HM Treasury

HM Revenue & Customs

Tackling aggressive tax planning:

implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements

December 2014

HM Treasury

HM Revenue & Customs

Tackling aggressive tax planning:

implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements

December 2014

This publication is available at www.gov.uk/government/publications

Any enquiries regarding this publication should be sent to us at public.enquiries@hmtreasury.gsi.gov.uk

ISBN 978-1-910337-48-6
PU1720

Summary

Subject of the consultation

Proposals for rules to neutralise the effect of hybrid mismatch arrangements in accordance with recommendations of Action 2 of the G20-OECD BEPS project. The aim is to tackle aggressive tax planning where, within a multinational group, either one party gets a tax deduction for a payment while the other party does not have a taxable receipt, or there is more than one tax deduction for the same expense. Introduction of the proposed rules will largely eliminate any tax advantage arising from the use of hybrid entities and instruments and encourage businesses to adopt less complicated and more transparent cross-border investment structures.

Scope of the consultation

This consultation seeks comments to inform the UK's contribution to the ongoing OECD work on a commentary to the G20-OECD report on Action 2, and on issues relating to implementation of the recommendations contained in that report which will guide development of legislation in the UK.

Who should read this

We would like to hear from businesses, individuals, tax advisers, professional bodies, civil society organisations and other interested parties.

Duration

This consultation will run for 10 weeks from 3 December 2014 until 11 February 2015.

Lead officials

Yasmin Ali, HM Revenue and Customs and David Howell, HM Treasury

How to respond or enquire about this consultation

Written responses should be submitted by 11 February 2015, preferably by email, to:
bepsresponses.condoc@hmrc.gsi.gov.uk

Yasmin Ali	David Howell
HM Revenue and Customs	HM Treasury
Room 3/21 3rd Floor	1st Floor
100 Parliament Street	1 Horse Guards Road
London	London
SW1A 2BQ	SW1A 2HQ

Additional ways to be involved

HMRC and HMT will consider meeting interested parties to discuss the issues raised during this consultation. Please use the contact details above if you are interested in a meeting.

After the consultation

The responses will inform the UK's involvement in the OECD's ongoing work to finalise the recommendations and to develop a commentary to the report by September 2015. Responses will be taken into account in developing the draft legislation. A summary of responses will be published in summer 2015.There will be further consultation on proposed draft legislation prior to its introduction in a future finance bill.

Contents

Foreword

This government's approach to businesses is simple. To help companies grow and compete in the world we have taken a strategy of reforming the corporate tax system to create the most competitive tax environment in the G20. That is why we have reduced the main rate from 28% in 2010 to 20% from April next year. But in exchange we expect them all to play by the rules and pay the tax they owe.

In September 2014, the Organisation for Economic Co-operation and Development (OECD) presented the first set of outputs from the Base Erosion and Profit Shifting (BEPS) project to the G20 Finance Ministers. International agreement has been reached on new rules to tackle tax avoidance by multinationals using certain cross-border business structures or finance transactions that exploit differences between countries' tax rules. On 5 October 2014, the Chief Secretary to the Treasury announced that the government will consult on how best to introduce these rules in the UK, once again demonstrating the UK's leadership of international efforts to combat tax avoidance by multinationals.

Because of the importance we attach to this issue, for the first time we are publishing a consultation document that sets out the key design issues on which we are seeking input. Our aim is that the banking sector should not be unfairly advantaged or disadvantaged by the introduction of these rules; we do not think that banks should be privileged over other groups and we will aim to prevent this.

We are determined to take every possible action against abuse of the UK tax rules. Since April 2010 the government has made 42 changes to tax law, closing down loopholes and introducing major reforms to the UK tax system. HMRC have secured £23 billion in compliance yield from large business since 2011-12. And today we are announcing an additional investment in HM Revenue and Customs' expanded Large Business Directorate, bringing in an extra 40 specialist staff to boost HMRC's ability to target tax compliance amongst the largest and riskiest businesses.

But in a global economy where goods and services flow freely between countries, international cooperation is the only way to tackle the challenge of tax avoidance. Measures taken in Britain alone will not deal with the problem; we need global tax rules too. That is why we have been pushing, through the G8 and the G20, the European Union and the OECD, for global solutions.

The UK has led the way in this international action, driving the international tax, transparency and trade agenda forward under the UK's G8 presidency in 2013. The UK fully backs the OECD's BEPS project and welcomes the progress made on delivering to the agreed timetable by the end of 2015. This will help shift the balance of the rules in favour of tax authorities, enabling us to clamp down on those who refuse to play by the rules.

I strongly believe that our approach is the only way to deal with this problem effectively, working at a global level to secure the changes Britain wants to see - an international tax system fit for a global economy.

David Gauke MP
Financial Secretary to the Treasury

1 Introduction

1.1 In 2013 the Organisation for Economic Co-operation and Development (OECD) and G20 countries adopted a 15-point Action Plan to address Base Erosion and Profit Shifting (BEPS). The Action Plan aims to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created.

1.2 Base erosion and profit shifting refer to tax planning strategies that exploit gaps and mismatches between tax rules in different countries. Such strategies can make profits 'disappear' for tax purposes or shift them to locations where there is little or no real activity but the tax rates are low. This results in little or no overall corporate tax being paid.

1.3 Many BEPS strategies take advantage of the interaction between the tax rules of different countries making it difficult for any single country, acting alone, to fully address the issue. There is therefore international consensus to provide a co-ordinated approach which facilitates and reinforces domestic actions to protect tax bases and which provides a comprehensive international solution to the problem.

1.4 The government announced its intention on 5 October 2014 to introduce domestic legislation to give effect to the recommendations of Action 2 of the G20-OECD Base Erosion and Profit Shifting (BEPS) project.

1.5 Action 2 of the BEPS project concerns hybrid mismatch arrangements and addresses situations where either one party gets a tax deduction for a payment while the other party does not have a taxable receipt, or there is more than one tax deduction for the same expense. It also considers where double taxation treaties are used to allow hybrid mismatches.

1.6 Domestic tax systems are generally coherent in that tax deductible payments by one person are included in the taxable income of the recipient. The BEPS Action Plan seeks to achieve similar international coherence in relation to hybrid mismatches, and in respect of dual resident companies, by introducing rules to neutralise their effect. This will help ensure that an economic expense gives rise to at most one tax deduction, and that this deduction is contingent on the corresponding receipt being included in the recipient's ordinary taxable income.

1.7 International consensus has been reached to deliver the BEPS policy objectives by following a common design to be implemented by participating jurisdictions. The adoption of these recommendations in major economies will largely eliminate any tax advantage arising from the use of hybrid mismatches and dual resident companies, encouraging businesses to adopt less complicated and more transparent cross-border investment structures.

1.8 The UK's domestic legislation will be introduced with effect from 1 January 2017 and will reflect the design principles detailed in the G20-OECD report published in September 2014. It will also have regard to any amendments to those proposals (including those needed to take into account recommendations on other actions of the BEPS project) and the commentary on the hybrid mismatch recommendations being developed by the OECD. Final recommendations and the commentary are due to be completed by September 2015.

1.9 The purpose of this consultation is to seek comments on the implementation of rules to neutralise the effect of hybrid mismatch arrangements and on the G20-OECD recommendations in relation to tax treaties. It seeks comments on specific areas of the proposals including those relating to hybrid regulatory capital, financial instruments used in sale and repurchase (repo) transactions and the treatment of certain arrangements involving intra-group hybrid and non-hybrid transactions (imported mismatches). Within the framework of the agreed recommendations the government wishes to minimise complexity and avoid outcomes that are not in line with policy objectives.

2 Background

What are hybrid mismatches?

2.1 A mismatch involving a hybrid entity or hybrid instrument is called a hybrid mismatch. The term describes arrangements made between members of multinational groups ("MNEs") or with unrelated parties which enter into arrangements to exploit asymmetries between different tax jurisdictions. Hybrid mismatches can arise both within a tax regime and in a cross-border situation.

2.2 This chapter describes the two types of hybrid mismatches addressed by the G20-OECD report recommendations. They involve:

1. obtaining a deduction for interest (or other expenses) where the corresponding receipt will not be taxable, or where taxation is not effective because of the availability of reliefs such as double taxation relief (referred to as a deduction/no-inclusion or "D/NI outcome"); and
2. obtaining a deduction for the same expenses (most commonly interest) in two or more different jurisdictions (referred to as a double deduction or DD outcome).

