050: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition C](#)

[INTM555060: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition D](#)

[INTM555070: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition E](#)

## **INTM555030: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition A**

Condition A of s259GA, TIOPA 2010 requires there to be a payment or quasi-payment made under, or in connection with, an arrangement. Definitions of the key terms for this condition are at s259BB.

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person who makes the transfer.

A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply.

See [INTM550530](#) for more detail on quasi-payments.

There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

Condition A also requires that the payment or quasi-payment to be made under an arrangement. S259NF sets out the definition of an arrangement for the purposes of this legislation to include any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

## **INTM555040: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition B**

Condition B of s259GA TIOPA 2010 requires a payee to be a hybrid entity (hybrid payee).

A hybrid entity is defined at s259BE as an entity that is regarded as a distinct and separate person for tax purposes under the law of any territory, and

- its income or profits (or would be if there were any) are treated wholly or partly as the income or profits of another person, or
- it is not regarded as a distinct and separate person for tax purposes under the law of another territory.

See [INTM555010](#) for further details on the definition of a hybrid entity.



## **INTM555050: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition C**

Condition C of s259GA requires

- the payer to be within the charge to UK corporation tax for a relevant payment period, or
- an investor in a hybrid payee to be within the charge to UK corporation tax for an accounting period that falls wholly or partly within a relevant payment period, or
- there is a hybrid payee that is a limited liability partnership.

The relevant payment period is the taxable period of the payer in which an amount may be deducted for a payment or quasi-payment.

### **Investor**

An investor is defined at s259BE.

If the payee is a hybrid entity because its income or profits are treated as the income or profits of another person, an investor is any person who is treated as having that income.

If the payee is a hybrid entity because it is treated as a person in one territory but is not recognised as a separate and different person under the law of another territory, an investor in that payee is any entity that is

- recognised in the first territory as a separate and different person to the payee, but
- not recognised in the other territory as a separate and different person to the payee.

### **Limited Liability Partnership (LLP)**

A Limited Liability Partnership (LLP) is governed by the Limited Liability Partnership Act 2000. It must be registered at Companies House and have at least two designated members. In law, an LLP is a body corporate.

Guidance on the UK tax treatment of LLPs can be found at [PM50400](#) onwards.

## **INTM555060: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition D**

Condition D of S259GA requires that it is reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a relevant deduction/non-inclusion mismatch (hybrid payee deduction/non-inclusion mismatch) in relation to the payment or quasi-payment

The test is whether a relevant deduction/non-inclusion mismatch would arise if Chapters 7 to 10 of Part 6A TIOPA 10 (or any equivalent non-UK legislation) did not apply.

There is no definition of the term reasonable to suppose in Part 6A, so it takes its ordinary meaning. Generally this does not require either party to actually know how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it would be reasonable to conclude that a mismatch may or may not arise.

The inclusion of this phrase is intended to assist in the practical application of Condition D. Parties to the payment or quasi-payment should take all reasonable steps to establish whether a mismatch will arise, taking account of the relevant tax laws of the territories involved and the relevant facts and circumstances. In applying this condition, it is appropriate to consider the relevance and extent of the information available between companies within the same group, and between parties to structured arrangements. It should not be necessary for the parties to await final resolution of the relevant tax returns.

## **INTM555070: Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition E**

Condition E is satisfied where one of the following applies -

- the payer is also a hybrid payee (for a quasi-payment only),
- the payer and a hybrid payee, or an investor in a hybrid payee, are in the same control group at any time from when the arrangement is made to the last day of the payment period, or
- the arrangement is a structured arrangement.

A payer may also be a hybrid payee in respect of a quasi-payment only where the UK is not the payer jurisdiction, and the hybrid payee -

- is an entity that is not a separate person from the payer under UK tax law, and
- is an entity that is a separate person from the payer for tax purposes in the payer's jurisdiction, and
- it would be reasonable to expect that entity to have an amount of ordinary income arising as a result of the circumstances giving rise to the quasi-payment.

Control groups are defined at s259NB, and more detailed guidance on control groups is at [INTM550580](#).

An arrangement is a structured arrangement if it is reasonable to suppose that-

- it is designed to secure a hybrid payee deduction/non-inclusion mismatch, or
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

## **INTM555080: Hybrids: Chapter 7 - Hybrid Payee: Extent of the mismatch**

If conditions A to E of s259GA TIOPA 2010 are satisfied the next step is to establish the extent of any hybrid payee deduction/non-inclusion mismatch for the purposes of Chapter 7.

S259GB defines a hybrid payee deduction/non-inclusion mismatch in relation to a payment or quasi-payment as a mismatch where

- there is an allowable deduction for the payer that exceeds the sum of ordinary income arising to each of the payees for a permitted period, and
- all or part of that excess arises because one or more of the payees is a hybrid entity.

The hybrid mismatch rules do not generally seek to neutralise temporary tax mismatches and so the permitted period for inclusion in ordinary income is a period of 12 months after the end of the taxable period in which the payment was deducted, or such longer time as is claimed as just and reasonable.

Where one of the hybrid payees is either

- not resident in any territory which imposes a tax charge, or
- does not have a permanent establishment in any territory which imposes a tax charge, and
- the payment or quasi-payment does not give rise to any CFC charge,

then there is provision in s259GB(3) and (4) to establish the extent to which the excess is due to hybridity; the 'relevant amount' of the excess.

The relevant amount is the lesser of the excess, and the amount of ordinary income that would arise to the payee by reason of the payment or quasi-payment if the payee were a company and if the payment was made in connection with a UK trade carried on by the payee through a UK branch.

The effect of this counterfactual test is to determine whether a counteraction should apply when there are other reasons for the mismatch, in addition to the hybridity of the payee.

## **INTM555090: Hybrids: Chapter 7 - Hybrid Payee: Counteraction**

Counteraction to address the hybrid payee deduction/non-inclusion mismatch is considered first in respect of the payer (the primary counteraction).

The second counteraction, against investors in the hybrid payee(s), applies if the payer is not within the charge to UK corporation tax.

The third counteraction, against an LLP that is a hybrid payee, applies if the primary counteraction and the secondary counteraction do not apply to address the mismatch.

Details of each of the counteractions are provided in the following pages.

[INTM555095: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Payer](#)

[INTM555100: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Investor in a hybrid payee](#)

[INTM555110: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: LLP](#)

## **INTM555095: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Payer**

The counteraction where the payer is within the charge to UK corporation tax is set out at s259GC.

The payer is denied a deduction for the payment period for the amount of the hybrid payee deduction/non-inclusion mismatch.

The payment period is the taxable period of the payer in which an amount may be deducted for the relevant payment or quasi-payment.

## **INTM555100: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Investor in a hybrid payee**

This counteraction applies to investors in a hybrid payee and treats all or part of the hybrid payee deduction/non-inclusion mismatch as income of the investor for the relevant counteraction period of that investor.

The counteraction at s259GD applies only where the investor is within the charge to UK corporation tax and where it is reasonable to suppose that

- no counteraction against the payer is possible under s259GC or equivalent non-UK provisions, or
- counteraction against the payer is possible under non-UK provisions equivalent to s259GC, but does not fully counteract the mismatch.

Where no overseas provision equivalent to s259GC applies, the amount counteracted is an amount equal to the hybrid payee deduction/non-inclusion mismatch.

The mismatch is fully counteracted only by a non-UK provision if this equivalent provision reduces the payer's deduction by the full amount of the mismatch (as quantified under s259GB). In all other cases the amount of the deduction that has not been counteracted is the lesser of

- the amount of the deduction that the payer may still deduct, and
- the amount of the mismatch that is not counteracted by the non-UK provision equivalent to s259GB.

If there is more than one investor the relevant amount is apportioned on a just and reasonable basis, as their share of the relevant amount for the counteraction period, having regard (in particular) to:

- any profit sharing arrangements between some or all of the payees, and
- the extent to which it is reasonable to suppose that the mismatch arises by reason of each hybrid payee being a hybrid entity

The counteraction period is:

- the investor's accounting period where that coincides with the payment period, or
- the first accounting period of the investor that is wholly or partly within the payment period

The payment period is the taxable period of the payer in which an amount may be deducted for the relevant payment or quasi-payment.



## **INTM555110: Hybrids: Chapter 7 - Hybrid Payee: Counteraction: Hybrid payee is a LLP**

This counteraction applies to a hybrid payee that is a Limited Liability Partnership (LLP), and treats all or part of the hybrid payee deduction/non-inclusion mismatch as income arising to the hybrid payee on the last day of the payment period.

The counteraction at s259GE applies only where it is reasonable to suppose that there has been

- no counteraction against the payer under s259GC, or any equivalent non-UK provisions,
- no counteraction against investors in a hybrid payee is possible under s259GD, or any equivalent non-UK provisions, or
- if counteraction has been applied under the above provisions, it does not fully counteract the mismatch.

The mismatch is fully counteracted only if the application of the above provisions reduces the payer's deduction by the full amount of the mismatch (as quantified under s259GB). When considering this, the amount of the mismatch is adjusted to take account of any secondary counteraction against investors in the hybrid payee.

The mismatch is not fully counteracted if the payer may still deduct part of the mismatch. In these cases the amount of the mismatch not counteracted is the lesser of

- the amount of the deduction that the payer may still deduct, and
- the amount of the mismatch that it is reasonable to suppose is not counteracted by sections 259GC and 259GD, or equivalent non-UK provisions.

If there is more than one hybrid payee you should apportion the relevant amount on a just and reasonable basis, particularly taking into account

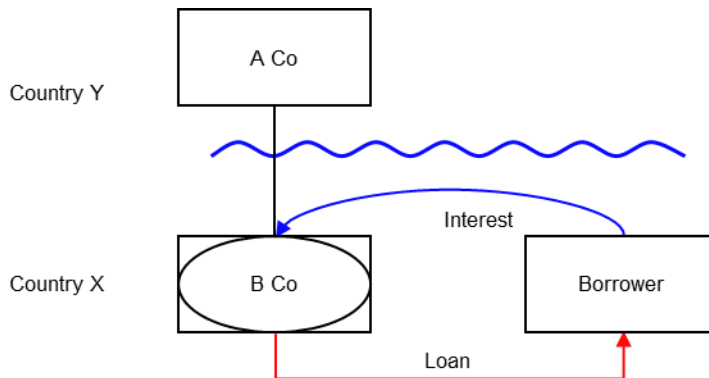
- any profit sharing arrangements between some or all of the payees, and
- the extent to which it is reasonable to suppose that the mismatch arises by reason of each hybrid payee being a hybrid entity.

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 allocate the income of an LLP carrying on a trade, profession or business with a view to profit to its members.

For the purposes of these rules s259GE(8) will disapply those sections and the LLP is chargeable to corporation tax on any income treated as arising as a result of counteraction under s259GE.

## INTM555120: Hybrids: Chapter 7 - Hybrid Payee: Example: Use of reverse hybrid by tax-exempt entity



### Background

- A Co is a company resident in Country Y
- B Co is an entity incorporated in Country X and is wholly owned by A Co
- Country X treats B Co as transparent for X tax purposes (that is, it is not a separate taxable person from A Co)
- Country Y treats B Co as a separate taxable person from A Co
- A Co is exempt from tax under Country Y law
- Borrower Co is a company resident in Country X, and is not connected to either A Co or B Co
- Borrower Co borrows money from B Co on arm's length and standard commercial terms (the Loan)
- Country X allows Borrower Co a deduction for interest payments made on the loan
- Country X does not tax the interest receipt by B Co, as it regards the income as belonging to A Co.

### 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 Mismatches rules?

**Condition A: Are payments made under, or in connection with, an arrangement?**

Transactions took place resulting in a transfer of money (the interest payments) directly from Borrower Co (payer) to B Co (payee), which represents a payment.

There was an arrangement (the Loan agreement), and payments were made under that arrangement.

Condition A is therefore satisfied.

**Condition B: Is the payee a hybrid entity?**

B Co is the payee. Country X regards B Co as transparent for tax purposes, so that income or profits are treated by Country X as those of A Co. Country Y treats B Co as a separate taxable person to A Co.

B Co has the characteristics of a hybrid entity, and Condition B is met.

**Condition C: Is the payer or investor within the charge to corporation tax for the relevant period, or is the hybrid payee a limited liability partnership?**

The charge to corporation tax is the charge to corporation tax in the UK. In this example condition C will be satisfied if

- the UK is Country X, or
- the UK is Country Y, or
- the hybrid payee is a LLP

If none of these circumstances are satisfied then Condition C is not met, and it is not necessary to consider the remaining conditions.

Note: If neither of these are satisfied but the mismatch is not countered by another territory and imported into the UK, then 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?**

Given the background above it is reasonable to suppose that if the hybrids legislation, or its foreign equivalent, did not apply

- Borrower Co would deduct an amount from income for the interest paid on the Loan (the relevant deduction), and

- Neither B Co nor A Co would not include the interest received from Borrower Co in its ordinary income.

This mismatch arises as a consequence of the contrasting treatment of B Co for tax purposes in Country X and Country Y, so is directly attributable to the fact that B Co is a hybrid entity. If B Co had been recognised as an entity separate from A Co in Country X it is reasonable to suppose that B Co would have included the interest payments in its ordinary income.

Condition D is therefore satisfied.

**Condition E: Is the payer also a hybrid payee, are the payer and either the hybrid payee or the investor within the same control group or is there a structured arrangement?**

This condition has three possible tests that can be met, so we must examine these in turn. If any of the three are met then this condition is met.

The payer, Borrower Co, is not a hybrid payee. Condition E is not met by this test.

The hybrid payee, B Co, is not in the same control group as Borrower Co. Condition E is not met by this test.

There is insufficient information regarding the terms of the Loan to consider whether the Loan is a structured arrangement in this example. If it is not a structured arrangement, Condition E is not met and no counteraction is possible under Chapter 7 of TIOPA 2010.

If, however, it looks as though the arrangement was designed to secure the mismatch, such as the funds being originally provided by A Co to B Co for no significant other reason than to benefit from the mismatch, then it may satisfy Condition E.

It would also satisfy the requirements to be considered a structured arrangement if the economic benefit was shared by the Borrower, such as the Loan terms being more beneficial or the interest rate being reduced in return for Borrower agreeing to borrow the money through B Co. The background here states that the loan is on standard commercial terms, therefore this is unlikely to be the case here.

Therefore condition E will be satisfied where it is reasonable to suppose that arranging for B Co to be the creditor was designed as such to secure the mismatch.

### **Amount of the mismatch**

If conditions A to E are satisfied, the payment of interest by Borrower Co under the Loan is a hybrid payee deduction/non-inclusion mismatch, and UK counteraction must be considered.

The extent of the mismatch must be calculated by quantifying the excess, which in this example is given by

- the amount of Borrower's deduction from income for the interest paid, less
- the amount of that interest payment included as ordinary income of A Co and B Co.

How much of that amount arises because B Co is a hybrid entity is then considered. In this example, if B Co were not a hybrid entity then either B Co would be recognised by Country X as a separate taxable person or Country Y would recognise it as a transparent entity. In either scenario it would be reasonable to suppose that the amount of ordinary income, equal to the interest received, would be recognised, and that a mismatch would not arise.

The extent of the mismatch arising by reason of B Co being a hybrid entity is therefore the full amount of the interest.

### **Conclusion**

Assuming all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payee deduction/non-inclusion mismatch', the relevant counteractions will need to be considered.

### **Counteraction**

- The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y or if B Co is an LLP.

#### **Counteraction where the UK is in the position of Country X (payer jurisdiction)**

##### **Primary Response**

The primary counteraction is against the payer.

If the UK is Country X (the payer jurisdiction) Borrower Co's deduction for interest payments to B Co is restricted (s259GC).

**Counteraction where the UK is in the position of Country Y (investor jurisdiction)**

**Secondary Response**

In this example, if the UK is Country Y and it is concluded that Country X has no provisions that apply to counteract the mismatch on the payer, then the UK legislation applies to treat the entire mismatch as income of A Co.

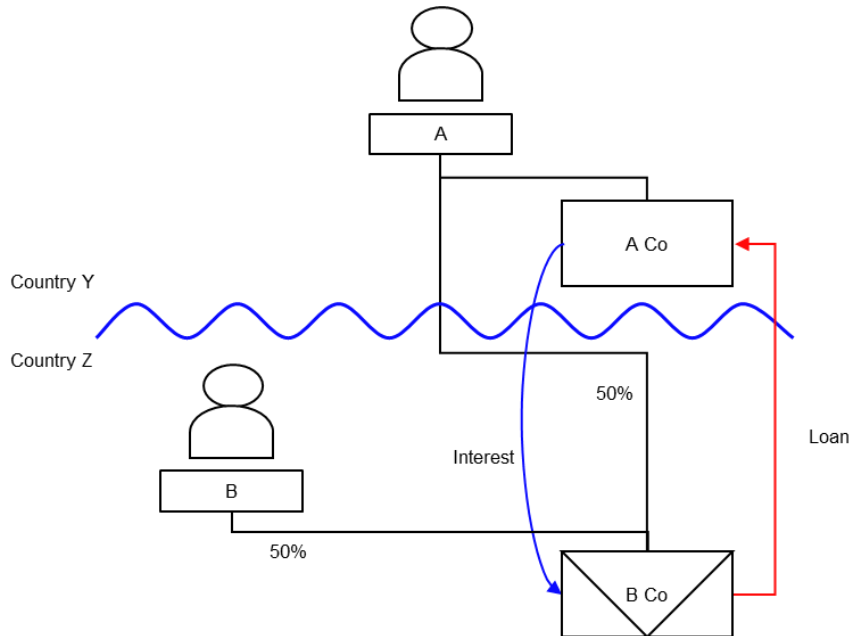
If it is concluded that Country X has provisions that apply but they do not fully counteract the mismatch then the UK provisions apply to treat part of the mismatch as income of A Co, to ensure the hybrid payee deduction/non-inclusion mismatch is fully counteracted.

**Counteraction where B Co is an LLP**

**Tertiary Response**

In this example the tertiary response (counteraction against a LLP that is a hybrid payee) is unlikely to apply - as both the payer and the hybrid payee are resident in the UK, the primary response applied against the payer takes priority, and will fully counteract the mismatch.

## INTM555130: Hybrids: Chapter 7 - Hybrid Payee: Example: Payments to reverse hybrid partially excluded



### 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 is permitted an interest deduction against its ordinary income on the Loan
- B Co attributes half the interest receivable to Individual A and half to Individual B
- Individual B is subject to tax at the full marginal rate applicable to interest income in Country Z
- Individual A does not include the interest receivable in his ordinary income because Country Z does not subject to tax foreign source income to the extent that it is attributable to a non-resident person, although it otherwise would do so
- Country Y recognises B Co as a person for tax purposes and Individual A is not subject to tax on distributions 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 Mismatches 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 with respect to the above.

### **Condition B: Is the payee a hybrid entity?**

B Co is the payee. Country Y treats B Co as a separate taxable person to Individual A.

Country Z treats B Co.'s interest receipts as the income of Individual A and Individual B for tax purposes.

B Co has the characteristics of a hybrid entity, and Condition B is met.

**Condition C: Is the payer or investor within the charge to corporation tax for the relevant period, or is the hybrid payee a limited liability partnership?**

The charge to corporation tax is the charge to corporation tax in the UK. In this example condition C can be satisfied if

- the UK is Country Y, or
- the UK is Country Z and the hybrid payee is a LLP.

