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Current Notes

Tales of the unexpected: the long arm of the UK hybrid rules

The UK hybrid and other mismatch rules set out in Part 6A of the Taxation (International and Other Provisions) Act 2010 (TIOPA) (the Hybrid Rules)[1] have been in force since 1 January 2017. So for 18 months now, UK taxpayers have been required to grapple with these rules and consider how they apply to their structures and arrangements.

The difficulties faced by UK taxpayers in applying these rules have been well documented but, generally, arise for three principal reasons:

1. Although the Hybrid Rules are purportedly based on the recommendations set out in Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements) of the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting Project (Action 2),[2] there are important differences between the Hybrid Rules and Action 2.
2. The UK was a "first mover" on implementing rules targeting hybrid arrangements. As the story of the Hybrid Rules shows, being a "first mover" is not always an advantage. Successfully drafting rules addressing complex matters is not straightforward; it is generally not appropriate to take a "broad brush" approach. However, unfortunately and as will be explored in this note, this is the approach taken under the Hybrid Rules. As a result there can be unexpected outcomes, with arrangements that one would not anticipate falling within the scope of the Hybrid Rules (on a purposive basis in that the arrangement does not involve any hybridity as that phrase would be commonly understood) resulting in potential counteractions. There is also the added complication that being a "first mover" in respect of rules that incorporate an "imported mismatch" concept can be challenging.[3]
3. There is no purpose or motive test when applying the Hybrid Rules; instead the question is whether certain mechanical conditions are satisfied. Whilst such an approach is perhaps understandable from a tax authority perspective, this can result in unexpected outcomes with no scope to mitigate unintended consequences in the absence of a purpose or motive test.

Of course, when any new significant legislation is introduced it is inevitable that there will be uncertainty and difficulty in its practical application. However, that uncertainty and difficulty

[1] FA 2016 Sch.10 Pt 1 para.1 inserting TIOPA Pt 6A.

[2] OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report* (Paris, OECD Publishing, 2015), available at: *http://www.oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm* [Accessed 2 July 2018].

[3] While it is expected that EU Member States will be required to implement equivalent rules by 1 January 2020 until such time the TIOPA Pt 6A Ch.11 "imported mismatch" rules may apply very widely.

are even more pronounced where the legislation in question is long and complex with a scope so broad that it potentially captures "innocent" transactions. This is the case with the Hybrid Rules.

As is now customary in order to assist in the application of new legislation in practice, in November 2017 (almost a year after the rules took effect) HMRC finalised their guidance on the Hybrid Rules (the Guidance).[4]

In the absence of HMRC practice and judicial decisions, guidance can be helpful. However, guidance should not be used as a substitute for appropriately targeted legislation. Further, as it is non-binding, it does not fully mitigate the practical uncertainties.

This note explores certain practical issues that have arisen in applying the Hybrid Rules, and the extent to which the Guidance has assisted taxpayers in those scenarios.

Overview of the Hybrid Rules

Before exploring the Hybrid Rules and the Guidance, a brief reminder of the operation of the Hybrid Rules. In broad terms, the stated aim of the Hybrid Rules is to counteract, for UK corporation tax purposes, situations that would otherwise involve an amount being deductible from either:

- a person's income without a corresponding amount of ordinary income (broadly, taxable income) arising to another person or with an amount of ordinary income arising to another person but being under-taxed (deduction/non-inclusion mismatches); or
- more than one person's income or from a person's income for the purposes of more than one tax (double deduction mismatches).

As noted previously:

- the Hybrid Rules can apply in respect of non-UK mismatches where that mismatch is able to be "imported" into the UK under Part 6A Chapter 11 TIOPA; and
- there is no purpose or motive test relating to the application of the Hybrid Rules; the Hybrid Rules apply mechanically.

Where the Hybrid Rules apply:

- with respect to deduction/non-inclusion mismatches:
  - — the primary counteraction is to deny a deduction for the payer; and
  - — if this primary counteraction does not occur, a secondary counteraction measure is applied to bring the relevant receipt into the charge to tax for the payee;
- with respect to double deduction mismatches, then for hybrid entities:
  - — the primary counteraction is to deny a deduction for the investor; and
  - — if this primary counteraction does not occur, a secondary counteraction is applied to deny a deduction for the hybrid entity.