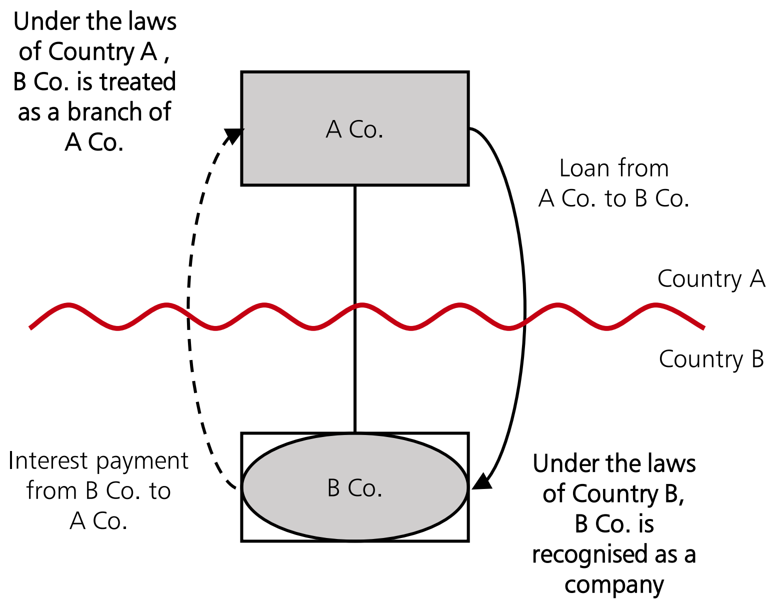
2.3 A hybrid entity is any entity (for example, a company or partnership) which is, or may be, treated differently under the rules of two tax jurisdictions.

2.4 This difference in the characterisation of an entity can result in a hybrid mismatch for tax purposes. For example, a loan from a parent company (A Co. in chart 2.A) to its subsidiary company (B Co.) may result in a deduction being allowed to B Co. for the interest payment in Country B but with no corresponding receipt being taxed in Country A.

2.5 This outcome would arise under the tax laws of Country A if B Co. is seen as a branch (i.e. a part) of A Co. The loan between A Co. and B Co. is then treated as a loan made by A Co. to itself and is therefore disregarded, and so the interest receipt in A Co. is not taxed in Country A.

2.6 From Country B's perspective, however, B Co. is an entity separate from A Co. and is seen as having made a payment of interest for which it obtains a deduction.

Chart 2.A: Example of a mismatch involving a hybrid entity

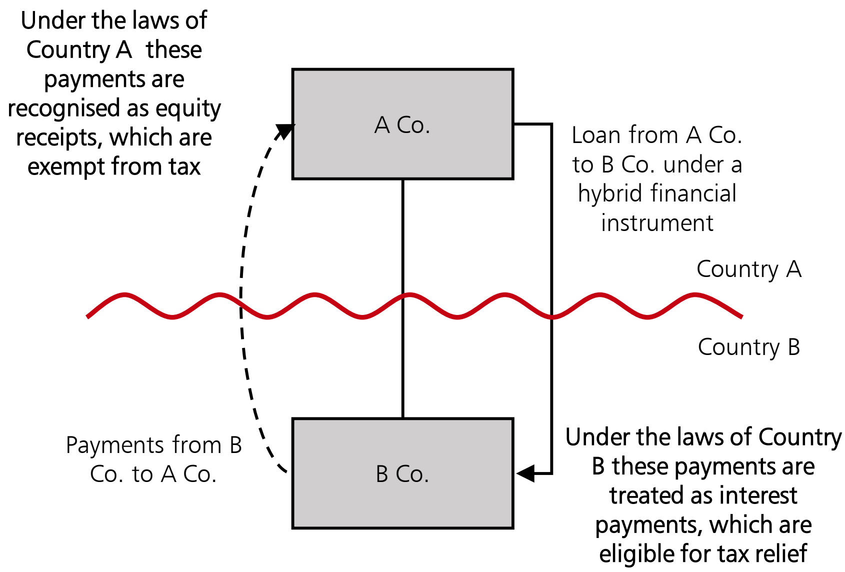


Source: OECD

2.7 A similar mismatch can arise from the use of hybrid instruments. A hybrid instrument is a financial instrument which is characterised differently by the parties' respective tax jurisdictions. For example, jurisdictions can differ in how they define debt and equity. This presents tax planning opportunities for MNEs seeking a tax deduction for interest payable in one jurisdiction and for the corresponding receipt to arise in a jurisdiction where it will be taxed as something other than interest (perhaps as a dividend or capital proceeds) or not taxed at all.

2.8 In chart 2.B a payment made under a hybrid financial instrument by B Co. to A Co. is treated as a payment of interest and eligible for tax relief in Country B. Under the tax laws of Country A, however, it is treated as a return on equity/ share capital and therefore not taxed as income.

Chart 2.B: Example of a mismatch involving a hybrid instrument



Source: OECD

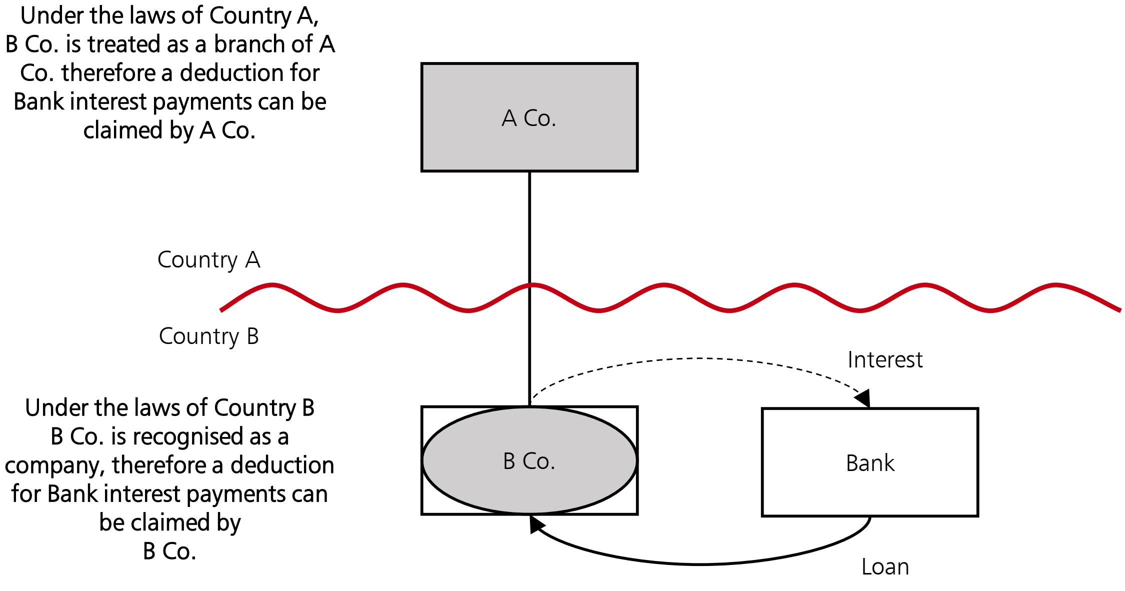
2.9 As well as producing mismatches involving a deduction and no corresponding inclusion, payments made by hybrid entities can also give rise to a mismatch resulting in two deductions.

2.10 In chart 2.C a loan from the Bank to B Co. results in a deduction being allowed for the interest in B Co. and for A Co. in country A.

2.11 B Co. is treated as an entity (company) under the tax laws of Country B and is able to claim a deduction for the interest paid on the loan.

2.12 However, under the tax laws of Country A, B Co is treated as a branch (part) of A Co. A Co is therefore treated as if it had made the payment directly to the bank and so is entitled to claim the deduction.

Chart 2.C: Example of a mismatch involving duplicate deduction of an expense



Source: OECD

2.13 Mismatch outcomes involving deduction/no inclusion can also arise through the improper use of double taxation treaties.

Current UK tax rules

2.14 The UK introduced arbitrage legislation in March 2005 to counter tax avoidance using contrived arrangements intended to avoid UK tax through the use of hybrid entities and hybrid instruments.

1. The UK legislation applies to both deductions and receipts.
2. With respect to deduction cases, the legislation is aimed at schemes where companies are seeking to achieve asymmetry of tax treatment (claiming a tax deduction in the UK for an expense where the corresponding receipt is untaxed overseas on the recipient) or "double dips" (where deductions are available for the same expense both in the UK and overseas.
3. The application of the legislation with respect to deduction cases is dependent on the scheme having a main purpose of achieving a UK tax advantage.
4. Different conditions apply in receipts cases, which look to catch those cases where a tax deduction is obtained overseas but the receipt is not otherwise taxed in the UK.

2.15 There are also UK corporation tax rules (group mismatch rules) which eliminate asymmetries arising from arrangements involving loan relationships or derivative contracts.