If none of these circumstances are satisfied then Condition C is not met, and it is not necessary to consider the remaining conditions.

Note: If neither of these are satisfied but the mismatch is not countered by another territory and imported into the UK, then 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 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 (neither a tax corresponding to the UK's income tax nor corporation tax) on the relevant receipts attributable to Individual A (in which case no tax will be charged on those receipts).

This mismatch arises as a consequence of the contrasting treatment of B Co for tax purposes in Country Y and Country Z, so is directly attributable to 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 therefore met.

**Conclusion**

As all the relevant conditions are satisfied to characterise the arrangement as a 'hybrid payee deduction/non-inclusion mismatch', the relevant counteractions will need to be considered.

**Counteraction**

As all of the conditions are met there is a hybrid payee deduction/non-inclusion mismatch.

**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**

In the facts of this example the UK is also the investor jurisdiction, however it cannot apply as Individual A is not within the charge to corporation tax.

## **Counteraction where a hybrid payee is a UK Limited Liability Partnership (LLP)**

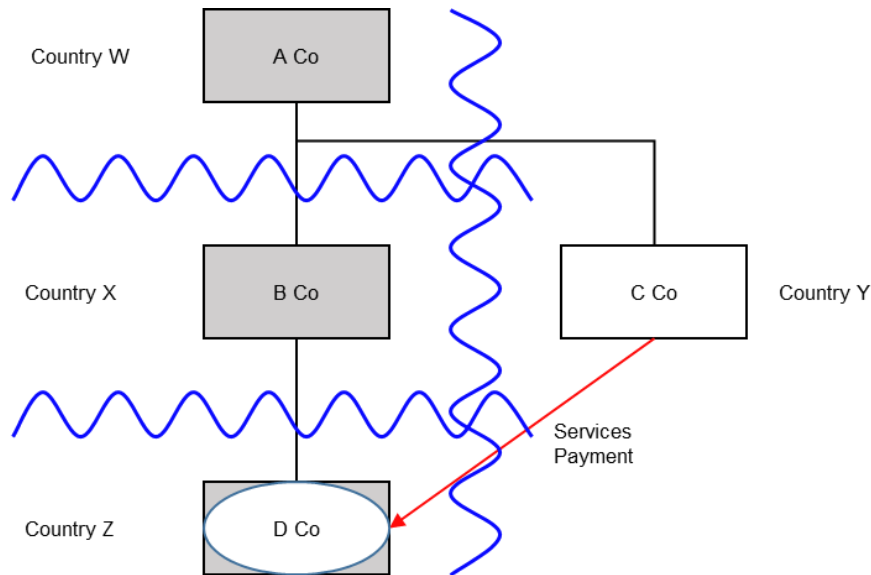
### **Tertiary response**

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 allocate the income of an LLP carrying on a trade, business or (if income tax) profession with a view to profit to its members. For the purposes of these rules s259GE(8) will disapply those sections for the purposes of bringing this income into charge on B Co.

## INTM555140: Hybrids: Chapter 7 - Hybrid Payee: Example: Payment to reverse hybrid caught by CFC regime



### Background

- A Co is resident in Country W.
- A Co owns all shares in B Co, which is a company resident in Country X.
- A Co also owns all shares in C Co, which is a company resident in Country Y.
- B Co has established D Co under the laws of Country Z.
- D Co is regarded as transparent for tax purposes under the law of Country Z, such that Country Z treats the income and profits of D Co as attributable to B Co. However, D Co is regarded as a person for tax purposes under the law of Country X.
- D Co receives a services payment from C Co, but receives no other income.
- Country W's CFC regime treats service income paid by a related party as attributable income and subjects such income, where all other relevant conditions are met (assumed to be satisfied here), to taxation. In this case, Country W's CFC rules extend to the service income received by D Co, which it also regards as a person for tax purposes under the law of Country W.

## **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 Mismatches rules?

### **Condition A: Are payments made under, or in connection with, an arrangement?**

The services payment is a transfer of money from C Co to D Co and it is made under the arrangement, which includes the transaction involving the provision of the relevant services by D Co and the subsequent compensation.

Therefore Condition A is satisfied.

### **Condition B: Is the payee a hybrid entity?**

D Co is the payee and is regarded as a person for tax purposes under the law of Country X.

Country Z treats D Co's service payment receipts as the income of B Co for tax purposes.

Therefore D Co is a hybrid entity, and Condition B is met.

### **Condition C: Is the payer or investor within the charge to corporation tax for a relevant period or is the hybrid payee a limited liability partnership?**

In the event the UK is in the position of Country Y, C Co is the payer and would be within the charge to corporation tax.

In the event the UK is in the position of Country X, B Co is the relevant investor and would be within the charge to corporation tax.

Condition C will therefore be satisfied under either of the above scenarios.

In the event that D Co is an LLP, Condition C will also be satisfied.

### **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 Country Y will permit C Co a full deduction for the service payments (the relevant deduction). It is also reasonable to suppose that the payment received by D Co will not be included in its ordinary income. D Co is regarded as transparent under Country Z's jurisdiction, but as a taxable entity (opaque) in Country X, so neither are likely to bring it into charge.

This mismatch arises as a consequence of the contrasting treatment of D Co for tax purposes in Country X and Country Z, so is directly attributable to the fact that D Co is a hybrid entity. If either:

- D Co had been recognised as an entity separate from B Co in Country Z, or
- D Co had not been recognised as an entity separate from B Co in Country X

then it is reasonable to suppose that either D Co (in the former situation) or B Co (in the latter situation) would have included the interest payments in its ordinary income. It therefore arises by reason of D Co (a payee) being a hybrid entity.

Condition D is therefore satisfied.

### **Extent of the mismatch**

The excess of the deduction over the amount not included in this example is equal to the total payment for services.

However, A Co subjects the service payments to a CFC charge (either a UK CFC charge or its foreign equivalent). Where there is a hybrid payee deduction/non-inclusion mismatch between the parties that are directly involved in the transaction, then recognition should be given to any CFC charge suffered on that same receipt per s259BD TIOPA 2010.

In this case, the receipt has been wholly brought into account by A Co in calculating D Co.'s chargeable profits for the purpose of that charge.

Having recognised the CFC charge, the result is that no hybrid payee deduction/non-inclusion mismatch remains. There is therefore no need to consider the remaining conditions.

## **INTM556000: Hybrids: Chapter 8 - Multinational payee: Contents**

[INTM556010: Hybrids: Chapter 8 - Multinational payee: Overview](#)

[INTM556020: Hybrids: Chapter 8 - Multinational payee: Conditions to be satisfied](#)

[INTM556030: Hybrids: Chapter 8 - Multinational payee: Condition A](#)

[INTM556040: Hybrids: Chapter 8 - Multinational payee: Condition B](#)

[INTM556050: Hybrids: Chapter 8 - Multinational payee: Condition C](#)

[INTM556060: Hybrids: Chapter 8 - Multinational payee: Condition D](#)

[INTM556070: Hybrids: Chapter 8 - Multinational payee: Condition E](#)

[INTM556080: Hybrids: Chapter 8 - Multinational payee: Extent of the mismatch](#)

[INTM556090: Hybrids: Chapter 8 - Multinational payee: Counteraction](#)

[INTM556100: Hybrids: Chapter 8 - Multinational payee: Example: Branch exemption – Only one country recognises a PE](#)



## **INTM556010: Hybrids: Chapter 8 - Multinational payee: Overview**

Chapter 8 of Part 6A TIOPA 2010 counters mismatches involving hybrid entities where it is reasonable to suppose the mismatch arises from payments or quasi-payments between connected parties or in structured arrangements and

- there is an allowable deduction for the payer that exceeds the sum of ordinary income arising from those circumstances – a deduction/non-inclusion mismatch (D/NI mismatch), and
- all or part of that excess arises because one or more of the payees is a company with a permanent establishment (a 'multinational company').

### **Multinational company**

A multinational company for the purpose of Chapter 8 of Part 6A is defined at s259HA. A company is a multinational company if it is

- resident for tax purposes in a territory (the parent or head office jurisdiction), and
- regarded as carrying on a business through a permanent establishment in another territory.

### **Ordinary income**

In broad terms, ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at [INTM550540](#).

There are special recognition rules at s259BD for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign companies (CFC) charge. This is discussed in more detail at [INTM550550](#).

### **Conditions to be satisfied**

The legislation applies where 5 conditions in s259HA (A to E) are met.

#### **Condition A**

Is there is a payment or quasi-payment under or in connection with an arrangement?

**Condition B**

Is the payee within the definition of a multinational company?

**Condition C**

Is the payer within the charge to UK corporation tax?

**Condition D**

Is it reasonable to suppose that there be a mismatch arising by reason of the payee being a multinational company if it were not countered by this legislation or equivalent legislation outside the UK?

**Condition E**

Are the relevant parties in the same control group, or it is reasonable to suppose the arrangement is a structured arrangement designed to secure the mismatch or under which the economic benefits of the mismatch are shared?

**Counteraction**

If all 5 conditions are met the mismatch is counteracted by denying all or part of the payer's deduction.

## **INTM556020: Hybrids: Chapter 8 - Multinational payee: Conditions to be satisfied**

The conditions applicable for Chapter 8 of Part 6A are set out at s259HA. For Chapter 8 to apply each of conditions A, B, C, D and E must be met.

[INTM556030: Hybrids: Chapter 8 - Multinational payee: Condition A](#)

[INTM556040: Hybrids: Chapter 8 - Multinational payee: Condition B](#)

[INTM556050: Hybrids: Chapter 8 - Multinational payee: Condition C](#)

[INTM556060: Hybrids: Chapter 8 - Multinational payee: Condition D](#)

[INTM556070: Hybrids: Chapter 8 - Multinational payee: Condition E](#)

## **INTM556030: Hybrids: Chapter 8 - Multinational payee: Condition A**

Condition A of s259HA requires there to be a payment or quasi-payment made under, or in connection with, an arrangement. Definitions of the key terms for this condition are at s259BB.

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply.

See [INTM550530](#) for more detail on quasi-payments.

There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments if the circumstances giving rise to the deduction do not include economic rights between the payer and a payee.

Condition A also requires that the payment or quasi-payment be made under an arrangement. S259NF sets out the definition of an "arrangement" for the purposes of this legislation to include any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

## **INTM556040: Hybrids: Chapter 8 - Multinational payee: Condition B**

Condition B of s259HA requires a payee to be a multinational company.

A multinational company is defined at s259HA as a company that is

- resident for tax purposes in a territory (the parent jurisdiction), and
- regarded as carrying on a business through a permanent establishment in another territory.

Company is not defined in the legislation, so takes its normal meaning under UK law.

A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

## **INTM556050: Hybrids: Chapter 8 - Multinational payee: Condition C**

Condition C of s259HA requires the payer to be within the charge to UK corporation tax for a relevant payment period.

The payer is the person who makes a payment.

The relevant payment period is the taxable period of the payer in which an amount may be deducted for a payment or quasi-payment.

## **INTM556060: Hybrids: Chapter 8 - Multinational payee: Condition D**

Condition D of s259HA asks whether it is reasonable to suppose that, if certain chapters of Part 6A (or equivalent non-UK legislation) did not apply, there would be a multinational payee deduction/non-inclusion mismatch in relation to the payment or quasi-payment?

The test is whether a relevant deduction/non-inclusion mismatch would arise if Chapters 8 to 10 of Part 6A TIOPA 10 (or any equivalent non-UK legislation) did not apply.

There is no definition of the term reasonable to suppose in Part 6A, so the phrase will take its ordinary meaning. Generally this does not require either party to actually know how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it is reasonable to conclude that a mismatch would arise in these circumstances.

See [INTM556010](#) for the requirements for a deduction/non-inclusion mismatch to be a multinational payee deduction/non-inclusion mismatch.

## **INTM556070: Hybrids: Chapter 8 - Multinational payee: Condition E**

Condition E of s259HA is satisfied where one of the following applies -

- (for a quasi-payment only) the payer is also a payee,
- (for a payment or quasi-payment) the payer and the multinational payee are in the same control group at any time from when the arrangement is made to the last day of the payment period, or
- (for a payment or quasi-payment) the arrangement is a structured arrangement.

A payer may also be a payee in respect of a quasi-payment only where the UK is not the payer jurisdiction, and the payee -

- is an entity that is not a separate person from the payer under UK tax law, and
- is an entity that is a separate person from the payer for tax purposes in the payer's jurisdiction, and
- it would be reasonable to expect that entity to have an amount of ordinary income arising as a result of the circumstances giving rise to the quasi-payment

### **Control groups**

Control groups are defined at s259NB, and more detailed guidance on control groups is at [INTM550580](#).

### **Structured arrangements**

An arrangement is a structured arrangement if it is reasonable to suppose that-

- it is designed to secure a multinational payee deduction/non-inclusion mismatch, or
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or the terms of the arrangement otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch.

When considering this issue, the test is whether it is reasonable to suppose



that the arrangement was designed to secure the mismatch, regardless of any other objective.

## **INTM556080: Hybrids: Chapter 8 - Multinational payee: Extent of the mismatch**

If conditions A to E of s259HA are satisfied, the next step is to establish the extent of any multinational payee deduction/non-inclusion mismatch for the purposes of Chapter 8, Part 6A of TIOPA 2010.

S259HB defines a multinational payee deduction/non-inclusion mismatch in relation to a payment or quasi-payment as a mismatch where

- there is an allowable deduction for the payer that exceeds the sum of ordinary income arising to each of the payees, and
- all or part of that excess arises because one or more of the payees is a multinational company.

The legislation requires a comparison of the excess identified above to a counterfactual position where a multinational company is not a payee. If, in the counterfactual position

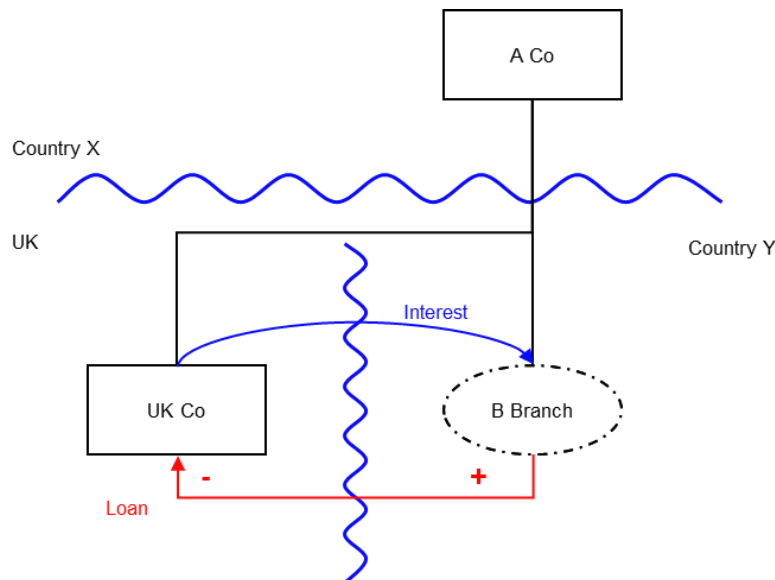
- the amount of the excess remains unchanged or increases, then there is no mismatch arising as a result of the payee being a multinational company.
- the amount of the excess is reduced, then the mismatch that arises because the payee is a multinational company is the amount by which the excess is reduced.

The amount of multinational payee deduction/non-inclusion mismatch is the amount of the excess that arises because the payee is a multinational company.

## **INTM556090: Hybrids: Chapter 8 - Multinational payee: Counteraction**

The counteraction where the payer is within the charge to UK corporation tax is set out at s259HC TIOPA 2010. The payer's deduction for the payment period is reduced by an amount equal to the multinational payee deduction/non-inclusion mismatch.

## INTM556100: Hybrids: Chapter 8 - Multinational payee: Example: Branch exemption – Only one country recognises a PE



### Background

- A Co is a company resident in Country X
- UK Co is a company resident in the UK, and A Co owns its entire shareholding
- A Co lends money to UK Co (the Loan) through a branch located in Country Y (B Branch)
- The UK allows a deduction for the interest payments made by UK Co
- Country X treats the Loan as attributable to a permanent establishment (B Branch) and exempts or excludes the interest receipts from taxation. This exemption or exclusion could be under Country X's domestic law or as a result of the application of the Country X-Y treaty
- Country Y, however, does not tax the interest income because A Co is not treated as having a sufficient taxable presence in Country Y to constitute a permanent establishment under local law. The payment of interest therefore gives rise to an intra-group mismatch (a D/NI outcome).

## **Analysis - Applying the tests in s259HA TIOPA 2010**

Do the interest payments from UK Co to the B Branch under the Loan satisfy the relevant conditions to fall within the scope of this chapter?

### **Condition A: Is a payment made under, or in connection with, an arrangement?**

A transaction took place resulting in an interest payment directly from UK Co (payer) to A Co (payee). The interest payment is in relation to the Loan made from A Co to UK Co. The arrangement is therefore the Loan and the resulting interest payment.

Condition A is therefore satisfied.

### **Condition B: Is a payee a multinational company, according to the definition at s259HA(4)?**

A Co is resident in Country X (the parent jurisdiction) for the purposes of a tax charged under the law of that territory, and it is also regarded as carrying on a business in another territory - Country Y (the PE jurisdiction) - through a permanent establishment (B Branch) in that territory.

Therefore A Co (the payee) is a multinational company and Condition B is satisfied.

### **Condition C: Is the payer or the multinational company within the charge to Corporation Tax for the payment period?**

UK Co is the payer and within the charge to Corporation Tax.

Condition C is therefore satisfied.

### **Condition D: Is it reasonable to suppose that there would be a multinational payee deduction/non-inclusion mismatch in relation to the payment?**

There will be a multinational payee deduction/non-inclusion mismatch if the relevant deduction exceeds the amount of ordinary income arising to each payee for a permitted taxable period, and all or part of that excess arises by reason of one or more of the payees being a multinational company.

Given the facts above, it is reasonable to suppose that UK will permit UK Co an interest deduction (the relevant deduction) under the Loan against its ordinary income.

It is also reasonable to suppose that no ordinary income will arise in either A Co or B Branch as:

- Country X treats the interest receipt as attributable to B Branch and exempts or excludes it from taxation. This could be under Country X's domestic law or as a result of the application of the Country X-Y treaty.
- Country Y does not treat A Co as having a sufficient taxable presence in Country Y to constitute a permanent establishment under local law, and therefore does not extend its domestic law to tax that receipt.

Therefore the relevant interest deduction is in excess of the ordinary income recognised (nil). This excess arises from the fact that A Co is a multinational entity, as Country X gives up its taxing rights over this interest income for this reason. There is therefore a multinational payee deduction/non-inclusion mismatch of the full value of the interest payment.

Condition D is therefore satisfied.

**Condition E: Are the payer and the multinational company in the same control group, or is the arrangement a structured arrangement?**

A Co and UK Co are in the same control group within the definition at s259NB, and therefore this condition is satisfied.

From the information given in this example, it is also reasonable to suppose that this is a structured arrangement designed to secure a multinational company deduction/non-inclusion mismatch (even if it is also designed to secure a commercial or other objective), and therefore the condition would also be met on these terms.

**Conclusion**

All the conditions are satisfied to characterise the arrangement involving the payment of interest under the Loan as a Multinational Payee Deduction/Non-Inclusion Mismatch and the relevant counteractions therefore need to be considered.

**Counteraction**

S259HC will apply and UK Co's allowable deduction is reduced by the extent of the mismatch.

