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HYBRID MISMATCHES

The UK “Hybrid and Other Mismatches” rules were introduced with effect from 1 January 2017 in response to one element of the OECD’s Base Erosion and Profit Shifting (BEPS) initiative.

The rules are extremely detailed and complicated, but in outline they are designed to neutralise “tax mismatches” that involve at least one entity that is subject to UK corporation tax.

Tax mismatches fall into one of the following types:

1. Deduction/non-inclusion mismatches. These typically arise in transactions where the paying entity is allowed a tax deduction but where corresponding taxable income does not arise in the hands of the recipient. These type of mismatches can also arise where taxable income does arise in the hands of the recipient, but where this is taxable at a lower rate, or where there is a delay between the deduction being allowed and the income being taxable.
2. Double deduction mismatches. These generally arise where expenses give rise to allowable deductions in more than one jurisdiction (except where they are allowed against income which is taxable in those same jurisdictions).

Tax mismatches might arise from hybrid financial instruments, hybrid entities, arrangements involving permanent establishments, hybrid transfers, and dual resident companies. Examples of these are given in the following sections of this document.

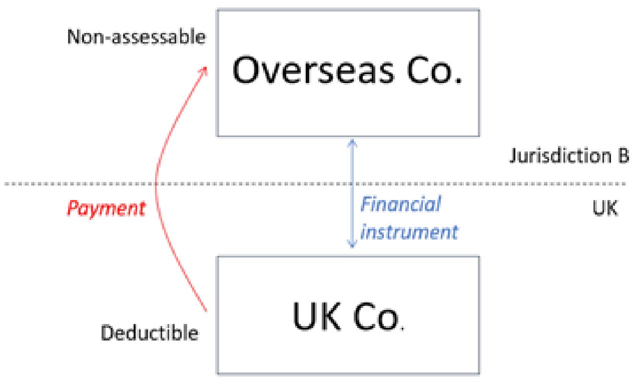
Where a tax mismatch is caught by the legislation, it will be counteracted either by denying (or restricting) a deduction, or alternatively by including an amount as taxable income. The rules are mechanical, and do not contain any de minimis exemptions based on the size of either the transactions or the entities involved.

Hybrid financial instruments

Financial instruments (typically loans) are most likely to give rise to tax mismatches where they are treated as debt in one jurisdiction and equity in another jurisdiction.

By way of example, consider the following:

Diagram A



In this scenario, amounts are paid from UK Co. to Overseas Co. in respect of a particular financial instrument. Under general principles, UK Co. would be allowed a tax deduction in respect of these payments as interest under the loan relationship rules. In Overseas Co.’s jurisdiction of residence, however, these amounts are treated as dividend income which is not taxable. This gives rise to a deduction/non-inclusion mismatch which could be counteracted in the UK under the legislation.

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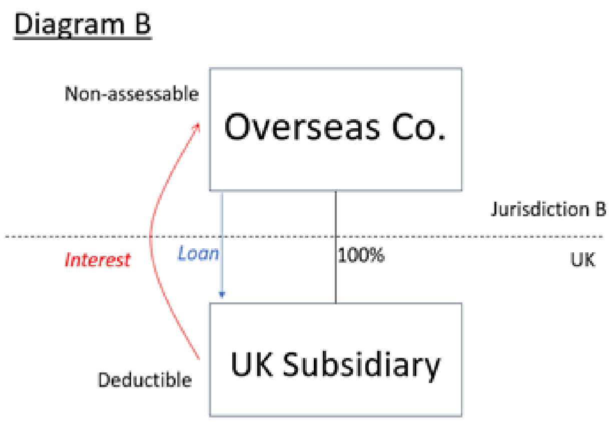
Hybrid entities

Hybrid entities are essentially those that are treated as taxable persons in one jurisdiction but as tax-transparent (or part of another entity) in another jurisdiction.

By way of example, consider the following:



In this example, UK Subsidiary is treated as a legal entity in its own right under UK law. Under the law of Jurisdiction B, however, it is regarded as a branch of Overseas Co. and not a separate legal entity.

If in this scenario a simple commercial loan is made from Overseas Co. to the UK Subsidiary, interest payments made by the UK Subsidiary would under general principles give rise to a tax deduction in the UK under the loan relationship rules. In Jurisdiction B, however, the interest would not be subject to tax because when Overseas Co. and UK Subsidiary are considered together there is overall no interest income. This gives rise to a deduction/non-inclusion mismatch which could be counteracted under the legislation.

A similar mismatch might arise where a company has a permanent establishment in a jurisdiction outside the company's place of residence, and where a payment by the permanent establishment to the "head office" is allowed as a deduction in the jurisdiction in which the permanent establishment is based, but where this is not brought into account in calculating the profits of the company in its home jurisdiction.

Hybrid transfer arrangements

Tax mismatches can arise as a result of arrangements such as repo transactions or stock lending transactions. These types of arrangements might, for example, give rise to a deduction from taxable income in one jurisdiction (e.g. for interest or fees) and a non-taxable credit (e.g. a capital gain or a dividend) in another jurisdiction.

Dual residents

Where an entity is resident in more than one jurisdiction, or where it is resident in one jurisdiction but has a permanent establishment in another jurisdiction, expenses may give rise to tax deductions in each of the jurisdictions. This kind of situation can give rise to a double deduction mismatch unless the respective tax deductions are given against income which is taxable in each of the jurisdictions.

Disclosure

Companies within the charge to UK corporation tax are specifically required to disclose on their corporation tax returns if they are a hybrid entity, or if they transact with hybrid entities within the same "control group" (typically corporate groups that are consolidated for accounting purposes). Companies will therefore need to consider whether either of these circumstances are met – and if so to make the relevant disclosures – regardless of whether or not they are subject to counteraction under the rules. Further disclosures and tax adjustments will be required where the company is subject to counteraction.

How we can help

The hybrid and other mismatch rules are extremely complicated, but they can apply in a number of common scenarios, including many that involve US entities. Please contact us if you need advice on any implications or disclosure obligations that might arise from particular transactions or arrangements.

Contact us

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