Hybrid Mismatch Consultation
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19 August 2020

Dear Sirs,

Re: BVCA response to the HMRC consultation on Hybrid and other Mismatches

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry ("PE/VC") in the UK. With a membership of over 750 firms, the BVCA represents the vast majority of all UK based PE/VC firms, as well as their professional investors and advisers. Over the five-year period 2014-2018, BVCA members invested over £38bn into nearly 2,800 companies based in the UK. Our members currently back around 4,330 companies, employing close to 1.6 million people on across the world, including 843,000 in the UK.

We are grateful for the continued engagement on the issues we have identified arising from the Hybrids and other Mismatches legislation. Set out below are our detailed comments to the questions in the consultation document and we look forward to discussing these further with you. This letter was prepared before the recent revised guidance was issued. We will write to you separately if, on reading that guidance, any particular points occur to us.

Double Deduction Rules

Q1. Can you identify and describe in detail structures that are disproportionately impacted by the double deduction rules due to their also involving inclusion/no deduction income? Please provide full group/jurisdictional context, nature of entities and scale of impact.

The UK investment management industry serves a global client base. A significant number of global asset management groups with a UK presence are headquartered in the United States. That UK presence of the business may consist of a number of operational functions carried on in the UK, including the central role of the provision of investment advice. A UK advisory entity (a UK limited company or a UK limited liability partnership with UK corporation taxpayer members) forms part of a complex, multi-national group, the structure of which is driven from the US headquarters of the business. In consequence, it is commonplace that the UK advisor entity has 'checked the box' for US tax purposes to be treated as a disregarded entity.

The US incorporated, taxpayer parent of the group ("**US TopCo**") may be the "Investor" in the UK entity for the purposes of the rules, or this could be a United States incorporated, taxpayer subsidiary of US TopCo (the "**US Investor Subsidiary**") depending on the particular structure.

We would typically expect the US TopCo or the US Investor Subsidiary to receive various forms of income from the business which are either aggregated in US TopCo or the US Investor Subsidiary, or have been aggregated further down the group before being distributed up the group through one or more group entities. This income consists of management fees, carried interest and co-investment returns from a number of management vehicles and fund vehicles, which may be domiciled in a variety of jurisdictions depending on the activities of the group and the jurisdictions in which the business operates. The management fee element of these returns are, commercially, seen as the income used to pay advisory fees to international sub-advisors. The payments of management fees, carried interest and co-investment returns are very unlikely to be directly payable from the entity which realises them (such, for example, as the fund entity or the investment manager) to US Topco or the US Investor Subsidiary. The funds usually flow through a number of group entities which are likely to have also checked the box for US tax purposes to be treated as flow-through in order to maintain US tax efficiency.

The US TopCo may pay the advisory fee to the UK advisor for investment advisory services that the UK advisor provides to non-UK investment managers in the group. However, the advisory fee may also be paid to the UK advisor directly by the non-UK investment managers for the services which results in the same economic outcome.

In summary, therefore, the UK advisor may receive an advisory fee from a US investor who is paying that advisory fee out of income it has received from various different income streams across a multi-national group. The income indirectly represents management fees realised by investment manager entities in the group, and carried interest and co-investment realised in fund vehicles and carried interest and co-investment vehicles which are managed by those investment manager entities. Alternatively, as pointed out above, the UK advisor may receive all or a portion of its advisory fee directly from certain investment manager entities in the group, which may not be an "Investor" in the UK advisor.

In the structure described, the fees received by the UK advisor from US TopCo or US Investor Subsidiary may not be considered dual inclusion income because the UK advisor has checked the box as a disregarded entity and therefore the US does not recognise the payment of the advisory fee from the US TopCo or US Investor Subsidiary to the UK advisor. The US TopCo or US Investor Subsidiary would recognise and pay US tax on the income that it uses to make the advisory fee payment to the UK advisor. This has the result that no UK corporation tax deduction is available for the UK company in respect of its normal business costs such as salaries as these costs are recognised both in the UK and the US, but there is no "dual inclusion income".

Q2. Can you identify which of the conditions of section 259ID are too restrictive? If a case could be made such that these were to be amended, what level of evidence of inclusion without deduction or disproportionate outcomes would you suggest is necessary?

Section 259ID as currently drafted would only apply to very simple structures, in which the "Investor" (in our example, US TopCo or US Investor Subsidiary) is the entity which directly pays the entire advisory fee to the UK advisor. As discussed, some or all of the advisory fee payment may be made directly to the UK advisor by other group investment management entities.

Further, section 259ID requires that the payment is made in direct consequence of a payment made to the Investor by an "unrelated party". Whilst, arguably, the underlying fund vehicles managed by the group's investment manager entities may be "unrelated parties", the management fee return is paid to the investment manager, and as explained in response to Q1, possibly aggregated in a holding company which could be, for example, a subsidiary or sister entity of US Investor Subsidiary. Therefore, whether the payment is made by the investment manager entity or via a series of group entities, the payment is no longer made to the US TopCo or US Investor Subsidiary by the "unrelated party" fund vehicle.

It is unlikely in a global asset management group that the underlying fund vehicle will make the management fee payment directly to the "investor".

We suggest that a group concept is embedded into Section 259ID, which accounts for multi-national groups with group entities which are resident in a number of jurisdictions and which may not be bodies corporate for UK purposes (for example, management fees are commonly directly received from fund vehicles by general partner limited partnerships). Specifically, we are referring to:

- the payment made to the hybrid entity referred to in Condition A being made by the "Investor" or a member of its group, to the UK hybrid entity;

- Condition C being amended such that the payment is made in direct consequence of a payment made to the Investor by an unrelated person, but that such payment is accepted as being in direct consequence where it is made via a series of steps within the Investor's group, or where there is a genuine economic link between the services provided by the UK adviser and the income received by US TopCo or US Investor Subsidiary.

We would note that these amendments to Conditions A and C would be consistent with the OECD principle that double taxation should be avoided.

The UK advisor would be required to self-assess that Conditions A to D have been met. As with any self-assessment, this involves the taxpayer gathering and retaining supporting evidence and information in relation to the relevant tax return. Given that the UK advisor forms part of the same business as the Investor, it should have access to information which allows it to assess whether Condition D is met (in fact, the UK advisor is likely to have more readily accessible information than other UK corporation tax payers required to assess the impact of the hybrid rules under other Chapters of Part 6A where an investor does not form part of its group or an active ongoing business relationship). Therefore, whilst we acknowledge that HMRC have raised concerns regarding evidence to support deduction without inclusion, our view is that, provided the group concept is appropriately and clearly drafted, taxpayers should be able to accurately self-assess whether Conditions A and C have been met as is currently the case under Chapter 9.

