Draft Examples

Clause 33: Hybrid and other mismatches

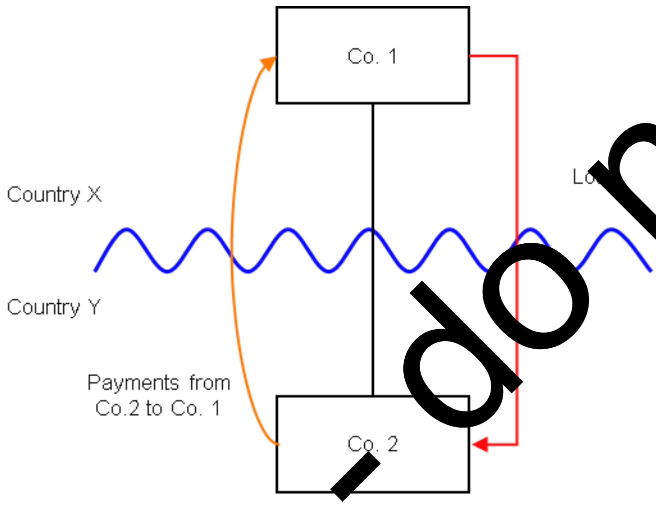
The following draft examples are provided to assist understanding of the application of the draft hybrids mismatch legislation published on 9 December 2015. They can be used in conjunction with the explanatory notes. The examples are based upon a selection of those contained within the OECD 'Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements', with some additional draft examples dealing with hybrid transfers. The examples are not exhaustive, but are designed to illustrate how the draft UK legislation is intended to apply to the range of hybrid mismatch arrangements considered by the OECD report. Further guidance on the application of the hybrids rules will be provided in 2016.

Contents

Hybrid and Other Mismatches from Financial Instruments

Example 3.1 (based on OECD example 1.01): Interest payment under a 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.

Neither Co. 1 nor Co. 2 satisfy any of the conditions within section 259BF (2) TIOPA 2010, which sets out permitted reasons for deduction/ non-inclusion mismatches relating to the status of the payee.

Analysis - Applying the tests in section 259CA 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 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 S259K.
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 both 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.

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?

Given the facts above 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 Loan, Country X will not require Co. 1 to bring the corresponding receipt into tax as ordinary income.

The mismatch outcome is not attributable to a permitted reason as it is not within section 259BF (2) TIOPA 2010.

Accordingly there is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch.

Note: It may be that Country X 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. To the extent that this 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.

The UK's counteractions under this legislation act only after the UK's other domestic rules have been applied, it is necessary therefore to consider whether any other UK legislation negate the mismatch. 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 are related within section 259KB TIOPA 2010 are met, and therefore Condition D is satisfied. There is thus no need to consider the remaining parts of the condition.

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.

Counteractions:

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

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

When the UK is in the position of Country X (the payer jurisdiction) then section 259CC 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 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 section259CB (9) TIOPA 2010.

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

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 a provision equivalent to the counteraction at section 259CC 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 section 259CD 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 also apply where the UK is in the position of both Country X and Country Y i.e. where the transaction is not cross-border. To the extent the counteraction at section 259CC TIOPA 2010 has not fully addressed the hybrid or otherwise impermissible deduction/ non-inclusion mismatch then the counteraction at section 259CD TIOPA 2010 will be applied to Co. 1.

Reasonable Supposition:

If the taxpayer subsequently proves to HMRC's satisfaction that either:

a) No hybrid or otherwise impermissible deduction/ non-inclusion mismatch actually arises, or

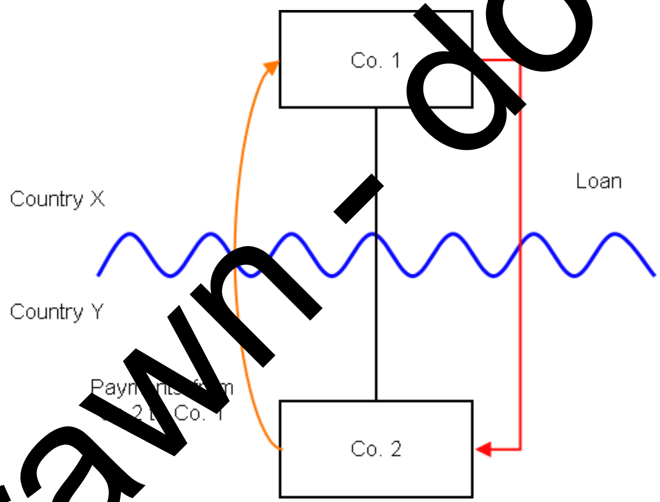
b) The actual hybrid or otherwise impermissible deduction/ non-inclusion mismatch which arises is different to the one reasonably expected to arise,

then S259J permits the reasonably quantified hybrid or otherwise impermissible deduction/ non-inclusion mismatch to be revised on a just and reasonable basis (subject to any time limits).

Hybrid and Other Mismatches from Financial Instruments

Example 3.2 (based on OECD example 1.02): Interest payable under a Hybrid Financial Instrument eligible for partial exemption

This example looks at situations where a company makes a payment to its parent company, which in the payer jurisdiction is treated as a payment of interest, and in the payee jurisdiction is treated as a dividend receipt, which in the recipient jurisdiction is partially exempt from tax.



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.

Neither Co.1 nor Co.2 satisfy any of the conditions within section 259CF (2) TIOPA 2010

Analysis - Applying the tests in section 259CA 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 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 S259K. 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 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.2 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 company are within the charge to corporation tax, Condition B would be 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 payment?

Given the facts above, 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.

This mismatch does not arise solely for an excepted reason in section 259BF (2) TIOPA 2010.

As such, there is a hybrid or otherwise impermissible deduction/non-inclusion mismatch which is attributable to a feature of the Loan – being the interaction 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 would 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 are related within section 259KB TIOPA 2010 and therefore Condition D is satisfied. There is thus no need to consider further the other parts of the condition.

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)

Where the UK is in the position of Country Y (the payer jurisdiction) then section 259CC 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 section 259CC 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.

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

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 section 259CC TIOPA 2010, then no further action will be taken by the UK.

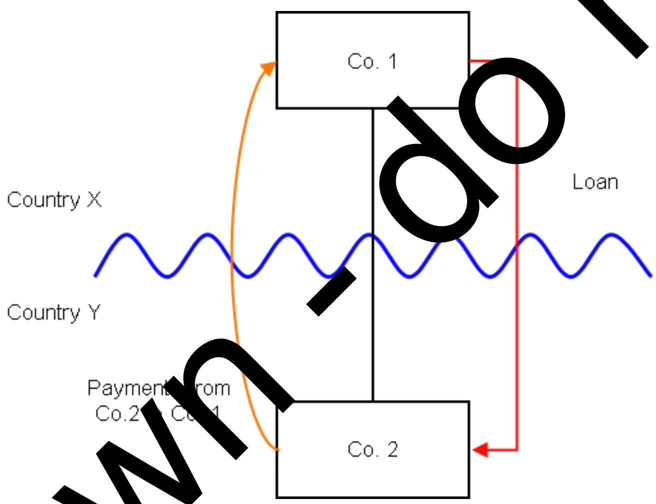
If however, under the law of Country Y, the hybrid or otherwise impermissible deduction/ non-inclusion mismatch has not been fully addressed, then the section 259CD TIOPA 2010 will apply and the UK will counteract the remaining hybrid or otherwise impermissible deduction/ non-inclusion mismatch by including that amount as income arising for the counteraction period.

This treatment will also apply 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 section 259CC TIOPA 2010 has not fully addressed the hybrid or otherwise impermissible deduction/ non-inclusion mismatch in Co.2 then the counteraction at section 259CD TIOPA 2010 will be applied to Co.1.

Hybrid and Other Mismatches from Financial Instruments

Example 3.3 (based on OECD example 1.03): Interest payment under a hybrid financial instrument that is undertaxed (by means of a reduced rate)

This example looks at the situation where receipt under a hybrid financial instrument receipt is subject to a reduced rate of tax by the recipient country because of its treatment as a dividend.



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 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 rate applicable to ordinary income.

Neither Co.1 nor Co.2 satisfy any of the conditions within section 259BF (2) TIOPA 2010.

Analysis - Applying the tests in section 259CA 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 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 which therefore falls within the definitions provided in section 259K 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?

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 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.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?

Given the facts above, 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 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).

This mismatch does not arise solely for an excepted reason in section 259BF (2) TIOPA 2010.

There is therefore a hybrid or otherwise impermissible deduction/ non-inclusion mismatch which is attributable to a feature of the Loan – being the interaction 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 would operate to make the distribution receipt either wholly taxable or wholly exempt – it would not treat it as subject to a reduced rate of tax. 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). The dividend exemption rules would take precedence over the counteractions below as once applied there would be no remaining hybrid or otherwise impermissible deduction/non-inclusion mismatch to be counteracted

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 section 259KB TIOPA 2010 and Condition D is satisfied. There is therefore no need to consider the other parts of the condition.

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:

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

Co.1 in Country X will have been charged a lower rate applicable to dividend on the receipt Co.2 will thus reduce the amount of the allowable deduction 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 means of the formula in section 259CB (9) TIOPA 2010.

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 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.

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), section 259CC 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 above formula. This amount is the amount disallowed in Co.2 by s295CC.

