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Hybrid and other Mismatches
Response by the Chartered Institute of Taxation

1 Introduction

1.1 We refer to the consultation document published on 19 March 2020 which examines the impact of the double deduction rules and the acting together rules within the Hybrid and other Mismatches regime at Part 6A of Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). We are pleased to submit the comments below on the various aspects of the rules considered in the consultation document.

1.2 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

1.3 Our stated objectives are for a tax system that includes:

- A legislative process which translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

2 Overview/summary

2.1 With regard to the double deduction rules in chapters 9 and 10, we would support the broader change proposed, 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. On balance, this would be the simplest and best approach to address the concerns and would be consistent with the policy objectives of both the UK anti-hybrid rules and the OECD principles (that is to ensure that deductions do not exceed corresponding income subject to tax). It would also avoid the artificiality of requiring groups to change commercial arrangements in order to meet the requirements of the anti-hybrid rules. Alternatively, we have suggested a legislative

changes to either Condition C (preferred) or Condition A in section 259ID that we believe would address the existing outcomes that are not aligned with the policy objectives.

2.2 With regard to the acting together test in section 259ND(7), we would support an amendment to the rules which addresses the main concern that this test generates difficulty for third party lenders, such as funds investing in debt instruments in private equity and venture capital backed companies. The changes to the rules suggested below would provide clarity to borrowers (and lenders) when analysing these rules.

2.3 We agree that a change of the type described in chapter 4 of the consultation document would be beneficial and suggest that all non-profit organisations are included within the exemption.

3 Double deduction rules – chapters 9 and 10

3.1 **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**

3.2 Below we set out an example of a typical structure which is disproportionately impacted by the double deduction rules.

Background information

- Company A is a wholly owned subsidiary of Company B and is resident in the UK for UK tax purposes. Company B is a US C Corp.
- An election has been made to treat Company A as disregarded for US tax purposes (that is a 'check the box' election has been filed in the US by Company B).
- Company B holds all contracts with third party customers and receives third party revenue.
- Company A provides engineering support services to Company B. Company A incurs UK costs in relation to providing these services (for example, employment costs and parts – together 'engineering costs') but also incurs other administrative and office support overheads.
- Company A earns a cost-plus remuneration for these services, but it does not itself have any third-party income. The cost-plus remuneration is paid by Company B and represents an arm's length reward for the services performed by Company A.

Tax position before application of UK anti-hybrid rules

- The check the box election means that the legal form of Company A is disregarded for US tax purposes (and that it is viewed as part of Company B). All income is included for US tax purposes, and all expenses are deductible. The election simplifies the US tax position, particularly in relation to the use of double tax relief.
- An arm's length profit (the cost-plus margin) is taxed in the UK. For US purposes, this is regarded as an allocation of profit to a UK permanent establishment.
- The payment from Company B to Company A is disregarded for US tax purposes, because all of Company A's profits are taxable in the US and thus transactions between Company A and Company B are ignored. Overall, an arm's length profit is taxable in the UK.
- We do not consider that, economically, there is any deduction/non-inclusion or double deduction amount.

UK anti-hybrid rules

We consider that all conditions under TIOPA 2010 section 259IA of the UK anti-hybrid rules are met on the basis that:

1. A deduction for the costs of Company A is available in the UK and in the US (condition A).
2. Company A is a UK resident company within the charge to UK corporation tax (condition B).
3. Company B and Company A are related companies (condition C).

Accordingly, under section 259IC the costs of Company A will be denied for UK tax purposes unless they are deducted from:

a. 'dual inclusion income' for that period, or
b. 'section 259ID income' for that period.

The income received by Company A in respect of the cost-plus payment is not considered to be 'dual inclusion income' as this income is not taxed in the US, since for US purposes it is a receipt from a branch and not a separate entity.

Section 259ID will only apply if all of the following conditions are met:

- Condition A is likely to be met as the cost-plus payment made by Company B is not deductible for US tax purposes.
- Condition B is expected to be met as the income received by Company A is subject to UK corporation tax.
- Condition C is discussed in response to question 2 below.
- Condition D is understood to be met as Company B (or its shareholders) recognise taxable income from the contracts with third parties (and Company B/the shareholders are subject to US federal tax in respect of such income).