Q3. What would be the impact of utilising non-hybrid entities in these structures so that no counteraction would be required? Please consider and describe any economic, regulatory and foreign tax impacts.

We have provided the specific example of a US-headquartered asset management business as this is the scenario in which these rules may cause challenges. The structure and US tax profile of the business is driven by the US headquarters. It would be unusual, if this structure were to be implemented, for an entity classification election not to be made in relation to the UK adviser. However, were this to occur the US tax treatment would result in the need to consider the US CFC rules and related tax exposure. The US rules also become complicated in instances in which the US TopCo is a US LLC where deductibility of the advisory fee may be unclear.

Q4. Are foreign owned groups able to get relief for additional tax arising in the UK in consequence of applying the hybrid rules? If not, why not?

In practice, it is unlikely that US tax relief will be available for additional tax arising in the UK in consequence of applying these rules. This is because of the nature of the US check the box election (i.e. the fact that the disregarded entity check the box election means that the payment to the UK adviser is not recognised in the US), and the amount that the US parent recognises as income for US tax purposes is the equivalent income received via potentially various third parties. In addition, in principle, the US will only grant a foreign tax credit for foreign source income as opposed to tax arising owing to a payment from the US.

Q5. What mitigating steps have businesses undertaken in the 3 years since Part 6A came into effect?

Taxpayers seek to comply with the law, rather than mitigate. The investment funds industry has carefully considered the application of the anti-hybrid rules and taken advice in order to ensure it is compliant. In scenarios such as that we have set out above, it has been accepted that section 259ID is not available for the vast majority of taxpayers in an industry which it was purported to help.

The lack of clarity in the rules means that Chapter 9 potentially has the ability to apply to benign, commercial arrangements. This would have the result that no UK corporation tax deduction is available for a UK company advisor in respect of its normal business costs such as salaries. Clearly, such an outcome would have a significant economic effect for the UK business. This risk, posed by lack of legislative clarity, has resulted in professional advisers taking careful, finely-judged views (in conjunction with advisors in other jurisdictions) as to whether an amount of income is "dual inclusion income" or not. Given the complexity of certain group structures, this analysis comes at significant cost and resource to the taxpayer.

Q6. What impact have other jurisdictions' corporate tax reforms had on the extent of the use of hybrid entities?

In establishing a new fund structure, investment managers take professional advice in the relevant jurisdictions involved to review the application of the applicable anti-hybrids regimes. It is clearly not desirable to use a hybrid entity in a structure where doing so is going to cause a counteraction under a relevant anti-hybrids regime. We come across this where the use of a hybrid entity is for a genuine commercial purpose. For example, if a Luxembourg SCSp is intended to be used as a fund vehicle, but the fundraising process attracts mainly French investors which may see that entity as opaque and potentially cause a counteraction for underlying Luxembourg portfolio companies, then the investment manager will take advice and potentially use a different fund vehicle.

However, the structures described above are existing structures of the management entities of a global group. Hybrid entities most commonly arise in the structures described in these responses as a result of the US check the box regime. The US check the box regime will continue to be used by US headquartered businesses.

Q7. Would a broader change, enabling inclusion/no deduction income to be treated in the same way as dual inclusion income for the purposes of the double deduction mismatch rules, be a more appropriate solution to the concerns raised? In considering this point please consider the consistency of any proposal with OECD principles.

Our preference would be for Chapter 9 to be amended to treat a payment which is made to an investor's group from an unrelated party and is "ordinary income" within that group as "dual inclusion income", provided it is also "ordinary income" of the UK entity. Our view is that this is consistent with OECD principles which only requires that a payment is brought into account for tax purposes under the laws of both the payer and payee jurisdiction. If the payment is brought into account in both the US and the UK (as is the case in the structures described in the responses to Q1 and Q2), our view is that the legislation would reflect the OECD principles more accurately if amended in this way. Currently, the structures described in Q1 involve payments which are brought into account in both the US and the UK, but the legislation results in potential counteraction.

Acting Together Definition

Q8. Do you recognise the concerns raised and consider that a change would be beneficial in better targeting the application of the hybrid rules? Please identify and describe the circumstances that reflect these concerns.

Yes; we have raised this concern in previous correspondence with you in relation to the anti-hybrid rules, including our response to the updated draft hybrid guidance dated 20 September 2017 (our "**2017 Letter**"), our follow on letter dated 9 April 2018 suggesting specific amendments to the guidance to provide further clarity on certain of the issues affecting our members (our "**2018 Letter**") and our letter dated 6 March 2020 summarising the matters we wished to discuss with you in our meeting on 20 April 2020 (our "**2020 Letter**" and, together with the 2017 Letter and the 2018 Letter, our "**Previous Submissions**") (copies of which are enclosed for ease of reference).

By way of recap, our concern is that the acting together test in section 259ND(7) generates difficulty for third party lenders, such as funds investing in debt instruments in private equity and venture capital backed companies – regularly the fund takes either no equity stake or, alongside their debt instruments, only a small equity stake (for example, in the form of shares, share warrants/options or convertible loans), but can nevertheless be caught by the breadth of the acting together concept in the X% investment conditions. This is because on almost all transactions involving our members the shareholder(s) (T) and fund lenders (P) will enter into agreements regularising the financing arrangements of the borrower (U).

Such agreements might include facilities agreements, intercreditor agreements, group behavioural covenants, parent company/investor guarantees and/or investment agreements (referred to as "**Standard Documents**" below), all of which could arguably affect the value of T's rights in relation to U and almost certainly do impact the ability of T to exercise its rights over U. These agreements are put in place to ensure that the rights of both P (as creditor) and T (as shareholder) are respected, but are not intended to create a mutual control framework between P and T in respect of U of the kind we understand were intended to be captured by the legislation. In particular, we note the statement in paragraph 3.9 of the Condoc which highlights that such arrangements do not generally create a level of control of the payer (U) by its counterparty (P), akin to group membership, that should be taken to give rise to acting together (with T) as these are just restrictions designed to protect the value of the third party's (P) contractual interest – we agree that these arrangements do not create a level of control akin to group membership; unfortunately the application of section 259ND(7) to Standard Documents does not currently reflect this policy intention.