[4] HMRC, *INTM Guidance—Hybrid and Other Mismatches* (2017), available at: *http://www.hmrc.gov.uk/gds/intm/images/INTM850000_hybrids.pdf* [Accessed 2 July 2018].

Therefore, the Hybrid Rules can have significant UK tax implications for taxpayers.

Payments and quasi-payments

An initial question concerning the application of the Hybrid Rules is whether there is a "payment" or a "quasi-payment". If not, then there can be no counteraction under the Hybrid Rules.

Payments

For these purposes, a payment is defined, broadly, as any transfer of money or money's worth from one person to another in relation to which the payer is able to claim a deduction in computing its taxable profits.[5]

At first glance there is nothing particularly controversial about this definition; clearly it would capture any payments which result in a tax deduction for the payer (for example, an interest payment).

However, there are concerns that this definition of payment captures a broad range of transfers and deductions because there is no apparent requirement for a direct and temporal connection between the transfer and the deduction. This concern arises because of the (somewhat vague) causal test of "in relation to".[6] In other words, by using the phrase "in relation to" (rather than, say, "as a result of") there is a concern that, if there is a transfer of money and, at the time of the transfer or at some other point (whether before or after), a deduction for the payer, that would be treated as a payment for these purposes. For instance, let us say that a lender advances a loan to a borrower which, five years later, it impairs and in respect of which it claims a tax deduction. Concerns have been expressed that HMRC could take the view that the subsequent deduction "relates" to the transfer of the money (in that if the loan had not been advanced then the lender would not have been able to claim the deduction so, although the deduction is not "as a result of" the transfer of money under the loan it "relates" to the transfer of money under the loan). This seems an overly broad interpretation; such an approach is not a natural reading of this definition and the type of circumstances that should fall within its scope. Further, if such a broad approach were appropriate, this raises questions as to why the separate quasi-payment concept is required. Unfortunately, the Guidance is silent on the issue.

Quasi-payments

In addition to payments, the Hybrid Rules also apply to quasi-payments.

For these purposes, a quasi-payment is defined, broadly, as an amount in respect of which a payer is able to claim a deduction in computing its taxable profits and it is reasonable to expect an amount of ordinary income to arise to one or more other persons, as a result of the circumstances giving rise to the deduction, making certain assumptions including, amongst others, that the payee is resident in the same jurisdiction as the payer and subject to the same accounting rules as the payer.[7]

[5] TIOPA Pt 6A s.259BB(1).
[6] TIOPA Pt 6A s.259BB(1)(b).
[7] TIOPA Pt 6A s.259BB(2).

The Guidance notes that something that is treated as a payment may also be a quasi-payment.[8] However, conversely, it seems reasonable to conclude that there are certain amounts that may be treated as quasi-payments but not payments (otherwise the quasi-payment concept is redundant). Of course, this lends support to a more narrow (natural) reading of the payment definition.

However, as noted, such an amount should only be treated as a quasi-payment where, effectively, applying (amongst others) the same accounting and tax rules as those which apply to the payer (being the person claiming the tax deduction) ordinary income would arise to another person.

The legislation specifically carves-out deemed deductions in the payer jurisdiction where the circumstances giving rise to that deduction do not include any economic rights, in substance, existing between the payer and, amongst others, the payee.[9]

There has been a lot of ink spilled on the reasons for this carve-out and the concerns around whether it works as intended, specifically on deemed deductions in respect of cross-border interest-free loans.

It is understood that HMRC previously confirmed that the operation of the carve-out was intended to exclude unilateral deductions and so bring the UK approach into line with Action 2. However, neither the draft Guidance nor the legislation were clear on the point.