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

Where the UK is in the position of Country X (the payee jurisdiction) if (under the law of Country Y) the deduction to Co.2 has been fully counteracted under the provision equivalent to the counteraction at section 259CC 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 section 259CD 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 treatment also apply where the UK is in the position of both Country X and Country Y. i.e. where the transaction is not cross border. To the extent the counteraction at section 259CC TIOPA 2010 has not full addressed the hybrid or otherwise impermissible deduction/ non-inclusion mismatch then the counteraction at section 259CD TIOPA 2010 will be applied to Co.1.

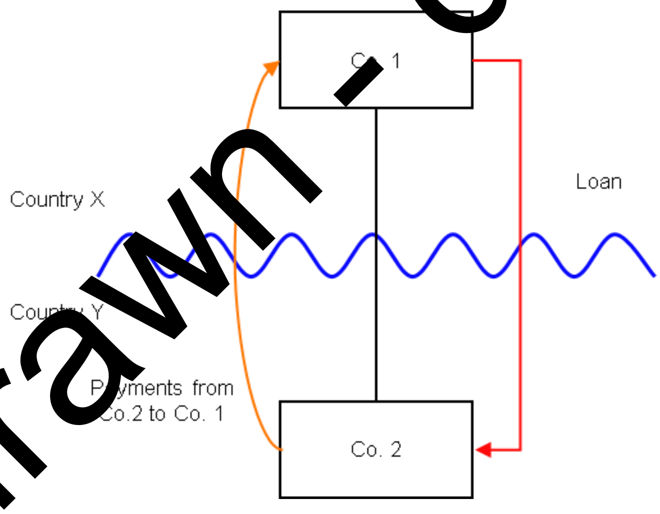
Hybrid and Other Mismatches from Financial Instruments

Example 3.4 (based on OECD example 1.06): Interest payment to a person established in a no-tax jurisdiction

This example consider the situation where a mismatch arises for one of the permitted reasons listed in section 259BF (2) TIOPA 2010. The hybrid mismatch rules are not intended to apply to these situations, and so there will be no hybrid or otherwise impermissible deduction/ non-inclusion mismatch.

This is contrasts with situations where the mismatch arises because of the terms or a feature of the financial instrument itself, and it is these latter situations which the rules are intended to cover.

The permitted reason which applies in this example relates to a jurisdiction which does not have a tax regime for corporate income tax. . The other permitted reasons are within section 259BF (2) TIOPA 2010.



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

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

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.

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

Analysis:

Co.1 is not charged to tax on the receipt because its residence jurisdiction does not tax income, profit or gains, and this is a permitted reason within section 259BF (2)(a) TIOPA 2010.

Hybrid and Other Mismatches from Financial Instruments

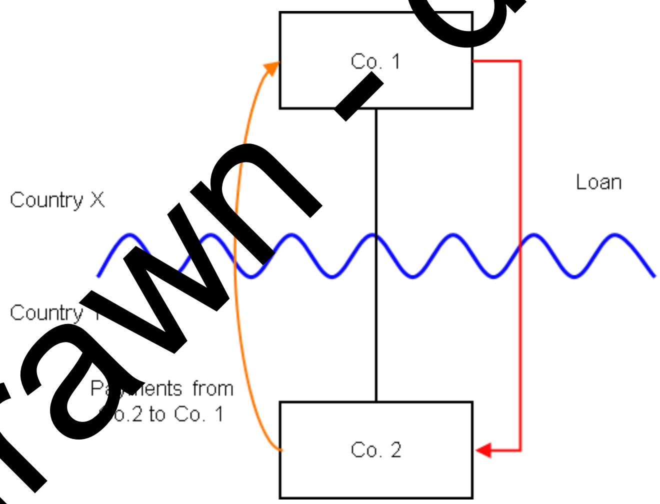
Example 3.5 (based on OECD example 1.07): Interest payment to a person established in a territorial tax regime

This example looks at the situation where a mismatch arises for one of the permitted reasons listed in section 259BF (2) TIOPA 2010. The hybrid mismatch rules are not intended to apply to such situations.

This contrasts with situations where the mismatch arises because of the terms or a feature of the financial instrument itself, and it is these latter situations which the rules are intended to cover.

The permitted reason which applies in this example relates to a territorial tax regime.

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.

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

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

Analysis:

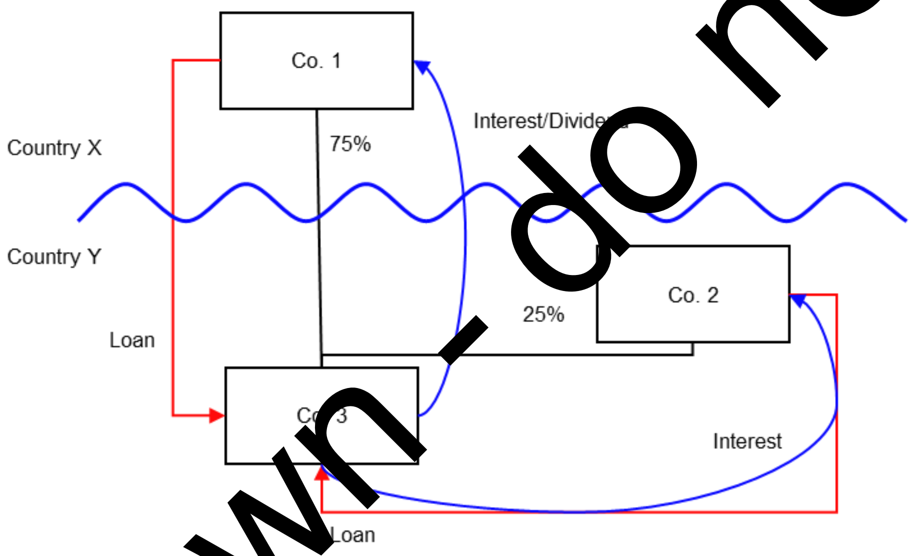
Co.1 is exempt from tax because of a permitted reason within section 259BF (2)(b) TIOPA 2010, and no counteraction is required.

Hybrid and Other Mismatches from Financial Instruments

Example 3.6 (based on OECD example 1.12): Debt issued in proportion to shares re-characterised as equity

This example highlights a situation in which there might be two or more different treatments of seemingly similar transactions, depending on the individual circumstances of the companies involved.

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.

Country Y treats the loan 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 loan is established by reference to the equity held, Country X treats the loan as equity and interest payments as returns on equity.

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

Neither Co.1 nor Co.3 satisfy any of the conditions within section 259BF (2) TIOPA 2010 (none of the permitted exceptions apply).

Analysis - Applying the tests in section 259CA 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 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 section 259N TIOPA 2010. Condition A is therefore satisfied.

Condition B: Are Co.3 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 CT, therefore Condition B is therefore satisfied.

If the UK is Country Y, Co. 2 is a payee and Co. 3 is the payer. Both are within the charge to corporation tax and therefore Condition B is satisfied.

If the UK is neither Country X nor Country Y then this condition would not be satisfied as none of the companies would be within the charge to corporation tax.

If this is a fully domestic transaction (where all three companies are within the charge to corporation tax) Condition B would be satisfied. In such an event, however, the structure of the loan agreements between Co. 3 and Co. 1 and Co. 2 respectively would need to differ, for their tax treatment to be as differ as in this example.

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 facts above, it is reasonable to suppose Country Y will permit Co.3 a deduction (the relevant deduction) for the payment of interest against its ordinary income.

It is also reasonable to suppose from the facts presented that Country X will treat the "dividend" received by Co. 1 as exempt from tax, and therefore none of that receipt will be brought within the charge to tax as ordinary income.

As this mismatch does not arise solely for a permitted reason in section 259BF(2) TIOPA 2010, there is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch, which is attributable to a feature of the loan in Country X and Country Y. The quantum of the mismatch will be to the extent of the payments from Co.3 to Co. 1.

Condition C is therefore satisfied.

Note: Where the UK is in the position of Country X then the Distribution Exemption rules at section 931D(c) or section 931B(c) CTA 2009 in the case of small companies 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). The application of the Distribution Exemption rules 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 there a structured arrangement?

As Co.1 owns 75% of the shares in Co.3 the companies are related parties within section 259KB TIOPA 2010 and therefore Condition D is satisfied. There is no need to consider the other parts of the condition.

All the conditions are satisfied to characterise the part of the arrangement involving the payments from Co. 3 to Co.1 as a hybrid or otherwise impermissible deduction/ non-inclusion mismatch. The relevant counteractions therefore 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)

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 an interest receipt.

However, as Country X treats the interest 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 that portion of the payment made by Co. 3.

Where the UK is in the position of the payer jurisdiction (i.e. Country Y), then section 259CC TIOPA 2010 will apply and Co.3's allowable deduction in relation to the payments of interest will be restricted by the apportioned amounts payable to Co.1 (which is treated as exempt from taxation under Country X's laws).

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

In this example, where the UK is in the position of a payee jurisdiction (but not, in this example, also a payer jurisdiction), in which the receipt is regarded as an equity dividend in nature (i.e. Country X), section 259CD TIOPA 2010 must be considered.

If, by reference to the law of Country Y, the apportioned part of 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 section 259CC TIOPA 2010, 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 section 259CD TIOPA 2010 will apply and the UK should counteract the remaining hybrid or otherwise impermissible deduction/ non-inclusion mismatch (as quantified by section 259CD(6)) TIOPA 2010 by including that amount as income arising for the counteraction period.