As noted in our 2017 Letter, the result is that funds providing debt financing to borrowers are often put at a competitive disadvantage to commercial banks providing similar financing arrangements (who are less likely to be subject to the anti-hybrid rules and who do not typically rely on the same provisions in Standard Documents to protect their lending, often achieving such protection by taking prior ranking security over the borrower group's assets) because borrowers are subject to the additional cost and complexity of considering the anti-hybrid rules when entering financing arrangements with such funds.

In the context of this question (and per our Previous Submissions) it would also provide much needed clarity to taxpayers if your guidance were updated to include confirmation that (i) references to amounts being distributed or available for distribution in the X% investment conditions means amounts distributed or available for distribution in respect of shares; and (ii) T and P will not be treated as acting together where they are otherwise unconnected simply because they both enter into conventional documentation relating to the loan in question. The suggested amendments to the guidance from our Previous Submissions are set out in the appendix for ease of reference, although these may need minor amendment to reflect modifications made to the rules further to question 9 below.

Q9. What modifications do you consider would address your concerns and how would you anticipate these acting in practice?

We have considered at length alternative control tests within the UK tax code which could be used to replace the acting together test, in particular the control tests in sections 450 and 1124 CTA 2010, sections 371RB to 371RE TIOPA 2010 and section 148 TIOPA 2010 (as refined by sections 157 to 163 TIOPA 2010) (together, the "**Tax Control Tests**"). As you will be aware, the concept of "related" persons as defined in section 259NC incorporates, to some degree, elements of all the Tax Control Tests through the "control group" definition (including the 50% investment condition) and the 25% investment condition.

There are however elements of the Tax Control Tests which are not absorbed within the 259NC definition of related persons which, if tailored to address the concerns of lenders outlined above, would allow a distinction to be made between rights protecting a lender's interest as a creditor under contractual loan arrangements and rights which provide a level of corporate control intended to be within the scope of the legislation. Examples include:

- the carve out from section 450 CTA 2010 (in subsection (4)) disregarding the rights which the lender, or any other person, has as a loan creditor for the purposes of the distribution among participators test in subsection (3)(c); and
- the carve outs from sections 371RD(4) and 159(4) TIOPA 2010 (see limb (b) in each subsection) for rights and powers of other persons confined, in a case where a loan has been made by one person to another, to rights and powers conferred in relation to property of the borrower by the terms of any security relating to the loan.

In the context of the anti-hybrid rules we consider that it would be appropriate to apply a similar carve out to those provided in section 450 CTA 2010 and subsections 371RD(4)(b) TIOPA 2010 and 159(4)(b) TIOPA 2010 in respect of limbs (b) and (c) of section 259ND(7) to make it clear that ordinary course rights of a lender to protect their contractual loan interests do not result in them acting together with other investors in the borrower group. This would be added as a new subsection (10) as follows:

(10) For the purposes of subsections 7(b) and (7)(c), in a case where a loan has been made by P to U, any rights and powers which P has that are confined to rights and powers conferred in relation to the property of U in order to protect the value of P's interest as a creditor in respect of such loan to U are to be ignored.

This modification would provide much needed clarity to borrowers (and lenders) in circumstances where lenders enter into Standard Documents and so alleviate the significant burden on borrowers (and competitive disadvantage for fund lenders) of the additional cost and complexity involved in analysing the anti-hybrid rules in such circumstances (often, as you note in paragraph 3.7 of the Condoc, in situations where it is very difficult for the borrower to access the information required to undertake this analysis). Furthermore this approach would not, in our view, leave the door open for exploitation of the rules because (as you note in paragraph 3.10 of the Condoc):

(i) in all conditions[1] or other provisions[2] where the concept of "related" persons or persons in the same "control group" is used in the anti-hybrid rules an alternative limb of the condition is that the arrangement is a "structured" arrangement and so, if the relevant conditions for a structured arrangement were met, the anti-hybrid rules would be engaged without acting together being necessary; and

(ii) the broad targeted anti-avoidance rule in chapter 13 would apply to situations where relevant avoidance arrangements exist, providing a further layer of protection against mischief.

Q10. Are there any other commercial arrangements which should be considered in the same way as loans and guarantees as described above?

As noted above, there are a range of documents through which a lender may have rights which fall within the very broad drafting of section 259ND(7), including Standard Documents. Our hope is that the approach outlined above will be adopted (in which case, our expectation is that the relevant rights under any such agreements would be excluded from consideration for the purposes of section 259ND(7)); if this is not the approach adopted we would be grateful if the solution arrived at takes into account the standard contractual arrangements typically included in Standard Documents in respect of loans.

Q11. Having regard to the purpose of the legislation, can you identify and describe any situations potentially caught by the other heads of the "acting together" test in sections 259ND(7)(a), (b) and (d) which in your view should be modified? How would you suggest these rules should be modified and why?

Subsection (b) of section 259(7) provides that P is to be taken to "act together" with T in relation to U if (and only if): for the purposes of influencing the conduct of U's affairs (i) P is able to secure that T acts in accordance with P's wishes, (ii) T can reasonably be expected to act, or typically acts, in accordance with P's wishes, (iii) T is able to secure that P acts in accordance with T's wishes, or (iv) P can reasonably be expected to act, or typically acts, in accordance with T's wishes.

[1] Being condition C in Chapter 9 (hybrid entity DD mismatches), condition D in Chapter 3 (hybrid and other mismatches from financial instruments), condition E in Chapters 4 (hybrid transfer D/NI mismatches), 5 (hybrid payer D/NI mismatches), 7 (hybrid payee D/NI hybrid mismatches) and 8 (multinational payee D/NI mismatches), and condition G in Chapter 11 (imported mismatches).

[2] Being the secondary counteraction condition in section 259IC(2)(a) (counteraction where the hybrid entity is within the charge to corporation tax in the case of chapter 9 (hybrid entity DD mismatches)). [Note also that the concept of being "related" is used in section 259ID to identify an unrelated party when determining the amount of any "section 259ID income" for the purposes of counteraction under section 259IC – we do not consider that our proposed amendment to the rules would provide any scope for exploitation of the rules here.

