Analysis

Hybrids: changes to HMRC's revised draft guidance

Speed read

On 1 December 2017, the new Finance (No. 2) Bill was published. The Bill contained a number of amendments to the hybrid and other mismatches legislation, most of which are retrospective back to 1 January 2017, with the remainder applying from 1 January 2018. In addition, on 29 November 2017, HMRC published a draft of its updated guidance on the legislation, which assists in understanding how it expects the rules to be applied in practice. These amendments include: extending the recognition of dual inclusion income in some chapters; deeming a mismatch to arise by reason of a company operating through a permanent establishment in a specified case; further clarifications on when unilateral deductions are outside scope; recognising capital taxes in specific circumstances; and putting beyond doubt some stances HMRC took in prior drafts of its guidance by legislating for them.

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This article follows our earlier article ('Examining HMRC's revised draft guidance on hybrids', *Tax Journal* on 27 April 2017).

The UK's legislation on the hybrid mismatch rules is now within TIOPA 2010 Part 6A, and all references below are to that Act unless stated otherwise.

HMRC has proposed changes to these rules under the Finance (No. 2) Bill 2017 (published on 1 December 2017), which is anticipated to receive royal assent by the end of January (with no changes arising from the parliamentary debate on 11 January). This article starts by explaining some of these changes.

This article also considers the key changes in the revised guidance published on 29 November 2017, which clarifies how HMRC will interpret the rules. The revised guidance replaces the version published on 31 March 2017. Although it does not reflect the latest amendments to the legislation, it does clarify some important points of interpretation that have been reflected in the legislative amendments, and it provides clarity in a number of other areas. The revised guidance can be found within HMRC's *International Manual* (INTM) at INTM 850000 onwards (currently available as a PDF via bit.ly/2mvDv83).

Definition of ordinary income

To be regarded as 'ordinary income', and therefore not give rise to a deduction/non-inclusion (D/NI) mismatch within the scope of the hybrid mismatch rules, a receipt must be brought into account as income/profit upon which a 'relevant tax' is charged. HMRC has clarified a number of points in relation to the concept of ordinary income.

Nil rate of tax

HMRC's guidance published during December 2016 reflected its interpretation that income will not be treated as being 'included' (i.e. brought into account for the purpose of a tax charged) where it is subject to a nil rate of tax. HMRC has put this position beyond doubt via a legislative amendment to s 259BC.

It is interesting that although a number of proposed legislative amendments introduced in order to confirm HMRC's interpretation are retrospective, this amendment is not.

Withholding tax

HMRC's updated guidance of March 2017 set out its view that withholding tax was not a relevant tax. This meant that if tax is withheld on, for example, rental payments made to a non-tax territory property holding company satisfying the requirements to be characterised as a hybrid entity, the receipt would be regarded as non-included.

This appeared to be clearly in contrast to the legislative wording, which specifically recognised 'income tax' as a relevant tax.

HMRC has now put this point beyond doubt at s 259B(3A), with retrospective effect from 1 January 2017.

HMRC has confirmed that the amendment covers UK withholding tax, as well. In our non-tax territory property example above, this would suggest an effective UK tax of 39% on those receipts, being the denial of a corporation tax deduction of 19%, together with the 20% withholding tax.

Capital gains taxes

Previously, the hybrid mismatch legislation only recognised a tax that was charged on 'income'. Therefore, if a payee was taxed in respect of a receipt that was capital in nature, there would be no recognition for this amount, even where the rate was the same as the rate that applied to revenue amounts.

Although the legislation will still regard a capital receipt as not being included in determining whether a mismatch arises, the legislation is being amended in order to offer a credit for capital taxes suffered when applying the chapters that target financial instruments (Chapters 3 and 4).

Relief will also be granted where taxes on capital have been imposed under another territory's controlled foreign companies (CFC) regime (as the UK's CFC regime only applies in respect of income).