Where the deduction allowed to the payer exceeds the amount of ordinary income arising to the payee, and that excess arises by reason of one or more payees being multinational companies (regardless of any other reason), the extent of the mismatch is equal to that excess.

## **INTM557000: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Contents**

[INTM557010: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Overview](#)

[INTM557020: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Conditions to be satisfied](#)

[INTM557030: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition A](#)

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[INTM557060: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction](#)

[INTM557070: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction: Investor in hybrid entity](#)

[INTM557080: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction: Hybrid entity](#)

[INTM557200: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Whether a double deduction \('DD'\) may be set off against dual inclusion income](#)

[INTM557210: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Accounting for timing and valuation differences](#)

[INTM557220: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Grant of share options](#)

[INTM557230: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Calculating dual inclusion income under a CFC regime](#)

[INTM557240: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Loan to a partnership](#)

## **INTM557010: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Overview**

Chapter 9 of Part 6A TIOPA 2010 counters mismatches involving hybrid entities where it is reasonable to suppose that all or part of an amount could be deducted from

- the income of the hybrid entity for a taxable period of the entity, and
- the income of an investor in the hybrid entity for a taxable period of that investor.

### **Conditions to be satisfied**

The legislation applies where 3 conditions (A to C) are met.

#### **Condition A**

Is there is an amount or part of an amount that it is reasonable to assume could be deducted from the income of both the hybrid entity and an investor in the hybrid entity for the purposes of calculating their respective taxable profits? (See [INTM557030](#))

#### **Condition B**

Is either the hybrid entity or any of the investors in the hybrid entity within the charge to UK corporation tax? (See [INTM557040](#))

#### **Condition C**

Are the hybrid entity and an investor related, or is it reasonable to suppose that the arrangement is a structured arrangement designed to secure the mismatch or under which the economic benefits of the mismatch are shared? (See [INTM557050](#))

### **Counteraction**

If all 3 conditions are met, the mismatch is then countered by –

- denying all or part of the deduction claimed by the investor(s) where they are within charge to corporation tax (See [INTM557070](#)), or
- denying all or part of the deduction claimed by the hybrid entity where the hybrid entity is within charge to corporation tax (See [INTM557080](#)).



## **INTM557020: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Conditions to be satisfied**

The conditions applicable for Chapter 9 of Part 6A TIOPA 2010 are set out at s259IA. For Chapter 9 to apply each of conditions A, B and C must be met.

[INTM557030: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition A](#)

[INTM557040: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition B](#)

[INTM557050: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition C](#)

## **INTM557030: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition A**

Condition A of s259IA is met if it is reasonable to suppose that an amount, or part of an amount, may be deducted by both a hybrid entity and an investor in that entity.

### **Hybrid entity**

A hybrid entity is defined at s259BE.

Whether an entity has the relevant characteristics to be treated as a 'hybrid entity' is discussed in more depth at [INTM550560](#). Generally an entity may be treated as having those characteristics if it is regarded as a person for tax purposes under the law of any territory, and

- its income or profits are treated wholly or partly as the income or profits of another person, or
- it is not regarded as a separate person for tax purposes under the law of another territory.

### **Investor**

An investor is also defined at s259BE(4).

If an entity is a hybrid entity because its income or profits are treated as the income or profits of another person, an investor is any person who is treated as having that income.

If an entity is a hybrid entity because it is treated as a person in one territory but is not recognised as a separate and different person under the law of another territory, an investor is any entity that is

- recognised in the first territory as a separate and different person to the hybrid entity, but
- not recognised in the other territory as a separate and different person to the hybrid entity.

### **Reasonable to suppose**

There is no definition of the term reasonable to suppose in Part 6A, so the phrase takes its ordinary meaning. Generally this does not require either party to know how the transaction has been treated by the counterparty but only

that, given the facts and circumstances, it would be reasonable to conclude that a double deduction will arise.

## **INTM557040: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition B**

Condition B of s259IA requires that

- the investor in a hybrid entity is within the charge to corporation tax in the UK for the investor deduction period, or
- the hybrid entity is within the charge to corporation tax in the UK for the hybrid entity deduction period.

The investor deduction period is the taxable period of the investor in which the amount is deducted for the purposes of calculating taxable profits of that investor.

The hybrid entity deduction period is the taxable period of the hybrid entity in which the amount is deducted for the purposes of calculating taxable profits of the entity.

The taxable period is defined at s259NF. Broadly speaking the taxable period is the period for which the specific tax is charged, but see [INTM550590](#) for more detail.

## **INTM557050: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Condition C**

Condition C of s259IA is satisfied where one of the following applies –

- the hybrid entity and any investor in it are related at any time in the relevant deduction period, or
- the arrangement is a structured arrangement.

Related persons is defined at s259NC. More detailed guidance on related persons is at [INTM550580](#) but in broad terms a hybrid entity and an investor are related on any day that

- they are in the same control group, or
- one holds a 25% investment in the other, or
- a third person holds a 25% investment in both entities

Control groups are defined at s259NB. More detailed guidance on control groups is at [INTM550580](#).

### **Structured arrangement**

An arrangement is a structured arrangement if it is reasonable to suppose that–

- it is designed to secure a hybrid entity double deduction amount, or
- the terms of the arrangement share the economic benefit of the double deduction between the parties to that arrangement, or the terms of the arrangement otherwise reflect an expected double deduction.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

## **INTM557060: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction**

If conditions A to C of s259IA are met the mismatch is countered by restricting the amount of the deduction.

The hybrid entity double deduction mismatch requires either the hybrid entity or an investor in the hybrid entity to be within the charge to UK corporation tax for the relevant deduction period. The counteraction then applies to reduce the allowable deduction available to that person by the amount that it is reasonable to suppose could be deducted twice.

Any counteraction is mitigated to the extent that the deduction may be set against any dual inclusion income in the relevant deduction period.

## **INTM557070: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction: Investor in hybrid entity**

The counteraction where an investor in a hybrid entity is within the charge to UK corporation tax is set out at s259IB. An investor may only deduct the amount of the hybrid entity double deduction mismatch against any dual inclusion income of the investor deduction period.

Where the amount deducted by the investor exceeds the dual inclusion income in the period, the excess may be carried forward to use against dual inclusion income of the investor in future accounting periods.

Where an amount has been deducted from the income of another person in the overseas jurisdiction, the deduction available to be set off against dual inclusion income of the investor is restricted by that amount.

If the Commissioners for HMRC are satisfied that no future dual inclusion income will arise to the investor then the amount not yet relieved may satisfy the requirements to be characterised as a stranded deduction, and be set against total profits of the relevant period.

### **Stranded deduction**

If the restricted deduction becomes stranded (a stranded deduction is defined at s259IB(4), (6) and (7) and s259IC(7), (8) and (9)) such that it has not already been used by any person to derive a tax benefit (either directly or, for example, as group relief), and on the facts it is reasonable to suppose that the counteraction will result in them never being used, then it may be set against total profits of the relevant period - once the Commissioners are satisfied that no dual inclusion income will arise.

### **Dual inclusion income**

Dual inclusion income of the investor is the amount of income arising during an accounting period that is ordinary income of both

- the investor for that period, and
- the hybrid entity for a permitted taxable period for the purposes of any tax charged outside the UK.

### **Ordinary income**

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific

reliefs may be treated as reducing the amount of ordinary income is in s259BC, and the concept is discussed further at [INTM550540](#).

**Permitted taxable period**

A taxable period of a hybrid entity is a permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the investor, or
- begins in a later period if a claim has been made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.



## **INTM557080: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Counteraction: Hybrid entity**

The counteraction where a hybrid entity is within the charge to UK corporation tax is set out at s259IC.

The section applies where it is reasonable to suppose that either

- no equivalent provision applies in the investor jurisdiction to counteract the double deduction in the investor jurisdiction, or
- such a provision does apply, but the deduction exceeds the dual inclusion amount (i.e. an element of the double deduction as quantified at s259IA has not been counteracted), and in addition
- either the hybrid entity and any investor are in the same control group at any time in their deduction periods, or they are party to a structured arrangement.

Where the section applies, a hybrid entity may have a deduction for the amount of the hybrid entity double deduction mismatch only against any dual inclusion income of the hybrid entity deduction period.

Where it is reasonable to suppose that some or all of the double deduction amount has been deducted from the income of another person, other than the hybrid entity, in the overseas jurisdiction and that income is not dual inclusion income, the deduction available to be set off against dual inclusion income of the hybrid entity is restricted by that amount. The restriction is applied by treating the amount to have been deducted in an earlier period.

Where the amount deducted by the hybrid entity exceeds the dual inclusion income in the period, the excess may be carried forward to use against dual inclusion income of the hybrid entity in future accounting periods.

If the Commissioners are satisfied that no future dual inclusion income will arise to the hybrid entity then the amount not yet relieved may satisfy the requirements to be characterised as a stranded deduction, and be set against total profits of the relevant period. This is further discussed at [INTM557070](#).

### **Dual inclusion income**

Dual inclusion income is the amount of income arising during an accounting period to the hybrid entity, where that income is ordinary income of both

- the hybrid entity for that accounting period, and

- an investor in the hybrid entity for a permitted taxable period for the purposes of any tax charged in the investor jurisdiction.

### **Ordinary income**

Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income is at s259BC and the concept is discussed further at [INTM550540](#).

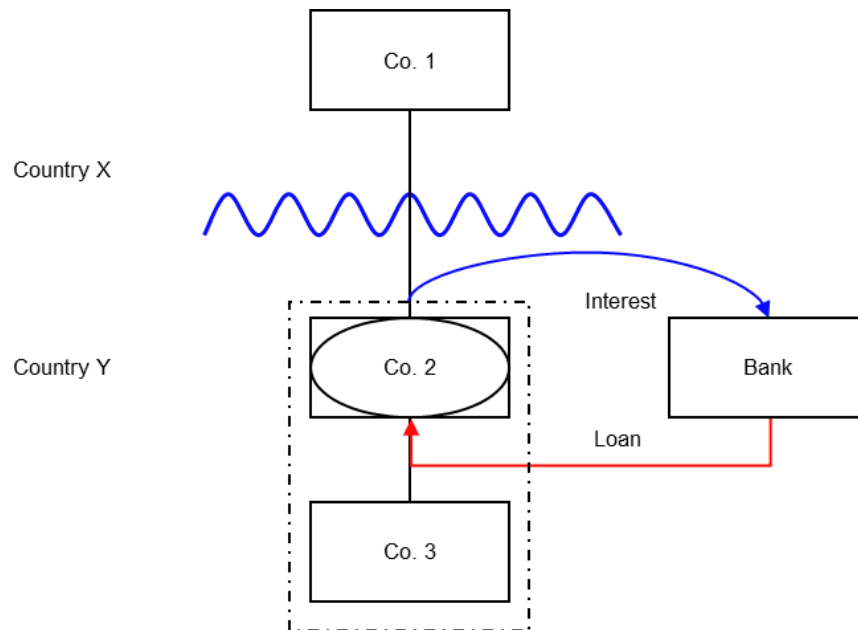
There are special recognition rules at s259BD in instances of non-inclusion for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign companies (CFC) charge. This is discussed at [INTM550550](#).

### **Permitted taxable period**

A taxable period of an investor is a permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the hybrid entity, or
- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

## INTM557200: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Whether a double deduction ('DD') may be set off against dual inclusion income



### Background

- Co. 1 is a company resident in Country X.
- Co. 2 is a company resident in Country Y, and Co. 1 owns its entire shareholding
- Co. 2 is treated as a separate person for tax purposes in Country Y but as a disregarded entity for tax purposes in Country X.
- Co. 3 is also resident in Country Y, and Co. 2 owns its entire shareholding
- Country Y operates a tax consolidation regime such that Co. 2 may surrender its deductions to Co. 3 for tax purposes
- Co. 2 borrows money from a bank resident in Country Y (the Loan).
- Country X allows Co. 1 a deduction for the underlying interest, as it sees Co. 2 as a branch of Co. 1.

- Country Y allows a deduction for the interest payments made by Co. 2, which can be surrendered to Co. 3.

## **Analysis - Applying the tests in s259IA TIOPA 2010**

Do the hybrid entity double deduction mismatch rules in Chapter 9 apply to the interest payment made by Co. 2?

**Condition A: Is there a hybrid entity double deduction amount i.e. is there an amount that it is reasonable to suppose could be deducted both from the income of a hybrid entity and also from the income of an investor?**

Co. 2 is a hybrid entity, as its profits are treated as the profits of Co. 1 under Country X's law, but it is regarded as being a separate person for tax purposes under the law of Country Y.

Co. 1 is the investor in Co. 2.

It is reasonable to suppose that deductions arising under the Loan could be deducted against the income of both Co. 2 and Co. 1 for the purposes of calculating their taxable profits.

Condition A is therefore satisfied, and the extent of the hybrid entity double deduction amount is the full amount of the interest payments under the Loan.

NB: Where the UK is Country X, it is not necessary for the UK to know how the deduction is being treated in Country Y before applying the rule: it is sufficient that it is reasonable to suppose that it could be deducted either in this period or a future period.

**Condition B: Is either Co. 1 (an investor in the hybrid entity) or Co. 2 (the hybrid entity) within the charge to corporation tax for the deduction period?**

If the UK is in the position of Country X (the investor jurisdiction), then Co. 1 is within the charge to corporation tax for a deduction period.

If the UK is in the position of Country Y, then Co. 2 is within the charge to corporation tax for the deduction period.

Condition B is therefore satisfied if either of the above applies.

If the UK is neither Country X nor Country Y, then Condition B will not be satisfied. If this is the case and the mismatch is imported into the UK through a series of arrangements, then the rules in Chapter 11 - Imported Mismatches – should be considered.

**Condition C: Are the hybrid entity and one or more investors in it related, or is there a structured arrangement?**

The hybrid entity (Co. 2) and its investor (Co. 1) are related within the definition at s259NC by virtue of being in the same control group.

Condition C is therefore satisfied.

**Conclusion**

All the conditions are satisfied to characterise the payments of interest as a Hybrid Entity Double Deduction Mismatch. The relevant counteractions therefore need to be considered.

**Counteraction**

The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y.

**Counteraction where UK is in the position of Country X (the investor jurisdiction).**

**Primary Response**

Where the UK is in the position of the investor jurisdiction, s259IB will apply to deny the hybrid entity double deduction amount to Co. 1, unless it can deduct it from dual inclusion income for that period.

If (as in this example) there is no dual inclusion income, then the UK will deny Co. 1 from offsetting the hybrid entity double deduction amount against other income. The UK will, however, permit Co. 1 to carry forward the excess deduction to utilise against any dual inclusion income arising in subsequent accounting periods.

If the denied deductions become stranded deductions as they have not already been utilised by any person to derive a tax benefit and the facts make it reasonable to suppose that the counteraction will result in them never being utilised, then they will become available as a deduction in Co. 1 under s259IB(4).

**Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)**

**Secondary response**

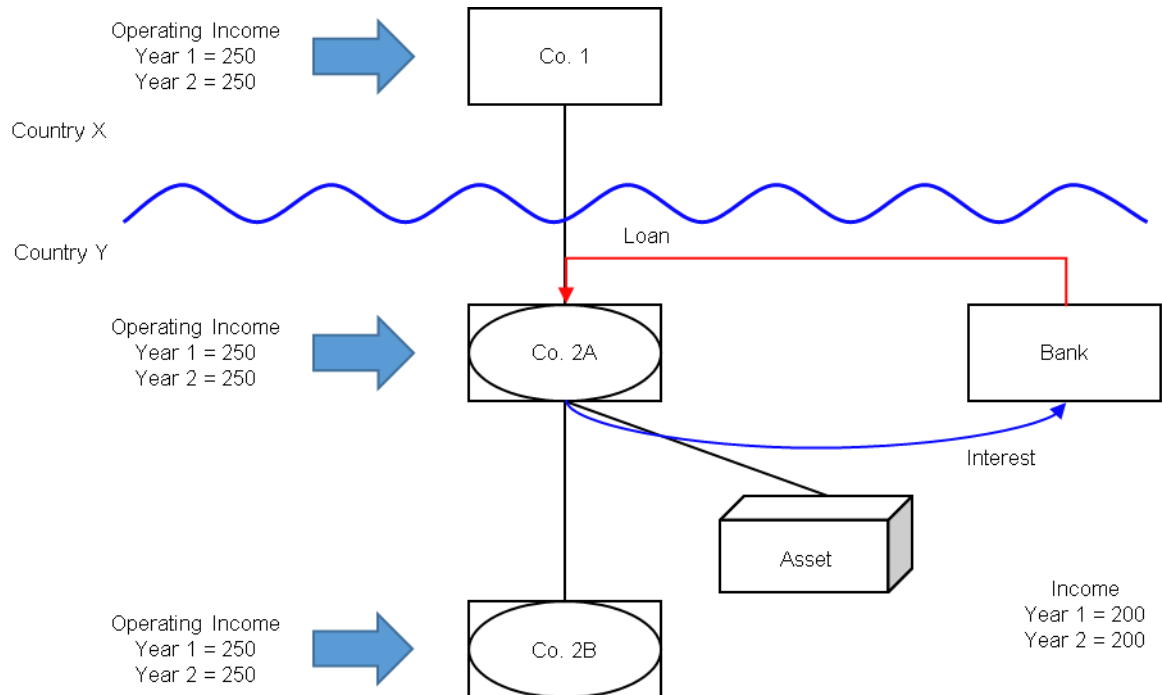
Where the UK is in the position of the payer jurisdiction (Co. 2), and the hybrid entity double deduction amount has not been fully counteracted by Country X, then s259IC will apply.

In this scenario, Country Y should deny a deduction for the hybrid entity double deduction amount to Co. 2 as there is no dual inclusion income to set

it off against. The UK will deny Co. 2 from offsetting the deduction against other income and require it to carry forward the excess deduction to utilise against any dual inclusion income arising in subsequent accounting periods.

NB: The same consideration of stranded deductions as above may apply.

## INTM557210: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Accounting for timing and valuation differences



### Background

- Co. 1 is resident in Country X and owns all the issued shares in Co.2A, which is resident in Country Y
- Co. 2A has borrowed money from a local bank (the Loan) and holds a depreciable asset
- Co. 2A owns all the issued shares in Co. 2B
- Co. 2A is treated as a taxable person in Country Y but is not a separate taxable person under the tax law in Country X
- Co. 2A's income or profits are taxable in Country X (as income or profits of Co.1) and in Country Y (as income or profits of Co.2A)
- Co. 2B is treated as a distinct taxable person under the tax law of Country X but is not so under the tax law in Country Y
- Co. 2B's income or profits are treated as income or profits of Co. 2A under the law of Country Y, and taxed accordingly

- Under Country X's law, Co. 2B's income and profits are not treated as arising to Co. 1 but remain those of Co. 2B.
- Co. 1, Co. 2A and Co. 2B each derive 500 of operating income, equally spread over a two year period (i.e. 250 in Year 1 and 250 in Year 2).

Due to the way that the arrangement has been structured, Co. 2A's income and expenses, including an allowance for the depreciation (i.e. capital allowances in the UK), are treated as taxable income and deductible expenditure under the laws of both Country X and Country Y.

However differences in the way that Country X and Country Y recognise the amount and timing of such income and expenditure mean that these items are recognised in different amounts and in different periods.

