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Global Tax Alert

UK proposes to amend hybrid and other mismatches regime - implications for US multinationals

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Executive summary

On 12 November 2020, the United Kingdom (UK) Government published its response to a consultation document alongside limited draft legislation for some changes proposed to the UK hybrid and other mismatches regime.

In particular, HM Revenue & Customs (HMRC) has accepted that many of the rules as currently drafted have a disproportionate outcome. In order to address the issues which have been raised, legislative change is required, some of which will have retrospective effect back to the commencement of the regime on 1 January 2017. However, some changes will only have prospective effect from the date that the *Finance Act 2021* receives Royal Assent.

This Alert summarizes the key proposed amendments to the regime.

Detailed discussion

Items which will have retrospective effect back to 1 January 2017

As noted above, HMRC has taken the somewhat unprecedented approach of backdating changes to certain areas while simultaneously making it clear within the consultation response that these changes were statutorily necessary to achieve the required result.

These changes include:

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Double deductions – relief for inclusion/no deduction income

In a welcome and unexpected development, following consultation responses on the disproportionate ways in which the hybrid rules can affect commercial structures, the Government has proposed to introduce a new concept of inclusion/no deduction income, which is to be regarded as dual inclusion income for the purpose of assessing whether any counteraction in respect of double deductions should be applied.

Broadly, where income arising to a UK hybrid entity is income which is taxable in the UK but not deductible for any non-UK tax purpose, that payment should be inclusion/no deduction income as long as it would be deductible for tax purposes in the investor jurisdiction, if the UK entity was instead regarded as a separate entity by the investor jurisdiction and therefore not a hybrid entity. Inclusion/no deduction income is to be regarded as dual inclusion income if it would not otherwise be so.

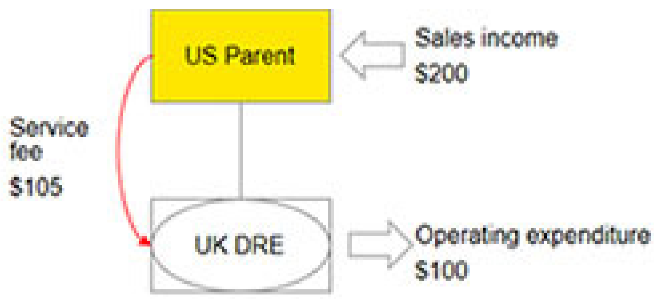
In practice, some United States (US) groups have or did have UK companies "checked" as disregarded subsidiaries of US companies, meaning that any expenses incurred by the UK company may give rise to double deductions where amounts were also deductible for US tax purposes. These double deduction amounts could only be deducted either against dual inclusion income, or so-called Section 259ID income (income arising in consequence of a payment made to the investor by an unrelated party). This was the case even though the UK company may have received taxable income from the US company (e.g., under a cost-plus reimbursement).

The consequence of the proposed change would be that relief is effectively provided for the economic double taxation which would otherwise arise as a result of income being taxed in the UK with no deduction being available in the US parent.

The specific application of the inclusion/no deduction rule should be considered based on a group's specific structure and operating flows, as it may still not provide full relief in more complex fact patterns. For example, the Government acknowledges that it was too complex to legislate for relief where there are a series of payments from a US parent via other non-UK disregarded entity(s).

It should be noted that due to the more widely applicable inclusion/no deduction income rule, the existing Section 259ID income relief relating to hybrid entity double deduction scenarios would be repealed as it is expected that income which is otherwise Section 259ID income should now qualify as inclusion/no deduction income.

Please see below a simplified diagrammatic representation of a commonly impacted structure and the implications of the proposed new legislation:



Existing law	Denial of double deduction for operating expenditure of $100 (no dual inclusion income)
Proposed legislation	Inclusion non deduction income (being regarded as dual inclusion income) of $105 arises so no denial of $100 double deduction

"Acting together"

Certain third-party debts have been previously treated as related party debts or debts within a control group due to the broad definition of "acting together" even though the lenders hold no, or only minimal, equity in the borrower.