Chapter 7: hybrid payee deduction/non-inclusion mismatches

Chapter 7 counteracts certain D/NI mismatches that it is reasonable to suppose would otherwise arise from payments or quasi-payments arising by reason of the payee being a hybrid entity.

Section 259GB(3) previously deemed a mismatch to arise by reason of the payee being a hybrid entity where that payee was not within the charge to tax of a territory, nor within a parent's CFC regime.

Figures 1 and 2 (opposite) illustrate how this could have given rise to some abnormal results.

In figure 1, the investors (Co. A, Pension A and Co. B) invest capital into a UK limited partnership (UK LP), which then on-loans these funds to a UK tax resident company (UK Co.) for use in its business, and for which UK Co. is able to obtain a tax deduction.

Co. A and Pension A are tax resident in Country A and regard UK LP as transparent for tax purposes, as does UK Co. However Co. B, a company tax resident in Country B, regards UK LP as opaque. Due to this asymmetry in how Co. B regards UK LP, it will be characterised as a hybrid entity.

Pension A is a tax exempt pension fund in Country A and therefore a total mismatch of 85% arises, being the difference of 30% on the tax-exempt amount attributed to Pension A and the 55% attributed to Co. B (which regards the income as being proper to UK LP). As s 259GB(3) works on a deduction by deduction basis, it would have deemed there to be a mismatch of 85%, despite the hybridity only being relevant in relation to the 55% amount attributable to Co. B.

A similar situation arises in figure 2, except that instead of the hybrid payee being a partnership it is a company resident in a non-tax territory (Co. C). As in figure 1, Co. A, Pension A and UK Co. regard Co. C as transparent but Co. B regards it as opaque, thereby giving rise to the same result as above and for the same reasons.

HMRC has introduced new legislation at s 259GB(4A) to rectify this anomaly where the hybrid payee is a 'partnership'. (On the basis that the legislation specifically references a 'partnership' and a 'partner in the partnership', it is uncertain whether this should also apply to limited liability partnerships, which has 'members' and not 'partners'. The reference to the definition of 'partnership' at s 259NE(4), which is entitled 'member of a partnership', gives hope that members and partners are interchangeable, however this is not beyond doubt.) The new rule will effectively apply s 259GB(3) on an investor by investor basis, thereby affecting only the proportion of the mismatch attributable to an investor in a territory that regards the payee as a hybrid entity.

This new rule applies retrospectively from 1 January 2017, and will address the problem highlighted in figure 1 above. It will not, however, affect the outcome in figure 2 above.

The revised guidance does not refer to this specific legislative amendment, but suggests that the underlying reasoning is that it 'ensures that the relevant amounts are not all treated as arising from the hybridity of just one payee and any disallowance is proportionate' (INTM555090).

A new example illustrating the application of this principle has been inserted into the revised guidance at INTM555210.

Chapter 8: multinational payee deduction/non-inclusion mismatches

Background

Chapter 8 counteracts D/NI mismatches that it is reasonable to suppose would otherwise arise by reason of a payee being a 'multinational company', where the payer is within the charge to corporation tax. (A 'multinational company' means a company that is resident in one territory for tax purposes, and is regarded as carrying on a business in another territory through a permanent establishment (PE).)

There has been some uncertainty as to how the 'by reason of' test should be applied. For example, should it be assumed that a company is resident solely in the PE territory or in the head office territory? EU Directive 2016/1164 (as amended 29 May 2017), which requires the imposition by member states of similar rules by 31 December 2019, seems to prefer the latter interpretation, and the revised HMRC guidance appears to suggest that HMRC has the same preference. (INTM556080 states that the relevant counterfactual position is 'that that same payee in the same territory is not a multinational company'.)