### **Under Country X law**

Co. 2A's operating income for the two year period is treated as arising:

- 20% in Year 1 (100), and
- 80% in Year 2 (400)

Co. 2A's interest expense under the Loan is:

- Year 1 (100)
- Year 2 (300) - as Country X law requires 50% of the interest expense accrued by Co. 2A in Year 1 to be recognised in Year 2.

Tax incentives in Country X allow Co. 2A to claim a larger depreciation allowance for the asset held by Co. 2A, being:

- Year 1 (180)
- Year 2 (180)

### **Under Country Y law**

Co. 2A's operating income for the two year period is treated as derived:

- 60% in Year 1 (300)
- 40% in Year 2 (200)

Interest payments are spread evenly over the two accounting periods. Co. 2A's interest expense under the Loan is:

- Year 1 (200)



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- Year 2 (200)

Country Y allows Co. 2A to claim the following depreciation allowance for the asset held by Co. 2A:

- Year 1 (120)
- Year 2 (120)

This is summarised as:

YEAR 1 - Country X		YEAR 1 - Country Y	
INCOME	Tax	INCOME	Tax
Operating income Co. 1	250	Operating income Co. 2A	300
Operating income Co. 2A	100	Operating income Co. 2B	250
EXPENDITURE		EXPENDITURE	
Interest paid by Co. 2A	100	Interest paid by Co. 2A	200
Depreciation/capital allowances	180	Depreciation/capital allowances	120
NET RETURN		NET RETURN	
TAXABLE INCOME	70	TAXABLE INCOME	230

YEAR 2 - Country X		YEAR 2 - Country Y	
INCOME	Tax	INCOME	Tax
Operating income Co. 1	250	Operating income Co. 2A	200
Operating income Co. 2A	400	Operating income Co. 2B	250
EXPENDITURE		EXPENDITURE	
Interest paid by Co. 2A	300	Interest paid by Co. 2A	200
Depreciation/capital allowances	180	Depreciation/capital allowances	120
NET RETURN		NET RETURN	

TAXABLE INCOME	170	TAXABLE INCOME	130
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## Analysis - Applying the tests in s259IA TIOPA 2010

How should Chapter 9 be applied to neutralise any hybrid entity double deduction amount arising under this structure?

**Condition A: Is there a hybrid entity double deduction amount i.e. is there an amount that it is reasonable to suppose could be deducted both from the income of a hybrid entity and also from the income of an investor?**

Co. 2A is regarded as being a separate person for tax purposes under the law of Country Y but its profits are treated as the profits of Co. 1 under Country X's law. Co. 2A is therefore a hybrid entity.

The investor relevant to Co. 2A would be Co. 1.

It is reasonable to suppose that deductions arising both under the Loan and in respect of depreciation could be deducted both against the ordinary income of Co. 2A and Co. 1 for the purposes of calculating their taxable profits.

Condition A is therefore satisfied.

The hybrid entity double deduction amounts are

- the interest payments of 400 and
- the depreciation allowance, quantified as 360 in Country X and 240 in Country Y, the relevant amount thereby deducted twice being 240.

Co. 2B is also a hybrid entity, as Country X regards it as a person for tax purposes but Country Y treats its profits as the profits of Co. 2A. The investor relevant to Co. 2B is Co. 2A.

However, it is not reasonable to suppose that deductions arising under the Loan and in respect of depreciation could be deducted against the ordinary income of both Co.2A and Co.2B in Country Y. Condition A is not satisfied in respect of Co.2B, and the remaining conditions do not need to be considered.

**Condition B: Is either Co. 1 (an investor in the hybrid entity) or Co. 2A (the hybrid entity) within the charge to corporation tax for the deduction period?**

If the UK is in the position of Country X then Co. 1 is within the charge to corporation tax.

If the UK is in the position of Country Y then Co. 2A is within the charge to corporation tax.

Condition B will therefore be satisfied as long as one of the above is satisfied.

If the UK was neither Country X nor Country Y then this condition would not be satisfied as neither Co. 1 nor Co. 2A would be within the charge to corporation tax.

**Condition C: Are the hybrid entity and one or more investors in it related, or is there a structured arrangement?**

Co. 1 is related to Co. 2A within the definition at s259NC through its 100% investment.

Condition C is therefore satisfied.

**Conclusion**

All the conditions are satisfied to characterise the payments of interest as a Hybrid Entity Double Deduction Mismatch. The relevant counteractions therefore need to be considered.

**Counteraction**

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y.

**Where the UK is in the position of Country X (the investor jurisdiction)**

**Primary Response**

As the UK is the investor jurisdiction, the hybrid entity double deduction amount will be countered under s259IB.

Year 1

Dual inclusion income: the only amount that is recognised as ordinary income of Co. 1, which is also treated as ordinary income of Co. 2A in Country Y, is the operating income of Co. 2A to the extent of 100.

The amount of the hybrid entity double deduction amount deducted from Co. 1's ordinary income for corporation tax purposes is 280 (100 interest plus 180 depreciation).

Therefore, the extent of the counteraction in Country X in Year 1 is  $280 - 100 = 180$ . This is the amount by which Co. 2A's hybrid entity double deduction amount, as recognised in Country X, exceed the amount of Co. 2A's dual inclusion income.

Co. 1 will be denied a deduction of 180, thereby recognising taxable profits in Year 1 of  $70+180 = 250$ .

Country X (the UK) will allow Co. 1 to carry forward the excess deduction of 180 into the subsequent Year (Year 2), to set-off against surplus dual inclusion income that arises in Year 2.

Year 2

Dual inclusion income is the operating income of Co. 2A which is 400.

The amount of the hybrid entity double deduction amount deducted from Co. 1's ordinary income for corporation tax purposes is 480.

Therefore, the extent of the counteraction in Country X in Year 2 is  $480-400 = 80$ .

Co. 1 will be denied a deduction of 80, thereby recognising taxable profits in Year 2 of  $170 + 80 = 250$ .

Co. 1 can carry forward the excess deductions of 180 (from Year 1) and 80 (from Year 2), making a total to carry forward of  $180+80 = 260$ .

The net effect of applying the legislation is, that over the two Year period, Co. 1 will be fully taxable on its non-dual inclusion income from its own activities (500) and will have an excess deduction to carry-forward (260) that effectively represents the net loss (for tax purposes) arising from Co. 2A's operations being relieved in Country Y.

### **Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)**

#### **Secondary Response**

Note that where Country X has implemented the counteraction at s259IB, this will take precedence over s259IC and therefore the hybrid entity double deduction amount will be neutralised by Country X. If the full extent of the hybrid entity double deduction amount is not neutralised in Country X, or if Country X has not implemented the legislation, then the UK will apply the counteraction at s259IC to neutralise the mismatch.

Year 1

Dual inclusion income: the only amount that is recognised as ordinary income of Co. 1, which is also treated as ordinary income of Co. 2A in Country Y, is the operating income of Co. 2A which is 300.

The amount of the hybrid entity double deduction amount deducted from Co. 2A's ordinary income for corporation tax purposes is 320.

Therefore, the extent of the counteraction in Country Y in Year 1 is  $320 - 300 = 20$ . This is the amount by which Co. 2A's hybrid entity double deduction amount exceed the amount of Co. 2A's dual inclusion income.

Co. 2A will be denied a deduction of 20, thereby recognising taxable profits in Year 1 of  $230 + 20 = 250$ .

Country Y (the UK) will allow Co. 2A to carry forward the excess deduction of 20 into the subsequent Year (Year 2), to set-off against surplus dual inclusion income that arises in Year 2.

Year 2

Dual inclusion income is the operating income of Co. 2A which is 200.

The amount of the hybrid entity double deduction amount deducted from Co. 2A's ordinary income for corporation tax purposes is 320.

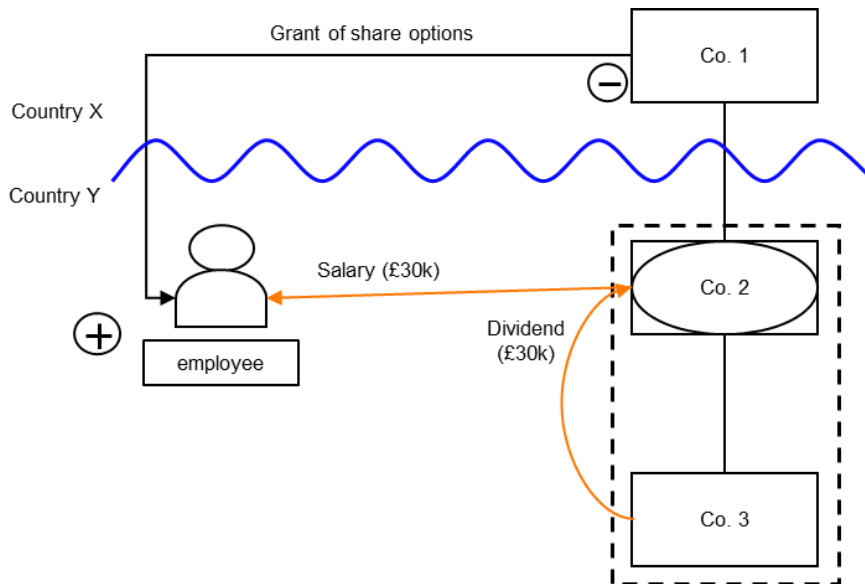
Therefore, the extent of the counteraction in Country Y in Year 2 is  $320 - 200 = 120$ .

Co. 2A will be denied a deduction of 120, thereby recognising taxable profits in Year 2 of  $130 + 120 = 250$ .

Co. 2A can carry forward the excess deduction of 20 (from Year 1) and 120 (from Year 2) making a total to carry forward of  $20 + 120 = 140$ .

The net effect of applying the legislation is that, over the two year period, Co. 2A will be taxable on its non-dual inclusion income from Co. 2B (500) and will have an excess deduction to carry-forward (140) that effectively represents the net loss (for tax purposes) arising from Co. 2A's operations.

## INTM557220: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Grant of share options



### Background

- Co. 1 establishes Co. 2 as the holding Co. for its operating subsidiary Co. 3.
- Co. 2 is treated as a separate person for tax purposes in Country Y but income or profits are treated as income or profits of Co. 1 for tax purposes by Country X.
- Co. 2 and Co. 3 are members of the same tax group and therefore, under the tax laws of Country Y, the net loss of Co. 2 can be set-off against ordinary income of Co. 3.
- Co. 2 has a single employee who is entitled to an annual salary of £30k. The salary cost is funded by a dividend payment from Co. 3 that is exempt from taxation in both Country Y and Country X.
- The employee also participates in a share incentive scheme which provides the employee with an option to acquire shares in Co. 1. The grant of the share option is deductible under the laws of both countries, but Country X values the grant of share option as £20k and Country Y values it as £15k.

Note: In this scenario the UK will only allow a deduction for the grant of share options once the shares are awarded. In addition the accounting deduction in the UK would be denied by virtue of sections 1038 CTA 2009 and 1038A CTA

2009, with any relief being granted by Part 12 CTA 2009 and measured by reference to the market value of the shares and the income tax position of the recipient.

## **Analysis - Applying the tests in s259IA TIOPA 2010**

Does the payment of salary and grant of share options to the employee give rise to a hybrid entity double deduction amount?

**Condition A: Is there a hybrid entity double deduction amount i.e. is there an amount that it is reasonable to suppose could be deducted both from the income of a hybrid entity and also from the income of an investor?**

Co. 2 is a separate taxable person under the tax law of Country Y. Income or profits of Co. 2 are treated as the income or profits of Co. 1 under the tax law of Country X. Co. 2 therefore satisfies the definition of being a hybrid entity, provided by s259BE, with Co. 1 being the relevant investor.

Given the facts above, it is reasonable to suppose that Co. 1 will receive a £30k deduction against its income for the salary payment and a £20k deduction for the granting of the share options, under the laws of Country X (the investor jurisdiction).

It is also reasonable to suppose that, under the laws of Country Y (the hybrid entity jurisdiction), Co. 2 will receive a £30k deduction against its income for the salary payment and a £15k deduction for the granting of Co. 1's share options by Co. 1 to the employee of Co. 2.

Condition A is therefore satisfied

The extent of the hybrid entity double deduction amount is the full amount of the salary cost and the deduction (as quantified) in relation to the grant of Co. 1's share options by Co. 1 to the employee of Co. 2.

NB: This example illustrates how such a transaction would be treated under the hybrid rules, and particularly where there is a difference in valuation. Where the UK is in the position of Country X it is likely that the deduction of £20k would be denied to Co. 1 as it is not the employer of the relevant employee. That disallowance will take precedence and the resulting tax position, once that legislation has been applied, will be the starting point for applying the hybrid mismatch rules.

**Condition B: Is either Co. 1 (investor in the hybrid entity) or Co. 2 (the hybrid entity) within the charge to corporation tax for the deduction period?**

If the UK is in the position of Country X (the investor jurisdiction), then Co. 1 (the investor in the hybrid entity) is within the charge to corporation tax.

If UK is in the position of Country Y, then Co. 2 (the hybrid entity) is within the charge to corporation tax.

Condition B is therefore satisfied if either of the above applies.

If the UK is in the position of neither Country X nor Country Y then Condition B will not be satisfied.

**Condition C: Are the hybrid entity and one or more investors in it related, or is there a structured arrangement?**

The hybrid entity (Co. 2) and its investor (Co. 1) are related within the definition of s259NC.

Condition C is therefore satisfied.

**Conclusion**

All the conditions are satisfied to characterise the payment of salary and the granting of the share options as a hybrid entity double deduction mismatch. The relevant counteractions therefore need to be considered.

**Counteraction**

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y.

**Counteraction where UK is in the position of Country X (the investor jurisdiction)**

**Primary Response**

Where the UK is in the position of Country X, s259IB will apply to deny the hybrid entity double deduction amount to Co. 1, unless it can deduct it from dual inclusion income for that period.

If, as in this example, there is no dual inclusion income, then the UK will deny Co. 1 from offsetting the hybrid entity double deduction amount against other income. Co. 1 will be permitted to carry forward these excess deductions to utilise against any dual inclusion income arising in subsequent accounting periods.

Co. 1 will thus be denied a deduction for the salary payment of £30k and the grant of share options of £20k. Co. 1 can carry forward the £50k to subsequent accounting periods to be utilised against future dual inclusion income.

Note: If, as outlined in the note to Condition A and as expected, the relief for the share option has already been disallowed under CTA 2009, then Co. 1 will



only be denied a deduction for the remaining hybrid entity double deduction amount of £30k for the salary payment.

Note: If Country X's dividends did constitute taxable profits in Co. 1 then there is still no dual inclusion income for Co. 2, as the dividend will not be included in the ordinary income of Co. 2 for tax purposes.

**Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)**

**Secondary response**

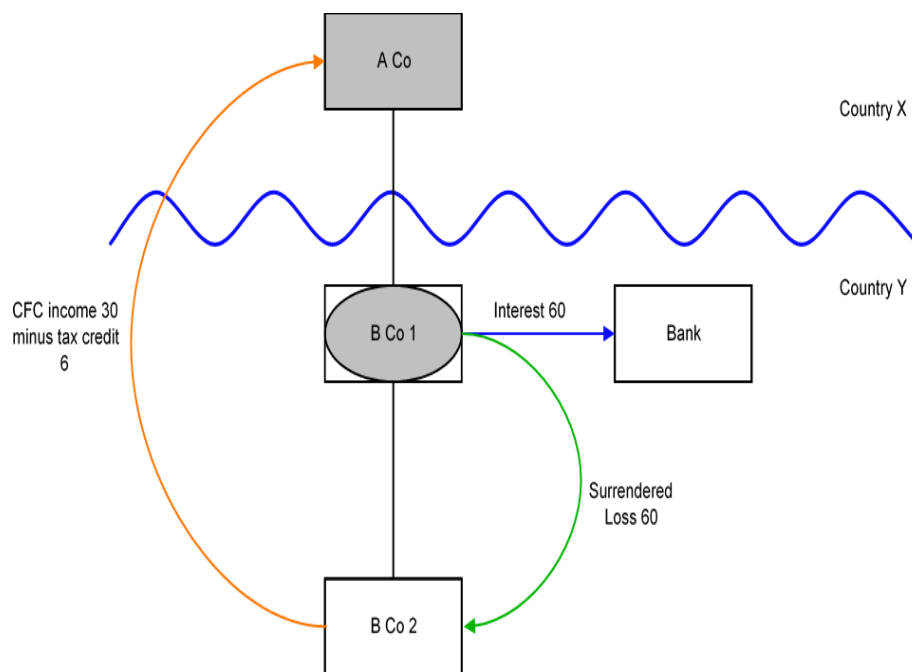
Where the UK is in the position of Country Y, and the hybrid entity double deduction amount has not already been fully counteracted then s259IC will apply.

In this case, the UK should deny a deduction for the hybrid entity double deduction amount to Co. 2 as there is no dual inclusion income to set it against. The UK will deny Co. 2 from offsetting the deduction against other income. Co. 2 will be permitted to carry forward the excess deduction to apply against any dual inclusion income arising in subsequent accounting periods.

Co. 2 is therefore denied the deduction for the salary payment of £30k and the grant of share options of £15k. Co. 2 can carry forward the £45k to subsequent accounting periods.

If the share options have not yet been awarded then under UK law they will not be considered as allowable deductions until they have been awarded.

## INTM557230: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Calculating dual inclusion income under a CFC regime



### Background

- A Co is resident in Country X and owns 100% of the shares in B Co 1.
- B Co 1 has no income during the period and owns 100% of the shares in its trading company, B Co 2. Both are resident in Country Y.
- B Co 1 takes out a loan (the 'Loan') from a local Bank, with interest of 60 arising in the period. As it has no income, this leads to a trading loss of 60 which it can surrender to B Co 2 to relieve against its ordinary income.
- B Co 1 income or profits are treated as income or profits of A Co under Country X law and therefore A Co can also claim a deduction of 60 in relation to the interest.
- B Co 2 has other income during the period of 90. After the deduction of 60 this leaves B Co 2 with profits of 30.
- A Co is subject to a CFC charge on B Co 2's profits of 90, with relief available for the relevant tax suffered on those profits in Country Y.

## **Analysis - Applying the tests in s259IA TIOPA 2010**

Do the Hybrid Entity Double Deduction Mismatch rules apply to the interest payment made by B Co 1?

**Condition A: Is there a hybrid entity double deduction amount i.e. is there an amount that it is reasonable to suppose could be deducted both from the income of a hybrid entity and also from the income of an investor?**

B Co 1 is recognised as a separate taxable person for tax purposes under the law of Country Y, but its income or profits would be treated as the profits of A Co under the law of Country X. Therefore, B Co 1 meets the definition of a hybrid entity and A Co is the relevant investor.

Given the facts above, it is reasonable to suppose that a deduction in relation to the interest arising under the Loan will be permitted as a deduction against the ordinary income of both A Co and B Co 1 in calculating their taxable profits.

Condition A is therefore satisfied.

The extent of the hybrid entity double deduction amount is the full amount of the deductions in relation to the interest arising under the Loan.

**Condition B: Is either A Co (investor in the hybrid entity) or B Co (the hybrid entity) within the charge to corporation tax for the deduction period?**

If the UK is in the position of Country X then A Co is within the charge of UK corporation tax.

If the UK is in the position of Country Y then B Co 1 will be within the charge of UK corporation tax.

Condition B is therefore satisfied if either of the above applies.

If the UK is neither in the position of Country X nor Country Y then Condition B will not be satisfied.

**Condition C: Are B Co 1 (the hybrid entity) and A Co 1 (the investor) related, or is there a structured arrangement?**

A Co 1 and B Co 2 are related within the definition of s259NC.