Reasonable Supposition:

If either Co.3 or Co.1 subsequently prove to HMRC's satisfaction that either:

a) No hybrid or otherwise impermissible deduction/ non-inclusion mismatch actually arises, or

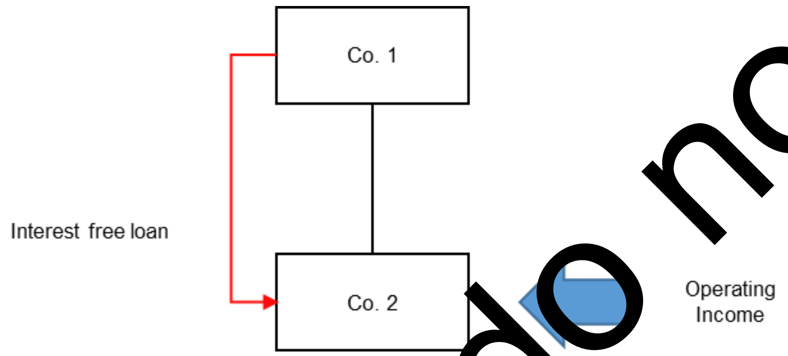
b) The actual hybrid or otherwise impermissible deduction/ non-inclusion mismatch which arises is different to the one reasonably expected to arise,

then S259J permits the reasonably quantified hybrid or otherwise impermissible deduction/ non-inclusion mismatch to be revised on a just and reasonable basis (subject to any time limits).

Hybrid and Other Mismatches from Financial Instruments

Example 3.7 (based on OECD example 1.13): Accrual of deemed discount on interest free loan

Background:



Co.1 (a company resident in the UK) establishes a subsidiary in the same jurisdiction (Co.2).

Co.1 provides Co.2 with capital of 40 which consists of 5 share capital and 35 interest free 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.

However, due to the particular tax accounting treatment adopted by Co.2 in respect of the interest free loan made by another group member, Co.2 is required to split the Loan into two separate components for accounting purposes:

(i) a loan of 20, which Co.2 is treated as having issued to Co.1 at a discount, and

(ii) a deemed equity contribution equal to the amount of that discount (15).

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

Neither Co.1 nor Co.2 satisfy any of the conditions within TIOPA 2010/section 259BF (2) TIOPA 2010 (permitted exceptions).

Co.2 – Assets, Liabilities and Equity	
Assets – Fixed assets	40
Liabilities – Shareholder loan	20
Equity:	
Share capital	5
Other equity	15

Table 1

As is detailed in Table 1 above, Co.2 has treated the interest free sum of 35 as an equity contribution of 15 and a loan of 20. 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		
Asset	**45**		**Income**	**Tax**	**Cash**
Current assets (cash)		5	Operating income	5	5
Fixed assets		40			
			Expenditure		
Liabilities	**23**		Accrued liability on	(3)	
Shareholder loan		23	shareholder loan		
Equity	**22**		**Net return**	**2**	
Share Capital		5			
Other Equity		17			

Table 2

In this case Co.2 treats the deemed discount as accruing on a straight-basis so at the end of Year 1 the shareholder Loan is recorded on the balance sheet as 23 (an increase of 3).

UK law permits this deemed increase in liabilities to be treated as a current expense in Year 1 so that while Co.2 has operating income of 5 in that year its accounts show a net return (increase in equity) of only 2.

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 a different tax accounting treatment from Co.2 and does not 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 by Co.1.

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

Analysis - Applying the test in section 259CA TIOPA 2010:

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 section 259K 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 bifurcation accounting approach and been within the charge to tax in Country Y. Therefore the accrued expense satisfies the definition of a quasi-payment within section 259BB (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, this 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 payment?

Given the facts 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.

This mismatch does not arise solely for a permitted reason in section 259BF (2) TIOPA 2010.

As such, there is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch which is attributable to a feature of the Loan.

Note: It is likely in this case that the Group Mismatch Scheme rules will apply to address the mismatch (CFM77500 refers). This will take precedence over the hybrid mismatch 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 within section 259NB TIOPA 2010 and therefore Condition D is satisfied. There is no need to consider the other parts of the condition.

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 counteraction applied will depend on whether the legislation is being applied to Co.1 or Co.2.

Counteraction to Co.2 (the payer) (under section 259CC TIOPA 2010)

The deductions claimed would be disallowed in Co.2.

Counteraction to Co.1 (the payee) (under section 259CD TIOPA 2010)

As both companies are UK resident, both payer and payee are UK resident and therefore the primary counteraction under section 259CC TIOPA 2010 would always apply, with the result that the mismatch would be counteracted in Co.2.

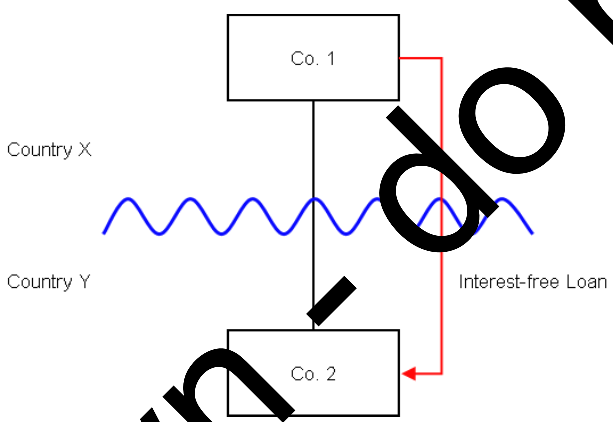
In the event the hybrid or otherwise impermissible deduction/ non-inclusion mismatch was not fully counteracted by section 259CC TIOPA 2010 in Co.2 the counteraction in section 259CD TIOPA 2010 would apply to Co.1. The amount of the remaining hybrid or otherwise impermissible deduction/ non-inclusion mismatch would be included as income arising for the counteraction period.

Hybrid and Other Mismatches from Financial Instruments

Example 3.8 (based on OECD example 1.14): Deemed interest on interest-free loan

This example highlights the need for there to be an actual transfer of economic rights under or in connection with a financial instrument for the legislation to apply. Unilateral payments will not be within the scope of these rules.

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. 2 provides Co. 1 with an interest free loan, 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.

Under the law of Country X, however, the loan is an equity instrument and there is no corresponding adjustment in that country, and 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.

Neither Co.1 nor Co.2 satisfy any of the conditions within section 259BF (2) TIOPA 2010, which sets out permitted reasons for deduction/ non-inclusion mismatches relating to the status of the payee.

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 as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in section 259K 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 may satisfy the definition of a quasi-payment within section 259BB (2) TIOPA 2010.

However, as the deduction is deemed to arise to Co.2 for tax purposes but the deemed interest deduction does not involve a creation or transfer of economic rights, it is specifically excluded from being a quasi-payment.

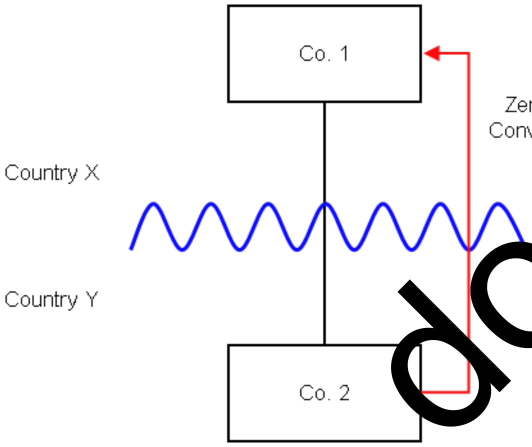
The deemed interest deduction also does not satisfy the definition of a payment within section 259BB (1) TIOPA 2010 as, although the interest free loan is a transfer of money directly from Co.1 to Co.2 and it is in relation to this that the deduction arises, the deduction does not arise to the payer (Co.1) but the payee (Co.2).

Condition A is therefore not satisfied and we do not need to consider further. The hybrids rules do not apply to this arrangement.

Hybrid and Other Mismatches from Financial Instruments

Example 3.9 (based on OECD example 1.16): Differences in valuation of discount on issue of optional convertible note

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 automatically be converted into shares of Co.2 at the option of Co.1.

Both Country X and Country Y laws bifurcate the Note for tax purposes.

The equity premium that arises on conversion of the Note 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 Note and 20 for the share option.

The Note is treated as issued at a discount and Co.2 is entitled to accrue the amount of that discount (100-80) as a deduction for tax purposes over the term of the loan.

Country X adopts the same tax treatment but treats Co.1 as having paid 90 for the Note and 10 for the share option.

Neither Co.1 nor Co.2 satisfy any of the conditions within section 259BF (2) TIOPA 2010, which sets out permitted reasons for deduction/ non-inclusion mismatches relating to the status of the payee.

Analysis - Applying the tests in section 259CA 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 section 259K 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 section 259BB (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.

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 facts above, it is reasonable to suppose the UK 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 equity premium by Country X and Country Y goes beyond a difference in valuation ascribed to a payment being characterised in the same way by both countries. The difference in measurement here has a direct impact on the characterisation of the payments made under the Note. The difference in the valuation of the option component results in a difference in the character and calculation of the underlying payment.

This mismatch does not arise solely for a permitted reason in section 259BF (2) TIOPA 2010.

As such, there is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch which is attributable to a feature of the Loan. The extent of the mismatch is 10.

Condition C is therefore satisfied.

Condition D: Is the payer company also the payee, or are two companies related, or is there a structured arrangement?

As Co.1 owns all the shares in Co.2 the companies are related within section 259KB TIOPA 2010 and therefore condition D is satisfied. There is thus no need to consider any other part of the condition.