Clearly the rights granted to P under Standard Documents in order to protect its interest as a creditor under contractual loan arrangements will provide P with rights falling within limb (b) of the test in specific scenarios where P's rights as a lender are triggered (for example, rights to demand repayment of the debt where financial covenants are breached). Our interpretation of limb (b), however, is that it applies in respect of business in the ordinary course and so would only capture rights that enable P to secure that T acts in accordance with P's wishes in ordinary course circumstances (and not those applicable in the specific circumstances where T requires action in order to protect its creditor position). Nevertheless, to provide clarity on this point our preference would be for the modification proposed in our response to question 10 to also apply to limb (b) of subsection 259(7) to confirm that customary creditor rights under Standard Documents would not result in P being treated as acting together with T under limb (b) of subsection 259(7).

Some jurisdictions have sought to address the disproportionate impact of the acting together concept in the context of investment funds by specifically excluding investors in those funds from being treated as "acting together" with one another where they hold less than a set percentage of the ownership and profit share of the fund concerned (save in cases where investors agree to take a collective approach to dealings with a fund manager). In Luxembourg, for example, this threshold is set at 10% and prevents such independent, small investors who do not have control over the fund's investments from being deemed to be associated with the fund or with the entities in which the fund invests. A similar refinement to the acting together test in the UK would remove a large degree of uncertainty and complexity surrounding the application of the rules in a fund context.

Exempt Investors in Hybrid Entities

Q12. Do you agree that a change of the type described above would be beneficial?

Yes we do agree that a change is required. The purpose of the anti-hybrids regime is to counteract mismatch outcomes arising from hybridity. The rules do not achieve this policy aim where the counteraction arises by virtue of non-taxation arising from the exempt status of an investor. The rules should therefore be amended to reflect this.

Q13. What entities other than pension funds might qualify for the exemption (whether implemented via principles-based definition or lists)?

While pension funds are an obvious example of an exempt investor there are others but in our view the list is not particularly long. This guides our view that a "permitted list" approach would be manageable from an ongoing practicable perspective.
We would wish to see the following entities included in such a permitted list:

- pension funds
- sovereign wealth funds
- university endowment funds
- charities (as defined by paragraph 1(1), Schedule 6, Part 1 of the Finance Act 2010)

Q14. What evidential requirements would be necessary to back up a taxpayer's contention that a new exemption of this type was available? Would the "reasonable to suppose" test suffice or would it be appropriate to require something different?

We see no reason to adopt a different evidential standard for this proposed exemption. The 'reasonable to suppose' hurdle is as a sufficient an evidential burden for taxpayers in the context of this proposed exemption as it is for the numerous tests for which it is adopted throughout the anti-hybrids legislation. We see no qualitative difference meriting a different approach.

We would be grateful for an opportunity to meet and discuss the difficulties this legislation creates for the industry and the UK companies it invests in. Please let us know if you have any comments or questions in the meanwhile.

Yours faithfully,

Mark Baldwin
Chairman of the BVCA Taxation Committee

Appendix – Suggested amendments to the guidance from our Previous Submissions

1. **Imported mismatches and third party borrowing arrangements**

We welcome the changes to the revised guidance at INTM559230 in relation to imported mismatches which helpfully set out the characteristics of third party borrowing arrangements in respect of which Condition C is unlikely to be satisfied.

INTM559230 focuses on the nature of the extent to which a series of arrangements can be said to exist. However, in our view the characteristics outlined in that paragraph also touch on the extent to which there may be a control group for the purposes of Condition G which is addressed primarily by INTM559270.

In particular, we have in mind the reference to the only relationship/connection between the lender and the borrower being the loan. In a conventional third party borrowing arrangement the existence of the loan of itself could not create a control group. This is because a control group is determined by reference to either:

i) being consolidated for accounting purposes (section 259 NB(1)(a));
ii) meeting the participation condition (section 259 NB(1)(b)); or
iii) meeting the 50% investment condition (section 259 NB(1)(c)).

In the context of third party debt finance the accounting consolidation condition and participation condition do not give rise to any particular concerns.

The 50% investment condition, however, may where there is no discernable policy reason why it should. This is because this condition has broadly two elements which could generate a connection (in the broad sense of the legislation) between the lender and borrower where one does not exist as a matter of fact.

The X% Tests

The X% test in section 259ND(3) considers the rights of the lender to acquire share capital, exercise votes or receive proceeds on the disposal of shares. As a non-shareholder these are not rights a third party lender would have and therefore this element of the test is unlikely to be relevant in most cases.

The X% test in section 259ND(4) considers the rights of the lender to distributions. The word 'distribution' is not further defined and must therefore take its ordinary meaning which is a distribution on shares (however made). Accordingly, a third party lender as a non-shareholder should not be troubled by this test.

We have made suggested amendments to the guidance below to reflect these points for clarity.

The Acting Together Test

The acting together test in section 259ND(7) does however generate some difficulty for third party lenders. In the language of the legislation the third party lender is P, the borrower is U and the third person T is the shareholder(s) in U.

In particular, section 259ND(7)(c)(ii) deems P and T to be acting together where they are party to arrangements where:

i) it is reasonable to suppose they are designed to affect the value of any of T's rights or interests in relation to U; or

ii) relates to the exercise of any of T's rights in relation to U.

On almost all transactions involving our members the shareholder (T) and third party lender (P) will enter into agreements regularising the financing arrangements of the borrower (U). These could arguably affect the value of T's rights in relation to U and almost certainly do impact the ability of T to exercise its rights over U. These agreements, typically in the form of an inter-creditor agreement, would ensure that the rights of both T and P are respected.

It is difficult to see a policy reason to capture third party lenders party to such arrangements within section 259ND(7) and our view is that it should not be read in that way. We have therefore provided some amendments (in blue) to INTM559230 to this end.

- **Suggested amendments to HMRC's Guidance:**

INTM550620: Hybrids: Chapter 2 - Definition of key terms: 50% investment and 25% investment

The investment condition is relevant to both the control and related persons definitions, as required by the appropriate chapter. The same test is used to determine whether the investment condition is met, simply replacing X% with 25% or 50%, as appropriate. Defined at 259ND.

A person (P) has an X% investment in a company (C) if it is reasonable to suppose that -

- P possesses or is entitled to acquire X% or more of the voting power in C, or

if the whole of C's share capital were disposed of, P would receive (directly or indirectly and whether at the time of disposal or later) X% or more of the proceeds of the disposal. Similarly, a person (P) has an X% investment in another person (Q) if it is reasonable to suppose that P would receive, directly or indirectly and whether at the time or later, X% or more of -

- the distributed amount if the whole of Q's income were distributed, or
- Q's assets which would be available for distribution in the event of a winding-up of Q or in any other circumstances.