Tackling hybrid mismatches – the G20-OECD solution

2.16 The OECD has considered the impact of hybrid mismatches in a number of reports, most notably the 2012 report entitled *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues,* which concluded that domestic laws linking the tax treatment of an entity or instrument to the tax treatment in another country could be used to address mismatches. This work contributed to the development of the G20-OECD proposals for tackling mismatches in response to Action 2 of the BEPS project. An overview of the G20-OECD proposals is provided in the following chapter.

2.17 The rules proposed by the G20-OECD create a commonality of approach across many countries. The rules are intended to apply automatically without a requirement to establish which jurisdiction has lost tax revenue under the arrangement. They are mechanical in operation, do not require a purpose test and are intended to minimise compliance and administration costs for both taxpayers and tax administrations by providing certainty in their application.

2.18 In view of the differences between the scope and operation of the new rules and our existing regime, the government has decided to introduce new legislation to give effect to the G20-OECD recommendations.

3 G20-OECD recommendations

3.1 In 2013 the Organisation for Economic Co-operation and Development (OECD) and G20 countries adopted a 15-point Action Plan to address Base Erosion and Profit Shifting (BEPS).

3.2 The Action Plan provides for 15 actions to be delivered by 2015, with a number of the actions to be delivered in 2014.

3.3 Action 2 of the Action Plan calls for the development of "model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities." The Action item states that this may include:

1. "changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident companies) are not used to obtain the benefits of treaties unduly;
2. domestic law provisions that prevent exemption or non-recognition for the receipts of payments that are deductible for the payer;
3. domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under the controlled foreign company (CFC) or similar rules);
4. domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and
5. where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure".

3.4 The G20-OECD's report recommends aligning the tax treatment of an instrument or entity with the tax outcomes in the counterparty jurisdiction.

3.5 The recommended rules target two types of payment:

1. payments under a hybrid mismatch arrangement that are deductible under the rules of the payer jurisdiction and not included in the ordinary income of the payee or a related party investor (deduction/ no- inclusion or "D/NI" outcomes); and
2. payments under a hybrid mismatch arrangement that give rise to duplicate deductions for the same single payment (double deduction or "DD" outcomes)

3.6 To avoid double taxation and to ensure that the mismatch is eliminated even where not all the jurisdictions adopt the rules, the recommended rules are divided into a primary response and a defensive rule.

3.7 The primary response is to deny the deduction in the payer's jurisdiction where there is a deduction and no inclusion, and to deny a deduction in the investor's parent jurisdiction where there is a double deduction. This is explained in more detail in table 3.A.

3.8 The defensive rule applies where there are no hybrid mismatch rules in the other jurisdiction or the primary rule does not apply to the entity or arrangement. In such circumstances the payment should be included as ordinary income in the payee's jurisdiction.

Hybrid instruments and hybrid entities

3.9 The G20-OECD recommendations seek to address mismatches involving both hybrid instruments and hybrid entities. The recommendations subdivided hybrid entities into three distinct types: hybrid payers; reverse hybrids; and dual resident companies. These categories reflect the underlying mechanics giving rise to the tax mismatch and the specific response required to address the mismatch.

Hybrid payer

3.10 A hybrid payer is an entity which is treated as transparent (not recognised as an entity in its own right) under the laws of its parent jurisdiction but as an opaque entity (a recognised entity) under the laws of the jurisdiction where it is located. It is able to claim a deduction for the payment that it makes under the laws of its own jurisdiction. A hybrid mismatch involving a hybrid payer can result in either a deduction/no-inclusion outcome or a double deduction outcome.

3.11 The G20-OECD report recommends that the primary response where there is a deduction/no-inclusion outcome is for the deduction to be denied to the hybrid payer. If the deduction is not denied the secondary response is to tax the income in the recipient entity.

3.12 Where there is a double deduction mismatch involving a hybrid payer, the recommendation's primary response is to deny a deduction to the parent (that is, the parent company of the hybrid entity, or the partner in the case of a partnership), with a secondary response of denying the deduction to the payer (that is, the hybrid entity or, in the case of a partnership, the partnership).

3.13 In a double deduction mismatch the response is limited to the extent it exceeds income brought into account for tax purposes under the laws of both states.

Reverse hybrid

3.14 The term reverse hybrid is used to describe an entity (e.g. a partnership) that is treated as transparent in the jurisdiction where it is located, but as opaque (a taxable entity) by the parent jurisdiction (e.g. where the partners, in the case of a partnership, are resident). An example of a reverse hybrid is provided by example E at annex C.

3.15 A mismatch involving a payment received by a reverse hybrid can result in a deduction/no-inclusion outcome because the receipt is not treated as taxable income by both the reverse hybrid and its parent company (or partners in the case of a partnership).

3.16 The G20-OECD report recommends that the payer jurisdiction should deny a deduction. Where the deduction is not denied, however, the report recommends either that the income should be included within CFC regimes of the parent jurisdiction or the introduction of rules to charge corporation tax on the net income of reverse hybrids such as partnerships and other entities.

Dual resident companies

3.17 A dual resident company is a company which is resident for tax purposes in more than one territory. Dual resident companies are able to obtain tax outcomes of a hybrid nature by being able to claim a deduction for a single economic expense in two jurisdictions.

3.18 To counteract this double deduction outcome for dual resident companies, the G20-OECD report recommends a primary response which has the effect of denying the deduction in both states of residence to the extent it exceeds income brought into account for tax purposes under the laws of both states.

3.19 Where there is a tax treaty between the states, their competent authorities may agree which is the resident state and in that case the deduction should be allowed in that state. This removes the opportunity for a double deduction provided that residence for domestic law purposes follows the treaty outcome.

3.20 Details of the government's proposed response in relation to dual resident company mismatches are provided at chapter 6 and examples are shown at annex D.

Imported mismatches

3.21 Although the G20-OECD recommendations are intended for implementation through a domestic law in all participating jurisdictions, they are designed to work effectively even if this is not achieved. A key part of the recommendations aimed at mismatch arrangements involving a jurisdiction which has not introduced the G20-OECD recommendations are the rules dealing with imported mismatches.

3.22 It is possible for an MNE to set up a hybrid mismatch arrangement between two jurisdictions which have not introduced the G20-OECD rules and to transfer the resulting tax advantage to a third jurisdiction which does have these rules using a transaction which does not itself give rise to a hybrid mismatch. The tax advantage from the hybrid mismatch is easily imported into this jurisdiction, despite its adoption of the G20-OECD recommendations. The rules for imported mismatches deny a deduction in this third jurisdiction, thus ensuring that the policy outcome of the recommendations is achieved.

3.23 A detailed example illustrating an imported mismatch and the proposed response is provided at example H of annex C.

Other recommendations

3.24 The G20-OECD report has also made four recommendations for changes to domestic law to achieve a better alignment between domestic and cross-border outcomes. These are in relation to:

a foreign distribution exemption,

b the prevention of duplicate tax credits for taxes withheld at source,

c improvements to CFC regimes, and

d rules restricting the tax transparency of reverse hybrids.

3.25 The government has concluded that it already has sufficient existing safeguards to ensure the denial of distribution exemption where there are deductible payments, limitation of tax credits for tax withheld at source, and an appropriate CFC regime. The government will, however, consider the introduction of rules restricting the tax transparency of reverse hybrids.

Further work by the OECD

3.26 There are a small number of areas where the recommendations within the G20-OECD report are identified as provisional and potentially subject to refinement in September 2015. The first of these concerns certain capital market transactions (such as on-market stock lending and repos) and the second deals with the detailed operation of the proposed rules on imported hybrid mismatches. The OECD is continuing work on these issues. It will publish its proposals as part of the commentary in September 2015.

3.27 In addition, there remain two issues on which the G20-OECD participants were unable to reach consensus prior to publication of the report in September 2014. These are in relation to hybrid regulatory capital, and whether or not income subject to charge under a controlled foreign company (CFC) regime should be treated as being brought into charge. While discussions will continue with a view to reaching agreement on these issues by September 2015, it has been left open to countries to make their own policy decisions in these areas. Chapters 4 and 8 set out the government's position on these areas.