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)

Where the UK is in the position of the payer jurisdiction (i.e. Country Y) then section 259CC 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 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 then Co.2's deductions will be restricted by 50% (10 / 20) in each accounting period until maturity. This will be the excess attributable to that period for the purposes of section 259CB (8) TIOPA 2010.

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

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 section 259CC 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 section 259CD 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.

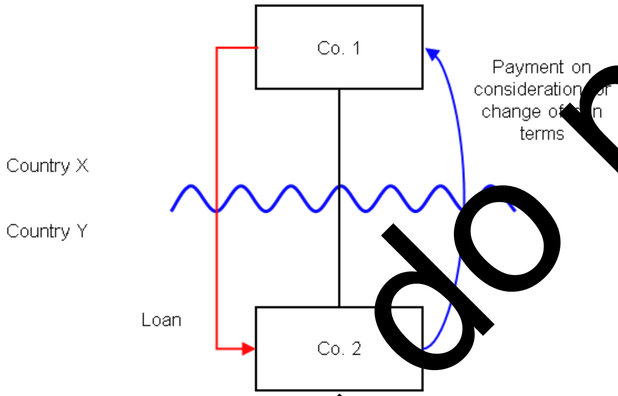
This will be computed in a similar manner to that outlined in the counteraction at section 259CC TIOPA 2010 above if Co.1 also recognises the discount on a straight line basis over the 5 years, that the payment period coincides with their accounting period and that the Note is not converted.

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 section 259CC TIOPA 2010 has not fully addressed the hybrid or otherwise impermissible deduction/ non-inclusion mismatch in Co.2 then the counteraction at section 259CD TIOPA 2010 will be applied to Co.1.

Hybrid and Other Mismatches from Financial Instruments

Example 3.10 (based on OECD example 1.18): Payment in consideration for an agreement to modify the terms of a 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.

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

The effect of this adjustment 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

Neither Co.1 nor Co.2 satisfy any of the conditions within section 259BF (2) TIOPA 2010, which sets out permitted reasons for deduction/ non-inclusion mismatches relating to the status of the payee.

Analysis - Applying the tests in section 259CA TIOPA 2010:

Co.2's payment should be treated as a payment made under the Loan itself. The payment will give rise to a hybrid or otherwise impermissible deduction/ non-inclusion mismatch to the extent it is treated as deductible under the laws of Country Y and is not included in ordinary income under Country X law.

Are the relevant conditions satisfied to fall within the scope of the Hybrid and Other Mismatches from Financial Instruments rules?

Condition A: Is the payment made under, or in connection with, a financial instrument?

The one off payment is considered a payment under section 259BA (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 section 259K 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.

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 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?

The relevant deduction identified in Condition A, and arising to Co.2, exceeds the amount included in the ordinary income of Co.1. As such, there is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch and this is attributable to a feature of the Loan.

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.

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 a claim has been made under section 259CB(5)(b)(i) TIOPA 2010 and this delay is considered just and reasonable, that amount will be compared to the relevant deduction to establish the extent (if any) of the hybrid or otherwise impermissible deduction/ non-inclusion mismatch.

(If the delay is not deemed just reasonable then, should it be brought within the charge to tax in Country X, a Reasonable Supposition adjustment within section 259J TIOPA 2010 may be made).

Condition D: Is the payer company also the payee; or are the two companies related, or is there a structured arrangement?

As Co.1 owns all the shares in Co.2, the companies are related within section 259KB TIOPA 2010 and therefore condition D is satisfied. There is thus no need to consider any other part of the condition.

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)

Where the UK is in the position of the payer jurisdiction (i.e. Country Y) then section 259CC 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.

Note: In this case the interest rate is stated to be high so it may be worth considering if it is at arm's length and whether the Transfer Pricing rules should be considered, in precedence to these rules, to check the value of the deductions both here and on any earlier interest payments.

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

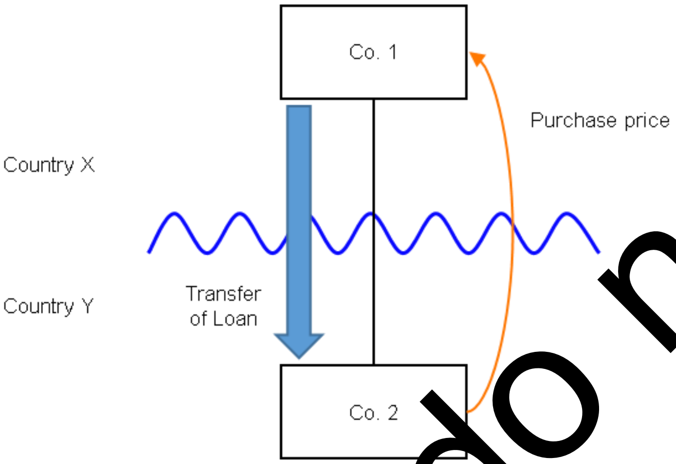
As the UK is in the position of the payee jurisdiction (i.e. Country X) then if, under the law of Country Y, the deduction in Co.2 has been fully counteracted under the provision equivalent to the counteraction at section 259CC TIOPA 2010, then no further action will be taken by the UK.

If however, under the law of Country Y, the hybrid or otherwise impermissible deduction/ non-inclusion mismatch has not been fully addressed then section 259CD 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 treatment will also apply 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 section 259CC TIOPA 2010 has not fully addressed the hybrid or otherwise impermissible deduction/ non-inclusion mismatch in Co.2 then the counteraction at section 259CD TIOPA 2010 will be applied to Co.1.

Hybrid and Other Mismatches from Financial Instruments

Example 3.11 (based on OECD example 1.20): Release of a debt obligation not a payment



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.

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.

The amount of debt forgiven is treated as deductible under Country X law but is not treated as income by Co.2.

Analysis – Applying the tests in section 259CA TIOPA 2010:

The forgiveness of debt between Co.1 and Co.2 is a transfer of money's worth and in connection with the Loan. However, the deduction is not by reason of a term or feature of the Loan and therefore does not give rise to a hybrid or otherwise impermissible deduction/ non-inclusion mismatch.

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 the payment made under, or in connection with, a financial instrument?

The forgiveness is considered a payment under section 259BA (1) TIOPA 2010 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.

It is made in connection with the Loan, which would be defined as a financial instrument for the purposes of the section 259K 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 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.

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. This is attributable to a feature of the Loan and therefore there is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch.

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: Is the payer company also the payee; or are the two companies related, or is there a structured arrangement?

As Co.1 owns all the shares in Co.2 the companies are related within section 259KB TIOPA 2010 are met, and therefore condition D is satisfied. There is thus no need to consider any other part of the condition.

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)

Where the UK is in the position of the payer jurisdiction (i.e. Country X) then section 259CC 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)

As the UK is in the position of the payee jurisdiction (i.e. Country Y) if, (under the law of Country X), the deduction in Co. has been fully counteracted under the provision equivalent to the counteraction at section 259CC TIOPA 2010, then no further action will be taken by the UK.

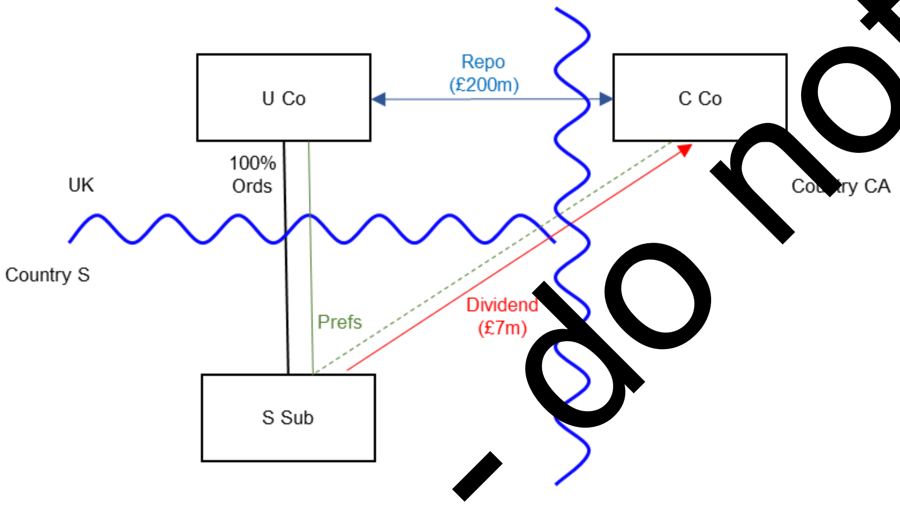
If however, under the law of Country X, the hybrid or otherwise impermissible deduction/ non-inclusion mismatch has not been fully addressed then section 259CD TIOPA 2010 will apply and the UK will counteract the remaining hybrid or otherwise impermissible deduction/ non-inclusion mismatch by including that amount as income arising for the counteraction period.

This treatment will also apply where the UK is in the position of both Country X and Country Y i.e. where the transaction is not cross border. To the extent the counteraction at section 259CC TIOPA 2010 has not fully addressed the hybrid or otherwise impermissible deduction/ non-inclusion mismatch in Co.1 then the counteraction at section 259CD TIOPA 2010 will be applied to Co.2.

Hybrid Transfer Deduction/ Non-Inclusion Mismatches

Example 4.1 (based on OECD example 1.31): Repo transaction creating an in-substance borrowing

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.

Three Scenarios are considered in this example:

<u>Scenario A</u>

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.

<u>Scenario B</u>

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.

<u>Scenario C</u>

3.9% represents an arm's length borrowing cost for U Co.