References to a person receiving any proceeds, amount or assets also include references to the proceeds, amount or assets being applied, directly or indirectly, for that person's benefit.

References to amounts being distributed or available for distribution means amounts distributed or available for distribution in respect of shares. This is because as a matter of company law distributions can only be made on shares and not in respect of other instruments.

The percentage investment a person (P) has in another person (U) may be increased where P and a third person (T) are acting together. P will be treated as having all of T's interest in U where –

- P and T are connected, or
- P can secure that T acts in accordance with P's wishes in respect of U's affairs, or vice versa, or
- T can reasonably be expected to act in accordance with P's wishes in respect of U's affairs, or vice versa, or
- P and T are party to an arrangement that it is reasonable to suppose will affect the value of T's rights or interests in relation to U, or
- P and T are party to an arrangement that relates to exercise of T's rights in U, or
- the same person manages some or all of P's rights in U and some or all of T's rights in U.

P and T are not treated as acting together in relation U where the person managing their rights in U –

- is the operator of a collective investment scheme in relation to P's rights,
- is the operator of a different collective investment scheme in relation to T's rights, and
- the Commissioners are satisfied that the management of those schemes is not coordinated to influence U's affairs.

INTM559230: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition C

Condition C of S259KA is that the imported mismatch arrangement is part of a series of arrangements.

A series of arrangements is defined at s259KA(5) as a number of arrangements where each arrangement is entered into in pursuance of, or in relation to, another arrangement (the over-arching arrangement).

A simple example of a series of arrangements might be –

- a loan arrangement between X Co and Y Co (the X/Y Loan)
- a loan arrangement between Y Co and UK Co (the Y/UK Loan)
- the X/Y Loan directly or indirectly funds the Y/UK Loan

Over-arching arrangements and third party borrowing

A company that raises funds by borrowing on a "plain vanilla" basis from a person will need to consider the application of Chapter 11 even if it is not part of the same control group. In considering condition C it will need to consider whether the arrangement under which the funding is provided is part of an "over-arching arrangement" within the meaning of S259KA.

The company will generally be able to conclude that the arrangement under which the funding is provided is not part of an over-arching arrangement where:

- the company borrows money under a straightforward loan agreement or facility 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. However, it would be very unusual for a normal commercial loan to satisfy the 50% investment condition. This is because the X% investment condition is framed in terms of rights arising by virtue of the holding of shares or distributions (which as a matter of company law) may only be made in respect of shareholdings.
- the only relationship or connection between the company and the lender is that the company has borrowed money from the person (and such relationship would encompass any documents entered into between the company and the lender in respect of the borrowing or between any other stakeholder in the company regulating their position as respects the borrowing), and
- the arrangement under which the funding is provided not a structured arrangement within the meaning of Chapter 3.

INTM559270: Hybrids: Chapter 11 - Imported mismatches: Conditions A to G: Condition G

Condition G of S259KA asks whether –

- the UK payer of the imported mismatch payment is in the same control group as either the payer or payee (or, in respect of an excessive PE deduction, the company with the PE), in relation to the mismatch payment, at any time from when the over-arching arrangement (see INTM559230) is made to the last day of the payment period in relation to the imported mismatch payment (see INTM559210), or
- the arrangement is a structured arrangement.

Control groups

Control groups are defined at s259NB. More detailed guidance on control groups is at INTM550610. Note that T and P are unlikely to be treated as acting together where they are otherwise unconnected simply because they both enter into conventional documentation relating to the loan in question such as a market standard facility agreement or inter-creditor agreement.

Structured arrangement

An arrangement is a structured arrangement if it is reasonable to suppose that-

- it is designed to secure a hybrid payer deduction/non-inclusion mismatch, or
- the terms of the arrangement share the economic benefit of the mismatch between the parties to that arrangement, or the terms of the arrangement otherwise reflect an expected mismatch.

An arrangement designed to secure a commercial or other objective may also be designed to secure a hybrid payee deduction/non-inclusion mismatch. When considering this issue, the test is whether it is reasonable to suppose that the arrangement was designed to secure the mismatch, regardless of any other objective.

2. Mismatch arising as a result of non-hybridity

Thank you for amending the new example at INTM555210, which considers the deeming rule in s259GB(3) of Chapter 7.

We note that this deeming provision is intended to increase the scope of the legislation beyond that envisaged by the OECD recommendations. We disagree with this approach which puts the UK out of step with other countries enacting the recommendations, and which in our opinion makes the rules conceptually much more difficult to understand; mismatches which have nothing to do with hybridity can be counteracted. In light of this, it would be helpful to have greater clarity on this deeming provision.

S259GB(1) states that there is a mismatch if the deduction exceeds the sums of ordinary income brought into account by the payees, and the amount of the excess is the part of that mismatch that arises by reason of one or more payees being hybrid entities.

Taking a hypothetical situation, let us assume that £1m of interest is paid by a UK company to a partnership which is a hybrid entity, and that none of the four partners in the partnership recognise ordinary income in respect of the payment. But let us also assume that it is only one partner (who is entitled to 10% of the partnership's income) that does not recognise ordinary income by reason of the hybridity of the partnership. The starting point under **S259GB(1)(b)** is that 10% of the interest payment could be counteracted under Chapter 7.

However, **S259GB(3)** goes on to say that a relevant amount of the excess <u>is to be taken (so far as would not otherwise have been the case)</u> (i.e. an amount of the remaining 90% in our example) to arise as mentioned in **S259GB(1)(b)** where certain conditions are met (which would be met for the hybrid partnership in our situation).

The relevant amount of that excess is determined under **S259GB(4)** as the lesser of (a) the amount of the excess [£900k] and (b) the amount of ordinary income that would be recognised by the payee were it a UK corporate receive trading income [again £900k]. Therefore as the legislation stands, the full £1m is counteracted.

Subsection **S259GB(4A),** which was inserted by the Finance Act 2018 and appears to be aimed at addressing this problem, states that no amount of ordinary income arises under **S259GB(4)(b)** if the payee is a partnership and <u>a</u> partner is entitled to <u>the</u> amount and both the partnership and <u>the</u> partner view the partnership as transparent (i.e. it is not a hybrid when considered only from the perspective of those jurisdictions).

This new subsection does not seem to go far enough: on a strict reading it would only apply where the entirety of the excess (the remaining 90% in our example) is allocated to a single partner i.e. it would only work in a partnership with two partners. On our example (with four partners) technically the entirety of the mismatch (£1m) would still be counteracted.

