KPMG report: HMRC proposals may solve many hybridity problems in the United Kingdom and United States

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Introduction

HM Revenue & Customs (HMRC) recently proposed guidance that could resolve many issues confronting U.S. multinationals operating in the United Kingdom in flow-through structures.

HMRC proposes a retroactive application of changes to the U.K. anti-hybrid rules that could create additional opportunities for U.S. multinationals that have had restrictions on the use of deductions in the United Kingdom based on the U.K.'s anti-hybrid rules and that have had restrictions on the use of deductions in the U.S. under the U.S. dual consolidated loss ("DCL") rules.

Background

HMRC on November 12, 2020, published a set of proposals that could resolve several U.K. and U.S. tax issues created by the interaction of the U.K. anti-hybrid rules and the U.S. DCL rules. The HMRC proposals are contained in a report titled "Hybrid and other Mismatches, Summary of Responses" (hereinafter the "HMRC Report") and are the result of a formal consultation process that opened on March 19, 2020, and ended on August 28, 2020.

Applicable for calendar tax years beginning on January 1, 2017, the U.K. anti-hybrid rules (as described below) are designed to eliminate double-dipping of tax deductions incurred by certain entities organized in or operating in the United Kingdom.[1] The U.K. anti-hybrid rules generally apply to U.K. entities that are disregarded or fiscally transparent under their owners' tax laws.

The U.K. anti-hybrid rules generally disallow or defer deductions of a U.K. hybrid entity, except to the extent the deductions offset the U.K. hybrid entity's "dual inclusion income," which is generally the U.K. hybrid entity's items of gross income that are subject to tax both in the U.K. at the hybrid entity level and in the owner's country as part of the owner's local income tax computation. In other words, if the U.K. anti-hybrid rules are applicable, deductions of a U.K. hybrid entity generally are not available to be used to offset the income of other U.K. entities in the U.K. group relief system.

U.S. corporate owners of U.K. entities that are subject to the U.K. anti-hybrid rules are also subject to the U.S. DCL restrictions if the U.K. entity (or group of U.K. entities) incurs a "net loss" for purposes of Treas. Reg. § 1.1503(d)-5(c). The U.S. DCL rules also are designed to eliminate double-dipping of deductions and are like the U.K. anti-hybrid rules in many respects. In particular, the general DCL rule prevents a U.S. corporate owner of a foreign hybrid entity from using a foreign hybrid entity's items of deduction and loss to offset any items of gross income other than the items of gross income earned by the foreign hybrid entity.[2] If a hybrid entity's items of deduction and loss exceed its items of income and gain (as computed under U.S. tax principles), the difference is a DCL that, under the DCL general rule,

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[1] *See generally* U.K. Finance Act of 2016, c. 24, sch. 10 (amending U.K. Taxation (International and Other Provisions) Act of 2010) (hereinafter "U.K. TIOPA") to include anti-hybrid provisions based on Action 2 of the OECD's Final Report on Base Erosion and Profits Shifting (hereinafter "BEPS"). The U.K. anti-hybrid rules are detailed and comprehensive, covering many topics that are beyond the scope of this article, which is limited to an overview of the interaction of certain U.K. anti-hybrid rules and the U.S. DCL rules in certain fact patterns.

[2] This is a simplified version of the DCL general rule to illustrate specific issues discussed in this article. The DCL rules combine all items of income and gain earned by all hybrid entities within the U.S. consolidated group with all items of deduction and loss incurred by all hybrid entities within the U.S. consolidated group on a country-by-country basis. *See* Treas. Reg. § 1.503(d)-1(b)(4)(ii), -5(c)(4)(ii). Discussion of this DCL combination rule is beyond the scope of this article.

may offset only the hybrid entity's prior or future taxable income using a modified version of the separate return limitation ("SRLY") rules contained in Treas. Reg. § 1.1502-21(c).[3]