Figure 1

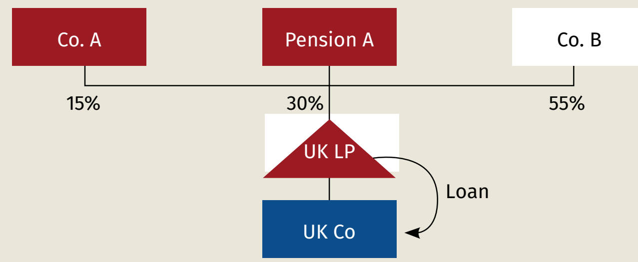
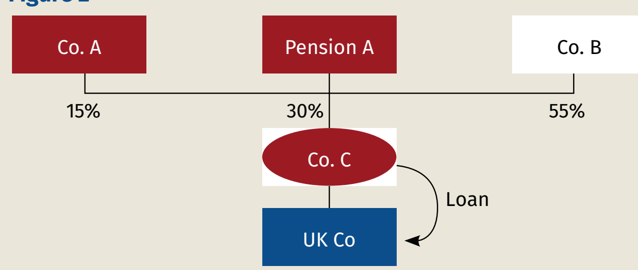


Figure 2



At first glance, the legislative amendments to Chapter 8 seem to provide some clarification on this area. However, they also potentially go a lot further, and could have unintended consequences.

New s 259HB(2A)

The new legislation deems a mismatch to arise by reason of a payee being a multinational company on making the assumption that:

- the company does not have a PE; and
- all of the company's income is regarded as arising in the territory of residence and nowhere else (s 259HB(2A).

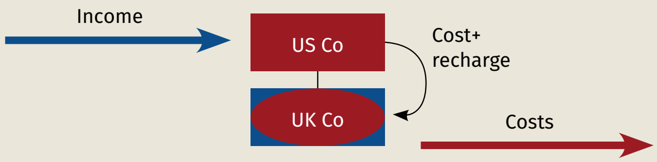
This would seem to accord with the interpretation set out above; however, as this provision only applies 'so far as would not otherwise be the case', it acts to extend the 'by reason of' test rather than clarifying it.

If the provision was intended to be an extension to the 'by reason of' test rather than the clarification that the guidance suggests (and as was stated in the parliamentary debate on 11 January), it would be helpful to understand what other counterfactuals need to be considered.

Additionally, the assumption that the company does not have a PE is separated from the assumption that 'all' of the company's income relating to the relevant payment should be regarded as arising to it in the territory of residence. This would appear to include not just income connected to the PE, but all income payable to that company regardless of why it was excluded from tax.

To illustrate this problem, consider a situation where a company resident in a territorial tax regime operates in another territory through a PE where it is subject to tax in full on the income attributed by both parties to the PE. Due to the territorial nature of that tax regime, there are likely to be other receipts not being brought into charge, arising by reason

Figure 3



of them either not having a domestic source or not being remitted to that territory.

This provision could be interpreted as not requiring one to deem the activities undertaken to generate that income to be treated as also being undertaken in that territory, which could provide welcome relief for companies resident in some territorial tax regimes. However, this is not clear and it could still capture companies resident in territorial tax regimes that operate on a receipt basis. Were the same company not to have a PE, then the rules would regard any such mismatch as being outside of scope, so it is hoped that this is unintended.

Through communications with HMRC, we understand that the change was targeted at situations where a company operates through a PE in another territory that does not take up its taxing rights (such that if the profit was not allocated to the PE, it would have been subject to tax in the head office territory). As such, it appears that it is not intended to capture non-PE related income, such as that highlighted in the 'territorial tax regime' example above. However, we have not yet received assurances from HMRC that this is the case.

These changes are not retrospective, and apply only from 1 January 2018.

Tax haven PE exemptions

There is also concern over how this deeming provision interacts with the specific exemption in s 259HB(3)(a).

This excludes from Chapter 8 any excess arising where the PE is resident in a no-tax jurisdiction. Where similar exclusions have been provided in the rules (e.g. s 259CB(4)), the legislation has been stated to be 'subject to' that exemption.