Condition C is therefore satisfied.

## **Conclusion**

All the conditions are satisfied to characterise the interest payment as a hybrid entity double deduction mismatch. The relevant responses therefore need to be considered.

## **Counteractions**

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y.

### **Counteraction where UK is in the position of Country X (the investor jurisdiction)**

#### **Primary response**

As the UK is the investor jurisdiction, the hybrid entity double deduction amount will be countered under s259IB.

The deduction is disallowed in the investor jurisdiction (Country X), except to the extent that it can be deducted from dual inclusion income for the period.

Dual inclusion income only includes amounts included in the taxable profits of both the investor and the hybrid entity i.e. B Co 1. The income recognised in the CFC charge in A Co, being 90, are those arising to B Co 2 and not B Co 1 and therefore do not represent dual inclusion income.

A Co will be denied a deduction for the full amount (60) of the deductions in relation to the interest arising under the Loan. A Co can carry forward these amounts to subsequent accounting periods to be offset against future dual inclusion income.

Note: Even if the income recognised in the CFC charge in A Co were to arise to B Co 1 it would not constitute dual inclusion income. This is because it is not recognised as ordinary income in A Co in addition to ordinary income in B Co 1: it would either be (i) treated under s259BC(3) as offset in Country X to the extent credit relief is given for tax suffered in Country Y, or (ii) the tax suffered in Country Y will be treated under s259BC(4) as refunded when that credit is offset in the tax computation of Country X.

It is in substance single inclusion income being subjected to a higher tax rate than that in Country Y. It does not bring in the same amount to charge again but effectively increases the tax suffered on that first amount, with the tax suffered in Country Y recognised and granted as relief.

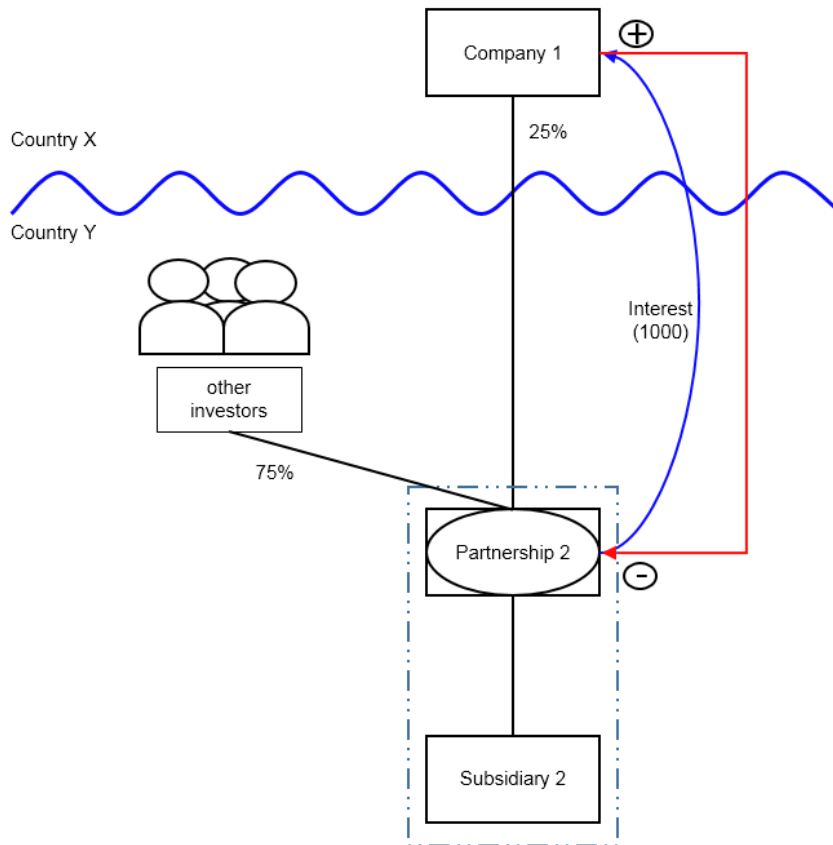
**Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)**

**Secondary response**

Where the UK is in the position of Country Y, and the hybrid entity double deduction amount has not already been fully counteracted then s259IC will apply.

In this case, the UK should deny a deduction for the hybrid entity double deduction amount to B Co 1 as there is no dual inclusion income to set it against. The UK will deny B Co 1 from offsetting the deduction of 60 against other income, or surrendering it to B Co 2. B Co 1 will be permitted to carry forward the excess deduction to apply against any dual inclusion income arising in subsequent accounting periods.

## INTM557240: Hybrids: Chapter 9 - Hybrid entity double deduction mismatches: Example: Loan to a partnership



### Background

- Company 1 is resident in Country X
- Partnership 2 is resident in Country Y, with 25% of its income and profits attributable to Company 1
- The remaining 75% is owned by other individual investors. Their involvement does not satisfy either the definition of being related to Partnership 2 under s259NC or the definition of a structured relationship under s259IA(7).
- Company 1 has no income in the relevant period
- Company 1 lends money to Partnership 2 (the Loan)
- The tax laws of Country X recognise Partnership 2 as transparent for tax purposes, so that a proportionate share of the items of income, gain and

expenditure derived and incurred by Partnership 2 are attributed (under Company X law only) to Company 1, in accordance with Company 1's interest in Partnership 2.

- Partnership 2 is recognised as a separate taxable entity in Country Y and is allowed to consolidate for tax purposes with Subsidiary 2. The effect is that the interest payment (1,000) is treated as a deductible expense under County Y law and can be surrendered against income of Subsidiary 2 under County Y's tax grouping regime.
- Under Country X law, however, for tax purposes both the income from the interest payment and the deduction from the interest expense, are set-off against each other by Company 1. Here, the interest receipt under the loan is 1,000 but a corresponding interest expense arises of 250, derived from Company 1's interest in Partnership 2.

Therefore the taxable profits for Company 1 will be 1,000 interest less the 250 interest expense = 750 taxable profits. This means that while Company 1 receives a net return of 1,000, its taxable profits under the arrangement is reduced by the proportion of the interest expense on the loan that is allocated to Company 1 under County X law, so only net 75% of the interest payment is included in Company 1's income.

## **Analysis - Applying the tests in s259IA TIOPA 2010**

**Condition A: Is there a hybrid entity double deduction amount i.e. is there an amount that it is reasonable to suppose could be deducted both from the income of a hybrid entity and also from the income of an investor?**

Partnership 2 is treated as a separate taxable person under the tax laws of Country Y, the jurisdiction where it is located. However, under Country X's tax laws, the jurisdiction of Partnership 2's parent (Company 1), Partnership 2 is treated as transparent for tax purposes and therefore its income or profits would be treated as the profits of Company 1.

Partnership 2 is therefore a hybrid entity and Company 1 is the relevant investor.

Condition A is therefore satisfied.

Partnership 2 makes a 1,000 interest payment to Company 1, in connection to the Loan made by Company 1 to Partnership 2. Given the facts above, it is reasonable to suppose that a deduction in relation to 250 of this amount will be permitted as a deduction against the ordinary income of both Company 1 and Partnership 2 in calculating their taxable profits.

The extent of the hybrid entity double deduction mismatch is therefore 250.

**Condition B: Is either Company 1 (investor in the hybrid entity) or Partnership 2 (the hybrid entity) within the charge to corporation tax for the deduction period?**

If the UK is Country X then Company 1 is within the charge of UK corporation tax.

If the UK is Country Y then Partnership 2 will be within the charge of UK corporation tax.

Condition B is therefore satisfied if either of the above applies.

If the UK is neither in position of Country X nor Country Y then Condition B will not be satisfied.

**Condition C: Are Partnership 2 (the hybrid entity) and Company 1 (the investor) related, or is there a structured arrangement?**

Company 1 is related to Partnership 2 within the definition of s259NC by virtue of its 25% investment.

Condition C is therefore satisfied.

**Conclusion**

All the conditions are met to characterise the payment of interest as a hybrid entity double deduction amount. The relevant responses therefore need to be considered.

**Counteractions**

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y.

**Counteraction where UK is in the position of Country X (the investor jurisdiction)**

**Primary Response**

As the UK is the investor jurisdiction, the hybrid entity double deduction amount will be countered under s259IB.

As there is no dual inclusion income the UK will deny Company 1 a deduction for the hybrid entity double deduction amount, to neutralise the mismatch in tax outcomes - here being 250. Company 1's resulting taxable profits will therefore be uplifted to 1,000.

Company 1 can carry forward this 250 to subsequent accounting periods to be offset against future dual inclusion income.



**Counteraction where the UK is in the position of Country Y (the hybrid entity jurisdiction)**

**Secondary response**

Note that where Country X has implemented a response equivalent to Response A, this will take precedence over s259IC.

If the full extent of the hybrid entity double deduction amount is not countered in Country X then the UK, being in the position of Country Y, will apply s259IC to address the remainder.

The UK will deny the deduction for the hybrid entity double deduction amount to Partnership 2, as there is no dual inclusion income to set it off against, but will permit it to carry forward the deduction to apply against any dual inclusion income arising in subsequent accounting periods.

If Response A has not been applied then the denial of deduction in this accounting period will be 250.

## **INTM558000: Hybrids: Chapter 10 - Dual Territory Double Deduction: Contents**

[INTM558010: Hybrids: Chapter 10 - Dual Territory Double Deduction: Overview](#)

[INTM558020: Hybrids: Chapter 10 - Dual Territory Double Deduction: Conditions to be satisfied](#)

[INTM558030: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition A](#)

[INTM558040: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition B](#)

[INTM558050: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction](#)

[INTM558060: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction: Dual Resident Company](#)

[INTM558070: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction: Relevant multinational and the UK is the parent jurisdiction](#)

[INTM558080: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction: Relevant multinational and the UK is the PE jurisdiction](#)

[INTM558090: Hybrids: Chapter 10 - Dual Territory Double Deduction: Example: Multinational company double deduction](#)

[INTM558100: Hybrids: Chapter 10 - Dual Territory Double Deduction: Example: Dual-resident company double deduction](#)

## **INTM558010: Hybrids: Chapter 10 - Dual Territory Double Deduction: Overview**

Chapter 10 of Part 6A TIOPA 2010 counters double deduction mismatches arising to either

- a dual resident company, or
- a company with a permanent establishment (a 'relevant multinational company').

For Chapter 10 to apply, two conditions, A and B must be met.

Condition A is that a company is a

- dual resident company, or
- relevant multinational company.

Condition B is that there is an amount that, in the absence of Chapter 10 and any equivalent overseas rules, it is reasonable to suppose could be deducted from both the company's income for corporation tax purposes, and from its income for the purposes of tax charged by an overseas territory. This is the dual resident double deduction (DD) amount.

Where both these conditions are met, the counteractions are broadly as follows.

For a dual resident company, the dual territory double deduction amount can only be deducted from dual inclusion income for the period, with any excess being carried forward for future periods.

For a relevant multinational where the UK is the parent jurisdiction, if the dual territory DD amount is deducted from overseas income that is not dual inclusion income, then the amount of the dual territory DD amount that can be deducted from the company's income for corporation tax purposes is reduced by the same amount.

For a relevant multinational where the UK is the PE jurisdiction, and there is no counteraction on the parent under the law of the parent jurisdiction, the dual resident DD amount may be deducted only from dual inclusion income for that period, with any excess being carried forward to future periods.

A dual resident company for the purpose of Chapter 10 of Part 6A is defined at s259JA.

A relevant multinational company is a company that is within the charge to tax in a jurisdiction because it carries on business in that territory through a

permanent establishment, but not resident in that jurisdiction, and where either the UK is the PE jurisdiction, or the company is resident in the United Kingdom (See [INTM558030](#))

## **INTM558020: Hybrids: Chapter 10 - Dual Territory Double Deduction: Conditions to be satisfied**

The conditions applicable for Chapter 10 of Part 6A TIOPA 2010 are set out at s259JA. For Chapter 10 to apply both conditions A or B must be met.

[INTM558030: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition A](#)

[INTM558040: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition B](#)

# **INTM558030: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition A**

## **Condition A**

Condition A of s259JA asks if a company is either

- a dual resident company, or
- a relevant multinational company.

### **Dual resident company**

A dual resident for the purpose of Chapter 10 is defined at s259JA. A company is a dual resident if it is a UK resident, and it is also within the charge to a tax under the law of a territory outside the United Kingdom because

- it derives its status as a company from that law,
- its place of management is in that territory, or
- it is for some other reason treated as resident under the law of that territory.

### **Relevant multinational company**

A relevant multinational company is a company that is within charge to tax in a jurisdiction because it carries on business in that territory through a permanent establishment, but not resident in that jurisdiction, (“the PE jurisdiction”) and where either the UK is the PE jurisdiction, or the company is resident in the United Kingdom (“the parent jurisdiction”).

“Company” is not defined in the legislation, so takes its normal meaning under UK law.

Permanent establishment includes anything that is a permanent establishment within the meaning of section 1119 CTA 2010, or within any similar concept outside the United Kingdom. This includes if the overseas concept of a permanent establishment is not based on Article 5 of the Model tax convention on Income and Capital published by the Organisation for Economic Cooperation and Development.

## **INTM558040: Hybrids: Chapter 10 - Dual Territory Double Deduction: Condition B**

### **Condition B**

Condition B of s259JA asks if it is reasonable to suppose that there is an amount which could, by reason of the company being either a dual resident or a multinational company, be deducted from the income of the company for corporation tax purposes and also deducted for the purposes of a tax charged by an overseas jurisdiction.

#### **Reasonable to suppose**

There is no definition of the term reasonable to suppose in Part 6A, so the phrase will take its ordinary meaning. Generally this does not require either party to know how the transaction has been treated by the counterparty but only that, given the facts and circumstances, it would be reasonable to suppose that a mismatch arises.

## **INTM558050: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction**

If conditions A and B are satisfied the mismatch is countered in the UK by restricting the amount of the deduction.

The counteraction applies to reduce the allowable deduction by the amount that has been doubly deducted.

Any counteraction is mitigated to the extent that

- the deduction may be set against any dual inclusion income in the relevant deduction period, and
- a stranded deduction may be set against total profits of the relevant period if the Commissioners of HMRC are satisfied that no dual inclusion income will arise.



## **INTM558060: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction: Dual Resident Company**

The counteraction where a dual resident company is within the charge to UK corporation tax is set out at s259JB. A dual resident company may have a deduction for the amount of the dual resident double deduction mismatch only against any dual inclusion income of the company for that period.

Where the deduction has been restricted, the restricted amount may be carried forward to use against dual inclusion income of the company in future accounting periods.

### **Dual inclusion income**

Dual inclusion income of the company is the amount of income arising during an accounting period that is ordinary income of both

- the dual resident company for that period for corporation tax purposes and
- the dual resident company for a permitted taxable period for the purposes of any tax charged outside the UK.

### **Ordinary income**

- Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at [INTM550540](#).
- There are special recognition rules at s259BD covering instances of non-inclusion for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign companies (CFC) charge. This is discussed further at [INTM550550](#).

### **Permitted taxable period**

A taxable period of a hybrid entity is a permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the investor, or
- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.



## **INTM558070: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction-relevant multinational and the UK is the parent jurisdiction**

The counteraction where the UK is the parent jurisdiction of a relevant multinational company is set out at s259JC.

S259JC(2) enables a dual territory double deduction to be set off against the income of the company in the parent jurisdiction in the period it arises, even though there may not be any dual inclusion income in that period, providing that the overseas deduction is allowed only against the dual inclusion income of the company in the PE jurisdiction.

Where some or all of the dual territory double deduction is deducted against the income of another person for the purposes of tax in another jurisdiction, that income is not treated as dual inclusion income of the company. The amount of the dual territory double deduction that can be deducted for corporation tax purposes is reduced by the amount of the overseas deduction.

### **Dual inclusion income**

Dual inclusion income of the company is the amount of income arising during an accounting period that is ordinary income of both

- the company for that period for corporation tax purposes, and
- ordinary income of the company for a permitted taxable period for the purposes of any tax charged outside the UK.

### **Ordinary income**

- Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at [INTM550540](#).
- There are special recognition rules at s259BD in instances of non-inclusion for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign companies (CFC) charge. This is discussed at [INTM550550](#).

### **Permitted taxable period**

A taxable period of a company is permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the company, or
- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

## **INTM558080: Hybrids: Chapter 10 - Dual Territory Double Deduction: Counteraction-relevant multinational UK is the PE jurisdiction**

The counteraction where a mismatch arises because of a relevant multinational company and the UK is the PE jurisdiction is set out at s259JD. The counteraction applies where there is no provision in the parent jurisdiction equivalent to this legislation which counteracts the mismatch.

A relevant multinational company may have a deduction for the amount of the double deduction mismatch only against any dual inclusion income of the company for that period.

Where the amount deducted by the company exceeds the dual inclusion income in the period, the excess may be carried forward to use against dual inclusion income of the company in future accounting periods.

Where an amount has been deducted from the income of another person in the overseas jurisdiction, the deduction available to be set off against dual inclusion income of the company is restricted by that amount.

If it is no longer possible for the deduction to be allowed in calculating the profits of the relevant multinational company, because the company ceases to trade, then the excess stranded deduction may be set against total profits of the relevant period if the Commissioners are satisfied that no dual inclusion income will arise.

### **Dual inclusion income**

Dual inclusion income of the company is the amount of income arising during an accounting period that is both ordinary income of the company

- for that period for corporation tax purposes, and
- for a permitted taxable period for the purposes of any tax charged outside the UK.

### **Ordinary income**

- Ordinary income means income that is brought into account when calculating taxable profits on which tax is charged. The full definition, including restrictions on what may be regarded as ordinary income and where specific reliefs may be treated as reducing the amount of ordinary income, is at s259BC and the concept is discussed further at [INTM550540](#).

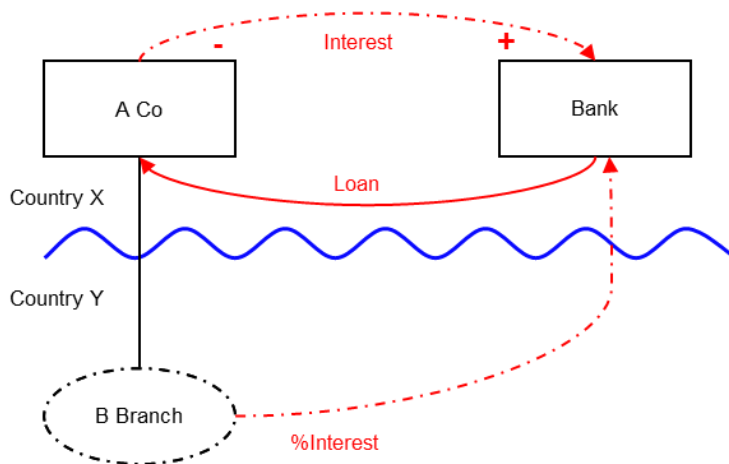
- There are special recognition rules at s259BD covering instances of non-inclusion for treating an amount of income as if it had been included where it has been subjected to another territory's controlled foreign company's (CFC) charge.

**Permitted taxable period**

A taxable period of a company is a permitted taxable period if it

- begins at any time before the end of 12 months after the end of the accounting period within which the amount is deducted by the company, or
- begins in a later period if a claim is made and it is just and reasonable that the ordinary income arises in that period instead of the earlier period.