3.28 The G20-OECD has also made a number of recommendations in relation to changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (including dual resident companies) are not used to obtain the benefits of Double Taxation Treaties unduly. The government has considered these proposals and its position on these is set out in chapter 7

Table 3.A: Extract from the G20-OECD report "Neutralising the Effects of Hybrid Mismatch Arrangements" summarising the G20-OECD recommendations

Mismatch	Arrangement	Specific recommendations on improvements to domestic law	Recommended hybrid mismatch rule		
			Response	Defensive rule	Scope
D/NI	Hybrid financial instrument	No dividend exemption for deductible payments Proportionate limitation of withholding tax credits	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by a hybrid		Deny payer deduction	Include as ordinary income	Controlled group and structured arrangements
	Payment made to a reverse hybrid	Improvements to offshore investment regime Restricting tax transparency of intermediate entities where non-resident investors treat the entity as opaque	Deny payer deduction		Controlled group and structured arrangements
DD	Deductible payment made by a hybrid		Deny parent deduction	Deny payer deduction	No limitation on response, defensive rule applies to controlled group and structured arrangements
	Deductible payment made by dual resident		Deny resident deduction		No limitation on response
Indirect D/NI	Imported mismatch arrangements		Deny payer deduction		Members of controlled group and structured arrangements

Source: OECD

4 Further OECD work

4.1 The G20-OECD's report with its recommendations addressing Action 2 was published in September 2014. The OECD is continuing to work on a small number of specific issues and is also developing guidance in the form of a commentary to be published in September 2015 which will explain more about the detailed operation of the rules.

4.2 This chapter summarises the issues identified for further discussion at OECD.

Hybrid regulatory capital and interaction with controlled foreign company (CFC) regimes

4.3 There are two issues where it has not been possible to reach consensus and where, in the absence of consensus, policy choices have been left open to participating countries. These are hybrid regulatory capital; and income taxed under a controlled foreign company regime.

Hybrid regulatory capital

4.4 The first such issue concerns the application of the rules to hybrid regulatory capital that is issued between group companies. The United Kingdom's proposals in relation to the treatment of hybrid regulatory capital are provided at chapter 8.

Income taxed under a CFC regime

4.5 The second issue is whether or not income taxed under a CFC regime or other offshore regime should be treated as included in ordinary income.

4.6 Various tax regimes bring into taxation profits that have been artificially diverted to low tax jurisdictions. This is achieved through CFC regimes, such as the UK provisions at Part 9A Taxation (International and Other Provisions) Act 2010 (TIOPA 2010) or through similar offshore investment regimes.

4.7 The government is considering whether a definition of "included in ordinary income" should include income that is subject to taxation under CFC regimes. This would entail considering, before applying hybrid mismatch rules, not only whether a payment has been included in the ordinary income of a company in its territory of residence, but also whether it had been subject to taxation under a CFC regime.

4.8 While recognising the possibility of double taxation if CFC charges are excluded, a number of other factors need to be considered. Requiring businesses to determine the application of the CFC or other offshore rules for each of the relevant parent jurisdictions of a particular subsidiary in a large global group is a substantial compliance task. This is especially true for regimes with no or low ownership thresholds. The different ways in which CFC and other offshore regimes quantify the tax charge due under the regime is a further consideration, as is the extent to which any CFC charge can be identified or matched with the income from the hybrid transaction. A further point, given the policy objective of neutralising the tax advantages from the use of hybrid mismatch arrangements, is whether any double taxation arising from the continued use of hybrids should be viewed differently from double taxation arising in other circumstances.

4.9 Similar considerations will apply to the interaction of hybrid mismatch rules and the proposed diverted profits tax.

Q1. Should income taxed under a CFC, or other offshore regime be treated as included in ordinary income?

Q2. If included, what steps could be taken to ensure that inclusion of the hybrid payment gave an equivalent outcome to inclusion of a CFC charge on the payment?

Q3. If included, how could the compliance burden of determining the relevant CFC charge be reduced?

Issues for which the recommendations are subject to refinement

4.10 There are also specific areas where the recommendations within the report are identified as provisional and potentially subject to refinement in September 2015. This is the case for certain capital market transactions, such as stock lending and repos and for the proposed rules on imported hybrid mismatches.

4.11 Stock loans are arrangements where shares/equities are temporarily transferred between entities. A mismatch can arise where the dividend falls to be paid during the period when the shares are held by the stock borrower: the dividend is paid to the borrower, who is typically obliged to pay a manufactured dividend (i.e. to pass on the dividend) to the stock lender.

4.12 In a banking environment, the payment of the manufactured dividend may be deductible for the payer but not included in ordinary income of the payee resulting in a mismatch.

4.13 With repos, shares/equities are transferred from one party to another and then repurchased at the end of a term. In substance, these are collateralised loan transactions, and the UK's current tax treatment reflects this.

4.14 Mismatches can occur in two ways. As with stock loans, a mismatch may arise where the payment of a dividend occurs during the period in which the lender (stock borrower in a stock loan) holds the shares as collateral, and the lender passes on the dividend to the borrower (stock lender in a stock loan) in the form of a manufactured dividend. The second mismatch may arise where the repo is cross-border and there is an inconsistency of tax treatment by the two relevant tax authorities: one treats the repo entirely as a borrowing transaction, while the other treats it according to form, as a capital purchase and resale of shares/equities. As a result, one tax authority may allow deductions for payment of interest, while the other will not tax the income as it is seen as a capital receipt.

4.15 Hybrid mismatches arising in both scenarios described seem likely to be within the scope of the proposed hybrid mismatch rules. The OECD is continuing to explore with interested parties whether this inclusion raises questions about the operability of the rules and the impact on the capital market.

4.16 The proposed hybrid mismatch rules are targeted at countering mismatches arising in both scenarios described. The government would welcome comments from business.

Q4. What practical issues could arise in distinguishing between stock loan and repo transactions within the scope of the proposed rules and those outside their scope?

Q5. Can you suggest any change(s) to the proposed rules that might allow this distinction to be made more easily (Note that the G20-OECD recommendations cannot accommodate a "purpose test" as the rules are intended to apply automatically)?

5 Proposals for hybrid mismatch arrangements rules

Background

5.1 The policy objective of the proposed change to domestic law is to reduce erosion of the collective global tax base by removing the tax benefit for multinational entities of using hybrid entities or hybrid financial instruments. One consequence of this change may be the use of less complicated and more transparent cross-border investment structures.

5.2 To achieve this objective, the government will introduce new rules to counteract hybrid mismatches by aligning the tax outcome of a payment made by an entity or under an instrument to the tax outcome in the counterparty jurisdiction.

5.3 This chapter sets out a possible approach for these rules, including the necessary conditions for arrangements to fall within the scope of the rules together with key definitions.

Overview of the proposed rules

5.4 The proposed rules focus on hybrid mismatch arrangements. A hybrid mismatch arrangement is an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more jurisdictions to produce a mismatch in tax outcomes, where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.

5.5 The hybrid mismatch rules recommended by G20-OECD are intended to be introduced by all jurisdictions where hybrid mismatch arrangements exist so that the same rules will be applied by each of the affected jurisdictions. Having consistent rules allows the outcome in one jurisdiction to be linked to the outcome in another, minimising the risk of double taxation as well as that of double non-taxation. The proposed design is such that the rules remain effective, however, even if introduction is not universal. In both cases the rules link the tax treatment of an instrument or entity to the tax outcomes in the counterparty jurisdiction to achieve the intended outcome.

5.6 To recap, Action 2 calls for domestic rules targeting two types of payment:

1. payments under a hybrid mismatch arrangement that are deductible under the rules of the payer jurisdiction and not included in the ordinary income of the payee or a related party investor (deduction/ no inclusion or D/NI outcomes); and

2. payments under a hybrid mismatch arrangement that give rise to duplicate deductions for the same payment (double deduction or DD outcomes).

5.7 To avoid double taxation, and to ensure that the mismatch is eliminated even where not all the affected jurisdictions have adopted the rules, the government proposal is for a primary "Rule A" response to a hybrid mismatch arrangement and a secondary, defensive rule, the "Rule B" response.

5.8 The Rule A response is to deny a deduction in the payer's jurisdiction where there is a deduction/no-inclusion outcome, and to deny the deduction in the parent jurisdiction where there is a double deduction outcome.

5.9 Rule B applies where there are no hybrid mismatch rules in the other jurisdiction or where Rule A does not apply to the entity or arrangement in the other jurisdiction. In such circumstances, the payment is included as ordinary income in the payee's jurisdiction.

5.10 The proposed rules will apply automatically without a requirement to establish which jurisdiction has lost tax revenue under the arrangement. They are mechanical in operation and do not include a test of the purpose of the hybrid mismatch arrangement. The G20-OECD recommendations do not include a purpose test because the aim is to neutralise hybrid mismatch outcomes irrespective of their purpose. The absence of a purpose test should provide greater certainty in their application and minimise compliance and administration costs for both taxpayers and tax administrations. It was recognised that in the context of hybrid mismatch arrangements it could be difficult to get consistent application of such a test on a multilateral basis, across many countries with different legal backgrounds and approaches to interpretation.

5.11 In order to ensure that the rules are targeted at the areas of greatest concern their scope is restricted to hybrid mismatch arrangements involving related parties and structured arrangements.