On the basis that s 259HB(2A) is a general deeming provision that is immediately followed by a specific exempting provision, and that no statement is made in the accompanying Explanatory Notes that this provision is intended to override s 259HB(3), then it is hoped that it was not intended to do so. However, this is not helped by what is 'hoped' to be a typo in the penultimate paragraph of the guidance at INTM556080, where it states:

> 'If the PE jurisdiction makes no provision for charging tax on a payee which is a multinational company operating through a PE in the jurisdiction, then the excess that arises is to be taken to arise by reason of that payee being a multinational company.'

It is hoped that it was intended to say that the excess is 'not' to be taken to arise by reason of…

Concept of residence

The legislation relies significantly on the concept of residence, yet there are some territories that tax on a source basis and have no concept of tax residence outside of tax treaties (such as Hong Kong).

The legislation is to be amended to regard entities as being 'resident' in such territories where they are resident 'generally' for the purpose of a local law, or for particular purposes under that law (s 259B(5)). There is no guidance on what the phrase 'generally' actually means, with no explanations in the revised guidance. It is hoped that a company would be respected as being resident in a territory where it is treated as such under a double tax treaty between that territory and the UK.

The revised legislation will only apply to Chapters 8 (multinational payee D/NI) and Chapter 11 (imported mismatches), with the Chapter 11 exclusion catching the importing into the UK of non-UK Chapter 8 mismatches. Although it seems non-UK Chapter 6 equivalent mismatches would also be caught (excessive PE deductions), we have received assurance from HMRC that the change was only directed at Chapter 8 (direct and imported).

HMRC has also confirmed that the change was targeted at jurisdictions that do not have a corporate tax system, and is not intended to apply to jurisdictions that otherwise have a concept of tax residence (e.g. territorial tax regimes). It should therefore not impact on how the term 'residence' is interpreted in applying the rules under other chapters.

Hopefully this will be clearly stated when the guidance is revisited to adjust for these new provisions.

This legislative change is not retrospective, and applies from 1 January 2018.

Chapter 9: hybrid entity DD mismatches

Chapter 9 counteracts double deduction (DD) mismatches that it is reasonable to suppose would otherwise arise by reason of a payer being a hybrid entity.

HMRC has introduced a provision to enable certain related party income to be taken into account for the purposes of Chapter 9 (s 259ID), generally by treating it as dual inclusion income. However, because it is drafted to permit relief where the current DD exceeds dual inclusion income as previously defined, it cannot be used to reactivate brought forward deductions previously disallowed.

Figure 3 (above) illustrates our understanding of why this amendment was deemed necessary.

In figure 3 UK Co. is a UK tax resident company that is wholly owned by US Co., a US tax resident company. UK Co. is disregarded for US tax purposes, such that it is recognised for US tax purposes as a division of US Co.; therefore it is a hybrid entity under these rules.

UK Co. undertakes low risk work on behalf of US Co., for which it is remunerated on a cost plus basis. UK Co. incurs costs in undertaking this work which is deductible both by UK Co. in the UK and by US Co. in the US, thereby giving rise to a Chapter 9 DD mismatch.

US Co. uses the products provided by UK Co. to generate sales.

UK Co. will therefore only be protected from a counteraction under Chapter 9 where it has sufficient dual inclusion income to offset against the DD. Under the existing legislation, no dual inclusion income would be recognised, as the income received by US Co. is not the same income as that being received by UK Co. – which receives the cost plus recharge.

The new provision effectively deems the income received by US Co. to be the same income as that received by UK Co. for the purpose of recognising dual inclusion income, and operates to give relief from 1 January 2017. However, there are a few restrictions imposed by the provision, which causes uncertainty as to how widely it could be applied:

- **Condition A** is that the investor (US Co.) makes a payment to the hybrid entity (UK Co.) for which it cannot claim a deduction.
- **Condition B** is that as a result of this payment, an amount of ordinary income arises to UK Co. for the relevant period.

- **Condition C** is that this payment is made 'in direct consequence' of a payment to US Co. from an unrelated person.