## INTM558090: Hybrids: Chapter 10 - Dual Territory Double Deduction: Example: Multinational company double deduction



### Background

- A Co is resident in Country X, and has a permanent establishment in Country Y ('B Branch').
- Both Country X and Y treat B Branch as giving rise to a permanent establishment in Country Y.
- A Co borrows money from an unrelated third party (Bank) and uses the loan to fund income-earning assets in Country Y.
- Country X allows A Co a deduction for the full amount of this interest expense.
- Country Y applies a fungibility approach to interest expenses and therefore allows B Branch a deduction for a portion of the interest expense ('%interest') on the same loan.

### Analysis - Applying the tests in s259JA TIOPA 2010

Do the interest payment by A Co and the interest deduction allowed to B Branch satisfy the relevant conditions to fall within the scope of the dual territory double deduction rules?

#### Condition A: Is A Co a relevant multinational company?

The definition of relevant multinational company is given at s259JA(4).

S259JA(4)(a) is satisfied as A Co is within the charge to tax in a country in which it is not resident because it carries on business in Country Y ('the PE jurisdiction') through a permanent establishment (B Branch).

Therefore, if either the UK is Country X (the parent jurisdiction) or if the UK is Country Y (the PE jurisdiction), thereby satisfying s259JA(4)(b), then both of the requirements at s259JA(4) are met and A Co is a relevant multinational company and Condition A will be satisfied.

If the UK is neither Country X nor Country Y then the condition is not satisfied. If this is the case then the Imported Mismatch rules within s259K TIOPA 2010 should be considered.

**Condition B: Is there an amount that it is reasonable to suppose can be deducted both from A Co's income for UK corporation tax purposes and also from A Co's income for a tax charged under the law of a territory outside of the UK, and that this is by reason of company being a relevant multinational company - thus giving rise to a dual territory double deduction amount?**

Given the facts above, it is reasonable to suppose that Country X will permit A Co a full deduction for the interest expense under the loan in the payment period.

It is also reasonable to suppose that Country Y will also permit a proportion of the interest expense (% interest) to be deducted in calculating the taxable income of Branch B, which is merely a part of A Co.

Therefore, whether the UK is Country X or Country Y, it is reasonable to suppose that an amount is allowed as a deduction against A Co's income both for UK corporation tax and for a tax charged under the law of a territory outside of the UK. This arises from the fact that A Co is a multinational company, as both Country X and Country Y each attribute the interest income to each other for this reason.

Therefore there is a dual territory double deduction amount and Condition B is satisfied.

The extent of the dual territory double deduction amount is %interest, being the amount of the interest deduction allowed to Branch B in Country Y.

All the conditions are satisfied to characterise the arrangement involving the payment of interest under the loan as a dual territory double deduction amount and the relevant counteractions therefore need to be considered.

## **Counteraction**

The counteraction applicable will depend upon whether the UK is in the position of Country X or Country Y.



**Counteraction where the UK is in the position of Country X (parent jurisdiction)**

Where the UK is in the position of Country X (the parent jurisdiction) then s259JB will apply. There is no dual inclusion income in this example so the interest deduction available to A Co will be reduced by the dual territory double deduction amount for the payment period. The UK will, however, permit A Co to carry forward the excess deduction to utilise against any dual inclusion income arising in subsequent accounting periods.

If the denied deductions become stranded deductions as they have not already been utilised to derive a tax benefit under a law of a territory outside the UK and it is very likely that the counteraction will result in them never being utilised, then they may be available as a deduction in A Co under s259JB(4).

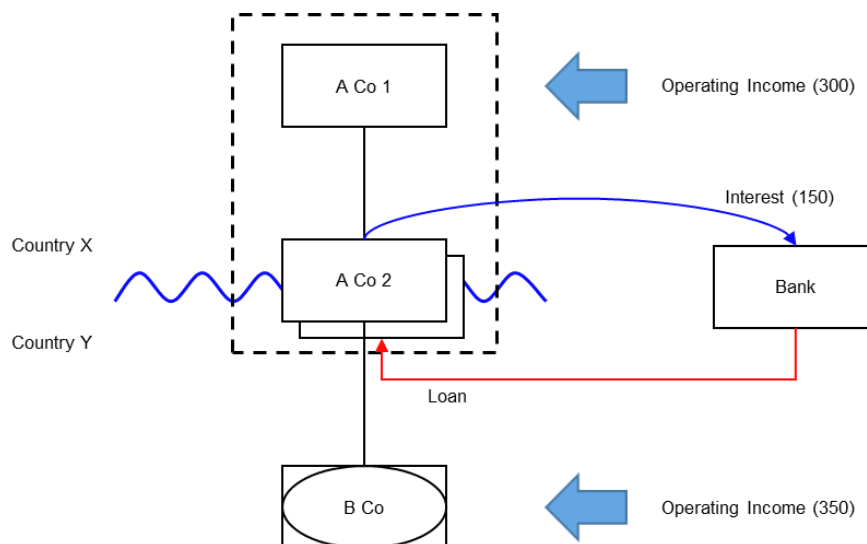
**Counteraction where the UK is in the position of Country Y (the PE jurisdiction)**

Where the UK is in the position of Country Y (the PE jurisdiction), and it is reasonable to suppose that the dual territory double deduction amount has not been fully counteracted by any other country under a counteraction equivalent to s259JB, then s259JC will apply. The interest deduction available to B Branch is reduced by the remaining dual territory double deduction amount. Therefore in this example if a counteraction equivalent to s259JB has not been applied, then no deduction for %interest is allowed to B Branch.

If the denied deductions become stranded deductions as they have not already been utilised to derive a tax benefit under a law of a territory outside the UK and it is very likely that the counteraction will result in them never being utilised, then they may become available as a deduction in B Branch under s259JC(5).

## INTM558100: Hybrids: Chapter 10 - Dual Territory Double Deduction: Example: Dual-resident company double deduction

This example illustrates a double deduction (DD) outcome arising as a result of a company being dual-resident.



### Background

- A Co 1 is resident in Country X. A Co 1 owns all the shares in A Co 2.
- A Co 2 is a dual-resident company that is it is resident for tax purposes in both Country X and Country Y.
- A Co 1 is consolidated with A Co 2 under Country X law.
- A Co 2 acquires all of the shares in B Co.
- B Co is treated as a separate entity under Country X law, but is recognised as fiscally transparent under Country Y law.
- A Co 2 borrows money from a bank. The loan interest (150) is deductible in both Country X and Country Y.
- Operating income of 300 arises to A Co 1, and 350 to B Co.
- A Co 2 has no other income or expenditure.

Without counteraction the combined position for the AB group is set out below:

Country A			Country B		
A Co 1			A Co 2 and B Co combined		
	Tax	Book		Tax	Book
Income			Income		
Operating income of A Co 1	300	300	Operating income of B Co	350	350
Expenditure			Expenditure		
Interest Paid by A Co 2 to bank	-150		Interest Paid by A Co 2 to bank	-150	-150
Net profit		300	Net profit		200
Taxable profit	150		Taxable profit	200	

The net effect of the structure is that the AB group has a net return of 500 profits, but the taxable profits are only 350.

### **Analysis - Applying the tests at s259JA TIOPA 2010**

Does the interest payment by A Co 2 satisfy the relevant conditions to fall within the scope of the dual territory double deduction rules?

**Condition A: Is there a company that is a dual-resident company, within the definition at s259JA(3)?**

If the UK is in the position of either Country X or Country Y the condition is satisfied, as A Co 2 is resident for tax purposes in both countries.

If the UK is in the position of neither then this condition is not satisfied.

**Condition B: Is it reasonable to suppose that an amount could be deducted from A Co 2's ordinary income for tax purposes in both Country X and Country Y (dual resident double deduction amount), by reason of A Co 2 being a dual resident company?**

Under the laws of Country X, A Co 2 can deduct the 150 interest amount from its ordinary income for corporation tax purposes. In this example the deduction has been utilised by A Co 1.

Likewise, under the laws of Country Y, A Co 2 can deduct the 150 interest amount from its ordinary income for the purposes of Country Y's tax. In this example, however, because B Co is fiscally transparent operating income of 350 is assessed on A Co 2. A Co 2 can deduct the 150 interest it has paid against this operating income.

A Co 2 could therefore deduct the same amount (150) from its ordinary income in both Country X and Country Y because of its dual residence.

Condition B is therefore satisfied and the extent of the dual territory double deduction amount is 150.

### Conclusion

As both conditions are satisfied the relevant counteraction needs to be considered.

### Counteraction

The counteraction for dual territory double deduction mismatches is found at s259JB TIOPA 2010.

The effect of the restriction is to deny the deduction for the interest payment (150). Where one of the jurisdictions in question is the UK the dual territory double deduction amount of 150 will be denied. A Co 2 will be permitted to carry forward the 150 under s259JB (2) TIOPA 2010 and this can be set off against any future dual inclusion income of A Co 2.

If the non-UK jurisdiction has also adopted a provision equivalent to s259JB TIOPA 2010 then it may also deny the deduction for the interest payment (150).

The position following this counteraction is set out below:

Country A			Country B		
A Co 1			A Co 2 and B Co combined		
	Tax	Book		Tax	Book
Income			Income		
Operating income of A Co 1	300	300	Operating income of B Co	350	350
Adjustment	150		Adjustment	150	

Expenditure		Expenditure		
Interest Paid by A Co 2 to bank	-150	Interest Paid by A Co 2 to bank	-150	-150
Net profit	300	Net profit	200	
Taxable profit	300	Taxable profit	350	

The net effect under the counteraction is that the AB group realises 500 of net profit, but its taxable profit has increased to 650. The 150 excess taxable income is a result of both countries applying the same rule and denying the dual territory double deduction amount. The AB group will need to engage with the tax administrations of Country X and Country Y to resolve this.

**A Co 2 ceases to be dual resident**

Should the Commissioners for HMRC be satisfied that A Co 2 has ceased to be a dual resident company and has become a resident of the UK, then any stranded deductions (as defined under s259JB(4) TIOPA 2010) will be permitted when calculating the company's taxable profits in the accounting period in which it ceased to be dual resident.

If the company is unable to utilise all of its previously stranded deductions in the period it ceases to be dual resident then it is permitted (under s259JB(4) TIOPA 2010) to carry these deductions forward to subsequent accounting periods for the purposes of calculating taxable total profits.

## **INTM559000: Hybrids: Chapter 11 - Imported mismatches: contents**

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[INTM559200: Hybrids: Chapter 11 - Imported mismatches: Conditions to be satisfied](#)

[INTM559210: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition A](#)

[INTM559220: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition B](#)

[INTM559230: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition C](#)

[INTM559240: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D](#)

[INTM559241: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D: dual territory double deduction](#)

[INTM559242: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D: excessive PE deduction](#)

[INTM559250: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition E](#)

[INTM559260: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition F](#)

[INTM559270: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition G](#)

[INTM559300: Hybrids: Chapter 11 - Imported mismatches: Counteraction](#)

[INTM559410: Hybrids: Chapter 11 - Imported mismatches: Example: Manufactured royalty](#)

[INTM559420: Hybrids: Chapter 11 - Imported mismatches: Example: Hybrid loan funded by several relevant payments](#)

## **INTM559100: Hybrids: Chapter 11 - Imported mismatches: Overview**

Chapter 11 of Part 6A TIOPA 2010 applies in connection with payments and quasi-payments made under arrangements where the tax effect of a hybrid or other mismatch is imported into the UK. The effect is to deny a deduction equal in amount to the UK company which is party to the arrangements.

A mismatch is in scope if, had the UK had been counterparty to a transaction, then the transaction would have been counteracted as a hybrid or other mismatch under Part 6A.

Where a mismatch is not countered by either Part 6A, or an equivalent rule in an overseas territory, and it is part of a series of arrangements such that the UK is counterparty to a transaction within those arrangements, and benefits from the relevant mismatch, then Chapter 11 applies to neutralise the mismatch.

Due to the nature of Chapter 6 (Deduction/Non-Inclusion Mismatches Relating to Transfers by Permanent Establishments) and Chapter 10 (Dual Territory Double Deduction Cases) the identification of a relevant mismatch in relation to these Chapters is considered separately within Chapter 11.

Imported mismatch rules were included as one of the G20/OECD Recommendations on tackling hybrid and other mismatches to support the effectiveness of the other recommendations.

The effect of an imported mismatch rule can be illustrated by this simple example, involving the UK and countries X and Y, neither of which have rules equivalent to Part 6A.

X Co (resident in Country X, not the UK) lends to Y Co (resident in Country Y, not the UK), using a hybrid financial instrument that gives rise to a deduction (in Y) and no inclusion (in X) outcome. Y Co then makes a plain loan to UK Co. UK Co deducts its interest payment to Y, but there is no effective taxation of the interest on Co Y because Co Y has a matching deduction for the untaxed payment to X under the hybrid financial instrument.

The countermeasures provided by Chapter 3 concerning hybrid financial instruments would not assist the UK here because it is a plain loan between UK Co and Y Co. So without the imported mismatch rules provided by Chapter 11, the UK would not be protected against base erosion using hybrid mismatches.





## **INTM559200: Hybrids: Chapter 11 - Imported mismatches: Conditions to be satisfied**

Chapter 11 of Part 6A TIOPA 2010 applies if seven conditions set out at s259KA are met.

[INTM559210: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition A](#)

[INTM559220: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition B](#)

[INTM559230: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition C](#)

[INTM559240: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D](#)

[INTM559250: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition E](#)

[INTM559260: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition F](#)

[INTM559270: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition G](#)

## **INTM559210: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition A**

Condition A of s259KA asks whether a payment or quasi-payment (the imported mismatch payment) been made under or connection with an arrangement (the imported mismatch payment)

A payment is any transfer of money or money's worth in relation to which an allowable deduction arises in calculating the taxable profits of the payer if Part 6A (or a non-UK equivalent of Part 6A) did not apply.

The payer is the person from whom the transfer is made. A payee is any person to whom

- a transfer of money or money's worth is made, or
- an amount of ordinary income arises.

An amount is a quasi-payment if

- an allowable deduction would arise in calculating the taxable profits of the payer, if Part 6A (or a non-UK equivalent of Part 6A) did not apply, and
- the circumstances giving rise to the deduction may reasonably be expected to result in ordinary income of one or more persons were certain assumptions to apply

See [INTM550530](#) for more detail on quasi-payments.

There is nothing to prevent an amount satisfying the definition of being both a payment and a quasi-payment.

The payer jurisdiction is the jurisdiction in which the deduction is available for tax purposes.

Deductions deemed to arise for tax purposes under the law of the payer jurisdiction are not quasi-payments where the circumstances giving rise to the deduction do not include economic rights between the payer and a payee.

Condition A also requires that the payment or quasi-payment to be made under an arrangement. S259NF contains the definition of an arrangement for the purposes of this legislation and it includes any agreement, understanding, scheme, transaction, or series of transactions (whether legally enforceable or not).

## **INTM559220: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition B**

Condition B of s259KA requires the payer, in relation to the imported mismatch payment identified within Condition A, to be within the charge to corporation tax for the payment period.

As identified in [INTM559210](#) the payer is the person from whom the transfer is made.

The relevant payment period is the taxable period of the payer in which an amount may be deducted, in relation to the payment or quasi-payment.

## **INTM559230: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition C**

Condition C of S259KA TIOPA 2010 asks whether the imported mismatch arrangement – as identified in Condition A ([INTM559210](#)) as being the arrangement which under, or in connection with, the payment to which the UK is a counterparty – is one arrangement in a series of arrangements.

An arrangement forms part of a series of arrangements where there is sufficient connection between the arrangements such that each are entered into in pursuance of, or in relation to, another arrangement, the over-arching arrangement.

Examples might include where the X/Y loan was entered into solely for the purpose of entering into the Y/UK loan, or that it is reasonable to assume that the funds provided under the Y/UK loan became available as a result of the X/Y Loan.

## **INTM559240: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D**

Condition D of S259KA asks whether there is an arrangement within the overarching arrangement (as defined by Condition C - [INTM559230](#)) that would be characterised as a targeted mismatch in Part 6A .

Condition D identifies separately those mismatches arising from a payment or quasi-payment within:

- Chapter 3 - Hybrid or otherwise impermissible deduction/ non-inclusion mismatch (s259CB)
- Chapter 4 - Hybrid transfer deduction/ non-inclusion mismatch (s259DC)
- Chapter 5 - Hybrid payer deduction/ non-inclusion mismatch (s259EB)
- Chapter 7 - Multinational payee deduction/ non-inclusion mismatch (s259GB)
- Chapter 8 - Multinational payee deduction/non-inclusion mismatches (s259HB)
- Chapter 9 - Hybrid entity double deduction (s259IA(4))
- Chapter 10 Dual Territory double deduction (s259KB)

And those which arise from an excessive PE deduction which are dealt with in s259KB (which includes the mismatch addressed by Chapter 6) (see [INTM559242](#))

The mismatch addressed by Chapter 10 is included indirectly through s259KB (see [INTM559241](#))

The relevant mismatch cannot be one to which the UK is a counterparty, as those will be directly subject to the relevant Chapter.

Chapters 6 and 10 require the UK to be in the position of the permanent establishment territory. Dealing with these separately within Chapter 11 ensures that the appropriate counteractions are covered by this Chapter.

The relevant mismatch is the extent of the mismatch as computed under the relevant Chapter.

[INTM559241: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D: dual territory double deduction](#)

[INTM559242: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D: excessive PE deduction](#)

## **INTM559241: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D: dual territory double deduction**

Chapter 10 (Dual Territory Double Deduction Cases) provides that there is a dual territory double deduction amount for the purposes of that chapter (see [INTM559000](#)) if:

- there is an amount that can be deducted against the company's income both in the UK and in a territory outside of the UK, and

either:

- the company is dual resident, or
- the company is a non-UK company operating in the UK through a permanent establishment.

S259KB in Chapter 11 provides for a dual territory double deduction if there is an amount that can be deducted against the company's income, but in any two territories.

This, therefore, neither requires that one of the deductions enables relief to be given under UK corporation tax nor requires it to be by reason of being a dual resident or a multinational company subject to UK corporation tax, but identifies and quantifies the amount of the mismatch for the purposes of Chapter 11 in the same way as Chapter 10.

## **INTM559242: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition D: excessive PE deduction**

Chapter 6 (deduction/non-Inclusion Mismatches Relating to Transfers by Permanent Establishments) establishes that there is an excessive PE deduction for the purposes of that chapter (see [INTM554000](#)) if:

- the company is a non-UK company operating in the UK through a permanent establishment (the UK PE),
- there is an amount that can be deducted against the company's income in the UK,
- the amount is in respect of a transfer of money or money's worth, from the UK PE jurisdiction to the company in another territory (either actually made or is in substance treated as being made), and
- it is reasonable to suppose that the resulting inclusion, within a permitted taxable period, will be less than the relevant deduction claimed by the UK PE, the difference being the relevant excessive PE deduction.

Similarly s259KB in Chapter 11 provides for an excessive PE deduction if:

- the company is operating through a permanent establishment in a different territory (the PE),
- there is an amount that can be deducted against the company's income in the PE,
- the amount is in respect of a transfer of money or money's worth, from the PE jurisdiction to the company in another territory (either actually made or is in substance treated as being made), and
- it is reasonable to suppose that the resulting inclusion, within a permitted taxable period (as defined above), will be less than the relevant deduction claimed by the PE, the difference being the relevant excessive PE deduction.

These conditions permit the relevant mismatch to be quantified in the context of Chapter 11.