Helpfully, the Guidance now states that the carve-out applies where[10]:

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

Distressed debt

Difficult questions can arise in applying the Hybrid Rules in distressed intra-group debt scenarios in determining whether there is the risk of counteraction under Part 6A Chapter 3 TIOPA.[11]

Debt releases

Let us imagine a scenario where, in January 2017, a non-UK parent advances a loan to its UK subsidiary but, subsequently, the UK subsidiary becomes distressed and the loan is released. Under applicable local tax law, the non-UK parent is able to claim a deduction in respect of the debt release but the UK subsidiary is not required to recognise income in respect of the amount waived because of its relationship with the parent company.

[8] The Guidance, above fn.4. See, for instance, INTM550540, "Hybrids: Chapter 2 - Definition of key terms: Payment and quasi-payment", 23.
[9] TIOPA Pt 6A s.259BB(3).
[10] The Guidance, above fn.4, INTM551270, "Hybrids: Chapter 3 - Financial instruments: Example: Interest-free loan – deemed interest", 114.
[11] TIOPA Pt 6A Ch.3. Ch.3 counteracts hybrid or other impermissible mismatches that it is reasonable to suppose would otherwise arise from payments or quasi-payments under, or in connection with, financial instruments.

There is a specific example addressing the application of the Hybrid Rules to debt releases in the Guidance.[12] In short, contrary to Action 2,[13] HMRC consider that intra-group debt releases may result in counteractions under the Hybrid Rules.

HMRC's view is that a debt release satisfies the definition of both a payment and a quasi-payment. It is questionable whether this is correct. No justification is provided as to why HMRC consider that a debt release constitutes a payment for these purposes (or why a debt release is properly treated as a payment under, or in connection with, a financial instrument) and, in the context of quasi-payments, the Guidance notes that "it would be unusual for a country to allow such a mismatch in domestic transactions".[14] This is an odd statement given that, in certain circumstances, UK domestic law specifically allows a deduction/non-inclusion mismatch on a debt release in a purely UK domestic transaction under the UK loan relationship rules.

Notwithstanding the arguments to the contrary, let us assume that a debt release is treated as a payment or quasi-payment and there is a deduction/non-inclusion mismatch. Whether there would be counteraction under Part 6A Chapter 3 TIOPA would likely turn on whether the deduction/non-inclusion mismatch arises by reason of the "terms or any other feature of the financial instrument"[15] (being the loan). In the Guidance HMRC explicitly state that:

> "The addition of the phrase 'or any other feature' to s259CB(2) widens the scope of Case 1, bringing within it, for example, mismatches that arise by reason of the financial instrument being treated in a more beneficial manner because of the relationship between the relevant parties."[16]

Accordingly, it seems that HMRC's view is that the fact that a loan is between related companies will be a feature of the loan. It is difficult to see how the relationship between the parties could properly be said to be a feature *of* the loan. Of course, the fact that the parties are related may well impact on the tax and/or accounting treatment of the loan (including a release) but that does not necessarily make that relationship a feature *of* the loan.

However, assuming that the relationship is treated as a feature of a loan, there is a concern that a UK debtor (who is not required to recognise income on the debt release because of its relationship with the creditor) may be subject to counteraction under the Hybrid Rules where the creditor is able to claim a deduction in respect of that debt release.

The legislators seem to have considered this point and sought to address it through section 259CB(3) TIOPA which makes clear that where the "excess arises by reason of a relevant debt relief provision", that excess will not be considered to have arisen by reason of the terms, or any other feature, of the financial instrument.[17]

[12] The Guidance, above fn.4, INTM551300, "Hybrids: Chapter 3 - Financial Instruments: Example: Release of debt obligation", 123.
[13] OECD, above fn.2, Example 1.20.
[14] The Guidance, above fn.4, INTM551300, "Hybrids: Chapter 3 - Financial Instruments: Example: Release of debt obligation", 124.
[15] TIOPA Pt 6A s.259CB(2)(b).
[16] The Guidance, above fn.4, INTM551130, "Hybrids: Chapter 3 - Financial instruments: Extent of the mismatch: Case 1", 71.
[17] TIOPA Pt 6A s.259CB(3). A "relevant debt relief provision" is defined in TIOPA Pt 6A s.259CC(3) and includes each of CTA 2009 ss.322, 357, 358, 359, 361C, 361D and 362A.