  The phrase 'in direct consequence' implies a temporal and causal relationship, requiring the cost plus recharge to be dependent upon the receipt of the third party income by US Co. and not to be paid until after its receipt. The nature of a cost plus recharge is usually to reflect that any credit risk should be borne by US Co. and therefore it should be paid regardless of when or if US Co. receives a receipt.

  Through our communications with HMRC, we understand that this is not intended to be read so narrowly, but merely requires a genuine economic link between the third party income and the activities the subsidiary is being rewarded for.

  HMRC's concern appears to be that it may not be possible to change commercial contracts so that subsidiaries such as UK Co. would be paid directly by the third party. It would therefore be beyond the group's control to restructure to avoid such double taxation.

  The unrelated person requirement means that intra-group transactions will still be caught, which may impact group service companies that outsource some of the activities to a hybrid subsidiary. Following from the above, it is presumed that HMRC believes that such issues could be avoided without undue burden by altering the contracts, such that the subsidiary is remunerated directly.
- **Condition D** is that the receipt in Condition C is brought in as ordinary income of US Co.

This pseudo-dual inclusion income will be recognised in the period received by the hybrid entity. As previously highlighted, if there is insufficient dual inclusion income in a prior period to cover the corresponding DD, then these provisions will not reactivate those amounts.

(Note: A similar situation could arise under Chapter 10 (dual territory DD mismatches), where a UK PE receives a recharge from its head office for costs incurred that are related to sales made by that head office. This relief has not been extended to such situations.)

Chapter 11: imported mismatch rules

Dual inclusion income recognition

Chapter 11 contains provisions denying deductions in connection with payments or quasi-payments that are made under, or in connection with, imported mismatch arrangements where the payer is within the charge to corporation tax.

The rules generally identify overseas transactions that would have been counteracted under the hybrid rules were a UK entity party to the transaction, and disallow any UK deduction regarded as funding that mismatch.

Due to the way the legislation within Chapter 11 identifies and quantifies the mismatch, there was no provision to recognise any dual inclusion income arising to a counterparty of the mismatch payment.

In HMRC's guidance, it has previously stated that recognition should be given in quantifying the relevant mismatch under Condition D; however, this was not supported by the wording of the legislation.

HMRC has now introduced s 259KD with retrospective effect from 1 January 2017 to ensure that dual inclusion income amounts are taken into account.

The rules act by effectively restricting any deduction to the amount which would have been imposed had the relevant counterparties to the mismatch been subject to a direct counteraction, as opposed to indirectly via Chapter 11, thereby taking into account dual inclusion income (in addition to recognising capital taxes within Chapters 3 and 4).

As with the extension to dual inclusion income within Chapter 9 (discussed above), the dual inclusion income is not able to reactivate amounts disallowed in prior periods. There is no such facility within Chapter 11, so any restriction is permanent.

Over-arching arrangement

Where a company borrows a significant sum of money from a third party lender, there has been some consternation over how far it would need to press the lender for information to ensure that there are no 'relevant mismatches' higher up in the funding structure which could give rise to an imported mismatch.

HMRC has provided some assurances in the revised guidance (INTM559230), stating that any mismatches in the wider funding structure will not be considered as part of the same 'over-arching arrangement' as the UK deduction, and thereby not give rise to a Chapter 11 counteraction, where the following factors are present:

- the company borrows money under a straightforward loan agreement that has no features indicative of a hybrid financial instrument;
- the borrowing is on normal commercial terms;
- the only reason why the company and the person may be considered to be in the same control group is that the person has, or may have, a 50% investment in the company by virtue of the loan;
- the only relationship or connection between the company and the lender is that the company has borrowed money from the person; and
- the arrangement under which the funding is provided is not a structured arrangement within the meaning of Chapter 3 (which refers to structuring the financial instrument or an arrangement connected with it).

Although this also confirms that commercial lending is not being taken outside scope completely, this would appear to give comfort to borrowers that a commercial loan should not bring them within the scope of the rules, unless the loan itself is designed to achieve that mismatch.