Country CC 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 section 259DA TIOPA 2010:

Are the Hybrid Transfer/Non-inclusion Mismatches rules applied?

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 at section 259DB(2) TIOPA 2010.

The arrangement would be a 'repo' 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 for Scenarios A, B and C.

Note: 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 section 259(3) (b) TIOPA 2010 *or* the 'dual treatment condition' in section 259DB (3) (a) TIOPA 2010 is satisfied.

The Prefs satisfy the definition of a financial instrument provided in S259K TIOPA 2010, being a 'financial instrument' within that meaning for the purposes of UK generally accepted accounting practice.

Substitute Payment, as defined at section 259DB (5) TIOPA 2010:

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 provided at section 259DB (5) TIOPA 2010.

Dual Treatment Condition, as defined at section 259DB (4) TIOPA 2010:

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 section 259DB (4) (a) TIOPA 2010 is satisfied in all scenarios.

In relation to <u>Scenario A</u> 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 section 259DB (4) (b) TIOPA 2010 are *not* met.

In relation to <u>Scenario B</u> 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 section 259DB (4) (b) TIOPA 2010 are met and the 'dual treatment condition' in section 259DB (4) TIOPA 2010 is satisfied.

In relation to <u>Scenario C</u>, whilst Country CC 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 section 259DB (4) (b) TIOPA 2010 are met and the 'dual treatment condition' in section 259DB (4) is satisfied.

The 'dual treatment condition' in section 259DB (4) TIOPA 2010 is therefore satisfied in Scenario B and C but not Scenario A.

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 purpose 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 section 259BB (2) TIOPA 2010 and Condition B is therefore met for Scenarios A, B and C.

Condition C: Is U Co within the charge to corporation tax for a relevant payment period?

It is clear that Condition C in section 259DA (4) TIOPA 2010 is satisfied for Scenarios A, B and C because U Co is within the charge to CT.

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 facts above it is reasonable to suppose in <u>all</u> Scenarios that the UK will permit U Co a deduction (the relevant deduction) for the interest accrual against its ordinary income

In relation to <u>Scenario A</u>, 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 in Scenario A.

Note: It might be unusual for lending to be structured in such an elaborate manner in the absence of some tax or other benefit.

In relation to <u>Scenario B</u> it is reasonable to suppose (based on the background above) 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 section 259DB (4) TIOPA 2010 being met or the payment being a Substitute Payment within section 259DB (5) TIOPA 2010. Condition D is therefore satisfied in Scenario B and there is a hybrid transfer deduction/non-inclusion mismatch.

In relation to <u>Scenario C</u> 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 at section 259DC(9) TIOPA 2010 and this is by reason of either the 'dual treatment condition' within section 259DB(4) TIOPA 2010 being met or the payment being a Substitute Payment within section 259DB(5) TIOPA 2010. Condition D is therefore satisfied in Scenario B and there is a hybrid transfer deduction/non-inclusion mismatch.

Condition D is therefore satisfied in Scenarios B and C, but not Scenario A.

Condition E: Is U Co also C Co, are they related, or is the arrangement a structured arrangement?

As Condition D is not satisfied in respect of <u>Scenario A</u>, there is no need to consider it further.

In relation to both <u>Scenario B</u> and <u>Scenario C</u> 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 section 259DA (7) TIOPA 2010, so condition E is satisfied.

Counteractions:

Scenario A

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 section 259DD TIOPA 2010.

Scenario B

All the Conditions are satisfied for there to be a hybrid transfer deduction/non-inclusion mismatch, the extent of which (as defined in section 259DC (11) TIOPA 2010) is the full amount of the relevant deduction.

As the UK is only in the position of the payer then the only relevant counteraction is section 259DD TIOPA 2010. U Co will be denied a deduction against its ordinary income for the entire interest accrual (£7m).

Scenario C

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 section 259DC(12) TIOPA 2010.

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.

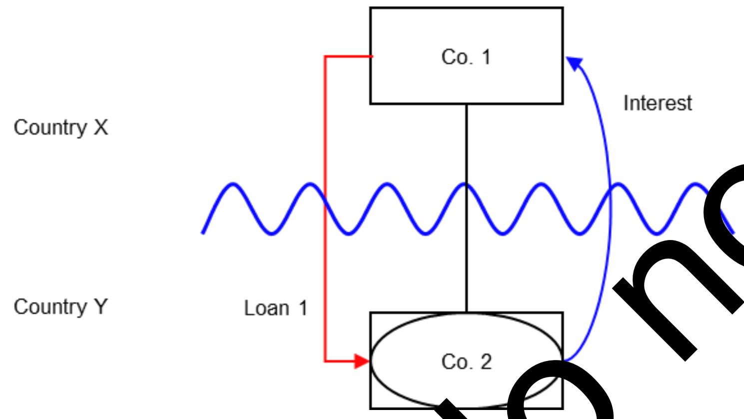
- R is the rate (expressed as a %) at which the relevant tax is charged on the ordinary income in which the under taxed amount is included. This is the lower rate being applied to the dividend income by reason of the underlying tax credit.

As the UK is only in the position of the payer then the only relevant counteraction is section 259DD 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.

Hybrid Payer Deduction/ Non-Inclusion Mismatches

Example 5.1 (based on OECD example 3.1): Interest payable by a hybrid payer

Background:



Co. 1 is resident in Country X.

Co. 1 establishes Co. 2 (resident in Country Y).

Co. 2 is treated as a separate person for tax purposes in Country Y but as a disregarded entity for tax purposes by Country X.

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, but Country X does not tax the interest receipt as it sees the loan as taking place intra company (between Co. 1 and Co. 2, which Country X sees as a branch of Co. 1). Accordingly there is a deduction/non-inclusion mismatch.

Neither Co. 1 nor Co. 2 satisfy any of conditions within section 259BF(2) TIOPA 2010 (i.e. they do not fall within the permitted reasons for a deduction/non-inclusion mismatch).

Analysis - Applying the tests in section 259EA TIOPA2010:

Do the interest payments from Co. 2 to Co. 1 under Loan 1 satisfy the relevant conditions to fall within the scope of the Hybrid Payer Deduction/ Non-Inclusion Mismatch rules?

Condition A: Are the payments made under, or in connection with, an arrangement?

A transaction took place resulting in an interest payment directly from Co. 2 (payer) to Co. 1 (payee).

Condition A is therefore satisfied.

Condition B: Is the payer a hybrid entity?

Co. 2 is regarded as a person under the tax law of Country Y. Income or profits of Co. 2 are also treated as the income or profits of Co. 1, a different person, under the tax law of Country X. Co. 2 is therefore a hybrid entity per section 259BE TIOPA 2010 and Condition B is satisfied.

Condition C: Is the hybrid payer or payee within the charge to corporation tax for a relevant payment period?

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

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

Condition C will therefore be satisfied as long as the UK is either Country X or Country Y.

If the UK is neither Country X nor Country Y then this condition would not be satisfied as neither Co. 1 nor Co. 2 would be within the charge to corporation tax.

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 facts above, it is reasonable to suppose that Co. 2 will be permitted the interest deduction (relevant deduction) against its ordinary income.

It is also reasonable to suppose that Co. 1 will not include the interest received from Co. 2 in its ordinary income.

It is therefore reasonable to suppose that the relevant deduction of Co. 2 will exceed the sum of amounts included in the ordinary income of Co. 1. This excess is by reason of Co. 2 being a hybrid entity. Condition D is satisfied and this excess will represent the extent of the hybrid payer deduction/non-inclusion mismatch.

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 within the definition at section 259KA TIOPA 2010, and therefore this condition is satisfied.

All the conditions are satisfied to characterise the arrangement involving the payment of interest under Loan 1 as a Hybrid Payer Deduction/Non-Inclusion Mismatch and the relevant counteractions therefore need to be considered.

Counteractions:

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

Where the UK is in the position of Country Y (the payer jurisdiction) then section 259EC TIOPA 2010 will apply. The deduction for the full interest payment is denied to Co. 2 in the payment period.

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

Where the UK is in the position of Country X (the payee jurisdiction), and it is reasonable to suppose that the hybrid payer deduction/non-inclusion mismatch has not been fully counteracted by Country Y under the counteraction at section 259CC TIOPA 2010, then section 259ED TIOPA 2010 will apply. Income equal to the quantum of the hybrid payer deduction/non-inclusion mismatch is treated as income arising to Co. 1 for the counteraction period.