3.3 **Q2: Can you identify which of the conditions of section 259ID are too restrictive?**

3.4 It is condition C in section 259ID that is, in our view, being interpreted too restrictively by HMRC and/or is too restrictive on its own terms.

Condition C is that the payment is made in direct consequence of a payment made to the investor by a person ('the unrelated party') who is not related (see section 259NC) to the investor or the hybrid entity.

The requirement for a payment to be made 'in direct consequence' of a payment made by an unrelated party is being interpreted strictly by HMRC. We understand that HMRC's view is that 'direct consequence' takes its strict meaning and therefore, section 259ID income may only be recognised in a very narrow, specific set of circumstances. We have considered the impact of this on the engineering support services below. As indicated, there is some uncertainty as to the extent of the linkage and narrowness of interpretation.

Engineering costs

Where the contract between Company B and the third party customer provides that engineering support services will be provided, we believe that the costs incurred by Company A are incurred in direct consequence of the sales income recognised by Company B. We would welcome HMRC's confirmation that they agree.

Other costs

For the other buckets of costs (administrative costs, general overheads etc), we understand that HMRC's view is that the 'direct consequence' link is not satisfied. Although the costs incurred by Company A support and drive the revenue which accrues to Company B, the legislation requires a causal link in the opposite direction:

there must be a payment made by Company B to Company A which is made 'in direct consequence' of a sales receipt in the hands of Company B.

Impact

For Condition C to be met the cost-plus recharge must be dependent upon the receipt of the third- party income by Company B and should not be paid until after its receipt. The nature of a cost- plus recharge is usually to reflect that any credit risk should be borne by Company B and therefore, it should be paid to Company A regardless of when or if Company B receives a receipt.

Based on this strict interpretation of Condition C, none of the expenses in Company A will be allowable under Chapter 9 of the anti-hybrid rules. At best, only those expenses where a clear causal link can be demonstrated will be allowed; overheads and general expenses will be disallowed. Therefore, Company A will probably need to disallow all or most of its expenses when filing its corporation tax return. UK corporation tax at 19% will be chargeable on at least the majority of costs incurred by Company A.

3.5 **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?**

3.6 The words 'in direct consequence of' in Condition C of section 259ID appear on a natural reading to be quite narrow, and certainly narrower than 'as a result of' in Conditions B and D. But equally, the words can be viewed as simply getting at the specific source of the funding, and not funding on a matching basis; that is to say that it is too narrow to say that the cost-plus payment by the parent must have been matched by a third party payment to the parent. What is relevant is how the cost-plus payment made by the parent is funded. If the parent earns sufficient income from third parties to fund the payment, that ought to be enough; there is a 'genuine economic link'. We suggest that what is required is for third party receipts to be the source of funding the cost-plus payments. If this can be established evidentially, that should be sufficient. Thus we suggest a reasonable interpretation of the legislation is somewhere between 'genuine economic link' and HMRC's current view: there must be third party funds available and it needs to be shown that those funds were used to make the cost-plus payment. It does not matter that the payments do not precisely match because that is not what 'in direct consequence' necessarily means.

3.7 In any event, currently the rules allowing the offset of taxable amounts in relation to double deductions are not working as expected and there is, therefore, uncertainty. We consider that amending HMRC's guidance will not be sufficient to eliminate this uncertainty. We suggest that there should be a change to Condition C in section 259ID so that this condition says that '*the payment is made as an indirect consequence of a payment made to the investor by a person ….*'.

3.8 Alternatively, we suggest that section 259ID Condition A be amended so as to include payments from any group member. We note the concerns that this would result in it becoming more difficult to evidence that the third-party income has been fully taxed without deduction, exemption or relief (and accordingly the change suggested above to Condition C is preferred), however, this additional burden would not be unreasonable given the scale of the cost to business.