Chapter 12: adjustments in light of subsequent events, etc.

A new s 259L has been added to Chapter 12, allowing adjustments to be made in circumstances where the accounting treatment in a later accounting period reduces or eliminates a mismatch which has already been counteracted by the hybrids regime.

Again, as with the other relieving provisions proposed within the Finance (No. 2) Bill, these provisions will have retrospective effect to 1 January 2017.

This replicates a concession made in HMRC draft guidance published on 31 March 2017 (INTM561130), which recognised that a deduction could arise in one year and be reversed in a subsequent year within the same entity.

An example was given where a deduction on an instrument recognised under fair value accounting could be given in one period and reversed in a later period. Where the counterparty accounted for the instrument on an accruals basis, no corresponding receipt would have been recognised and a D/NI mismatch counteraction could have been triggered. The legislation would have only provided relief were a 'payee' to subsequently include a receipt, whereas in this scenario, any subsequent inclusion would arise to the payer and not the payee.

This provision now allows relief upon the subsequent reversal in the payer. Although the guidance originally specified a situation arising under Chapter 3 (hybrid financial instrument D/NI), the legislation could also apply in a DD situation where, say, a foreign exchange movement is recognised under a cross currency swap to a hybrid entity and is subsequently reversed.

Priority rules

There is no legislative priority to the hybrid mismatch rules, and there has been some uncertainty as to how they should be applied in conjunction with other UK legislation targeted at limiting deductions; e.g. the transfer pricing rules at TIOPA 2010 Part 4, the loan relationship unallowable purpose rules at CTA 2009 Part 5, or the group mismatch rules at CTA 2010 Part 21B. (The corporate interest restriction rules within TIOPA 2010 Part 10 have explicitly given supremacy to the hybrid rules within their guidance at CFM95140.

The revised guidance reaffirms HMRC's view that there is no general priority order, stating that the rules should be considered 'alongside' each other. The only exception appears to be where a territory has applied similar rules to those at CTA 2009 ss 931B(c) and 931D(c), which removes an exemption for distribution receipts when the distributor benefits from a corresponding deduction.

When considering how the rules should interact in practice, HMRC has provided some further guidance at INTM550080, stating the following:

> 'If a transfer pricing adjustment reduced the allowable deduction to the point where there was no mismatch in connection with the hybrid financial instrument, then Part 6A would not apply. If there were still a mismatch after the transfer pricing adjustment was made, Part 6A would apply to the extent of the remaining mismatch.
>
> 'A similar result might be expected if Part 6A were considered in priority to transfer pricing. If the deduction after adjusting for the mismatch under Part 6A were still in excess of the arm's length price, then the transfer pricing rules would apply to further reduce the deduction to the arm's length price.
>
> 'In the same circumstances, the transfer pricing and Part 6A rules may have to be applied to different amounts within the same deduction, where the deduction includes a number of payments/quasi-payments in connection with more than one financial instrument.'

This would imply an approach of applying the rules simultaneously under an assumption that the other rules would not result in a disallowance. To the extent that a disallowance under the hybrid rules would not exceed that disallowed under the other rules, then it would appear there is discretion as to which should apply.

Presumably, the policy intent of each rule should also be given due consideration, such that if the hybrid rules would act not to permanently disallow a deduction then another rule that would give rise to a permanent disallowance should take priority.

Quasi-payments

Unilateral deductions

As highlighted in our prior article, there has been a significant amount of uncertainty about whether the UK would follow the OECD's recommendations in excluding unilateral deductions from the scope of the rules.

The 2015 OECD report characterised unilateral relief situations as those where a deduction is granted for 'an amount that is not capable of being paid' (example 1.14). HMRC's guidance now confirms that it will exclude similar deductions from the scope of the rules.

The rules targeting D/NI scenarios generally require the deduction to arise from either a payment or 'quasi-payment', with the exception of a dealing between a branch and its head office.