A U.S. corporate owner of a hybrid entity may avoid the effect of the DCL general rule—and thus use items of deduction and loss taken into account in computing the DCL to offset the U.S. owner's other U.S. consolidated income—if the U.S. consolidated group files a "domestic use election" ("DUE") for the DCL.[4] A U.S. corporation may not make a DUE for a DCL if there is a "foreign use" of a DCL.[5] A foreign use of a DCL generally occurs if any portion of an item of deduction or loss taken into account in computing a DCL is made available under foreign income tax law to offset the income of an entity that it treated as a foreign corporation for U.S. tax purposes.[6] The U.S. DCL rules also contain a special "Mirror Legislation Rule," which provides that a foreign use is deemed to occur (thus precluding a DUE) if an item of deduction or loss taken into account in computing the DCL is subject to foreign law provisions that closely resemble the U.S. DCL rules.[7]

Issues presented and potential solutions in the HMRC proposal

The simultaneous application of the U.K. anti-hybrid rules and the U.S. DCL rules affects many common fact patterns, only two of which are addressed in this article. The first fact pattern involves a U.K. hybrid entity that incurs a net loss for both U.K. and U.S. tax purposes. The second fact pattern involves a U.K. hybrid entity that incurs a DCL for U.S. tax purposes but is otherwise profitable for U.K. tax purposes. Simple facts illustrate the issues.

Fact Pattern 1

USCo, a domestic corporation and parent corporation of a group of domestic corporations that files a U.S. consolidated income tax return, owns all of the interests in UK1, an entity organized under the laws of the U.K. but treated as a disregarded entity for U.S. tax purposes. UK1 owns UK2, an entity organized under the laws of the U.K. and treated as a foreign corporation for U.S. tax purposes. UK1 has $10 of gross income attributable to services performed for unrelated parties and incurs $100 of salary expense. UK2 earns $100 of net income for U.K. income tax purposes.

UK1 has incurred a $90 net loss for both U.S. and U.K. income tax purposes. As a result, USCo's U.K. separate unit has incurred a $90 DCL, consisting of $90 of salary expense deductions that, under the DCL general rule, are ineligible to reduce any of USCo's U.S. consolidated taxable income. Instead, USCo includes in its U.S. tax base the $10 of gross income and $10 of the salary expense deductions; the remaining $90 of salary expense deductions are treated as a SRLY loss and deductible against only future taxable income earned by UK1. For U.K. tax purposes, UK1 is a hybrid entity and its $100 salary expense is subject to the U.K. anti-hybrid rules, which means the salary expense may be used to offset only the $10 of dual inclusion income, and the remaining $90 of salary expense deductions may not be surrendered under the U.K. group relief system to reduce UK2's U.K. taxable income.

The inquiry in both jurisdictions, however, should not end there. The rules of each jurisdiction should account for the fact that the $90 net salary expense loses its dual hybridity (and thus

[3] *See generally* Treas. Reg. § 1.503(d)-4(b), (c).
[4] *See generally* Treas. Reg. § 1.503(d)-6(d).
[5] *See generally* Treas. Reg. § 1.503(d)-6(d)(2), (e)(1).
[6] *See generally* Treas. Reg. § 1.503(d)-3(a).
[7] *See generally* Treas. Reg. § 1.1503(d)-3(e).

> should be eligible to reduce USCo or UK2's income) if the other jurisdiction's anti-hybrid rules prevent the salary expense from being used to reduce the income of any entity other than UK1. That is to say, if the $90 net salary expense is subject to the DCL general rule and deductible in the U.S. only against UK1's future income on a SRLY basis, the U.K. anti-hybrid rules ought not prevent the $90 salary deductions to be used in U.K. group relief to offset the U.K. taxable income of UK2 because the DCL general rule has effectively eliminated the hybrid nature of the $90 net salary expenses. The corollary ought to be true under the U.S. DCL rules such that the DCL rules ought to account for the fact that the $90 of salary expense deductions are effectively policed by the U.K. anti-hybrid rules.