However, in the example above, although it might be thought that the debt release by the parent would fall within the scope of the UK connected company exemption as set out in section 358 of the Corporation Tax Act 2009 (CTA 2009) and, therefore, within the scope of the "relevant debt relief provisions" exemption, following the repeal of section 321 CTA 2009, it is not so straightforward.

It is beyond the scope of this note to explore section 321 CTA 2009 but, in short, it is understood that the effect of its repeal is that, for the purposes of the UK loan relationship rules, from 1 January 2016 any credits and debits in respect of loan relationships which are recognised in equity or in shareholder funds under generally accepted accounting principles are no longer required to be brought into account for the purposes of the UK loan relationship rules.

As such, in the example above, the writer understands that any credits arising in respect of a debt release would not need to be brought into account for the purposes of the UK loan relationship rules. As a result, the UK debtor would no longer be relying on the section 358 CTA 2009 connected companies exemption to relieve any UK loan relationship credit arising on a debt release. Although this does not impact on the position for the UK debtor under the UK loan relationship rules (in that, in both cases, the UK debtor should not be required to recognise income on the debt release), this may give rise to counteraction under the Hybrid Rules; the exemption for "relevant debt relief provisions" does not apply.

The outcome described above cannot be what was intended by the Parliamentary draftsmen when including the "relevant debt relief provisions" exemption in the Hybrid Rules. There does not seem to be any clear policy reason for treating the release of loans entered into post 1 January 2016 differently from those entered into before 1 January 2016 under the Hybrid Rules. Rather this outcome would appear to be an anomaly reflecting an oversight to consider the interaction of the repeal of section 321 CTA 2009 and the Hybrid Rules. Unfortunately, this is not addressed in the Guidance.

A couple of further points to note on debt releases:

- The "relevant debt relief provisions" definition only includes certain UK exemptions to the recognition of taxable income on a debt release; this does not extend to any equivalent provisions in a non-UK jurisdiction. This is not only relevant in a UK debt context but may be relevant when considering the application of the Part 6A Chapter 11 TIOPA "imported mismatch" rules.[18]
- It is not clear why section 322 CTA 2009 is included within the "relevant debt relief provisions" definition. Section 322 CTA 2009 provides relief in a number of unconnected scenarios, including where a debtor is in a liquidation process. It is difficult to see how the type of scenarios falling within section 322 CTA 2009 could properly be treated as "features" of the loan relationship. On this basis, it seems reasonable to conclude that reference to section 322 CTA 2009 is simply "for the avoidance of doubt".

[18] TIOPA Pt 6A Ch.11.

Impairments

Where a debtor company is in financial distress a creditor will, under applicable accounting rules, be required to consider its loan relationships and where that loan relationship is unlikely to be repaid in full it may be required to revalue the loan relationship accordingly. In circumstances where a creditor is required under the relevant accounting rules to recognise an impairment in respect of a loan relationship, there is then the related tax question as to whether the creditor is able to claim tax relief (normally in the form of a deduction) in respect of that impairment.

Before considering the application of the Hybrid Rules to any impairment related tax deduction claimed by a creditor, it is important to note that, generally, where a creditor impairs a loan relationship this should not have any impact on the debtor company (that is, the debtor would not ordinarily write down the value of the liability outstanding in its financial statements). In other words, an impairment is an asymmetric event which does not impact on the legal liability of a debtor to repay in full the amount outstanding on the debt in question; in that respect an impairment is different to a debt release.

With that background, let us assume that a creditor is able to claim a tax deduction in its jurisdiction in respect of an impairment of a debt owed by a UK debtor. As noted above, the asymmetric nature of an impairment means that, generally, the debtor would not be required to bring into account a corresponding amount as taxable income and may not even be aware of the impairment. Notwithstanding, there is a possible deduction/non-inclusion mismatch.