Where a deduction arises in relation to a transfer of money or money's worth, it will represent a payment. A quasi-payment catches a wider variety of situations and exists where a territory permits a deduction under an expectation that the counterparty would bring in a corresponding receipt.

The legislation identifies such 'quasi-payments' by asking whether it would be reasonable to expect a person (which would be characterised as the payee) to bring in a taxable receipt:

- had the 'payee' been resident in the payer territory;
- adopted the same approach to accounting; and
- assuming it was a distinct and separate person if it would be so treated under the law of the payer's territory.

To encourage overseas investment and reduce the distortion between debt and equity, some territories grant unilateral relief for some equity investments in the knowledge that the other territory may not tax the receipt, as the lender does not receive a corresponding payment.

For example, a territory may grant relief on an interest free loan to reflect what would have been paid had it been interest bearing. To ensure that only foreign investments receive relief, they may require domestic investors to bring in a corresponding receipt. The above assumptions could characterise relief given in such situations as a quasi-payment that could be subject to a counteraction, which could negate the incentive intended by the investee territory.

Where the circumstances giving rise to the deduction satisfy the requirements of s 259BB(3), then no quasi-payment would arise. We have previously been assured by HMRC that this was intended to carve out unilateral deductions. However, it was expressed to apply where the 'circumstances giving rise to the relevant deduction do not include any economic rights, in substance, existing' between the payer and payee. As economic rights do exist under instruments such as interest free loans, being the right to repayment of the principal, there has been some uncertainty over whether the legislation clearly achieved this.

HMRC has now updated an example in its guidance to confirm how s 259BB(3) should be interpreted. The carve-out would apply where (INTM551270):

- 'there is no value transfer' as a consequence of the circumstances giving rise to the deduction; and
- those circumstances do not include 'the creation or amendment' of any economic rights 'in relation to interest'.

This should provide significant comfort, and it is hoped that the legislation will be amended in the near future to avoid the seeming conflict between the law and the guidance.

Hybrid entities

The definition of a hybrid entity requires that the entity be regarded as a person for tax purposes under the law of 'any territory', and that either another territory recognises it as being part of a different person or that its income or profits are attributed to a different person.

The concept of a 'person' is therefore significant and there has been some uncertainty about whether a partnership should be regarded as a person.

The Interpretation Act 1978 states that as a partnership is a body of persons, then it should qualify. However, CTA 2010 s 1119, which generally contains definitions for the purposes of the Corporation Tax Acts, restricts the concept of a 'body of persons' to not include partnerships.

HMRC's interpretation from the latest guidance is that a 'person' does include a partnership (INTM550630).

The definition of a hybrid entity itself has also led to some strange conclusions, where assurances have now been provided:

- HMRC has confirmed that although an investor in a hybrid entity could also technically satisfy the definition of being a hybrid entity itself, as some of its income or profits (i.e. those of the non-investor hybrid entity) could also be regarded as arising to someone else (the non-investor hybrid entity), the investor will not be regarded as a hybrid entity (INTM550580).
- A similar uncertainty could arise with PEs and the guidance also confirms that a PE cannot also be a hybrid entity (INTM550590).

Illegitimate/impermissible overseas deductions

The revised guidance has been updated to give more prominence to the permanent denial of deductions where a previously disallowed deduction has been offset against foreign non-dual inclusion income. If it were not permanently disallowed, then it would otherwise generally be carried forward and offset against future dual inclusion income to prevent double taxation.

The relevant chapters are Chapter 9 (hybrid entity DD) and Chapter 10 (dual territory DD).

To illustrate how these rules apply, consider a US group with a disregarded UK subsidiary. In period 1, the UK subsidiary makes net losses of 100. The UK denies a deduction but, due to the US consolidated tax system, relief is permitted in the US against the income of a group company (ignoring any US rules that could also apply to disallow a US deduction). No double taxation or double relief has occurred but the use in the US will 'taint' those losses for the purposes of the UK hybrid rules and so they will become permanently disallowed.