5.12 A structured arrangement is any arrangement where it is reasonable to assume that the hybrid mismatch is priced into the terms of the arrangement or where the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.

Q6. Can you give examples of transactions that you think are, or may be, structured arrangements, and transactions that you think are not structured arrangements?

5.13 Introducing Rule A and Rule B means that where the United Kingdom is the payer jurisdiction in relation to a hybrid mismatch in tax outcomes, the proposed hybrid mismatch rules will result in a denial of certain deductions made in arriving at the profits chargeable to corporation tax, where the relevant circumstances are satisfied.

5.14 Where the United Kingdom is the payee jurisdiction in relation to a mismatch in tax outcomes, and the payer jurisdiction does not operate Rule A under their domestic legislation, then the United Kingdom will bring the payment into charge to corporation tax.

5.15 These proposals cover mismatches arising in both domestic and international context. The scope of the proposed rules overlaps that of the current anti-arbitrage rules at Part 6 TIOPA 2010. Subject to the final agreed scope of the proposed rules, it is unlikely that the existing rules will need to be retained.

5.16 The rules will apply only to corporation tax, including partners in a partnership liable to corporation tax.

5.17 The G20-OECD report identifies a number of different circumstances in which payments can give rise to a hybrid mismatch in tax outcomes, but in each case the tax effect can be neutralised by the rules set out above.

Structure of proposed rules

5.18 Key elements of the proposed rules will include:

1 Qualifying criteria or conditions that need to be satisfied in order for the rules to apply to a hybrid mismatch arrangement.

2 Exceptions to hybrid mismatch arrangements.

3 Hybrid mismatch arrangements not within scope of the rules.

4 How the rules will apply in order to counteract the hybrid mismatch.

Qualifying criteria for hybrid mismatch arrangements

5.19 Hybrid mismatch arrangements arise where:

a the entities involved are related parties; or

b the arrangement is a structured arrangement.

5.20 An arrangement is a hybrid mismatch arrangement if a payment is made between two entities in connection with the arrangement which:

a results in, or is expected to result in, a deduction/no-inclusion outcome or double deduction outcome; and which

b is a payment made under or in connection with a hybrid financial instrument by or through a hybrid entity.

5.21 A hybrid entity will be an entity that:

a is recognised as a person under the tax code of any territory; and

b its income or expenses are also treated under the same or a different tax code as the income or expenses of one or more other persons.

Definitions

5.22 To assist in assessing the impact of these rules and in considering any issues arising from their implementation or operation, the following paragraphs set out proposed definitions and meanings for the various terms used in the qualifying criteria.

Person

5.23 A person should be taken to mean any natural or legal persons, unincorporated bodies of persons, trusts and permanent establishments. The inclusion of unincorporated bodies and trusts enables the United Kingdom to apply the definition of control group and related parties.

5.24 It is proposed that the scope of these proposals does not extend to mismatch arrangements between companies and individuals.

Arrangement

5.25 Although the G20-OECD report recommends a definition of "an arrangement", the United Kingdom considers that the same result suggested by the G20-OECD report can be achieved by using the definition of arrangement already provided within UK statute at section 207 Finance Act 2013 (FA 2013).

Payment

5.26 Payment is intended to have a broad meaning and means almost anything that gives rise to a tax deduction. It includes any amount capable of being paid including (but not limited to) a distribution, credit, debit, or accrual of money.

5.27 A widely drawn definition of payment ensures that the payer should not be able to claim a deduction for an amount that is accrued but unpaid if a corresponding amount is not taken into account as ordinary income by the holder of the income.

5.28 It does not, however, extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties. In respect of stock loans and repos, payment includes the aggregate amounts paid under the arrangement that give rise to a deduction/no-inclusion outcome.

5.29 Ordinary income means income that it is subject to the taxpayer's full marginal tax rate (whether or not reduced by withholding tax). It should not benefit from any exemption, exclusion, credit or other tax relief applicable to particular categories of payments.

5.30 A payment will be treated as included in ordinary income to the extent that it is properly included as income in a computation of the payee's taxable income under the law of a relevant jurisdiction. The fact that, for example, the income did not actually give rise to a tax charge because of the availability of loss relief would not bring the legislation into play.

Related parties and control groups

5.31 The G20-OECD report recommends definitions for related parties and control groups. These definitions are similar to definitions provided in existing UK tax legislation.

5.32 Two persons will be related if they are in the same control group or if the first person has a 25% or greater investment in the second person, or there is a third person that holds a 25% or greater investment in both.

5.33 Two companies are in the same control group if:

- a they are consolidated for accounting purposes,
- b the first company has an investment that provides that company with effective control of the second company or there is a third person that holds an investment which provides that person with effective control over both companies;
- c the first company has a 50% or greater investment in the second company or there is a third person that holds a 50% or greater investment in both, or
- d they can be regarded as associate enterprises under Article 9 of the OECD's Model Double Taxation Agreement (DTA)

5.34 A person will be treated as holding a percentage investment in another person if that person holds directly (or indirectly through an investment in other persons) a percentage of the voting rights in respect of that person or of the value of any equity interest of that person.

Acting together

5.35 For the purposes of the related party rules, a person who acts together with another person in respect of ownership or control of any voting rights or equity interests will be treated as owning all the voting rights and equity interests of that other person.

5.36 Two persons will be treated as acting together in respect of the ownership or control of any voting rights or equity interests if:

a they are members of the same family.

b one person regularly acts in accordance with the wishes of the other person in respect of ownership or control of such rights or interests.

c they have entered into an arrangement that has material impact on the value or control of any such rights or interests; or

d the ownership or control of any such rights and interests are managed by the same person or group of persons.

5.37 In respect of any taxpayer that is a collective investment vehicle, if under the terms of the investment mandate and the circumstances in which the investment was made the investment manager can demonstrate that the two funds were not acting together in respect of the investment, then the interest held by those funds should not be aggregated under the acting together test.

5.38 A person (A) is the member of the same family as another person (B) if B is:

a the spouse of civil partner of A,

b a 'relative 'of A (brother, sister, ancestor, or lineal descendent),

c the spouse or civil partner of a relative of A,

d a relative of A's spouse or civil partner,

e the spouse or civil partner of a relative of A's spouse or civil partner, or

f an adopted relative.

5.39 For the purposes of the proposed rules the definition of relative is the same as that used in section 575A of the Capital Allowances Act 2001.

Financial instrument

5.40 The term financial instrument is not currently defined in the United Kingdom legislation. For the purposes of the hybrids rules we propose to define it as:

a any contract or other arrangement, profits, gains or losses from which would fall to be brought into account in accordance with Parts 5 to 7 of Corporation Tax Act (CTA 2009) if a company within the charge to corporation tax were party to it,

b a finance arrangement within chapter 2 of part 16 CTA 2009

c an equity instrument,

d forward sale of an asset, or

e a stock lending arrangement.

5.41 A hybrid financial instrument should be taken to mean any financial instrument which results in a hybrid mismatch outcome (i.e. D/NI or DD) arrangement). There is no requirement for the financial instrument to have any intrinsic hybrid characteristics for it to be deemed to be a hybrid financial instrument: only that it gives rise to a mismatch.

5.42 A payment gives rise to a deduction/no inclusion (D/NI) outcome to the extent that the payment is deductible under the laws of the payer jurisdiction but is not included in the ordinary income of any person in the payee jurisdiction.

5.43 A payment gives rise to a double deduction (DD) outcome if the payment is deductible under the laws of more than one jurisdiction or gives rise to a deduction for more than one person in the same jurisdiction.

Hybrid transfer

5.44 The term hybrid transfer has been used by the G20-OECD report to describe arrangements such as collateralised loan arrangements or derivative transactions, where the counterparties to the same arrangement in different jurisdictions both treat themselves as the owner of loan collateral or subject matter of the derivative. The difference in the way in the arrangement is characterised can lead to a mismatch in tax outcomes in respect of payments made under the instrument.

5.45 The most common such arrangement is a repo (sale and repurchase transaction) which is a form of collateralised loan where legal ownership of securities is separated from economic ownership.

5.46 Repos and similar collateralised loan or financing arrangements would all fall within the proposed definition of "financial instrument".

5.47 A "payer" will be any company that makes a payment directly or indirectly under a hybrid mismatch arrangement.

5.48 A "payee" means any company which receives a payment, or would be expected to receive a payment had there been an actual cash payment.

5.49 The terms deduction (and deductible) in respect of a payment refer to situations where after a proper determination of the character and treatment of the payment under the laws of the payer jurisdiction, the payment is taken into account as a deduction or equivalent tax relief under the law of that jurisdiction in calculating the taxpayer's net income.