## **INTM559250: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition E**

Condition E of s259KA is that it is reasonable to suppose that where one of the relevant mismatches identified by Condition D arises ([INTM559240](#)), that the mismatch has not been counteracted:

- any of Chapters 3 to 10, nor
- by any equivalent provision under the law of a territory outside the UK.

## **INTM559260: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition F**

Condition F can be met in either of two ways.

Firstly, assuming that s259KA(6)(a) applies, is it reasonable to suppose that either Chapters 3 to 5 or 7 to 10 of Part 6A, or equivalent overseas rules, would apply to the tax treatment of either a UK payer, UK payee or UK hybrid entity investor as appropriate?

Secondly, is the relevant mismatch an excessive PE deduction as defined by s.259KB?

Section 259KB(3) defines a PE deduction as an amount that:

- may be deducted from the PE's income in the PE jurisdiction, and
- which is an amount in respect of the transfer of money or money's worth made from the PE to its head office.

The transfer of money or money's worth must actually occur or must in substance be treated as being made for tax purposes.

This PE deduction will be considered to be an "excessive PE deduction" as defined in s259KB(4) if the amount of the deduction in the PE jurisdiction exceeds the sum of:

- any increase in the taxable profits in the head office territory where this results from the circumstances giving rise to the PE deduction, and
- any amount of the deduction in the PE jurisdiction exceeds any reduction in losses made by the company for the purposes of tax charged under the law of the company's territory of residence as a result of the circumstances giving rise to the PE deduction.

## **INTM559270: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition G**

Condition G of S259KA is satisfied where one of the following applies –

- the UK payer of the imported mismatch payment is in the same control group as either the payer or payee (or in respect of an excessive PE deduction the company with the PE), in relation to the mismatch payment, at any time from when the over-arching arrangement (see [INTM559230](#)) is made to the last day of the payment period in relation to the imported mismatch payment (see [INTM559210](#)), or
- the arrangement is a structured arrangement.

### **Control groups**

Control groups are defined at s259NB. More detailed guidance on control groups is at [INTM550580](#).

### **Structured arrangement**

An arrangement is a structured arrangement if it is reasonable to suppose that–

- it is designed to secure a hybrid payer deduction/non-inclusion mismatch, or
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or the terms of the arrangement otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

## **INTM559300: Hybrids: Chapter 11 - Imported mismatches: Counteraction**

If Conditions A to G are satisfied then s259KC will apply to restrict the amount of the deduction by the amount of the relevant mismatch.

The relevant mismatch is established at Condition D (see [INTM559240](#)).

For example, if there was a mismatch involving a Hybrid Financial Instrument such that it was characterised as a hybrid or otherwise impermissible deduction/ non-inclusion mismatch under s259CB, then the principles within s259CB would also determine the extent of the mismatch – taking into account whether, by reason of the terms or other feature of the financial instrument, it is non-included or under-taxed.

Due consideration for the dual inclusion income of the relevant counter-parties to the relevant mismatch will also be taken into account where appropriate. However, this will not extend to considering whether the income of the UK payer is dual inclusion income.

If there is more than one relevant payment in relation to the relevant mismatch, then the UK company shall be subject to a counteraction on their share of the relevant mismatch. The share which will be determined by apportionment on a just and reasonable basis, having regard to the extent to which the imported mismatch payment made by the UK company and the other relevant payments fund (directly or indirectly) the mismatch payment.

s259KC(8) places the onus on the UK company payer of the imported mismatch payment to identify and justify other relevant payments.

A simple example might be where the relevant mismatch is in relation to a hybrid financial instrument whereby the receipt was effectively 50% undertaxed. If a portion of the funds obtained under this instrument was passed to the UK under a plain vanilla debt, under which interest payments were made (the imported mismatch payments), and the balance was passed to a company in a non-UK territory, then a just and reasonable apportionment might be 50% of the relevant mismatch.

Where there is a question as to the extent that an imported mismatch payment funds a mismatch payment or transfer, s259KC(5) provides that the former is to be taken to fund the latter unless it can be shown that the mismatch payment or transfer has instead been funded by one or more relevant payments.

The funding requirement covers either direct or indirect funding. Expanding on the example above, if the funds obtained under the Hybrid Financial Instrument are instead contributed as equity down to a wholly owned

subsidiary which then loans the funds to the UK subsidiary, the funding requirement can be satisfied.

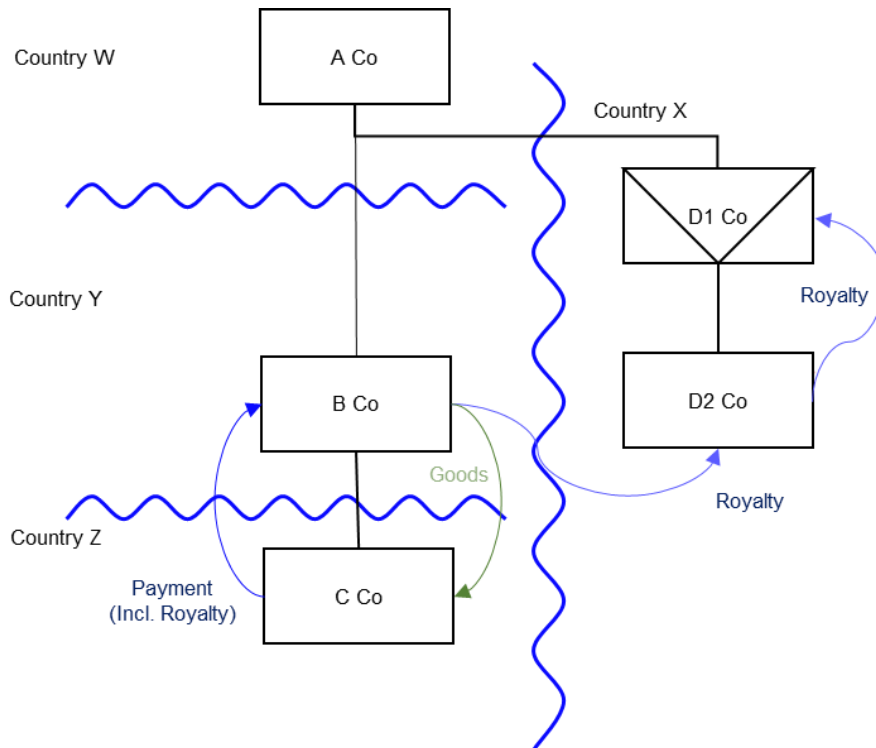
### **Excessive PE Deduction**

Where we are considering an excessive PE deduction that is actually made, and there is more than one relevant payment that can be considered as funding the relevant mismatch, then the recognition of the relevant share of the mismatch born by the UK company is the same. The share is determined by apportionment on a just and reasonable basis, having regard to the extent to which the imported mismatch payment made by the UK company and the other relevant payments fund the mismatch transfer of money or money's worth.

Where we are considering an excessive PE deduction that is in substance treated as being made for tax purposes, but not actually made, then we establish on a just and reasonable basis to what extent the imported mismatch payment made by the UK company and the other relevant payments would have funded the mismatch transfer if it had actually been made.

As with relevant payments, in this situation s259KC(5) and (6) place the onus on the company to show that the relevant mismatch was funded by other relevant payments, with a de-facto presumption otherwise that it was funded by the UK's imported mismatch payment.

## INTM559410: Hybrids: Chapter 11 - Imported mismatches: Example: Manufactured royalty



### Background

- A Co is a company resident in Country W
- B Co is a company resident in Country Y, and A Co owns its entire shareholding
- C Co is a company resident in Country Z, and B Co owns its entire shareholding
- D1 Co is a corporate entity established and resident in Country X, with A Co as its sole member
- D1 Co is regarded as transparent in Country X but opaque by Country W. As such its profits are subject to tax in neither Country X nor Country W
- D2 Co is a company resident in Country X, and D1 Co owns its entire shareholding
- This group (including A Co, B Co, C Co, D1 Co and D2 Co) holds intellectual property (IP) in D1 Co

- D1 Co grants a licence to D2 Co to exploit that IP in exchange for royalties
- B Co produces and sells goods exploiting the IP - granted by D2 Co in exchange for royalties
- B Co sells some of those goods to C Co
- Country Z grants C Co a deduction for the cost of those goods purchased, which includes an amount that can be attributed to the IP
- Country Y subjects B Co to tax on the corresponding receipt, but its profits are reduced by a deduction corresponding to the royalty paid to D2 Co
- D2 Co, in turn, pays D1 Co a royalty under the licence agreement, for which Country X allows a deduction.

As D1 Co is treated as transparent in Country X but opaque in Country W, D1 Co is in effect a hybrid payee that would have been subject to the Hybrid Payee Deduction/ Non-inclusion Mismatch rule within Chapter 7 had the UK been in the position of Country X or Country W.

For the purposes of this example, however, the UK is not in the position of either Country W or Country X. Neither Country W nor Country X have applied rules equivalent to the rules within Part 6A TIOPA 2010.

## **Analysis - Applying the tests in s259KA TIOPA 2010**

Are the relevant conditions satisfied to bring this example within the scope of the Imported Mismatches rules?

**Condition A: Are there payments, or quasi-payments, made under, or in connection with, an arrangement (the imported mismatch arrangement)?**

Both the royalty paid by B Co to D2 Co (the B/D2 arrangement) and the payment (including an element of royalty) from C Co to B Co (the C/B arrangement) are payments made under, or in connection with, an arrangement.

Condition A is therefore satisfied.

**Condition B: Is the payer, in relation to that imported mismatch arrangement, within the charge to corporation tax for a relevant payment period?**

Where the UK is Country Y, B Co is a payer in relation to the B/D2 arrangement and is within the charge to corporation tax.

Where the UK is Country Z, C Co is a payer in relation to the C/B arrangement and is within the charge to corporation tax.

Condition B will therefore be satisfied as long as one of the above is satisfied.

**Condition C: Is this arrangement one of a number of arrangements which are each entered into in pursuance of, or in relation to, an over-arching arrangement (a series of arrangements)?**

As identified in Condition A the royalty paid by B Co to D2 Co, and the payment (including the element of royalty) from C Co to B Co are relevant arrangements, and both of these form a number of related arrangements that includes the royalty payment from D2 Co to D1 Co.

The over-arching arrangement here, as defined in s259KA(5) TIOPA 2010, includes the payment from C Co to B Co, the royalty payment from B Co to D2 Co and the royalty payment from D2 Co to D1 Co.

Condition C will therefore be satisfied for either the B/D2 arrangement or the C/B arrangement in relation to the royalty payment from D2 Co to D1 Co.

**Condition D: Under an arrangement within this series (other than the imported mismatch arrangement), is there a payment or quasi-payment in relation to which it is reasonable to suppose that there would be a relevant mismatch (as targeted by the Part 6A TIOPA 2010 rules)?**

As stated above, with D1 Co being treated as transparent in Country X but opaque in Country W, D1 Co is in effect a hybrid payee that would have been subject to the rules in Chapter 7, TIOPA 2010.

The relevant arrangement in the series is therefore the royalty paid from D2 Co to D1 Co and the relevant mismatch would be a hybrid payee deduction/non-inclusion mismatch within Chapter 7.

Condition D is therefore satisfied in respect of the royalty paid from D2 Co to D1 Co.

The relevant mismatch here is the extent of the mismatch as computed under Chapter 7.

**Condition E: Is it reasonable to suppose that there will be no relevant counteractions under the Part 6A rules, or their foreign equivalent provision?**

As stated in the Background above neither Country W nor Country X have adopted rules equivalent to rules within Chapter 3 to 10 TIOPA 2010, so they do not counteract the mismatch payment arising under the royalty payment between D2 Co and D1 Co.

If the UK were in the position of Country Z, then whether Country Y adopts their equivalent provision to Chapter 11 (imported mismatches) would be irrelevant.



Condition E is therefore satisfied.

**Condition F: Is either the relevant mismatch an excessive PE deduction or is it reasonable to suppose that a chapter within Chapters 3 to 10 of TIOPA 2010, other than Chapter 6, or its foreign equivalent, would apply to the relevant mismatch in relation to the tax treatment were the UK payer in the relevant position of the payer (D2 Co), payee (D1 Co) or (if relevant) investor (A Co)?**

The rule within Chapter 7, or its foreign equivalent, would have applied to the royalty payment between D2 Co and D1 Co (the mismatch payment) had either D2 Co, D1 Co or A Co been within the charge to UK corporation tax.

Condition F is therefore satisfied.

**Condition G: Is the relevant payer that is within the charge to UK corporation tax within the same control group as the payer (D2 Co) or payee (D1 Co) of the mismatch payment within the relevant period, or is there a structured arrangement?**

All the companies are within the same control group, as defined at s259NB TIOPA 2010.

However, from the information given in this example, it is also reasonable to suppose that this is a structured arrangement designed to secure the relevant mismatch (even if it is also designed to secure a commercial or other objective), and therefore the condition would also be met on these terms.

Condition G is met.

## **Conclusion**

As all the relevant conditions are satisfied to characterise the imported mismatch payments under either (or both) the C/B arrangement and the B/D2 arrangement as giving rise to a relevant mismatch. The relevant counteraction under the Imported Mismatch rules must be considered.

## **Counteraction**

Where there is more than one relevant payment in relation to the relevant mismatch arising, each company's share of the relevant mismatch will be determined by apportioning it on a just and reasonable basis, having regard to the extent that it funds the Imported Mismatch.

### **Counteraction where the UK is in the position of Country Y**

Where the UK is in the position of Country Y, then s259KC will apply to deny B Co a deduction to the extent that it directly or indirectly funds the relevant mismatch.

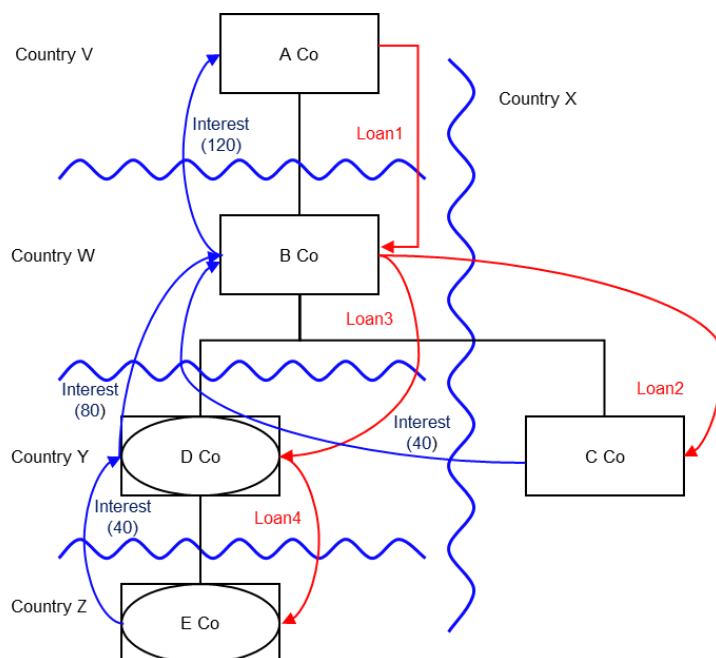
Therefore s259KC will apply to deny B Co a deduction for the royalty payments made to D2 Co, to the extent that they do not exceed the royalty payments made by D2 Co to D1 Co. As D2 Co would be exposed to tax in Country X on any excess it is not part of the mismatch payment.

**Counteraction where the UK is in the position of Country Z**

Where the UK is in the position of Country Z, then s259KC will apply only to the extent that the mismatch payment attributed to B Co has not been fully counteracted in Country Y by a provision equivalent to the Imported Mismatches rule. Any counteraction taken in Country Y will reduce the extent to which the mismatch is imported into Country Z.

If the relevant mismatch has been fully counteracted in Country Y then there is no remaining imported mismatch to be addressed in Country Z. S259KB will therefore not apply to deny C Co from deducting an amount in relation to that part of the payment which is attributable to the IP.

## INTM559420: Hybrids: Chapter 11 - Imported mismatches: Example: Hybrid loan funded by several relevant payments



### Background

- A Co is resident in Country V, and owns all the shares in B Co (resident in Country W)
- B Co owns all the shares in C Co (resident in Country X) and D Co (resident in Country Y)
- D Co owns all the shares in E Co (resident in Country Z)
- A Co makes a loan to B Co (Loan1), under which the payments of interest are treated as deductible in calculating B Co.'s ordinary income but are treated as non-taxable equity receipts in calculating A Co.'s ordinary income.
- The terms of Loan1 satisfy the conditions in s259CA TIOPA 2010 and fall within the Hybrid and Other Mismatches from Financial Instruments rules.
- Neither Country V nor Country W have applied rules equivalent to the Hybrid and Other Mismatches rules within Part 6A TIOPA 2010, so do not counteract this hybrid or otherwise impermissible deduction/ non-inclusion mismatch which arises under Loan1

- B Co on-lends two thirds of the funds provided under Loan1 to C Co (Loan2) and the balance to D Co (Loan3).
- D Co on-lends half of the funds provided under Loan3 to E Co (Loan4)
- B Co, C Co, D Co and E Co under the laws of Country W, Country X, Country Y and Country Z respectively treat the relevant loans as debt instruments and treat the payments of interest as deductible or as taxable as ordinary income in the relevant jurisdictions accordingly.

## **Analysis - Applying the tests in s259KA**

Are the relevant conditions satisfied to bring this example within the scope of the Imported Mismatches rules in Chapter 11?

**Condition A: Are there payments, or quasi-payments, made under, or in connection with, an arrangement (the imported mismatch arrangement)?**

Loan1, Loan2, Loan3 and Loan4 each constitute an arrangement and the relevant interest payments are each transfers of money made under them.

Condition A is met.

**Condition B: Is the payer, in relation to that imported mismatch arrangement, within the charge to corporation tax for a relevant payment period?**

As the UK has adopted the Part 6A rules the assumption is that the UK is not in the position of either Country V or Country W, otherwise the relevant counteractions under s259CC or s259CD would have been applied to address the hybrid or otherwise impermissible deduction/non-inclusion mismatch.

Where the UK is Country X, C Co is a payer in relation to the Loan2 arrangement and is within the charge to corporation tax.

Where the UK is Country Y, D Co is a payer in relation to the Loan3 arrangement and is within the charge to corporation tax.

Where the UK is Country Z, E Co is a payer in relation to the Loan4 arrangement and is within the charge to corporation tax.

Condition B will therefore be satisfied as long as one of the above is satisfied.

**Condition C: Is this arrangement one of a number of arrangements which are each entered into in pursuance of, or in relation to, an over-arching arrangement (a series of arrangements)?**

As identified in Condition A - Loan2, Loan3 and Loan4 each constitute a relevant arrangement, and all four of these form a number of related arrangements that includes Loan1.

Loan4 was made pursuant to Loan3, which was made pursuant to Loan1. This is part of the over-arching arrangement as defined in s259KA(5) where the UK is in the position of either Country Y or Country Z.

Loan2 was also made pursuant to Loan1. This is therefore part of the over-arching arrangement as defined in s259KA(5) where the UK is in the position of Country X.

Condition C will therefore be satisfied for Loan2, Loan3 and Loan4 in relation to Loan1.

**Condition D: Under an arrangement within this series (other than the imported mismatch arrangement), is there a payment or quasi-payment in relation to which it is reasonable to suppose that there would be a relevant mismatch (as targeted by Part 6A rules)?**

As stated above in the Background, the terms of Loan1 are such that they would satisfy the conditions to fall within Chapter 3.