The current U.K. anti-hybrid rules do contemplate the effect of overlapping anti-hybrid legislation and provide that if the investor's taxing jurisdiction subjects the items of deduction to rules that are an "equivalent provision," the U.K. anti-hybrid rules will not apply to the items of deduction.[8] Most U.K. tax advisors do not believe that the U.S. DCL rules are an equivalent provision because the U.S. DCL rules do not sufficiently resemble the U.K. anti-hybrid provisions, which were based on BEPS Action 2 and contain different restrictions and employ different statutory mechanics. The HMRC has come to the same conclusion.[9]

The U.S. DCL rules also contemplate the effect of foreign anti-hybrid provisions. In particular, the Mirror Legislation Rule provides that if such foreign law applies to the DCL, the DCL is deemed put to a foreign use and, thus, no DUE is available for the DCL. The policy undergirding the Mirror Legislation Rule is to prevent foreign jurisdictions from passing anti-hybrid legislation that has the effect of forcing all hybrid deductions into the U.S. tax system via consolidation, resulting in the U.S. tax system funding all hybrid deductions.[10] Consistent with this overarching policy point, the DCL Mirror Legislation Rule contains an exception when the foreign anti-hybrid legislation has an elective procedure that is similar to the DUE, which would allow the taxpayer to elect to use the hybrid deductions in foreign consolidation or ring-fence them in the entity that incurred the hybrid deduction.[11]

The simultaneous application of the U.K. anti-hybrid rules and the U.S. DCL rules to *Fact Pattern 1* has heretofore created a logical loop that results in a legal stand-off. That is, the U.S. DCL rules require a U.K. law determination as to whether the U.K. anti-hybrid rules prevent the $90 net salary expense deductions from being used in U.K. group relief to offset UK2's income. The U.K. tax law response to the U.S. tax law question historically has been in the form of a question: will the $90 of net salary expense be eligible for U.S. tax purposes to offset any income other than UK1's income? The U.S. tax answer to that question, of course, brings the inquiry back to the initial question, thus creating the logical loop and stand-off. The final result is that the $90 net salary expense deductions in *Fact Pattern 1* usually are subject to both the DCL general rule and the U.K. anti-hybrid restrictions and may result in a "double non-deduction" scenario whereby both countries disallow the $90 of net salary expense in their respective jurisdictions.

HMRC proposes to resolve this issue favorably through administrative guidance:

> *HMRC agrees that there should not be a UK counteraction where the US has denied loss relief in respect of double deduction amounts. HMRC guidance will be updated to clarify the interaction. Other recommendations accepted above in respect of dual inclusion*

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[8] *See* U.K. TIOPA, § 259IA(2), (3).
[9] *See* HMRC Report, § 5.50.
[10] *See* Preamble to DCL Regulations, 72 Fed. Reg. 12902, 12906 (citing Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (the "1986 Bluebook"), at 1065-66 (Comm. Print 1987), and *British Car Auctions, Inc. v. U.S.*, 35 Fed. Cl. 123 (1966), *aff'd without op.*, 116 F.3d 1497 (Fed. Cir. 1987)).
[11] *See* Treas. Reg. § 1.1503(d)-7(c)(18) (Alternative Facts).

> *income and illegitimate overseas deductions will further simplify the economic impact of the DCL rules.*[12]

The precise mechanics of the forthcoming HMRC guidance are not clear, but presumably the guidance will clarify: (1) that the U.K. anti-hybrid rules **do not** apply if there is no DUE made with respect to the hybrid deductions; and (2) that the U.K. anti-hybrid rules **do** apply if there is a DUE made with respect to the hybrid deduction. That guidance might cut the logical loop and stand-off created by the current simultaneous application of the competing regimes by making the U.K. anti-hybrid rules elective in a manner similar to the foreign anti-hybrid regime described in Treas. Reg. § 1.1503(d)-7(c)(18) (Alternative Facts).