5.50 Recommendation 1 (Hybrid financial instrument rule) of the Action 2: 2014 Deliverable defines "hybrid transfer" as follows:

> *A hybrid transfer is any asset transfer arrangement entered into by a taxpayer with another party where:*
>
> *a) the taxpayer is the owner of the asset and the rights of the counterparty in respect of that asset are treated as obligations of the taxpayer; and*
>
> b) *under the laws of the counterparty jurisdiction, the counterparty is the owner of the asset and the rights of the taxpayer in respect of that asset are treated as obligations of the counterparty*.
>
> *Ownership of the asset for these purposes includes any rules that result in the taxpayer being taxed as the beneficial owner of the corresponding cash-flows from the asset.*

Exceptions to hybrid mismatch arrangements

5.51 An arrangement will not be a hybrid mismatch arrangement if any of the following are met:

Timing differences

5.52 A timing difference may arise where a deduction in one jurisdiction is claimed on an accruals basis and inclusion in the counterparty does not occur until actual payment has been received.

5.53 Timing mismatches are not generally intended to be within the scope of the rules but they are within the scope if it appears that they will not unwind within a reasonable time scale. The government considers 5 years to be a reasonable time scale in this context.

Dual inclusion income

5.54 Income is dual inclusion income if the income has been subject to tax as ordinary income in both jurisdictions.

5.55 This exclusion applies only in respect of hybrid entities. Where the double deduction mismatch is set off against dual inclusion income no mismatch will arise.

5.56 An illustration of how the dual inclusion income exception will operate is provided at example G of annex C.

Payments involving a special status entity

5.57 These rules are not intended to apply where the mismatch only arises because the payee is subject to special regulation and tax treatment – for example certain pension funds.

5.58 A list will be provided of special status entities that will not be caught by these rules. These will include:

1. Unit trusts (to cover both Unauthorised Unit Trusts and Authorised Unit Trusts);
2. Open-Ended Investment Companies;
3. Investment Trusts;
4. Bodies with charitable exemption.

5.59 To safeguard against potential abuse, consideration is being given to dis-applying this exclusion if a mismatch would have arisen had the same financial instrument been directly entered into between taxpayers of ordinary status under the law of their respective jurisdictions. That is, the exception would not apply if the instrument has an inherently hybrid quality that would give rise to a mismatch between two ordinary companies.

Hybrid mismatch arrangements not within scope of the rules

5.60 It is not proposed to extend the hybrid mismatch arrangement rules to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties. These are considered to be closer to a tax exemption/specific concession and do not produce a mismatch in tax outcomes in the sense contemplated by the G20-OECD recommendations.

5.61 For example, some jurisdictions provide a deduction for capital. Such unilateral deductions, such as a notional interest deduction for equity capital, granted by domestic law and which do not involve a payment, are considered to be outside the scope of these rules.

5.62 Mismatches involving differences in tax rates (tax rate arbitrage) are also outside the scope of these provisions.

Q7. UK law, some financing arrangements involving transfers of securities are taxed on the basis that risk and rewards of ownership of the securities remain with the transferring entity, even though under UK law that entity is not treated as holding the securities. The economic effect of such arrangements is the same as being treated as holding the securities. Should the definition of "hybrid transfer" be expanded to include arrangements that are taxed on this basis? If not, why not?

Q8. Are there any entities not shown on the list in paragraph 5.58 that should be included? If so, please explain why they should be treated as special status entities.

Hybrid regulatory capital

5.63 Concerns were raised during the OECD consultation that the mismatch rule could impact disproportionately on banks' hybrid regulatory capital which is issued intra-group.

5.64 Recognising this, in the absence of G20-OECD consensus, it was agreed that countries be allowed to provide on an individual basis how the hybrid mismatch rule should apply to hybrid regulatory capital.

5.65 The government proposes to introduce special provisions for banks' hybrid regulatory capital which reduce the scope for these instruments to be used for tax-planning purposes, while continuing to accommodate regulatory-driven arrangements to ensure a level playing field with other industries.

5.66 This is considered further in chapter 8.

The effect of the hybrid mismatch rules

5.67 The rules are intended to have the effect set out by the G20-OECD report and will apply to counteract payments under hybrid mismatch arrangements so that:

5.68 Rule A will apply where a United Kingdom entity

- a is the payer in relation to a D/NI outcome, or
- b is an investor in a hybrid entity (treated as transparent by the UK rules) that makes a payment which gives rise to a DD outcome, or
- c is a hybrid entity treated as opaque by the UK rules that makes a payment which gives rise to a DD outcome.

5.69 Rule B will apply where a UK entity is the payee in relation to the hybrid mismatch.

5.70 The rules are designed to ensure that they can be applied unilaterally to ensure a coordinated multilateral response which avoids giving rise to double taxation. If all territories introduce these rules then only Rule A should ever be applied, but Rule B will operate as a safeguard when the territory which would otherwise operate Rule A does not have hybrid rules or does not implement them.

5.71 Although these rules are primarily focused on the context of mismatches arising in a cross-border situation, they will, (like the UK's current arbitrage rules), also apply within the UK.

Operation of Rule A

Hybrid arrangement results in a deduction/no-inclusion mismatch outcome

5.72 Where a UK entity is the payer, Rule A should operate to deny the deduction for such payment to the extent that it gives rise to a D/NI outcome.

Hybrid arrangement results in a double deduction outcome

5.73 Where a UK entity is an investor in a hybrid entity treated as transparent by the UK rules that makes a payment which gives rise to a DD outcome, the UK will operate Rule A; that is, it will deny the deduction to the extent it gives rise to a DD outcome.

5.74 For the purposes of operating Rule A in relation to a double deduction outcome, the payer will be the entity identified as the hybrid entity in the mismatch arrangement and the investor will be an entity which recognises some or all of the expenses of the hybrid entity as its own.

Operation of Rule B

Hybrid arrangement results in a deduction/no-inclusion mismatch outcome

5.75 Where a hybrid mismatch arrangement results in a deduction/ no-inclusion outcome, Rule B will operate to the extent that, at the time the payee files its corporation tax return, the deduction has not in fact been denied in the jurisdiction of the payer so as to remove the mismatch.

5.76 To the extent that Rule B operates, the payment must be included within taxable income in the payee entity's corporation tax return.

5.77 Rule B will also apply in cases where both the payee and the payer are resident in the UK.

Hybrid arrangement results in a double deduction mismatch outcome

5.78 Where a hybrid mismatch arrangement results in a double deduction outcome, Rule B will operate to the extent that, at the time the hybrid entity files its corporation tax return, the deduction has not in fact been denied in the jurisdiction(s) of the investor so as to remove the mismatch.

5.79 To the extent Rule B operates, the payment may not be deducted in the hybrid entity's corporation tax return.

Order of rules

5.80 Where the mismatch occurs as a result of both a hybrid financial instrument and a hybrid entity, the rules relating to hybrid financial instrument will apply first. This is because Rule A, for hybrid financial instruments, allows a deduction to be denied for the entire payment. In contrast, the operation of Rule A, when applied to a payment made by a hybrid entity, only denies the deduction to the extent that the payment exceeds any dual inclusion income.

Original mismatch no longer exists

5.81 If subsequent to the application of the rules the original mismatch no longer exists, because, for example, the other jurisdiction has brought income into charge or denied the original deduction, it is proposed that the taxpayer will be able to amend its corporation tax return.

5.82 Where Rule B has operated and the mismatch is eliminated by the operation of Rule A in another jurisdiction or in the UK subsequent to the taxpayer making or amending its corporation tax return, it is proposed that the time limits for amending the return will be extended, but only to allow the effect of Rule B to be amended or removed as necessary.

5.83 In cases where there is a double taxation agreement between the UK and the other jurisdiction involved in the mismatch which provides for Mutual Assistance Procedures similar to those in Article 25 of the OECD Model Tax Convention, the taxpayer will also be able to seek remedy for any double taxation through those Mutual Assistance Procedures.

5.84 As noted at 3.16, the G20-OECD has recommended the introduction of rules to charge corporation tax on the net income of reverse hybrids. The situation is thought to be only likely to occur with UK Limited Liability Partnerships. The proposal is to dis-apply the deeming provision that treats the UK LLP as a partnership in respect of these transactions. This would bring these transactions within the charge to corporation tax.

Q9. Could the situation described in paragraph 5.84 arise with entities other than UK LLPs?

Q10. Would treating the UK LLP as opaque only in respect of these transactions be an administrative burden? Would it be preferable to treat the UK LLP as opaque for all its activities for that period?