The relevant arrangement in the series is therefore Loan1 and the relevant mismatch would be a hybrid or otherwise impermissible deduction/non-inclusion mismatch within Chapter 3.

Condition D is therefore satisfied in respect of Loan1.

The relevant mismatch here is the extent of the mismatch as computed under Chapter 3, which is the entire 120 deduction arising to B Co (assuming there is no dual inclusion income between A Co and B Co).

**Condition E: Is it reasonable to suppose that there will be no relevant counteractions under the Part 6A rules, or their foreign equivalent provision?**

As stated above in the Background, neither Country V nor Country W have adopted an equivalent to the rules within Chapters 3 to 10 TIOPA 2010, so they do not counteract the mismatch payment arising under Loan1.

If the UK were in the position of Country Z, then whether Country Y adopts their equivalent provision to Chapter 11 (imported mismatches) would be irrelevant.

Condition E is therefore satisfied.

**Condition F: Is either the relevant mismatch an excessive PE deduction or is it reasonable to suppose that a chapter within Chapters 3 to 10 of TIOPA 2010, other than Chapter 6, or its foreign equivalent, would apply to the relevant mismatch in relation to the tax treatment were the UK payer in the relevant position of the payer (D2 Co), payee (D1 Co) or (if relevant) investor (A Co)?**

The rule within Chapter 3, or its foreign equivalent, would have applied to the deductions claimed under Loan1 (the mismatch payment) had either B Co or A Co been within the charge to UK corporation tax, which would have affected their tax treatment.

Condition F is therefore satisfied.

**Condition G: Is the relevant payer (C Co, D Co or E Co) that is within the charge to UK corporation tax within the same control group as the payer (B Co) or payee (A Co) of the mismatch payment within the relevant period, or is there a structured arrangement?**

All the companies are within the same control group, as defined at s259NB TIOPA 2010.

However, from the information given in this example, it is also reasonable to suppose that this is a structured arrangement designed to secure the relevant mismatch (even if it is also designed to secure a commercial or other objective), and therefore the condition would also be met on these terms.

Condition G is met.

## **Conclusion**

As all the relevant conditions are satisfied to characterise the imported mismatch payments under Loan2, Loan3 or Loan4 as giving rise to a relevant mismatch. The relevant counteraction under the Imported Mismatch rules must be considered.

## **Counteraction under s259KC**

There is more than one relevant payment in relation to the relevant mismatch of 120 arising between A Co and B Co, therefore each company's share of the relevant mismatch will be determined by apportioning it on a just and reasonable basis, having regard to the extent that the Imported Mismatch and the other relevant payments fund the relevant mismatch.

The background facts in this example are that the relevant mismatch (120) is funded, on a just and reasonable basis, by 40 from C Co, 80 from D Co and 40 (indirectly) from E Co.

Note: The onus is on the relevant company within the charge to UK corporation tax to justify the other payments as relevant payments and the extent to which they should be considered as also funding the relevant mismatch. In this example the allocation is obvious. However if loan 1 was only for 80, and it used 40 of its own retained cash to fund the balance, then the starting presumption would be that the entire payment made by the relevant company within the charge to UK corporation tax had funded the relevant mismatch of 80 – the onus would be upon that company to show that this is not appropriate.

### **Counteraction where the UK is in the position of Country X**

Where the UK is in the position of Country X then s259KC will apply to deny C Co a deduction in relation to the payments under Loan2, which in this example would be the entire deduction 40.

### **Counteraction where the UK is in the position of Country Y**

Where the UK is in the position of Country Y, then s259KC will apply to deny D Co a deduction in relation to the payments under Loan3, which in this example would be the entire deduction of 80.

### **Counteraction where the UK is in the position of Country Z**

Where the UK is in the position of Country Z, then s259KC will apply only to the extent that the relevant Imported Mismatch attributed to D Co (80) has not been fully counteracted in Country Y by an equivalent provision similar to the Imported Mismatches rule.

Therefore, if the entire mismatch of 80 has not been fully counteracted, then s259KC will apply to deny E Co a deduction in relation to the payments under Loan4 to the extent of the remaining mismatch (and not restricted to only half of the remaining mismatch).

If the entire 80 has been fully counteracted then s259KC will not apply to deny E Co from deducting an amount in relation to the payments under Loan4.

## **INTM561100: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Contents**

[INTM561110: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Overview](#)

[INTM561120: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Adjustments where suppositions cease to be reasonable](#)

[INTM561130: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Deduction from taxable total profits where an amount of ordinary income arises late](#)



## **INTM561110: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Overview**

Chapter 12 of Part 6A TIOPA 2010 provides for compensatory adjustments where an amount has been counteracted under another chapter within Part 6A, but there effectively ceases to be a mismatch in the circumstances to which Chapter 12 applies.

S259L (see [INTM561120](#)) applies where a counteraction is applied under Part 6A but the understanding upon which that counteraction was based subsequently turns out to be incorrect, so that either no mismatch arises, or the mismatch is smaller than that originally calculated. Such adjustments as are just and reasonable may be made in these circumstances.

S259LA (see [INTM561130](#)) applies where a deduction arising from a payment or quasi-payment is reduced by application of Chapters 3, 4, 7 and 8 and the only reason for the reduction is that the ordinary income arose to the payee outside the permitted period. If, as expected, an amount of ordinary income arises in a later period, an equal amount may be deducted in calculating the taxable profits of the payee for that later period.

[INTM561120: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Adjustments where suppositions cease to be reasonable](#)

[INTM561130: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Deduction from taxable total profits where an amount of ordinary income arises late](#)

## **INTM561120: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Adjustments where suppositions cease to be reasonable**

S259L applies to adjust a tax consequences of the application of a counteraction under Part 6A was applied, but where the supposition upon which that adjustment depends turns out to be incorrect, and subsequent additional information suggests that the targeted mismatch was of a lesser amount with different tax consequences.

There are many instances in the rules where the application of the rules depends upon whether it is reasonable to suppose that a targeted mismatch would arise, or that an equivalent provision under the law of a non-UK territory would not apply to address that mismatch.

Including conditions which depend on reasonable suppositions is necessary for several reasons. For example, whether a corresponding receipt actually becomes included in ordinary income, or whether a non-UK territory applies a corresponding counteraction, may not be finalised for a significant time after a UK company's self-assessment is due.

The rules are not intended to lead to double taxation in these circumstances, and so where it is later established that a supposition made for the purposes of applying Part6A is incorrect, then such adjustment as is just and reasonable can be made under s259L.

The adjustment can be made by means of an assessment, the modification of an assessment, amendment or disallowance of a claim, or otherwise. The time limits which apply are those which are imposed by the legislation that is relevant to the adjustment necessary and to the company to which the counteraction was applied. The effect of these provisions is to give flexibility in determining how a just and reasonable adjustment can be given effect

S259L does not apply in circumstances to which s259LA applies (see [INTM561130](#)).

## **INTM561130: Hybrids: Chapter 12 - Other provisions: Adjustments in light of subsequent events: Deduction from taxable total profits where an amount of ordinary income arises late**

S259LA TIOPA 2010 applies where a deduction arising from a payment or quasi-payment is reduced by application of Chapters 3, 4, 7 and 8 and the only reason for the reduction is that the ordinary income arose to the payee outside the permitted period. If, as expected, an amount of ordinary income arises in a later period, an equal amount may be deducted in calculating the taxable profits of the payee for that later period.

This section applies where a deduction has been denied to a payer within the charge to corporation tax (the UK payer) because the relevant payment or quasi-payment gave rise to:

- a hybrid or otherwise impermissible deduction/non-inclusion mismatch under the rules in Chapter 3 (see [INTM551000](#))
- a hybrid transfer deduction/non-inclusion mismatch under the rules in Chapter 4 (see [INTM552000](#))
- a hybrid payee deduction/non-inclusion mismatch under the rules in Chapter 7 (see [INTM555000](#)), or
- a multinational payee deduction/non-inclusion mismatch under the rules in Chapter 8 (see [INTM556000](#)).

The section applies if

- the only reason for the mismatch under these Chapters was that it was reasonable to suppose that the deduction exceeded the total ordinary income arising by reason of the payment or quasi-payment arising within the permitted taxable period, and
- an amount of ordinary income arises later, outside the permitted taxable period, by reason of the payment or quasi-payment and for reasons unconnected to the application of Part6A or equivalent overseas rules.

### **Adjustment**

Where this section applies then an amount equal to the late income may be deducted from the payer's total taxable profits in the accounting period within which the late period ends.

The deduction is recognised at step 2 in s4(2) CTA 2010. So it is not given in computing the amount within the computation of the company's total profits for the period, but is relieved against them after so they have been computed. If there are insufficient total profits in that period, then the unusable balance is carried forward to be treated as being relievable in the next subsequent period, and so on, until it can be so offset.

A consequence of granting relief in this manner is that the deduction does not retain its original character. For example, if the counteraction was against a trading deduction or a non-trade loan relationship debit, then it will not remain as such and therefore can neither create nor augment a trading loss or non-trading deficit on loan relationships for that period. By extension, therefore, it will not be eligible for group relief or any other transfer of relief that is dependent on the character of the payment.

### **Exceptions**

As indicated earlier, an amount of ordinary income will not be deductible if it arises only because of another counteraction by an overseas equivalent of Part 6A.

No deduction is available if one of the other rules within Part 6A would apply to counteract the relevant mismatch, or an equivalent provision in a non-UK territory i.e. where a mismatch targeted by the rules still remain.

If the relevant receipt exceeds the amount counteracted, then this section does not apply to the excess.

The following examples illustrate the application of s259L.

### **Hybrid payer deduction/non-inclusion mismatch**

A Chapter 5 counteraction is applied to a UK hybrid payer, on the assumption that there would be a hybrid payer deduction/non-inclusion mismatch. This assumption was based on the fact that the payee jurisdiction would disregard the hybrid payer, and therefore no ordinary income would be recognised by the payee in that jurisdiction.

Subsequently, it transpires that the payee jurisdiction had not disregarded the hybrid payer, but in fact treated it as a separate taxable entity (because it did not meet the precise requirements of the relevant tax law in that jurisdiction). As a result, the payee did bring into account ordinary income which matched the relevant deduction claimed by the UK payer.

In these circumstances, a consequential adjustment under Chapter 12 would be appropriate, because the reasonable supposition which was made when a counteraction was applied under Chapter 5 would no longer be reasonable, in the light of the actual treatment in the payee jurisdiction.

### **Hybrid Financial Instrument deduction/non-inclusion mismatch**

A Chapter 3 counteraction is applied to a quasi-payment by a UK payer, on the assumption that there would be a deduction/non-inclusion mismatch. That assumption was based on the fact that the whilst the quasi-payment gave rise to a deduction in year 1 based on the fair value movement in relation to the underlying instrument, the related counterparty did not bring a matching amount into account because they accounted for the instrument on an accruals basis.

In the next accounting period, the UK payer brought an amount of income into account in relation to the underlying instrument, again based on the fair value movement. The amount of income in year 2 corresponds to the deduction in year one, effectively cancelling out the mismatch that arose in year 1. As this second fair value movement gives rise to income for the payer, rather than the counterparty payee, the permitted period time limit rules within Chapter 3 will not apply. However, the overall effect of the two fair value adjustments is to cancel out the mismatch which has been counteracted in year 1 under Chapter 3.

In these circumstances, we would treat the reasonable assumption made in applying a counteraction under Chapter 3 as no longer being reasonable, and a consequential adjustment under Chapter 12 would be appropriate.

## **INTM561200: Hybrids: Chapter 13 - Other provisions: Anti-avoidance**

Section 259M TIOPA 2010 contains a targeted anti-avoidance rule (TAAR). Arrangements that attempt to circumvent the hybrid and other mismatches rules may be caught and counteracted by s259M.

Arrangements may be counteracted by s259M where

- the main purpose, or one of the main purposes, of those arrangements is to enable any person to obtain a tax advantage by avoiding the hybrid and other mismatches rules, or any overseas equivalent, and
- if s259M did not apply, the arrangements would achieve that purpose.

Arrangements are defined as including any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable).

The rule applies where a person is

- within the scope of UK corporation tax, or
- would be within the scope of UK corporation tax but for the arrangements.

Chapter 13 applies in relation to "relevant avoidance arrangements" that would, absent s259M, provide a "relevant tax advantage" to a person who either is or would be within the charge to corporation tax.

The relevant tax advantage is counteracted by a just and reasonable adjustment to the person's corporation tax treatment, per s259M(2).

Adjustments by means of assessment, modification of an assessment, amendment, disallowance of a claim or otherwise are provided for by s259M(3).

A "relevant tax advantage" is defined in s259M(4) as where a person avoids the application of Part 6A, or any non-UK equivalent rules, and so prevents either the restriction of a deduction, or an amount being taxed as income.

A "relevant avoidance arrangement" is defined at s259M(5) as being an arrangement where the main purpose, or one of the main purposes, is to obtain a relevant tax advantage.

Chapter 13 will not apply in cases where obtaining the tax advantage is regarded as consistent with the principles and policy objectives underlying Part 6A or any overseas equivalent.

When considering the principles and policy objectives underlying Part 6A, regard can be taken, where appropriate, to the principles and objectives set out in the Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements, published by the Organisation for Economic Cooperation and Development on 5 October 2015 (or any replacement, update or supplement to it).

However it may not always be appropriate to consider the OECD Report.

For example, it would not be appropriate to have regard to the OECD Report if the UK has expressed an intention to depart from that Report.

Similarly, if the OECD Report is subsequently replaced or updated, or if any supplement is added to the Report, it will not be appropriate to give regard to the Report if the relevant revision, addition or supplement indicates a material departure from the understanding of the Report when the legislation was drafted.

One consequence of the introduction of Part 6A may be that companies look to restructure with a view to removing hybrid entities from their group structures, or to change their funding arrangements with the aim of reducing their use of hybrid financial instruments. Where the replacement structures and funding arrangements do not fall within the policy scope of the OECD Report it is unlikely that the Part 6A TAAR would apply, though the application of other measures might need to be considered.

## **INTM597000: Hybrids: Chapter 14 - Operational guidance: Contents**

[INTM597010: Hybrids: Chapter 14 - Operational guidance: When does the legislation take effect?](#)

[INTM597020: Hybrids: Chapter 14 - Operational guidance: Non-statutory requests for clarification \(clearance applications\)](#)

[INTM597030: Hybrids: Chapter 14 - Operational guidance: Clearances: Where to send clearance applications?](#)



## **INTM597010: Hybrids: Chapter 14 - Operational guidance: When does the legislation take effect?**

Part 6A of the Taxation (International and Other Provisions) Act 2010 was introduced by section 66/Schedule 10 of Finance Act 2016 ("FA 16"), and has effect from 1 January 2017. The commencement provisions for chapters 3 to 11 are set out at paragraphs 18 to 22 of Schedule 10, FA 16

Broadly speaking, the legislation applies from 1 January 2017 for -

- deduction/non-inclusion mismatches arising from payments made on or after that date
- deduction/non-inclusion mismatches arising from quasi-payments in a payment period beginning on or after that date
- double deduction mismatches for accounting periods beginning on or after that date
- imported mismatch payments arising from payments made on or after that date
- imported mismatch payments arising from quasi-payments in a payment period beginning on or after that date.

There are transitional rules for payment periods and accounting periods that begin before 1 January 2017 and end after that date at paragraphs 23 and 24 of Schedule 10, FA 16.

In these cases the payment/accounting period is treated as 2 separate taxable periods -

- one ending on 31 December 2016, and
- the other beginning on 1 January 2017.

Apportion amounts to each of these period on a time basis, unless that produces a result that is unjust or unreasonable. In those circumstances, apportion the amounts on a just and reasonable basis.

Transactions between 16 March 2005 to 31 December 2016 involving hybrids and mismatches fall within the arbitrage rules set out at INTM590000 onwards.

## **INTM597020: Hybrids: Chapter 14 - Operational guidance: Non-statutory requests for clarification (clearance applications)**

HMRC will, on request, consider clearance applications in respect of the application of the Part 6A hybrid and other mismatch rules in line with the general guidance on [non-statutory business clearances](#) in situations where there are points of genuine uncertainty.

In line with a number of similar provisions, HMRC will not consider a clearance application concerning the application of the TAAR provided by Chapter 13 of Part 6A.

Precisely what information the application should contain will of course depend on the nature of the clarification requested, the nature of the potential mismatch and the entities involved. Consequently it is not feasible to list the information required in all circumstances but the more relevant information provided with the initial application, the greater the likelihood it can be considered without the need for the provision of additional information. The material required has also been kept intentionally flexible to ensure that the cost of seeking a clearance in any particular case is no greater than absolutely necessary.

HMRC would expect to receive the following information in all applications.

- A clear indication at the start of the application as to what chapters and particular legislation the request for clearance refers to and for which accounting periods
- Details of the UK resident company, or UK permanent establishment of a foreign company, potentially impacted by the hybrids mismatches legislation
- Details of the other territory or territories involved
- A description of all business undertaken by all the entities relevant to understanding the application. Any anticipated changes in subsequent accounting periods should also be detailed.
- The nature and extent of all direct or indirect transactions or arrangements relevant to the application. Any anticipated changes in subsequent accounting periods should also be detailed.
- Details of the group and UK ownership structure

- Diagrams of the relevant part of the overall group structure that contains the entities involved in the potential hybrid mismatch (and any other connected entities with which these transact or are involved in an arrangement) together with the UK connection clearly detailed. Where changes are expected in the group structure it would be helpful for anticipated changes to be highlighted.
- The name and UTR number of the UK resident company or companies that would be expected to apply the counteraction should a hybrid mismatch arise.
- A full description of the overall structure, arrangements and transactions relevant to the application of the hybrid mismatches legislation. This should include any step plans, diagrams, group structure, contracts, agreements or other relevant documents that cover the various stages of the arrangements.
- Tax analysis for the specific legislation in relation to which clearance is sought providing both the UK and anticipated foreign tax treatment.

## **INTM597030: Hybrids: Chapter 14 - Operational guidance: Clearances: Where to send clearance applications**

All hybrid mismatch clearance applications should be sent electronically, together with all relevant supporting documentation, to the UK group's CRM. If the group does not have a CRM, for example it is a Mid-Size Customer or a group contemplating migration to the UK, please send the application to [HMRC Non-Statutory Clearance Team](#).

Further details of the Non-statutory Clearance service can be found at the link at the end of this page.

We will be able to process your application more efficiently if you send your clearance application by email. Please don't send self-extracting zip files as our software will block them.

HMRC cannot guarantee the security of emails you send to us or we send to you over the internet. Any information you send us by email is at your own risk.

It is important that you have assessed the risks of using email to send information or to receive it from us.

If you would like us to reply by email, please tell us so and confirm that you understand and accept the risks involved in using email. We will not always be able to reply by email.

No hard copies of an application are required.

The clearances will be reviewed within the normal HMRC turnaround time of 28 working days. If further information is required in order fully to consider the application, then a fresh turnaround time of up to 28 days will apply from the time the further information is provided.

It is possible that applications involving novel or complex issues will need more time to allow for more detailed discussion and this may involve ongoing correspondence and meetings before resolution. If this is the case, it is likely that the CRM and tax specialists assigned to the case will be involved as well as the Foreign Profits Team. In all cases, comments on the application from the CRM or the case team will be welcome.

<https://www.gov.uk/guidance/non-statutory-clearance-service-guidance>