It is helpful that you have amended the example at INTM555210 to show that **S259GB(4A)** applies to partnerships with more than two partners and that that section is applied on a partner by partner basis. Similarly, it is helpful that that example shows that **S259GB(3)** applies on a payee by payee basis. However, we suggest that the guidance at INTM555090 is amended to expressly make these points.

We are also concerned that the deeming provision in **S259GB(3)** can lead to unfair results. For example, if A in the example was exempt from tax but in a jurisdiction that did view the partnership as opaque, **S259GB(4A)** would not apply to reduce the mismatch, even though it has nothing to do with hybridity. This is a fairly common situation in practice, where US exempt investors might invest alongside other investors in a partnership that has elected to be treated as opaque for US tax purposes.

One way to address this would be to permit pension schemes and other exempt investors (where HMRC's approach is that they do not recognise ordinary income) to be treated for the purposes of **S259GB(1)(b))** as recognising ordinary income.

Another result which seems unfair is the situation where, rather than investors choosing to pool funds through a tax transparent partnership, they invest through a corporate in a jurisdiction with a 0% tax rate (commercially these are not dissimilar, as both prevent an extra layer of taxation being imposed where investors wish to pool funds rather than invest directly). All taxable investors would still pay tax on any amounts received from that corporate subject to their local jurisdiction tax rules. In this case, if the company is a hybrid entity e.g. because it has checked the box to be treated as a partnership for US purposes, then **S259GB(4A)** could not apply to reduce the mismatch, even if some of those investors are exempt from tax and the mismatch has nothing to do with hybridity. We would therefore recommend that the rule in **S259GB(4A)** is not limited to apply only to partnerships.

- **Suggested amendments to HMRC's Guidance:**

INTM555090: Hybrids: Chapter 7 – Hybrid Payee: Extent of the mismatch – hybrid payee not chargeable to tax in any territory

There are a number of areas where the provisions in Part 6A TIOPA 2010 have a broader scope than the OECD recommendations. One example of this is where Chapter 7 of Part 6A applies to mismatches arising because a hybrid payee is not within the charge to tax in any territory.

The legislation treats an amount as arising from the payee being a hybrid payee where the conditions set out at s259GB(3) are satisfied.

S259GB(3) treats a relevant amount of the excess as arising from hybridity where

- a hybrid payee is not resident in any territory which imposes a tax charge, including tax charged at a nil rate or
- a hybrid payee does not have ordinary income arising from a payment or quasi-payment in respect of a permanent establishment in any territory, and

(in both circumstances) that payee does not have income arising from the payment or quasi-

The excess is the amount by which the relevant deduction exceeds the sum of ordinary income arising to the payees, and which results wholly or partly from the hybridity of one or more of the payees.

A “relevant amount” of the excess is defined at s259GB(4) as the lesser of the excess, and the amount of ordinary income that would arise to a particular payee by reason of the payment or quasi- payment if

- that payee were a company, and
- the payment was made in connection with a UK trade carried on by the payee through a UK branch.

Where there are multiple payees in relation to any payment or quasi-payment, it is important to calculate a relevant amount of the excess for each payee (from a UK perspective) before carrying out a separate s259GB(3) test on each relevant amount. This ensures that the relevant amounts are not all treated as arising from the hybridity of just one payee and that any disallowance is proportionate. For the avoidance of doubt, where a payee is a partnership that is a hybrid entity s259GB(3) should be applied on a partner by partner basis. (See example at INTM555210).

Where the payee is a partnership, when considering the "relevant amount" in s259GB(4) it is to be assumed that no ordinary income arises to the payee if a partner is entitled to the amount, and the payee would not be regarded as a hybrid entity when considering only the laws of the jurisdictions where

- the partnership is established, and
- the partner is resident for tax purposes.

Extract from Example at INTM555210

The next step is to test whether that excess of £500 arises by reason of ABC Partnership being a hybrid entity. Part of the excess, the amount of £100 allocated to C Co, arises by reason of ABC Partnership being a hybrid entity. If Country C viewed ABC Partnership as transparent, then the amount allocated to C Co would be ordinary income of C Co and no mismatch would arise.

The £400 allocated to Trust A, does not arise by reason of ABC Partnership being a hybrid entity as both Country X and Country A view ABC Partnership as transparent.

However, the provisions at section 259GB(3) ~~that~~ may apply to treat part of the excess as arising by reason of ABC Partnership being a hybrid entity (to the extent that is not already the case).

Section 259GB(3) treats a relevant amount of the excess ~~to arise~~ as arising by reason of one o~~n~~f the payees being a hybrid entity where –

- a payee is a hybrid entity, and
- that payee is not resident for tax purposes in any territory,
- that payee does not have ordinary income from a permanent establishment in any territory as a consequence of the payment, and
- income arising to that payee is not brought into account in computing profits for a CFC charge.

Applying these tests to the facts given –

- ABC Partnership is a payee, and
- ABC Partnership is a hybrid entity,
- there is no territory where ABC Partnership is resident for the purposes of a tax charged under the law of that territory,
- there is no territory where ABC Partnership has ordinary income arising from a permanent establishment and
- no income arises to ABC Partnership which is brought into account for the purposes of a CFC charge.

As the conditions for s259GB(3) are met the next step is to establish what the relevant amount of the excess is that needs to be considered. The relevant amount is computed as set out in s259GB(4), as amended by s259GB(4A) in partnership cases.

Section 259GB(4) defines the relevant amount of the excess as the lower of –

- the amount of the excess, and
- an amount equal to the amount of ordinary income that it is reasonable to suppose would arise to the payee if the payee were a company trading in the UK through a UK permanent establishment and the payment was received in connection with that trade.

This amount of ordinary income to be used in this comparison is amended by s259GB(4A) where –

- the payee is a partnership,
- a partner in the partnership is entitled to an amount of the payment, and
- the partnership would not be regarded as a hybrid entity under the laws of the territories where the partnership and the relevant partner are tax resident/established.

If these conditions are met, it is assumed that no ordinary income arises to the payee for the amount of the payment to which the partner is entitled when carrying out the comparison at s259GB(4). The application of s259GB(4A) is not limited to partnerships with two partners (or with any other particular number of partners).

It is necessary to apply the test in S259GB(4A) on a partner by partner basis.