In period 2, the UK subsidiary makes net profits of 100. These net profits will be taxed both in the UK and the US. Effectively, the company has made no profit or loss but the UK will expose the company to double taxation on 100.

It is difficult to understand the policy reasoning for this, as it creates double taxation where the UK group has already been penalised by having any relief delayed. The rules also appear to be discriminatory as they only apply a permanent disallowance where the deduction is offset against non-UK non-dual inclusion income, and retains relief where the deduction is against UK non-dual inclusion income.

The provisions could be understood from a policy perspective were they restricted to determining the extent to which a 'stranded deduction' could arise. In those instances, the rules would otherwise permit relief for such amounts were it to be shown that no future dual inclusion income could arise.

Where presented with such a situation, agents may wish to consider advising their clients to seek resolution within the Mutual Agreement Procedure under article 25 of the relevant OECD based treaty.

Other minor amendments of interest in the guidance

The recent guidance also confirms HMRC's interpretation in a number of other areas:

- HMRC has made it clear that exempt income arising to charities and pension funds is 'not brought into account' as ordinary income.
- All clearances should now be sent direct to the policy team, i.e. the Base Protection Policy team at 100 Parliament Street (INTM597030). The information to be supplied has been adjusted to include more details of the overseas party and the amounts involved.
- Assurance has been given that a UK company's foreign subsidiary will not be regarded as a 'dual resident company' by reason of it being deemed under TIOPA 2010 s 371SD(1)(a) to be UK resident for the purposes of computing a UK CFC charge (INTM558030).
- Similarly, HMRC has confirmed that a disregarded subsidiary will not be regarded as a PE where it is actually tax resident in that territory, and therefore the investor/subsidiary will not also be characterised as a multinational company (INTM558030). This statement is made within Chapter 10 but there is no reason to suggest that it should not be applied more widely.
- There is confirmation in the revised guidance that the regulated capital securities exemption, where it is excluded from being recognised as a financial instrument, is not restricted to banking and insurance businesses but also applies to some regulated financial firms (INTM551060).
- The revised guidance at INTM550560 confirms that members of a consortium will be considered to be acting together for the purpose of the related persons/control rules.
- New sections have been added to provide further clarity on when a structured arrangement will be regarded as occurring (INTM550650 and INTM55115). The guidance considers a number of very fact-specific finance related scenarios, which suggest that where the financial benefit of the mismatch has not been shared then there will need to be a significant degree of facilitation before it would be regarded as a structured arrangement. However, no certainties are offered, other than those specific fact patterns mentioned.

HMRC has also brought it to our attention that the legislation at s 259DB(2) is incorrectly set out in the *Tolley's 2016/17 Yellow tax handbook* (Part 1C), changing the meaning of that subsection. The legislation as enacted also requires repos and stock loans to be arrangements within s 259DB(3).

Conclusion

The legislation remains extremely complicated, and still seems to capture a number of situations where overall there is no mismatch benefit actually being achieved.

Groups will need to work closely with their tax advisors on positions they can take for filings, as the legislation is ambiguous in several places, and there are instances where there is a direct contradiction between comments in the guidance and the wording of the legislation.

A number of the new provisions are not retrospective; however, as those will apply from 1 January 2018, there is very little time for restructuring prior to their enactment. Any groups with hybrid entities or affected branch structures will need to determine quickly the impact of these new rules, and take action where needed. ■

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- The anti-hybrids rules and private equity fund structures (Ceinwen Rees & Richard Ward, 8.6.17)
- Examining HMRC's revised draft guidance on hybrids (Kashif Javed & Greg Smythe, 27.4.17)
- ATAD II: the revised EU rules on hybrid mismatches (Sandy Bhogal & Kitty Swanson, 5.4.17)
- Hybrids: making sense of the draft guidance (James Ross, 19.1.17)
- Hybrids: the UK and OECD proposals (Tom Scott, 29.10.16)