Whether this outcome results in a quasi-payment will turn on the counterfactual analysis described above and the accounting and tax rules in the payer (creditor) jurisdiction. For the reasons noted above, if payment was interpreted broadly, there is concern that impairments could be treated as payments for the purposes of the Hybrid Rules. This would be an odd outcome and, again, lends support to a more natural reading of the definition of payment. Further, there is an argument that impairments are simply asset revaluations required for accounting purposes and so should be treated in a similar way to other valuation adjustments which, it is understood, HMRC do not regard as being within the scope of the Hybrid Rules.

The Guidance does not address impairments specifically. However, assuming that an impairment deduction may be treated as a payment for the purposes of the Hybrid Rules, whether there would be a counteraction under Part 6A Chapter 3 TIOPA would likely turn on whether the deduction/non-inclusion mismatch arises from a term or any other feature of the financial instrument. As noted previously, HMRC interpret "feature" broadly.[19]

Therefore, the question may turn on whether the impairment deduction arises because of the relationship between the parties (if that relationship gives rise to a more beneficial tax outcome). It will be a question of fact in the relevant jurisdiction(s) to determine whether the impairment deduction turns on the relationship between the parties.

Although HMRC (presumably) had in mind something equivalent to a group or connected party relationship which gives rise to a more beneficial tax outcome, in certain cases, the absence of such a relationship may result in a more beneficial tax outcome. For instance, in a UK context, an impairment deduction may be allowed for a creditor in respect of an unconnected debt whereas

[19] See above fn.16.

an impairment deduction would be denied in a connected party context.[20] The question would then be whether the absence of a relationship is itself a relationship. In the context of impairments, which, by their nature, are asymmetric, it seems counterintuitive that an impairment by a creditor could trigger a counteraction for the UK debtor. It is disappointing that the Guidance does not address this point.

Tax consolidated groups

Although the UK does not have a general concept of corporate tax consolidation, this is not an uncommon feature of the corporate tax regimes of other jurisdictions. The way in which a tax consolidation regime operates varies from jurisdiction to jurisdiction. For instance, in some jurisdictions, each entity within the tax consolidated group is required to file tax returns; in others the "lead" company is responsible for the filing of a single return for the entire group and payment of tax for the entire group.

Taking an example, let us say Company A (which forms part of a tax consolidated group in jurisdiction A) advances a loan to a UK company. The UK company claims a deduction in respect of interest payments on the loan. However, because of the way in which the tax consolidation regime in jurisdiction A operates, Company A itself is not subject to tax on the receipt of the interest albeit that, economically, the interest paid will be recognised as income by the group (for example, in the return filed by the "lead" company).

Although economically there is no deduction/non-inclusion mismatch, absent a purpose or motive test, taxpayers are required to consider the application of the Hybrid Rules in respect of those arrangements (given that, as a matter of fact, the payer is able to claim a deduction in respect of a payment with no corresponding income recognition for the recipient of that payment).

With respect to tax consolidated groups, the Guidance states (in the context of Part 6A Chapter 7 TIOPA[21])[22]:

> "When considering entities that are part of a consolidation regime, s259BE(4) applies in most instances so that the lead company in the consolidation is an investor in the company that actually receives the payment. A relevant mismatch should not arise where this is the case."

Although this is a helpful statement and reflects what should be the correct outcome under the Hybrid Rules where the arrangements involve a tax consolidated group, it is not immediately apparent how the "investor" concept ties into section 259GB TIOPA (being the section to which the statement above relates); section 259GB(1) TIOPA refers to the "payee" not the "investor". A "payee" is defined in section 259BB(6) TIOPA as being (in the case of a payment) either the person to whom the transfer of money or money's worth is made, *or* to whom an amount of ordinary income arises as a result of the payment. Given that section 259GB(1) TIOPA simply refers to a "payee" (and not the "hybrid payee" being Company A in the example above), it is

[20] In an unconnected scenario, it should be borne in mind that whilst a creditor and debtor may be unconnected for the purposes of the UK loan relationship rules, they may be "related" for the purposes of the Hybrid Rules.
[21] TIOPA Pt 6A Ch.7.
[22] The Guidance, above fn.4, INTM555060, "Hybrids: Chapter 7 - Hybrid Payee: Conditions to be satisfied: Condition D", 295.

not clear why this point is not made in the Guidance rather than referring to the "investor" concept. Notwithstanding, it is helpful that the Guidance confirms that where an amount is brought into account by the consolidated group (or one of its members) then that should not result in counteraction under the Hybrid Rules (even if the statutory route to this outcome is unclear).