In this example, the conditions under s259GB(4A) are met in relation to Trust A as –

- ABC Partnership is a payee and is a partnership
- Trust A is entitled to £400 of the payment of £1,000 received by ABC Partnership
- ABC Partnership would not be regarded as a hybrid entity if only the laws of Country A and Country X applied.

Consequently, for the purposes of the comparison at s259GB(4) it is assumed that no ordinary income arises to the ABC Partnership to the extent of the amount of £400 to which Trust A is entitled.

The conditions under s259GB(4A) are also met in relation to Individual B as –

- ABC Partnership is the payee and is a partnership
- Individual B is entitled to £500 of the payment of £1,000 received by ABC Partnership
- ABC Partnership would not be regarded as a hybrid entity if only the laws of Country B and Country X applied.

Consequently, for the purposes of the comparison at s259GB(4) it is assumed that no ordinary income arises to the ABC Partnership to the extent of the amount of £500 to which Individual B is entitled.

The conditions under s259GB(4A) are not met in relation to C Co as ABC Partnership is regarded as a hybrid entity if the laws of Country C and the UK are applied.

Returning to comparison under s259GB(4) the relevant amount of the excess is £100, that is, the lower of –

- £500, the excess, and
- £100, the amount of ordinary income that would arise to ABC Partnership in respect of the payment of £1,000, as reduced in respect of Trust A and Individual B under s259GB(4A).

As the relevant amount of the excess is the £100 already identified as a hybrid payee deduction / non-inclusion mismatch under s259GB(1)(b), there is no need to deem a further amount of the excess as arising by reason of the hybridity of ABC Partnership.

Condition D is satisfied, and the extent of the hybrid payee deduction/non-inclusion mismatch is £100.

3. Interaction with other legislation

As discussed above, we consider that the appropriate approach is to analyse the disallowance under each regime and then apply the largest one rather than to layer the regimes on top of each other. On this basis INTM550080 should be amended as set out below.

- **Suggested amendments to HMRC's Guidance:**

INTM550080: Hybrids: Chapter 1 – Introduction: Interaction with other legislation

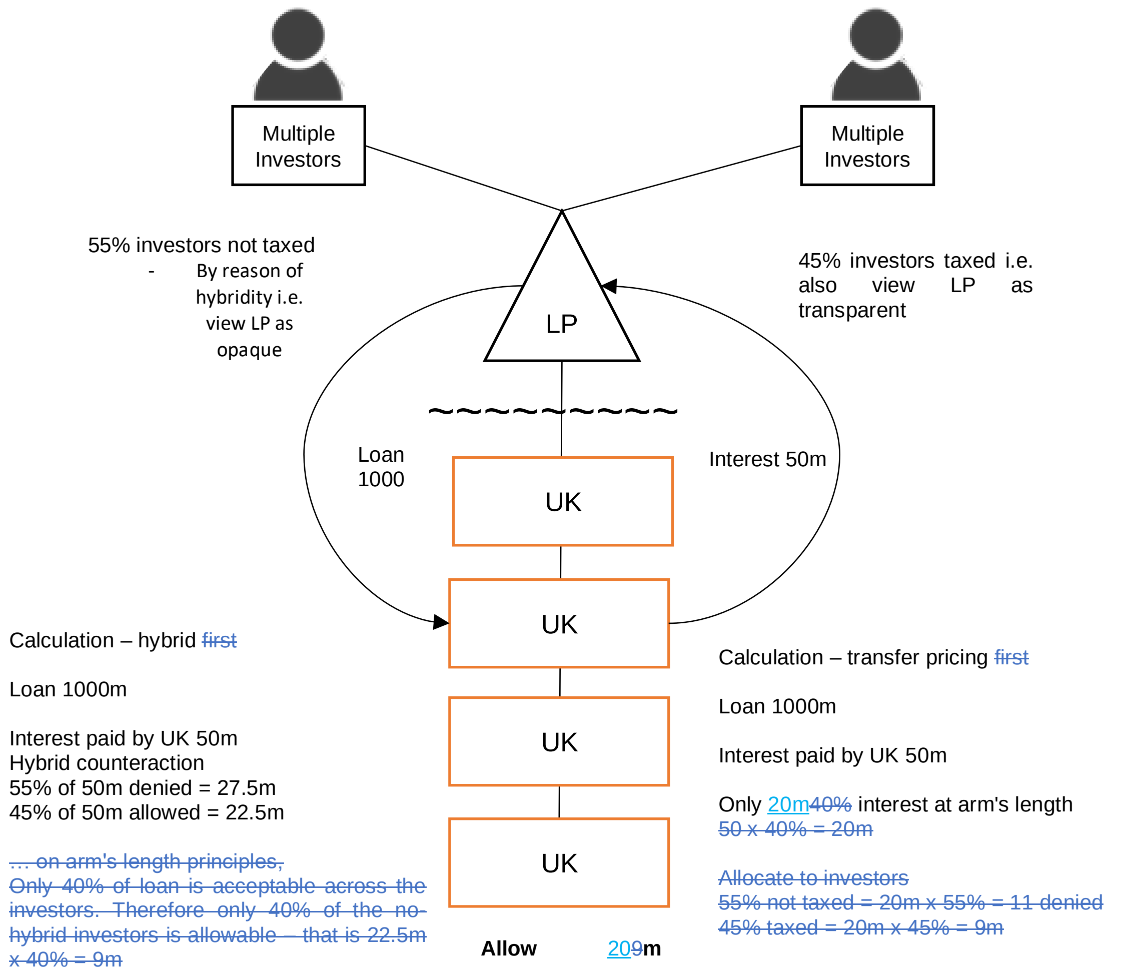
Counteraction under Part 6A TIOPA 2010 should be considered alongside the UK's other domestic rules. Examples of the type of rules that might be applicable are distribution exemption, transfer pricing, group mismatch legislation and unallowable purpose for loan relationships.

We would expect to apply the hybrids mismatch legislation in priority to the corporate interest restriction rules.

Although there is no statutory provision requiring it to be considered in priority, the distribution exemption provisions may also be considered before applying the hybrid mismatch rules – see INTM551170.

The hybrid mismatch rules do not contain a priority order for considering the application of other legislation. This means that customers will need to consider all relevant rules as part of their self-assessment. In general the hybrid rules will need to be ~~considered~~ applied whenever a mismatch within scope of Part 6A arises, unless the application of other rules results in a disallowance in excess of that which would (but for the application of those other rules) have arisen under Part 6A ~~removes the mismatch entirely~~.