3.9 However, we also note from question 7 of the consultation document that HMRC may be prepared to countenance a broader change to the legislation. We would support a broader change as the simplest and best solution and have commented further at paragraph 3.19 below.

3.10 **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.**

3.11 As noted in response to question 5 below, some groups have taken the step of revoking the 'check the box' election, to ensure that there is no hybrid entity, thus taking themselves out of the regime. However, whilst

this may be a practical solution for some groups going forward, it may not be appropriate for all and it does not solve the problem of the disproportionate effect of the rules that has accrued to date. As such, it is only a partial solution.

3.12 **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?**

3.13 We understand that it is not always possible to get relief for the additional tax arising in the UK. The UK tax imposed is significantly more than would apply to an arm's length return to the UK operations.

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

3.15 There are several options which have been undertaken by many businesses because of Part 6A coming into effect. These include the following:

- Revoke the 'check the box' election in the investor jurisdiction, so that the UK company would no longer be a hybrid entity for UK tax purposes. Therefore, the UK entity would no longer be impacted by Chapter 9 of Part 6A as Condition A would not be met (as noted above, this is only a partial solution).

- To mitigate the impact of Part 6A, some groups are amending their sales and transfer pricing policies, so that a cost-plus structure is no longer used, and it is clear that dual inclusion income arises and hence there is no need to rely on section 259ID. This requires a restructuring of the group's commercial arrangements and transfer pricing policies.

- Alternatively, it may be possible to draft a cost-plus agreement spelling out how the parent will fund its payments. For example, the intra-group contract may say that, during the accounting period, the US company would put the UK company in funds to make necessary payments and at the end of the year the US company will pay the UK company a fee for the services provided by the UK company to the US company equal to the balance on the intercompany account plus the required margin **provided that** there had been 'relevant turnover' of the US company in the accounting period. While we consider that this would meet the 'in direct consequence' test, it would require a certain level of artificiality in the group's transfer pricing arrangements, which could be challenged on other grounds.

- In some circumstances, a restructuring or partial restructuring of the group has been possible. However, having to consider and implement a restructuring to eliminate a tax charge is an unwelcome distraction to management. Further a restructuring is not always possible to eliminate a group's wider anti-hybrid restriction due to competition law and ensuring proper governance is in place.

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

3.17 We are aware that this anomaly has been identified as a potential concern under some other EU Member States' implementation of the Anti-Tax Avoidance Directive 2 (ATAD2) and they are also seeking to address it, but we do not have detailed knowledge of this so have limited our comments to the UK tax position.

3.18 **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.**

3.19 Yes, we consider that this would be an appropriate legislative response. The cost-plus recharge is included as UK income, but does not give rise to a US deduction. As noted at paragraph 3.2 above, we do not consider

that this structure gives rise to any double deduction or deduction/non-inclusion, and hence that this solution would be consistent with OECD principles, and the purpose of both the EU ATAD2 and the UK's anti-hybrid rules generally. We think that, on balance, this would be a simpler and better approach than the change to the legislation suggested at paragraph 3.7 above. It would also avoid the artificiality of requiring groups to change commercial arrangements in order to meet the requirements of the anti-hybrid rules.

4 Acting together definition – section 259ND(7)

4.1 **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.**

4.2 We understand that this concern is of particular relevance in the context of private equity. The main 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 most transactions the shareholder(s) (T) and fund lenders (P) will enter into agreements regularising the financing arrangements of the borrower (U).

4.3 However, as noted in paragraph 3.9 of the consultation document which describes some commonly encountered arrangements, these do not generally create a level of control of the borrower (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. Unfortunately the application of section 259ND(7) to many such common arrangements does not reflect the policy intention and can result in them falling within the definition of 'acting together'.

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

4.5 There are several alternative control tests within the UK tax code which could be considered to modify the acting together test, in particular the control tests in CTA 2010 sections 450 and 1124, TIOPA 2010 sections 371RB to 371RE and TIOPA 2010 section 148 TIOPA 2010 (as refined by TIOPA 2010 sections 157 to 163). The concept of 'related' persons as defined in section 259NC incorporates, to some degree, elements of all these control tests through the 'control group' definition (including the 50% investment condition) and the 25% investment condition. There are however elements of them which are not reflected in the section 259NC definition of related persons. For example:

- the carve out from CTA 2010 section 450 (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 TIOPA 2010 sections 371RD(4) and 159(4) (see subsection (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.