Tax exempt entities

There is no explicit exemption for tax exempt entities in the Hybrid Rules. Therefore, where payments (or quasi-payments) are made to tax exempt entities, it is necessary to consider the application of the Hybrid Rules.

Let us say a UK company makes an interest payment to a related non-UK pension fund on an ordinary "plain vanilla" loan. The UK company is able to claim a deduction for the interest paid and the pension fund is not subject to tax on receipt (as it is tax exempt).

Factually, there is a deduction/non-inclusion mismatch. It is not entirely clear why the legislation does not simply include an exclusion to the Hybrid Rules in such circumstances. Instead, working through the definition of "ordinary income" (namely the implicit suggestion that if there is a general exemption to the recognition of ordinary income the amount is treated for these purposes as being "ordinary income") and applying the "relevant assumptions" in section 259CB(5) TIOPA (namely considering the counterfactual position were the payee is a taxpaying entity) it may be possible to conclude that there should not be any counteraction under the Hybrid Rules.

The Guidance provides an example of the application of the Hybrid Rules on payments to a tax exempt charity (this example should be equally relevant to other tax exempt persons such as pension funds and sovereign wealth funds).[23]

HMRC's position seems to be that the legislation does not deem ordinary income where a payee is generally exempt; it is questionable whether this approach is correct given the drafting of section 259BC(3)(b)(i) TIOPA.

Instead, HMRC's view appears to be that it will be necessary to demonstrate that, effectively, if the tax exempt were taxable it would have brought the amount paid into account as taxable income. Whilst that may seem straightforward, in a cross-border context or when considering the "imported mismatch" rules, in the absence of a purpose or motive test, it is not. For instance, in some jurisdictions, there may well be a requirement for a pension fund to take a particular corporate form (for example, for regulatory purposes) and by being incorporated in that corporate form the pension fund (in this example) is tax exempt (in other words the tax exemption attaches to the specific corporate form); it is difficult to run a counterfactual analysis in those circumstances as no equivalent taxpaying entity exists.

[23] The Guidance, above fn.4, INTM551320, "Hybrids: Chapter 3 - Financial instruments: Example: Interest payment to a charity", 131.

Hybrid entities

Permanent establishments

In broad terms, for the purposes of the Hybrid Rules, a hybrid entity is an entity regarded as a person for tax purposes under the law of any territory, and either another territory does not regard it as a separate and distinct person for tax purposes or attributes its income or profits to a different person.[24]

Notwithstanding that the Hybrid Rules contain chapters specifically addressing permanent establishments (PEs), there was a concern that PEs could be treated as hybrid entities for the purposes of the Hybrid Rules.

Helpfully, the Guidance now confirms that:

> "A permanent establishment is not a hybrid entity under the definitions in Part 6A TIOPA 2010. Instead there are rules at Chapters 6, 8 and 10 that apply where certain mismatches involving a permanent establishment arise."[25]

Of course, this does not mean that the application of the Hybrid Rules to PEs is straightforward. It is beyond the scope of this note to consider those difficulties and, although the Guidance may address some of the practical difficulties, there remain a number of concerns arising out of those rules, including, for instance, the deeming rule contained in section 259HB(2A) TIOPA.

Partnership

Part 6A Chapter 7 TIOPA counteracts certain deduction/non-inclusion mismatches that it is reasonable to suppose would otherwise arise from payments (or quasi-payments) because a payee is a hybrid entity.

Prior to a recent change to the Hybrid Rules (see below), in certain circumstances, the application of Part 6A Chapter 7 TIOPA potentially gave rise to odd outcomes where there was a partnership in the structure.