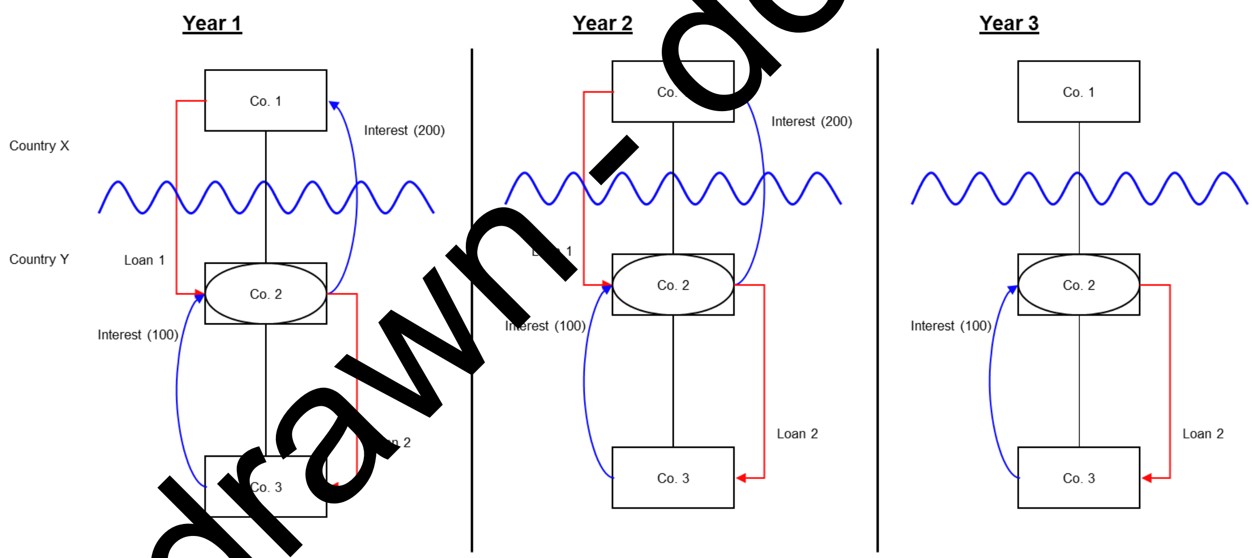
Hybrid Payer Deduction/ Non-Inclusion Mismatches

Example 5.2 (based on OECD example 3.1): Interest payable by a hybrid payer

This example expands upon Example 3.1 to show how hybrid or otherwise impermissible deduction/ non-inclusion mismatches denied under the Hybrid Payer Deduction/ Non-Inclusion Mismatches rules may be utilised in later accounting periods, and specifically when the Hybrid Payer Deduction/ Non-Inclusion Mismatches situation is no longer present at the point of utilisation.

In this example the receipts on Loan 2 are taxable as ordinary income on both Co.1 and Co.2, therefore those receipts satisfy the definition of dual inclusion income for the purposes of the Hybrid Payer Deduction/ Non-Inclusion Mismatches rules.

Background:



Year 1:

In the above scenario, section 259EC (2) TIOPA 2010 serves to restrict the interest deduction from Co.2 to Co.1 to the extent that it exceeds dual inclusion income.

In this example:

- Co.1 and Co.2 have corresponding payment periods

- the relevant hybrid or otherwise impermissible deduction/ non-inclusion mismatch under Loan 1 is 200

- 100 is payable under Loan 2, which satisfies the definition of dual inclusion income as it is included in the ordinary income of both Co.1 and Co.2

The resulting denied deduction under section 259EC (2) TIOPA 2010 is restricted to the extent that the hybrid or otherwise impermissible deduction/ non-inclusion mismatch exceeds the dual inclusion income. In this example the restricted deduction is therefore 100 (200 – 100).

This restricted deduction is carried forward per section 259EC (3)(a) TIOPA 2010 to subsequent periods of the hybrid payer and may be deducted against future dual inclusion income.

Year 2:

- the relevant hybrid or otherwise impermissible deduction/ non-inclusion mismatch arising under Loan 1 in Year 2 remains at 200

- In Year 2 100 is payable under Loan 2, which still satisfies the definition of dual inclusion income as it is included in the ordinary income of both Co.1 and Co.2

Again, the resulting denied deduction under section 259EC (2) TIOPA 2010 is restricted to the extent that the hybrid or otherwise impermissible deduction/ non-inclusion mismatch exceeds the dual inclusion income. In this example the restricted deduction is therefore 100 (200 – 100).

This restricted deduction is added to the 100 restriction arising in Year 1, totalling 200 to be carried forward per section 259EC (3)(a) TIOPA 2010 to subsequent periods of the hybrid payer available to deduct against future dual inclusion income.

Year 3:

- Loan 1 has ceased and there is no longer any hybrid or otherwise impermissible deduction/ non-inclusion mismatch

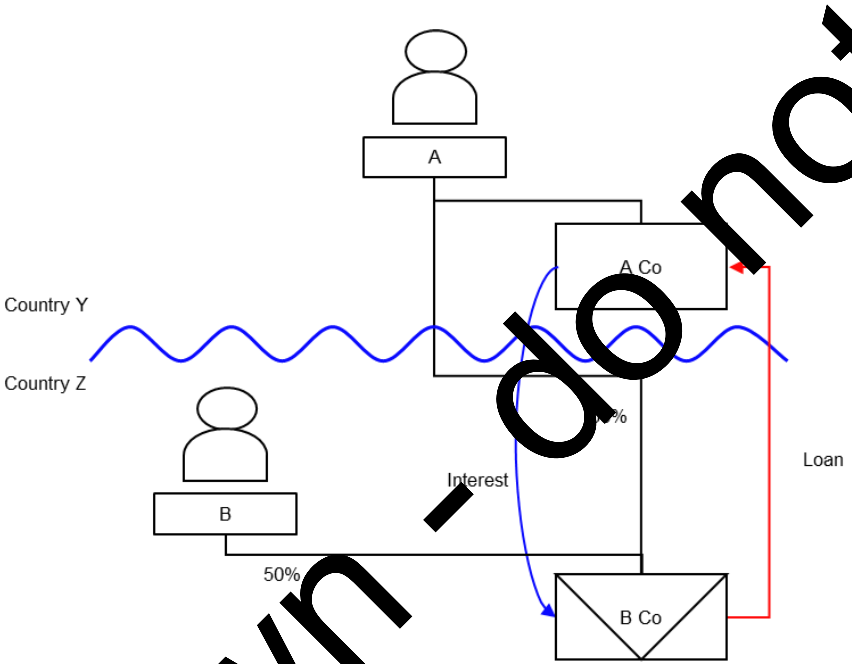
- In Year 3 100 is payable under Loan 2, which still satisfies the definition of dual inclusion income as it is included in the ordinary income of both Co.1 and Co.2

Co.2 is still suffering 100 dual inclusion income, and may utilise 100 of the restricted deduction carried forward (200) under section 259EC (3) (b) TIOPA 2010. The 100 remaining would continue to be carried forward per section 259EC (3) (a) TIOPA 2010 to subsequent periods of the hybrid payer available to deduct against future dual inclusion income.

Hybrid Payee Deduction/ Non-Inclusion Mismatches

Example 6.1 (based on OECD example 4.2): Payment to a reverse hybrid (hybrid payee) that is partially excluded from income

Background:



Two individuals, one resident in Country Y (Individual A) and one in Country Z (Individual B) 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, and is recognised in Country Y as a person for tax purposes under the law of Country Y, but treated in Country Z as transparent (i.e. its income or profits are treated in Country Z as those of A Co.).

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 receivable to Individual A and half to Individual B.

Country Z does not subject to tax foreign source income to the extent that it is attributable to a non-resident. The receipt is therefore not charged to tax in Country Z to the extent that the receipt is attributable to Individual A.

Individual B is subject to tax at the full marginal rate applicable to interest income in Country Z.

Country Y recognise B Co as a person for tax purposes and Individual A is not subject to tax on distributions from B Co.

Analysis:

To what extent is the interest payment made by A Co to B Co caught by the hybrid payee deduction/ non-inclusion cases rules within section 259F TIOPA 2010:

Condition A: Is a payment made under, or in connection with, an arrangement?

The interest payment is a transfer of money from A Co to B Co and it is made under the arrangement which includes the contributions to B Co, the Loan and the attributions of that interest to Individual A and Individual B.

Condition A is met.

Condition B: Is the payee a hybrid entity?

B Co is the payee and is regarded as a person for tax purposes under the law of Country Y. However, Country Z treats B Co.'s interest receipts as the income of Individual A and Individual B for tax purposes.

B Co is therefore a hybrid entity and Condition B is met.

Condition C: Is the payer within the charge to corporation tax for the payment period or is the hybrid payee a limited liability partnership?

If the UK is in the position of Country Y, A Co is the payer and is within the charge to corporation tax therefore Condition C would be met.

If the UK is in the position of Country Z, then if B Co is a limited liability partnership Condition C would be met.

If neither of the above applies, then Condition C will not be met.

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).

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. This mismatch arises by reason of B Co being a hybrid entity: had the payment been made directly by A Co to Individual A, there would be no hybrid payee deduction/non-inclusion mismatch as Country Y would have required the amount to be included as the ordinary income of Individual A.

Condition E – Are the payer and the hybrid payee in the same control group or is it a structured arrangement?

A Co (payer) and B Co (reverse hybrid) are all part of the same control group as Individual A who holds 50% of the voting power both companies.

(Even if Individual A were to hold less than 50% the voting power in of 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.

All the conditions are satisfied to characterise the arrangement involving the payment of interest under Loan 1 as a Hybrid Payee Deduction/ Non-Inclusion Mismatch and the relevant counteractions therefore need to be considered.

Counteractions:

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 jurisdiction)

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).

Counteraction where a hybrid payee is a UK Limited Liability Partnership ("LLP")

Where B Co is an LLP the UK will be in the position of Country Z. If the extent of the hybrid payee deduction/non-inclusion mismatch has not already been fully counteracted in Country Y, then the remaining quantum of the mismatch (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 at all, then the counteraction under section 259FD TIOPA 2010 will apply to the full amount attributed to Individual A.