6 Proposals for dual resident company rules

Introduction

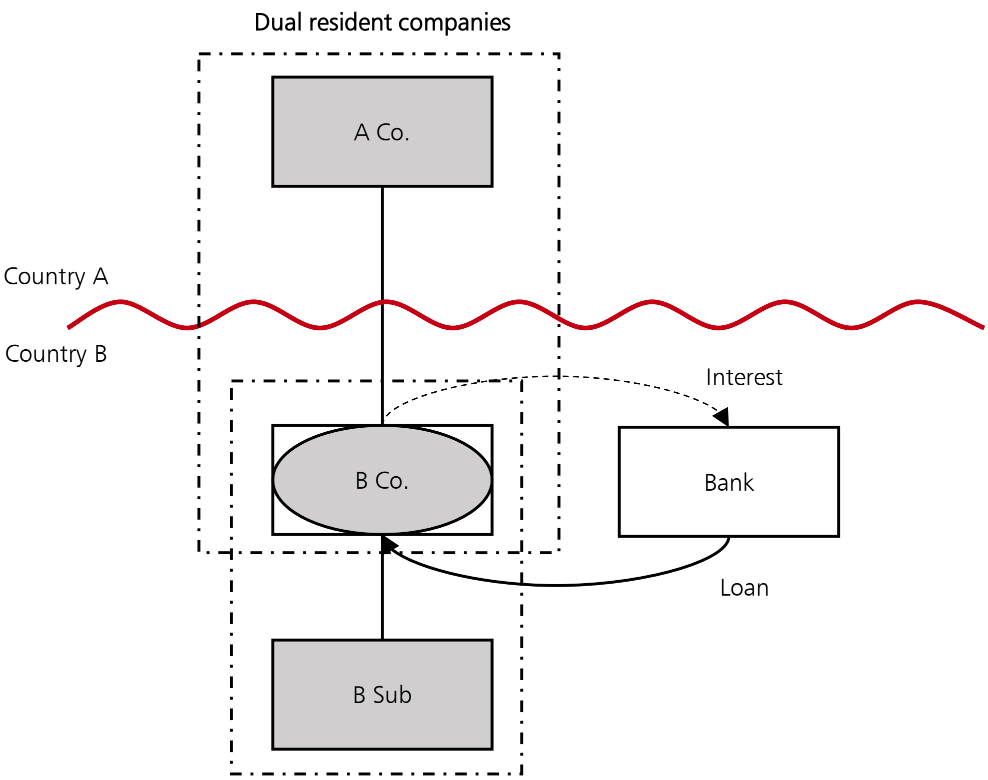
6.1 The primary focus of hybrids rules is to counter mismatches in tax outcomes involving hybrid financial instruments or hybrid entities. A similar hybrid effect can however, be achieved using a dual resident company which, although not a hybrid may be able to obtain relief for losses in more than one jurisdiction.

6.2 A dual resident company is a company which is resident for tax purposes in more than one territory.

6.3 Dual resident companies are able to obtain a "hybrid effect" by being able to claim a deduction for the same economic expense in two jurisdictions.

6.4 The policy objective of this proposal is to deter companies from becoming dual resident by removing any tax advantage that may arise as a result of a company being dual resident.

Chart 6.A: Dual resident companies



Source: OECD

6.5 An example of the hybrid effect is where, A Co (a company incorporated and tax resident in Country A) holds all the shares in B Co (a company incorporated in Country B, but tax resident in both Country A and Country B). B Co is consolidated, for tax purposes with both A Co (under the laws of Country A and with its subsidiary B1 (under the laws of Country B). B Co pays interest which generates a deduction, but is in receipt of no income.

6.6 B Co is a dual resident company, resident in both countries A and B. It is subject to tax on its worldwide income in both jurisdictions on a net basis. Other companies in the same group resident in either country are able to obtain relief for any net losses of B Co against their profits either by virtue of tax consolidation regimes or the ability to surrender losses, for example as in the UK's group relief regime.

6.7 The ability to surrender the tax benefit through the consolidation or group relief schemes allows two deductions for the interest expense to be set off against separate income arising in Country A and Country B. The mismatch arises as a consequence of the tax treatment of the dual resident company rather than from a mismatch involving hybrid entities.

Existing UK rules regarding dual residents

6.8 Mismatches involving dual resident companies are not within the scope of the UK's current arbitrage rules but are instead dealt with under s109 CTA 2010 (dual resident Investing Companies) provisions.

6.9 The UK introduced legislation in 1987 to counter tax avoidance using dual resident companies that met certain criteria. The criteria were that the company was considered resident both in the UK and another territory, and then that the company was also either:

a not trading,

b that it was trading but the trade involved certain activities, or

c that the company carried on a trade but also undertook the relevant activities to an extent not needed by, or not for the purpose of, its actual trade.

6.10 Where a company met these criteria any losses it incurred were not available to be surrendered for group relief but could otherwise be used by the dual resident company.

6.11 The rules recommended by the G20-OECD will operate differently to the UK's current rules. The proposed new rules will deny a deduction to a dual resident company that is resident in the UK unless certain criteria are met.

Structure of proposed rules

6.12 In order to implement the BEPS hybrid mismatch proposals relating to dual resident companies new rules will be introduced replacing the provisions of s109 CTA 2010.

6.13 In line with the BEPS proposals the new rules will apply to deny all deductions claimed by a dual resident company other than as provided for by the exceptions set out below (see paragraphs 6.21 and 6.22 below).

6.14 This rule will apply without regard to whether the dual resident company disclaims the deduction either fully or partially in the other resident jurisdiction. This is necessary to ensure that the dual resident company cannot obtain a tax advantage by "choosing" the jurisdiction in which it obtains the tax deduction.

6.15 A dual resident company will be defined in accordance with the definition provided at S109 (1) CTA 2010.

6.16 A payment means a payment made under the laws of the payer jurisdiction, and taken into account as a deduction or as equivalent tax relief under the law of that jurisdiction in calculating the taxpayer's net income.

6.17 Payment is intended to have a broad meaning and means almost anything that gives rise to a tax deduction. It includes any amount capable of being paid including (but not limited) to a distribution credit, debit, or accrual of money but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties.

6.18 Payer means the dual resident company that makes the payment directly or indirectly which results in a deduction that may be claimed in more than one state.

6.19 Payer jurisdiction is any jurisdiction where the payer is liable.

Arrangements outside the scope of these rules

6.20 These rules do not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between parties. These are considered to be closer to a tax exemption/specific concession and do not produce a mismatch in tax outcomes in the sense contemplated by the G20-OECD report.

Exceptions from these rules

6.21 A deduction will only be allowable if it has been subject to an agreement between the competent authorities of both jurisdictions. Where there is no treaty this exception will not apply. Where there is a treaty it is expected that, upon the application of the dual resident company the competent authorities of the relevant territories will consider whether the deduction may be allowed and if so in which territory.

6.22 A deduction is to be allowable to the extent that the deduction is set off against dual inclusion income. Income is dual inclusion income if the income has been subject to tax as ordinary income in both jurisdictions.

The effect of the rule

6.23 No deduction is available to a dual resident company unless the deduction has been subject to an agreement between the competent authorities of both jurisdictions or is to be set against dual inclusion income.

Operation of the rule

6.24 A dual resident will be required to file its corporation tax return on the basis of this rule. HMRC will be able to enquire into the dual resident's corporation tax return to ensure that this provision has been given effect.

6.25 If both resident jurisdictions deny deductions to a dual resident company, where there is a double taxation arrangement with the other territory and that double taxation arrangement contains a provision in line with or similar to Article 25 of the OECD Model Tax Convention through the "Mutual Agreement Procedure". The taxpayer will be able to seek remedy for any double taxation through this provision.

6.26 It is envisaged that the operation of the UK's double tax treaties will limit substantially the number of companies subject to the dual resident company provisions set out above. This is because the dual resident company provisions will only apply to a company that is dual resident *after* any relevant treaty has been applied.

Q11. Do you consider that the definition for dual resident companies set out at section 109 (1) CTA 2010 is appropriate? If not, can you suggest alternative definition, with reasons?

Q12. Could the proposals as set out in paragraphs 6.12 to 6.15 inclusive be modified to achieve the same effect with a lower administrative burden?

7 Proposals for treaty provisions

Introduction

7.1 The G20-OECD's report examined both the interaction between tax treaties and proposed domestic law rules on neutralising hybrid mismatch arrangements and the potential for hybrid instruments and entities (as well as dual resident entities) to be used to obtain the benefits of tax treaties unduly. While recognising that further analysis may be required in light of the outcome of the further work to be performed by the OECD, the conclusion of the report is that tax treaties will not prevent the application of the recommended domestic law rules to neutralise the effect of hybrid mismatch arrangements. HMRC agrees with this conclusion and no amendments to UK tax treaties will be required in order to give full effect to Rule A and Rule B outlined above. The G20-OECD's report does though contain two specific recommendations to prevent hybrid instruments and entities being used to obtain the benefits of tax treaties unduly and these are discussed below.