As such, the third-party lender is treated as owning all of the shares of the equity owner as they are treated as "acting together" with the equity holders. This gives rise to a disallowance of the UK tax deduction in the borrower where the lender is not taxed on the income as a result of a hybrid effect.

These "acting together rules" can be triggered through the existence of certain commercial arrangements required as part of the security package including intercreditor agreements and covenants which can impact the value of the shares held by the equity owners.

HMRC is proposing to disapply the "acting together rules" where the lender holds no equity or where its equity interest is less than 5% in order to mitigate this issue.

However, where the equity interest is in excess of 5%, the existing rules will continue to apply and therefore there is a risk that certain third-party financing arrangements could still fall within the hybrid rules (i.e., this is not a blanket carve out).

Items which will only take effect from Royal Assent in 2021

Double deductions – group allocation of dual inclusion income

The Government has recognized that the current hybrid mismatch rules dealing with double deductions are also inflexible in requiring that dual inclusion income arises in the same entity as any double deduction, in order for a counteraction to be avoided.

It is therefore proposing that members of a UK group relief group will, on the making of relevant claims, be able to match dual inclusion income and double deductions within a group, so that the resulting counteraction applies only on the net group position.

Tax-exempt investors

It has been proposed that the provisions dealing with deduction non-inclusion mismatches will be amended to ensure that where an investor in a hybrid entity is a certain type of tax exempt entity (such as a pension fund, sovereign wealth fund, or charity), any deduction/non-inclusion outcome attributable to that investor will not be treated as caused by the hybridity of either the payer or the payee. This change will bring the UK rule in line with the European Union (EU) Anti-Tax Avoidance Directive (ATAD 2) and the Base Erosion and Profit Shifting (BEPS) Action 2 Report and should reduce the quantum of any disallowance that does arise to UK holding companies or portfolios. It is important to note, there is a detailed list of the tax-exempt entities which are included within this change (i.e., this is not a catch all).

Other key areas addressed in the consultation response

The consultation response document also addresses the following:

- **Imported mismatch rules** – changes to this chapter would be introduced which effectively allow an overseas regime to be considered as a whole, where equivalent to the OECD BEPS Action 2 recommendations, rather than requiring a review of the specific equivalent provisions in detail. As an example, it is expected this may mean that detailed review of local provisions would not be required for EU ATAD 2 compliant regimes in determining that imported mismatch rules should not apply.
- **US Global Intangible Low-Taxed Income (GILTI)** – the Government has confirmed that it does not consider that a GILTI charge is equivalent to a controlled foreign company charge. Its view is therefore that GILTI is not capable of being treated as "ordinary income," which may otherwise reduce the extent of any deduction/non-inclusion mismatch. The Government has confirmed it will legislate to clarify this treatment.
- **Relief for US limited liability companies (LLCs) under hybrid payee rules** – under current legislation, a hybrid payee deduction/non-inclusion counteraction can arise where income is received by a disregarded US LLC but not fully included as ordinary income because an LLC is typically a hybrid entity. The Government will legislate to align US LLCs with the existing rule for partnerships, providing relief where all members view the LLC as transparent for tax purposes.
- **US dual consolidated loss (DCL) rules** – the Government has reiterated its view that there should not be a UK counteraction where there is denial of loss relief under the US DCL rules.

- **Illegitimate overseas deductions** – currently rules relating to hybrid entity or dual territory double deductions permanently disallow double deductions to the extent offset against income not taxable in the UK. The Government proposes to remove this permanent disallowance as long as the deduction is not offset against income of another entity (e.g., via tax consolidation or loss sharing).
- **Interaction of hybrid mismatch rules and transfer pricing** – HMRC has used the response to the consultation document to again reiterate its view on the interaction of the transfer pricing rules with the hybrid rules for direct mismatches which remains unchanged from that articulated in December 2019. However, HMRC has accepted that the current imported mismatch rule applies disproportionately where there is also a transfer pricing adjustment, effectively resulting in a double disallowance, and so will legislate to correct this outcome.

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