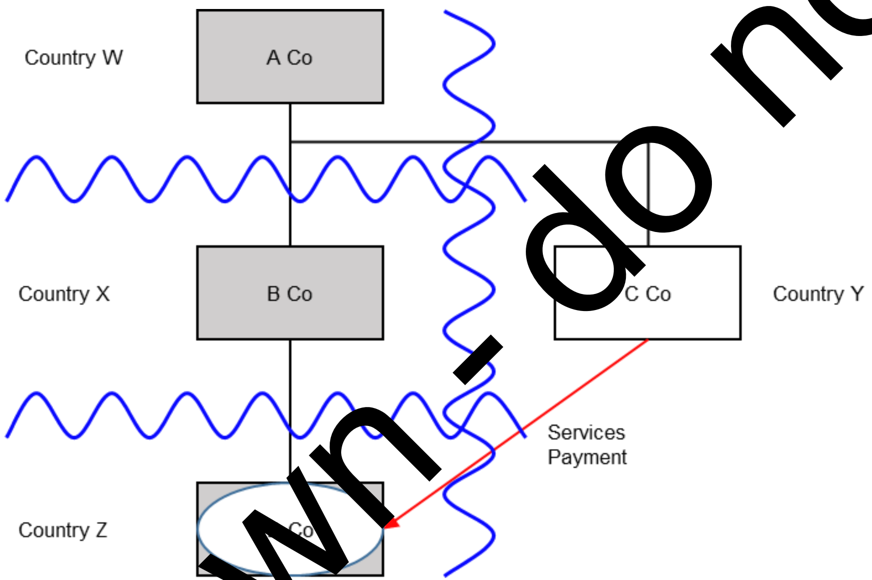
This income will be brought within the charge to corporation tax on B Co under Chapter 8 of Part 10 of CTA 2009.

Hybrid Payee Deduction/ Non-Inclusion Mismatches

Example 6.2 (based on OECD example 4.3): Payment to a reverse hybrid included under a CFC regime

This example illustrates where a deduction/ non-inclusion outcome does not give rise to a mismatch due to the income being included in the ordinary income of another jurisdiction via a Controlled Foreign Company (CFC) regime. "CFC" has the same meaning as in section 371VA TIOPA 2010.

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. D Co receives no other income.

Country W's CFC regime treats services 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.

Does a hybrid payee deduction/non-inclusion mismatch arise per section 259FA TIOPA 2010?

If so:

a) Should the counteraction at section 259FC TIOPA 2010 apply to deny the deduction where the UK is Country Y; or

b) Should the counteraction at section 259FD TIOPA 2010 apply to charge the service payment to corporation tax where D Co is a hybrid entity?

Analysis - Applying the tests at section 259FA TIOPA 2010:

Condition A: Is a payment 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 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. However, 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 within the charge to corporation tax for the payment period **or** is there a hybrid payee?

In the event the UK is in the position of Country Y (question a), C Co is the payer and is within the charge to corporation tax. Therefore Condition C is satisfied.

In the event that D Co is a hybrid payee Condition C is satisfied.

Condition D: Is it reasonable to suppose that there is, or will be, a hybrid payee deduction/non-inclusion mismatch per section 259FB TIOPA 20?

It is reasonable to suppose that Country Y will permit C Co a full deduction for the payment for services (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.

The excess of the deduction over the amount not included is equal to the total payment for services. The mismatch arises entirely by reason of D Co being a hybrid entity. Therefore, analysing the situation between C Co and D Co, there is a hybrid payee deduction/non-inclusion mismatch and Condition D would be satisfied.

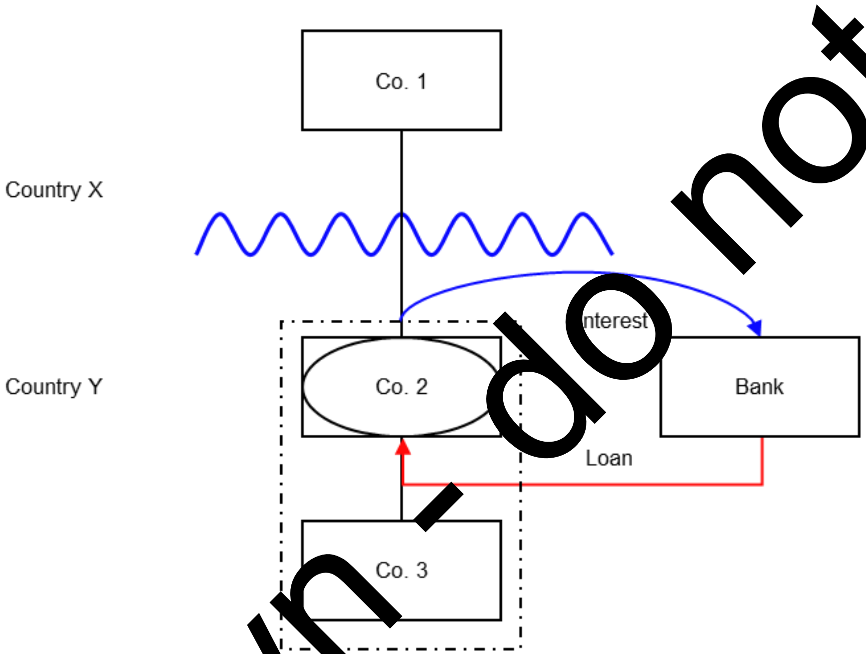
However, A Co subjects the Service Payment to a CFC charge (a UK CFC charge or a foreign equivalent). Where there is a hybrid payee deduction/non-inclusion mismatch between the parties that are directly involved in the transaction, then recognition should be given to any CFC charge suffered on that same receipt per section 259BD 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.

Hybrid Entity Double Deduction Mismatches

Example 7.1 (based on OECD example 6.2): 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 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.

Analysis - Applying the tests in section 259G TIOPA 2010

Does the hybrid entity double deduction mismatch rule 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 ordinary income of a hybrid entity and also from the ordinary income of an investor?

Co. 2 is a hybrid entity. Co. 2's profits are treated as the profits of Co. 1 under Country X's law, but it is regarded as being a 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 ordinary 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: Are either Co. 1 or Co. 2 within the charge to corporation tax for the relevant 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.

Condition C: Are the hybrid payer 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 by virtue of being in the same control group. Condition C is therefore satisfied.

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 (the investor jurisdiction)

Where the UK is in the position of the investor jurisdiction, section 259GB TIOPA 2010 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 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.

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

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 section 259GC TIOPA 2010 will apply.

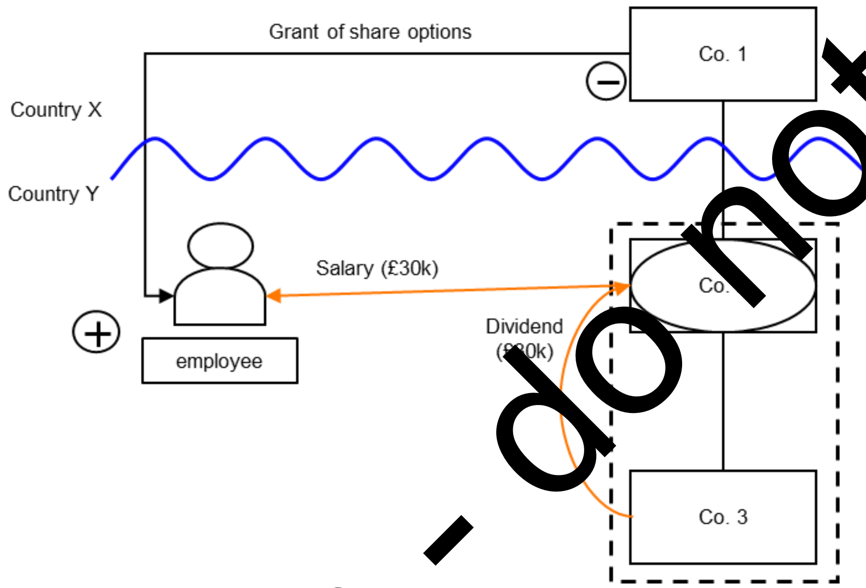
In this case, Country Y should deny a deduction for the hybrid entity double deduction amount to Co. 2 as there is no dual inclusion income to set it off against. The UK will deny Co. 2 from offsetting the deduction against other income and require it to carry forward the excess deduction to utilise against any dual inclusion income arising in subsequent accounting periods.

NB: The same consideration of 'stranded deductions' as above may apply.

Hybrid Entity Double Deduction Mismatches

Example 7.2 (based on OECD example 6.3): Double Deduction Outcome from the 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 as fiscally transparent for tax purposes by Country X.

Co. 2 and Co. 3 are members of the same tax group, 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 section 259GA TIOPA 2010:

Does the payment of salary and grant of share options to the employee give rise to a hybrid payer 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 ordinary income of a hybrid entity and also from the ordinary income of an investor?

Co. 2 is a 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 section 259BE TIOPA 2010, 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 ordinary 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 payer jurisdiction), Co. 2 will receive a £30k deduction against its ordinary 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, and 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 Co. 1 (investor in the hybrid entity) within the charge to corporation tax for a deduction period, or is 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 payer) is within the charge to corporation tax.

If UK is in the position of Country Y, then Co. 2 (the hybrid payer) 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 payer 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 section 259KB TIOPA 2010. Condition C is therefore satisfied.

All the conditions are satisfied to characterise the payment of salary and the granting of the share options as a hybrid payer double deduction mismatch. The relevant counteractions therefore need to be considered.

Counteractions:

Counteraction where UK is in the position of Country X (the investor jurisdiction).

Where the UK is in the position of Country X, section 259GB TIOPA 2010 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 (£30k) and the grant of share options (£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 payer jurisdiction)

Where the UK is in the position of Country Y, and the hybrid entity double deduction amount has not already been fully counteracted then section 259GC TIOPA 2010 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 (30k) and the grant of share options (15k). Co. 2 can carry forward the £45k to subsequent accounting periods.