Let us say that there are three corporate partners (each incorporated in different jurisdictions) each holding a 33.33 per cent share in an English limited partnership, with the partnership holding 100 per cent of the shares in a UK company. The limited partnership advances a loan to the UK company. The UK company is able to claim a deduction for UK corporation tax purposes in respect of interest payments on the loan. Under applicable law, each of the UK company debtor and two of the partners treat the English limited partnership as tax transparent but the third corporate partner treats the partnership as tax opaque.

Given that the English partnership is treated as transparent by two of the partners but opaque by the other, the partnership is treated as a hybrid entity for the purposes of the Hybrid Rules, and so is a hybrid payee for the purposes of Part 6A Chapter 7 TIOPA. On one reading of Chapter 7 it was arguable that because one partner treated the partnership as opaque, then Chapter 7 had the effect of denying in full the deduction for the UK debtor on interest payments to the partnership

[24] TIOPA Pt 6A s.259BE.
[25] The Guidance, above fn.4, INTM550590, "Hybrids: Chapter 2 - Definition of key terms: Permanent establishment", 32.

even though, economically, there was only a deduction/non-inclusion mismatch in respect of 33.33 per cent of any interest paid.

The Hybrid Rules have now been amended to address this outcome where the hybrid payee is a partnership.[26] The effect of this change is to apply Chapter 7 on a partner-by-partner basis which means that there should only be a counteraction under Chapter 7 to the extent of the actual deduction/non-inclusion mismatch. So, in the example above, 33.33 per cent (rather than 100 per cent) of the deduction claimed by the UK debtor would be counteracted under Chapter 7. Helpfully, the Guidance also includes an example addressing this specific scenario noting that the purpose is to ensure that "any disallowance is proportionate".[27]

Interaction of Hybrid Rules with other rules

In addition to the Hybrid Rules, there are a significant number of other UK rules that restrict the deductibility of expenses. For instance, in respect of interest payments, taxpayers will need to consider, amongst others: transfer pricing; thin capitalisation; unallowable purpose rules; and the corporate interest restriction rules. There is no provision in the Hybrid Rules which establishes the order of priority of these rules.[28] This is an important practical consideration.

The Guidance states that the Hybrid Rules should be considered "alongside" each of the other restrictions.[29] The Guidance also provides some practical advice which suggests that taxpayers should apply each of the deductibility restriction rules separately and independently and, if the counteraction under the Hybrid Rules is less than any counteraction under the other rules, the taxpayer should apply the rule that gives rise to the largest counteraction (that is, taxpayers should apply the various tests in parallel rather than in series).

Conclusion

The Hybrid Rules are complex with a far-reaching scope. As explored in this note, this has resulted in practical difficulties in applying the rules, in particular where the mechanical application of the rules to the facts may lead to unexpected outcomes. In large part these difficulties arise from the UK being a "first mover" in implementing the Hybrid Rules and the lack of a purpose or motive test. In those circumstances, absent HMRC practice and judicial decisions, taxpayers and practitioners alike have looked to the Guidance to assist in interpreting

[26] TIOPA Pt 6A s.259GB(4A).

[27] The Guidance, above fn.4, INTM555090, "Hybrids: Chapter 7 - Hybrid Payee: Extent of the mismatch – hybrid payee not chargeable to tax in any territory", 298. INTM555210, Hybrids: Chapter 7 – Hybrid Payee: Example: Calculating the mismatch where there are multiple payees", 306.

[28] Although note HMRC expect that the Hybrid Rules would apply in priority to the corporate interest restriction rules (see the Guidance, above fn.4, INTM550080, "Hybrids: Chapter 1 - Introduction: Interaction with other legislation", 13. HMRC, Internal Manual, *Corporate Finance Manual* (published: 16 April 2016; updated: 31 July 2018), CFM95140, "Interest restriction: Overview: A short guide").

[29] The Guidance, above fn.4, INTM550080, "Hybrids: Chapter 1 - Introduction: Interaction with other legislation", 13.

the Hybrid Rules. Although the Guidance is helpful, it does not provide all of the answers and is no substitute for appropriately targeted legislation.

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Base erosion and profit shifting; Exemptions; HMRC guidance; Hybrid entities; Hybrid mismatch arrangements; Interest

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