

Hybrids and other mismatches from financial instruments

As part of the United Kingdom's ongoing commitment to the OECD's Base Erosion and Profit Shifting (BEPS) initiatives, new legislation was enacted in the Finance Act 2016 containing provisions to remove tax mismatches arising from the use of hybrid financial instrument and hybrid entities. Broadly, a tax mismatch arises where a double deduction is being claimed for the same expense (the double-deduction outcome) or a deduction is being claimed for an expense without the corresponding receipt being fully taxed (the deduction/non-inclusion outcome).

Who will be affected?

The rules affect all entities subject to UK corporation tax, including UK Permanent Establishments (PEs), that enter into arrangements involving both:

- A hybrid instrument or hybrid entity; and
- A tax mismatch caused by the hybrid.

An entity or a financial instrument is a hybrid for these purposes if, generally, two different jurisdictions apply different tax treatments.

The rules will impact a wide range of structures, most typically those involving entities which are treated as opaque in the country of incorporation but transparent for the investor or parent entity, for example US parented groups where UK subsidiaries are disregarded by election for US tax purposes. Certain arrangements involving PEs and dual resident entities will also be affected.

Other structures affected will include those where financial instruments have been entered into which may be treated as debt for the paying entity but equity for the payee, thereby generating an interest deduction with no corresponding taxable income for the investor or parent entity.

What do the new rules look like?

The rules are complex however, broadly, for payments and/or quasi-payments (broadly, accruals) made on or after 1 January 2017 that give rise to a tax mismatch, if the conditions relating to the particular kind of mismatch are met, the mismatch will be countered by either:

- Disallowing the excess deduction claimed; or
- Bringing within the charge to tax in the UK an amount of income representing the mismatch amount.

The legislation targets hybrid mismatches in the following circumstances:

Deduction/non-inclusion outcomes involving:	Double deduction outcomes involving:
Hybrid financial instruments	Hybrid entity payers
Hybrid transfers	Dual resident companies
Hybrid entity payers	Arrangements involving PEs
Hybrid entity payees	
Arrangements involving PEs	

Further rules relating to 'imported mismatches' also apply where there may have been an attempt to circumvent the main hybrid mismatch rules by routing the mismatch outcome to a third non-UK jurisdiction.

Examples of some common scenarios where the rules are likely to apply are illustrated overleaf.

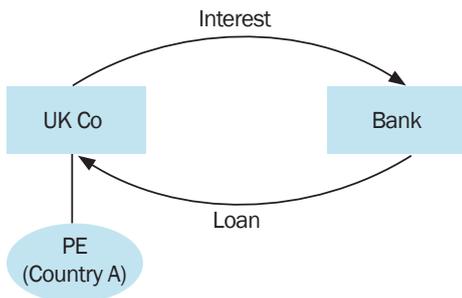
Next steps?

Given the complexity of the rules and the fact that they operate mechanically without the need for there to be any tax avoidance motive, groups with cross border activities should take steps to review their structures for potential exposures.

The 'imported mismatch' rules mean that arrangements entered into by a UK entity not actually involving a hybrid mismatch can still be caught if there a mismatch elsewhere is the group. It may therefore be necessary to look in more detail at the wider group to understand the overarching arrangements than has previously been required.

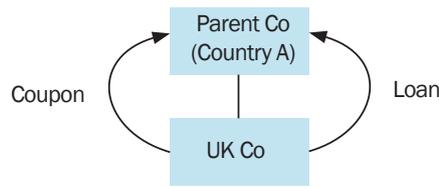
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Double deduction mismatch: foreign/UK PE



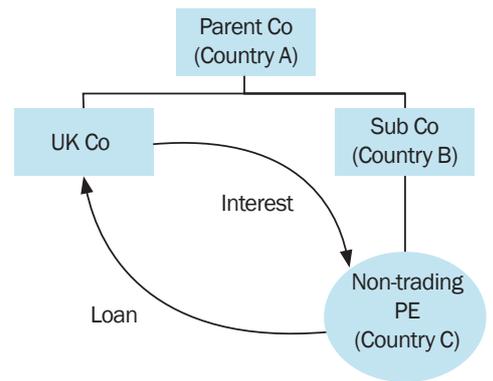
- UK Co has a PE in Country A
- UK Co pays interest to third party bank on loan taken out to fund income-earning assets in Country A
- UK Co claims deduction for full amount of interest
- PE in Country A also claims deduction for a proportion of interest on the same loan
- Hybrid mismatch rules deny UK Co deduction for element of interest.

Deduction/non-inclusion mismatch: hybrid financial instrument



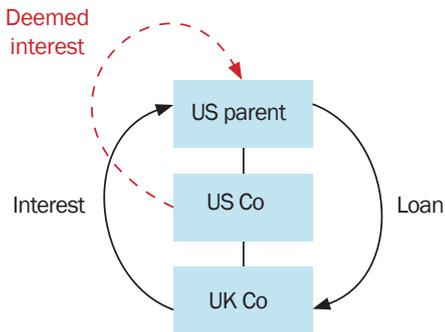
- Loan is a hybrid instrument – debt in UK Co and equity in Country A
- No income inclusion for Parent Co due to participation exemption
- Hybrid mismatch rules deny UK Co deduction for interest paid.

Deduction/non-inclusion mismatch: foreign PE



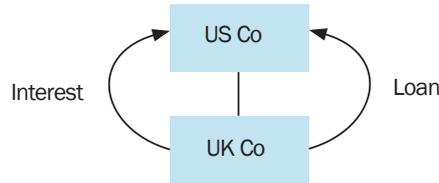
- UK Co pays interest to a group foreign PE
- No income inclusion in Country C for non-trading PE
- No income inclusion for Sub Co in Country B as a result of a double tax treaty
- Hybrid mismatch rules deny UK Co deduction for interest paid.

Double deduction mismatch: hybrid payer



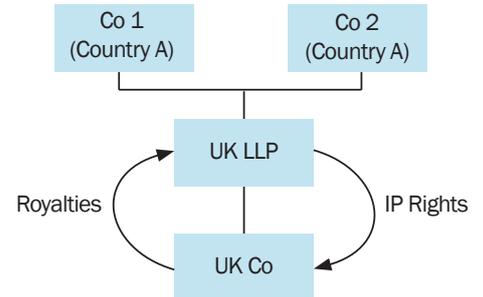
- UK Co is a hybrid entity as opaque for UK tax purposes but disregarded by election for US tax
- UK Co pays interest to UK Parent – US Co also claims deduction for this interest
- Hybrid mismatch rules deny UK Co deduction for interest paid.

Deduction/non-inclusion mismatch: hybrid payer



- UK Co is a hybrid entity as opaque for UK tax purposes but disregarded by election for US tax
- UK Co pays interest to US Co which is disregarded for US tax purposes
- Hybrid mismatch rules deny UK Co deduction for interest paid.

Deduction/non-inclusion mismatch: hybrid entity payee



- UK LLP is a hybrid entity as transparent in UK but opaque in Country A
- No income inclusion for UK LLP for royalties paid by UK Co as UK LLP treated as transparent
- No income inclusion in Country A as UK LLP treated as opaque
- Hybrid mismatch rules deny UK Co deduction for royalties paid.