Interaction with Transfer Pricing



For example, a customer may need to consider both transfer pricing and Part 6A in relation to a deduction arising in connection with a hybrid financial instrument. If a transfer pricing adjustment exceeds the amount by which the deduction is restricted as a result of Part 6A ~~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. However, i~~I~~f the amount by which the deduction is restricted as a result of Part 6A exceeds ~~there were still a mismatch after~~ the transfer pricing adjustment ~~was made~~, Part 6A would apply (and there would be no transfer pricing adjustment) ~~to the extent of the remaining mismatch~~.

~~A similar result would 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.

4. Hybrid entity double deduction mismatches – "section 259ID income"

S259IC sets out how counteraction applies where there is a hybrid entity double deduction mismatch and the hybrid entity is within the charge to corporation tax. Broadly, counteraction under s259IC only applies to the extent that the double deduction has not been counteracted under equivalent hybrids rules in the jurisdiction of the investor and either (i) the hybrid entity and any investor in it are in the same "control group" at the relevant time, or (ii) the hybrid entity or any of its investors is a party to a "structured arrangement".

Assuming those conditions are met, the relevant deduction is not deductible for the hybrid entity unless it is deducted from either "dual inclusion income" or "section 259ID income" for the relevant period.

"*Dual inclusion income*"

"Dual inclusion income" is, broadly, an amount that is both ordinary income of the hybrid entity for corporation tax purposes and ordinary income of an investor in the hybrid entity for the purposes of any tax charged under the law of an investor's jurisdiction. However, a concern with this definition is that it (arguably) does not apply to income received by the UK hybrid entity from an investor that treats the UK entity as a division of itself for the tax purposes of its jurisdictions. This is because the investor jurisdiction does not recognise the payment between the UK entity and the investor.

This can be illustrated in a hypothetical situation involving a UK fund management company which is the 100% subsidiary of a US parent fund management company where a US "check-the-box" election has been made in relation to the UK company to disregard it for US tax purposes. If, in that situation, the US parent agrees to provide fund management services to a third party and enters into an arm's length sub-contract for those services with the UK company, the fees received by the UK company from its parent (arguably) would not be considered dual inclusion income as they are not recognised in the US. This is despite the fact that the US parent would recognise as income for US tax purposes, the equivalent amount received from the third party. This would potentially result in no corporation tax deduction being available for the UK company's normal business costs e.g. salaries, as those costs would be recognised in both the UK (for the UK company) and the US (for the parent company) but there would be no "dual inclusion income" to set them against.

"section 259ID income"

The concept of "section 259ID income" was not included when the hybrids regime was first enacted but, rather, was introduced (with retrospective effect back to the date that the regime came into force) in the Finance Act 2018 (s23 and paragraphs 1, 13 and 14 of Schedule 7). Although the explanatory notes to the Finance Bill (that was ultimately enacted as that Finance Act) did not provide a detailed explanation as to the reason for this introduction[3], we understand it to be to address the concern described above in relation to "dual inclusion income".

Section 259ID applies where there is a restricted deduction under s259IC that exceeds the dual

[3] Paragraph 19 of the part of explanatory notes relating to clause 23 and schedule 7 of the Bill states: "*Paragraph 13 and 14 amend sections 259IC and section 259ID to enable certain related party income to be taken into account for the purposes of Chapter 9. These changes ensure that such income can be set against double deductions when quantifying the counteraction to be applied in Chapter 9*."

inclusion income of the hybrid entity and four statutory conditions are met. Essentially, these conditions are met where the investor receives a payment of taxable income from a third party and, as a direct consequence of that payment, makes a payment to the hybrid which gives rise to taxable income for the hybrid but not a tax deduction for the investor. The "section 259ID income" is the lesser of the two payments (i.e. the payment by the third party to the investor and the payment by the investor to the hybrid).

Unfortunately, our members are, in practice, coming across many common and benign situations that should fall within section 259ID but where there is real doubt as to whether they do so, due to the narrow drafting of the conditions. For example, building on the example given above, if instead of the UK company being a subcontractor of its US parent, it is instead a subcontractor of a sister company which has the same US parent and which has entered into a fund management agreement with a third party. If a check-the-box election has also been made to treat the sister company as a disregarded entity (so that, for US tax purposes, the sister company is treated as another division of the US parent), section 259ID would not apply as the subcontractor fee would not give rise to taxable income in the US.

The latest guidance states that 'direct consequence' is not defined and takes its ordinary meaning, i.e. an effect that is a result of an event or occurrence suggesting something that follows on, there is a prescribed order to the events. Taking the example of the Fund Management company noted, this guidance could potentially lead to different outcomes in seemingly exactly the same situation. For example, the UK Fund Management Company could receive exactly the same arm's length remuneration (in numerical terms) from the same party, but in one scenario the remuneration was calculated on a commission basis and in the other it was calculated on a cost plus basis.

With regards to the commission arrangement the payment to the UK company would follow the receipt of income by the US parent and therefore may be argued to arise 'in direct consequence' of it; but in the cost plus scenario arguably the UK return does not arise as a 'direct consequence' of the US receiving the income from a third party, instead it arises as a result of the services provided by the UK Fund Management Company regardless of whether revenue is received by the US Parent. We do not consider that it can be the intent of the hybrid rules to counteract one scenario but not the other, purely as a result of the pricing method used in the contractual arrangements, but the latest guidance has led to significant uncertainty in this regard.

Further we would suggest that the inclusion of the restriction in 'Section 259ID Income' contained within section 259ID(6) provides protection to HMRC by limiting the amount of income treated as dual inclusion income to the lower of the amount received by the investor from a third party and the payment to the UK Fund Management Company. If it was the intent of HMRC to differentiate between a cost plus and a commission arrangement arguably this restriction would not be required (as a commission can never be greater than the amount received from the third party).

We understand that at the time section 259ID was released there were a number of discussions between advisers and HMRC regarding the meaning of 'direct consequence', and HMRC commented that it was not intended to be interpreted so narrowly. Instead it was only intended that there should be a genuine economic link between the services provided by the UK Fund Management Company and the income received by the US Parent from the third party. However, the latest guidance reverts to a very narrow interpretation of the rules and has created significant uncertainty for a number of clients. We would therefore recommend that this point is clarified further in the guidance released by HMRC to make it clear that the it is required to show that there is a direct link between the services provided by the UK hybrid entity and the income received from a third party, rather than requiring the payment to the UK company to follow the receipt of income in the US from a third party.