That is to say, USCo in *Fact Pattern 1* would have a choice either to: (1) use the $90 salary expense deductions in U.K. tax consolidation and thereby make the U.S. DCL general rule applicable to DCL without ability to file a DUE; or (2) make a DUE for the DCL consisting of the $90 salary expense deductions and thereby subject the $90 salary expense deductions to the restrictions in the U.K. anti-hybrid rules. Either of these alternatives would be an improvement to the "double non-deduction" result created by the legal stand-off. Any such guidance is welcome because it might enable a sensible and equitable method by which to apply both the U.S. DCL rules and the U.K. anti-hybrid rules.

Fact Pattern 2

Same facts as *Fact Pattern 1*, except UK1 is a cost-plus service disregarded entity of USCo that incurs $100 of salary expense and is compensated by USCo in an amount of $105.

USCo's interest in UK1 has likely created a $100 DCL because the $105 cost-plus payment is generally disregarded for U.S. tax purposes and is generally disregarded for DCL computational purposes.[13] Unless U.K. TIOPA § 259ID applies to the $105 cost-plus payment, the $105 cost-plus payment is not dual inclusion income because the item of income is disregarded for U.S. tax purposes and, thus, is not subject to U.S. tax.[14] Accordingly, the $100 salary expense deductions are a DCL and are subject to U.K. anti-hybrid restrictions. Thus, the $100 salary expense deductions in *Fact Pattern 2* are subject the same analysis as the $90 salary expense deductions in *Fact Pattern 1*.

HMRC proposes to solve this problem as well, except HMRC's proposal does not involve administrative guidance, but rather takes the form of proposed amendments to the relevant statutory provisions. In particular, HMRC proposes to repeal U.K. TIOPA § 259ID and proposes the creation of a new statutory definition of dual inclusion income that will include payments similar to the $105 cost-plus payment described in *Fact Pattern 2*.[15] If adopted by Parliament, the statutory changes could be part of the Finance Bill in March of 2021.

If HMRC's statutory proposals are adopted by Parliament and made part of U.K. tax law, then presumably the $100 salary expense deduction would be absorbed by the $105 of gross and the U.K. anti-hybrid rules would not apply to the $100 salary expense deduction. If that is the case, the $100 DCL would not

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[12] HMRC Report, § 5.49.
[13] *See* Treas. Reg. § 1.1503(d)-5(c)(1), -7(c)(23).
[14] If applicable to *Fact Pattern 2*, U.K. TIOPA, § 259ID could include all or a portion of the $105 cost-plus payment in dual inclusion income if the $105 payment is "in direct consequence" of payment made by a third party to USCo. This tracing rule is helpful in certain circumstances but requires detailed factual analysis, and there is limited guidance on whether such payments are in direct consequence of one another. Thus, U.K. TIOPA, § 259ID is a narrowly drafted exception that provides limited relief.
[15] HMRC Report, § 2.

be subject to the DCL Mirror Legislation Rule and USCo otherwise would be eligible to make a DUE for the $100 DCL.

KPMG observation

The HMRC proposals could provide welcome relief for U.S. multinationals that own U.K. hybrid entities. Whether one or both of the proposals will be adopted and whether the actual changes properly dovetail with the U.S. DCL rules as described above are yet to be seen. In addition, HMRC suggests that its proposals will be retroactive to tax years beginning on or after January 1, 2017. If either or both of the proposals are adopted, it could also confer a retroactive benefit to 2017 for U.S. corporate taxpayers that have not made DUEs with respect to their U.K. separate units because of the Mirror Legislation Rule problem.

The same or similar issues arise with respect to U.S. multinationals operating in any other jurisdiction that has adopted anti-hybrid legislation based on the OECD BEPS Action 2 proposals. These jurisdictions include each EU Member State (that are required to adopt such legislation pursuant to the Anti-Tax Avoidance Directive 2 ("ATAD 2")), Mexico, Australia, and New Zealand. Hopefully, some or all of these other jurisdictions will follow HMRC's lead.

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