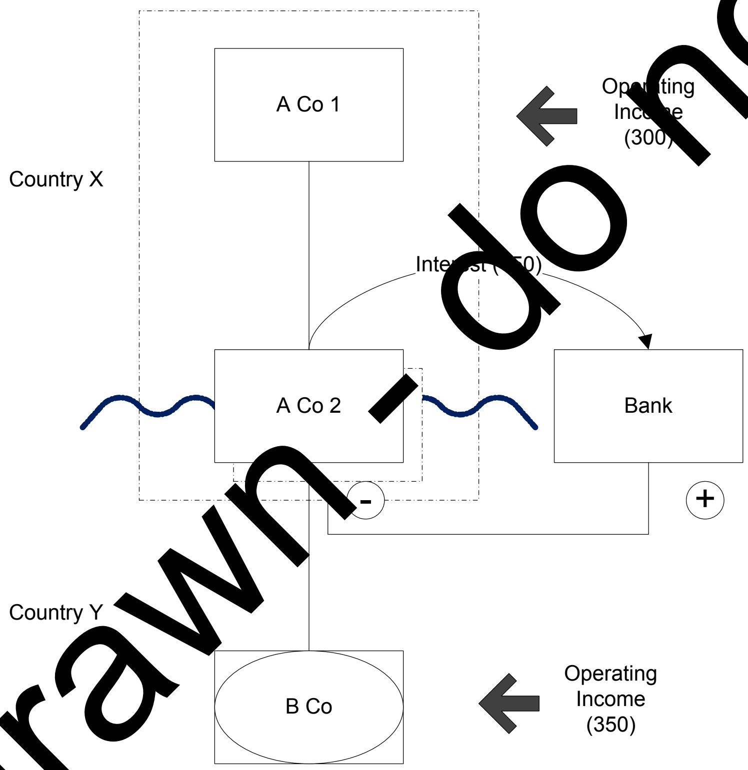
If the share options have not yet been awarded then under UK law they will not be considered as allowable deductions until they have been awarded.

Dual Resident Company Double Deduction Cases

Example 8.1 (based on OECD example 7.1): 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 County 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 A Co 1			Country B 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 table profits are only 350.

Analysis - Applying the tests at section 259HA TIOPA 2010:

Condition A: Is there a company that is a dual-resident company, within the definition at section 259HA (3) TIOPA 2010?

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 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 residence double deduction amount is 150.

As both conditions are satisfied the relevant counteraction needs to be considered.

Counteractions:

The counteraction for dual resident double deduction mismatches is found at section 259HB 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 residence double deduction amount of 150 will be denied. A Co 2 will be permitted to carry forward the 150 under section 259HB (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 section 259HB 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 A Co 1			Country B 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 residence double deduction amount. While this has resulted in double taxation in this example there is no reliable way of determining which jurisdiction has priority in a dual residence double deduction mismatch scenario. 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

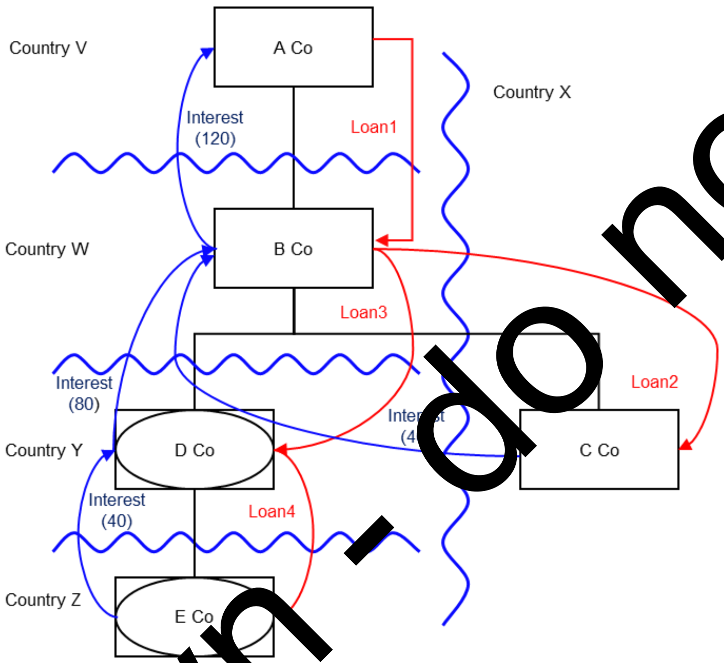
Should the Commissioners for HMRC be satisfied that A Co 2 has ceased to be a dual resident company and has become a resident of the UK, then any stranded deductions (as defined under section 259HB(3) TIOPA 2010) will be permitted when calculating the company's taxable profits in the accounting period 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 section 259HB(4) TIOPA 2010) to carry these deductions forward to subsequent accounting periods for the purposes of calculating taxable total profits.

Imported Mismatches

Example 9.1 (based on OECD example 8.1): Structured imported mismatch rule

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 V) and D Co (resident in Country W)

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 section 259CA TIOPA 2010 and fall within the Hybrid and Other Mismatches from Financial Instruments rules.

Neither Country V nor Country W have adopted an equivalent provision to the rules within Chapter 3 to 8 (TIOPA10), so do not counteract this hybrid or otherwise impermissible deduction/ non-inclusion mismatch which arises under Loan1

B Co on-lends the funds provided under Loan1 to C Co ('Loan2') and D Co ('Loan3').

D Co on-lends 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 section 259IA TIOPA 2010

Are the relevant conditions satisfied to fall within the scope of the Imported Mismatches rules?

Condition A: Are there payments made under, or in connection with, an arrangement?

Loan1, Loan2, Loan3 and Loan4 each constitutes an arrangement and the relevant interest payments are each transfers of money made under them.

Condition A is met.

Condition B: Is there a payer within the charge to corporation tax for a relevant payment period?

As the UK has adopted the Hybrid Financial Instrument Hybrid and Other Mismatches from Financial Instruments rules the assumption is that the UK is not in the position of neither Country V nor Country W, otherwise the relevant counteractions under section 259CC TIOPA 2010 or section 259CD TIOPA 2010 would have been applied to address the hybrid or otherwise impermissible deduction/ non-inclusion mismatch.

In the event the UK is Country X, C Co is a payer and is within the charge to corporation tax.

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

In the event the UK is Country Z, E Co is a payer 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 part of a series of arrangements which are each entered into in pursuance of an 'over-arching arrangement'?

As identified in Condition A - Loan1, Loan2, Loan3 and Loan4 each constitute an arrangement.

Loan4 was made pursuant to Loan3, which was made pursuant to Loan1. This is therefore the 'over-arching arrangement' as defined in section 259IA (5) TIOPA 2010 where the UK is in the position of either Country Y or Country Z.

Loan2 was also made pursuant to Loan1. This is therefore the 'over-arching arrangement' as defined in section 259IA (5) TIOPA 2010 where the UK is in the position of Country X.

Condition D: Under an arrangement within the 'over-arching arrangement' is there a payment in relation to which it is reasonable to suppose that there would be a mismatch which satisfies the conditions in any of Chapters 3 to 8 (TIOPA10)?

As stated above in the Background, the terms of Loan1 are such that they would satisfy the conditions in section 259CA TIOPA 2010 to fall within the Hybrid and Other Mismatches from Financial Instruments rules.

Loan1 is therefore the relevant arrangement and it is within the 'over-arching arrangements'.

Condition D is therefore satisfied for both 'over-arching arrangements' involving Loan2, Loan3 and Loan4.

Condition E: Is it reasonable to suppose that the counteractions in Chapters 3 to 7 (or their foreign equivalent provision) would not apply to fully counteract the relevant mismatch, but if the UK had been in the position of either of the relevant counterparty jurisdictions to the mismatch then one of those counteractions would have applied?

As stated above in the Background, neither Country V nor Country W have adopted an equivalent provision to the rules within Chapter 3 to 8 (TIOPA10) so do not counteract the hybrid or otherwise impermissible deduction/ non-inclusion mismatch arising under Loan1.

Given Condition D is satisfied, then if the UK had been in the position of either Country V or Country W it is reasonable to suppose that it would have been able to apply the relevant counteraction.

Condition E is therefore satisfied.

Condition F: Is the relevant payer that is within the charge to UK corporation tax within the same control group as either A Co or B Co, or is there a structured arrangement?

C Co, D Co and E Co are all within the same control group as A Co and B Co, within the definition at section 259KA TIOPA 2010.

Condition F is therefore satisfied.

All the conditions are satisfied to characterise both 'over-arching arrangements' involving Loan2, Loan3 and Loan4 as within the Imported Mismatch rules, and the relevant counteractions need to be considered.

Counteractions under section 259IB TIOPA 2010:

There is more than one relevant payments 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 funds 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.

Counteraction where the UK is in the position of Country X

Where the UK is in the position of Country X then section 259IB TIOPA 2010 will apply to deny C Co a deduction in relation to the payments under Loan2, which in this example would be the entire deduction of 40.

Counteraction where the UK is in the position of Country Y

Where the UK is in the position of Country Y, then section 259IB TIOPA 2010 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 section 259IB TIOPA 2010 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 section 259IB TIOPA 2010 will apply to deny E Co a deduction in relation to the payments under Loan4 to the extent of the remaining mismatch.

If the entire 80 has been fully counteracted then section 259IB TIOPA 2010 will not apply to deny E Co from deducting an amount in relation to the payments under Loan4.