4.6 We suggest that the definition in the context of the hybrid mismatch rules could incorporate similar carve outs to ensure that the test is better targeted and allows 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. This would address the difficulties

currently arising in the circumstances described above. Specifically, we suggest that there should be carve outs similar to those detailed above in respect of subsections (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 could 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 clarity to borrowers (and lenders) when analysing these rules in such circumstances (often, as acknowledged in paragraph 3.7 of the consultation document, in situations where it is very difficult for taxpayers to obtain the necessary information).

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

4.8 We envisage that the approach outlined in response to question 9 above would ensure that the relevant rights under most commercial arrangements would be excluded from consideration for the purposes of section 259ND(7).

4.9 **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?**

4.10 Subsection (b) of section 259ND(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. The rights commonly granted to P in order to protect its interest as a creditor under contractual loan arrangements will provide P with rights falling within subsection (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 understanding of subsection (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 it would be helpful if the modification proposed in our response to question 10 were also to apply to subsection (b) of section 259ND(7) to confirm that customary creditor rights would not result in P being treated as acting together with T under (b) of section 259ND(7).

4.11 The acting together concept is included in ATAD2 to prevent the threshold of 50% in relation to associated enterprises being circumvented by, for example, splitting the holding of the participation into several persons or entities. ATAD2 provides that an individual or entity who is acting together with another individual or entity in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other individual or entity. As such, the percentages of these persons involved are aggregated for the purposes of the 50% threshold. In addition, the threshold is reduced to 25% for hybrid financial instruments.

4.12 HMRC could consider amending the hybrid mismatches legislation to include a provision similar to that within the Luxembourg tax code implementing ATAD2. This includes a rebuttable presumption in relation to investment funds so that an individual or an entity, which holds directly or indirectly, less than 10% of the shares or interests in an investment fund and is entitled to receive less than 10% of the profits thereof, is deemed not to act together with another person or entity which also holds shares or interests in such

investment fund. We think this would be a pragmatic approach to help ensure that the rules do not apply where individuals or entities are very unlikely to act together in practice, although we recognise that some thought would be needed around how to define a 'fund' in this situation and we would be happy to provide some further thoughts on this if it would be helpful. In addition, we understand that many fund structures are held through Luxembourg and so this approach should allow for consistency of treatment between jurisdictions.

5 Exempt investors in hybrid entities

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

5.2 We agree that a change of the type described in chapter 4 of the consultation document would be beneficial. We do not have strong views around which approach should be adopted. We suggest that in order to provide the necessary clarity, but also maintain the flexibility in terms of being able to make additions (or deletions) from the exemption, to address concerns about the exemption being too wide, a principles-based definition should be adopted, alongside either a 'white list' or a black list'. A principles-based exemption could work well with a 'black list' and a black list can be updated more quickly than waiting for a Finance Bill. However, we can also see benefits of drawing on CFC experience and having a principles-based approach with a 'white list'.

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

5.4 We suggest that all not for profit organisations should be included within the exemption.

5.5 **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?**

5.6 We do not have any strong preferences or views in this regard.

6 Assessment of Impacts

6.1 **Q15: Having considered the areas discussed, do you think if changes were introduced they would have any impact on administrative burdens and costs? If so, please provide details, including any one-off and on-going costs.**

6.2 We do not have any evidence or information to comment on impact on administrative burdens and costs.

6.3 **Q16: Having considered the areas discussed, do you think if changes were introduced they would have any additional impact on small and micro businesses, not already covered? If so, please provide details, including any one-off and on-going costs.**

6.4 We do not have any evidence or information to cause us to comment on this aspect of the impact assessment.

7 Acknowledgement of submission

7.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

8 The Chartered Institute of Taxation

8.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 19,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation

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