Dual resident companies

7.2 The report makes reference to a change proposed to the corporate residence tie-breaker in the G20-OECD's September 2014 report on Action 6 (*Preventing the Granting of Treaty Benefits in Appropriate Circumstances*). The use of the place of effective management as the criterion for determining treaty residence in the case of a company that is resident in both treaty partners under the provisions of their domestic laws presents opportunities for tax avoidance. Allowing the competent authorities of those states to determine on a case by case basis the treaty residence of a company allows a range of factors to be taken into account including whether determining that a company is a resident of one state but not another carries with it the risk of improper use of the tax treaty or an inappropriate application of the domestic law of either state.

7.3 It is the government's preference to determine company residence for treaty purposes on the basis of competent authority agreement and a number of the UK's tax treaties already contain provisions similar to that proposed in the report (see for example Article 4(4) of the 2008 UK/Netherlands tax treaty). We would welcome the proposed change to the OECD Model Tax Convention (the OECD Model) and will continue to propose provisions very similar to it in future bilateral negotiations.

Treaty provision on transparent entities

7.4 The G20-OECD's report recommends adding to the OECD Model a provision that will extend the conclusions of the 1999 OECD report on *The Application of the OECD Model to Partnerships* to entities other than partnerships. The UK already has similar provisions in some of its tax treaties (for example, Article 1(8) of the 2001 US/UK tax treaty) and the government would support this addition to the OECD Model. Its widespread adoption would bring welcome certainty to persons deriving income through transparent entities of all sorts as well as confirming that treaty benefits are not due in the UK where a resident of the treaty partner state is not liable to tax in respect of income derived through a transparent entity. It is the government's intention to seek to include the provision, or provisions with a similar effect, in its tax treaties either through future bilateral negotiations or via the Multilateral Instrument that it is envisaged will amend tax treaties to give effect to the BEPS recommendations.

Q13. Do you agree with the conclusion that tax treaties will not interfere with the operation of Rule A and Rule B?

8 Hybrid regulatory capital

8.1 Unlike most other industry groups, banks face regulatory requirements to hold loss-absorbent capital as a proportion of their balance sheet size and risk. These requirements (which apply at both a group and solo entity level) are designed to increase banks' ability to absorb losses in periods of financial stress and reduce harmful negative spillovers to the real economy.

8.2 Banks can meet a proportion of their regulatory capital requirements through hybrid instruments. These are generally subordinated debt instruments which are perpetual, make regular coupon payments, and are either written down or converted to ordinary share capital in times of stress.

8.3 Due to the hybrid nature of these instruments, countries have chosen to take different positions with respect to their taxation. For example, the UK, France and Germany treat these instruments as debt for tax purposes, while the US and Canada treat these instruments as equity. This creates the possibility of hybrid mismatch outcomes where these instruments are issued cross-border.

8.4 The general mismatch rule is targeted towards intra-group transactions and should not generally impact on UK banks issuing hybrid regulatory capital directly to third party investors, irrespective of where these investors are resident.

8.5 There is a concern however that the hybrid mismatch rule would have a negative impact on hybrid regulatory capital issued intra-group, which may occur legitimately from the fact that:

1. a number of regulators, including the UK and US, increasingly require banks to issue regulatory capital externally at the top holding company level and then down-stream this to operating subsidiaries through intra-group instruments (with the aim of facilitating more effective and orderly resolution in the event of a crisis); and

2. regulatory capital issued directly to the market by a non-wholly owned subsidiary will be discounted or disregarded in the calculation of group capital resources, which creates incentives to issue capital higher up the group and then down-stream to the relevant operating subsidiaries.

8.6 For example, the rule would have a negative impact on a US banking group which, at the request of its regulator, issues hybrid regulatory capital at the top holding company level and then down-streams this to its UK operating subsidiary through a comparable hybrid instrument.

8.7 While this arrangement could be seen to replicate the effect of the subsidiary issuing the hybrid instrument directly to the market, it would trigger the mismatch rule and put the subsidiary (and possibly the wider group) at a tax disadvantage relative to banks for whom direct UK issuance is possible.

8.8 This would create an uneven playing field between UK and some non-UK headquartered banks. It could also create tension between the tax and regulatory regimes, by providing incentives for groups to raise capital in a way that is sub-optimal from a financial stability standpoint.

8.9 The government is keen to avoid this. It is also committed to ensuring that the mismatch rule is effective and fully removes the scope for banks to use hybrid instruments for tax-planning purposes. The special provisions set out below are designed to achieve this balance.

Hybrid regulatory capital options

8.10 The government considers that there should be special provisions to accommodate mismatches arising from down-streaming of externally issued hybrid regulatory capital i.e. intra-group hybrid regulatory capital should be accommodated under the mismatch rule to the extent – and only to the extent – that it originates from an external issuance at top holding company.

8.11 The fungibility of banks' funding (and the fact that capital is typically raised in tranches) means that it is difficult to trace intra-group hybrid regulatory capital back to external issuance at top holding company level.

8.12 We therefore need a model that approximates this, by allocating hybrid regulatory capital issued by the top holding company around the group on some reasonable basis, and then limits the application of the mismatch rule to anything in excess of the allocated amounts.

Option 1

8.13 A UK subsidiary of a US banking group issues a hybrid regulatory capital instrument to its parent giving rise to a mismatch outcome.

8.14 The proposal would be as follows:

a Calculate the amount of hybrid regulatory capital issued externally out of the group's top holding company (Amount A).

b Calculate the amount of hybrid regulatory capital issued intra-group across the worldwide consolidated group (Amount B).

c If Amount A is greater than or equal to Amount B, then the mismatch rule would not apply to the hybrid regulatory capital instrument issued by the UK subsidiary.

d If Amount A is less than Amount B, then allocate a proportion of Amount A to the UK subsidiary based on its relative proportion of Amount B. The mismatch rule would not apply to the hybrid regulatory capital instrument issued by the UK subsidiary up to the allocated amount.

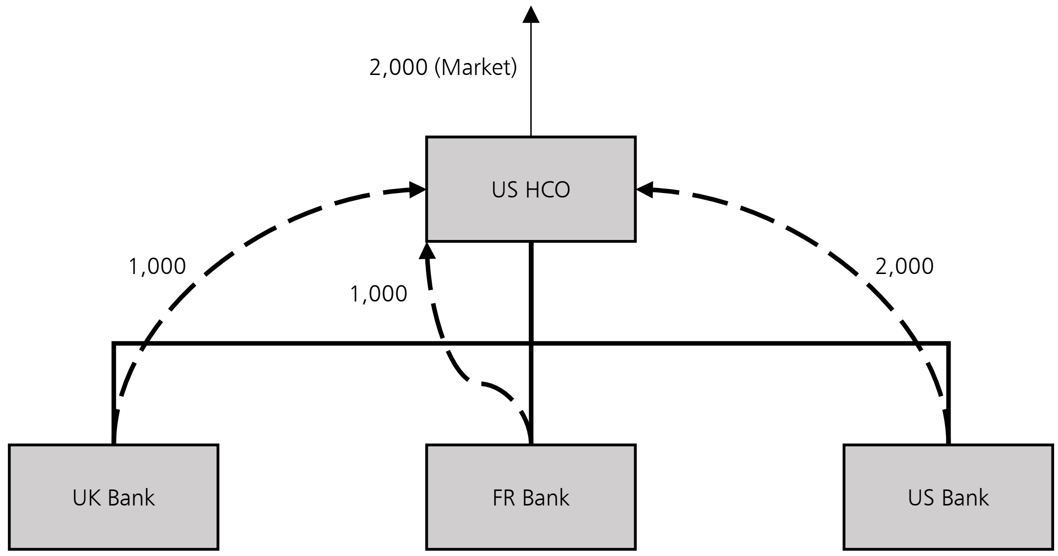
8.15 The example below shows how this model would work at a high-level. The hybrid regulatory capital instrument issued from the UK bank to the US holding company gives rise to a mismatch outcome. The amount of worldwide intra-group hybrid regulatory capital exceeds hybrid regulatory capital issued externally out of the top holding company: the model therefore allocates a proportion of the latter to the UK bank according to its relative proportion of the former:

a Amount A is 2000. This is the total amount of externally issued regulatory capital issued as at 31 December 2017.

b Amount B is 4000. This is the total intragroup regulatory capital issued by the UK, French and US banks.

c As Amount B is greater than Amount A, allocate 2000 x (1000/4000) = 500 to the UK bank.

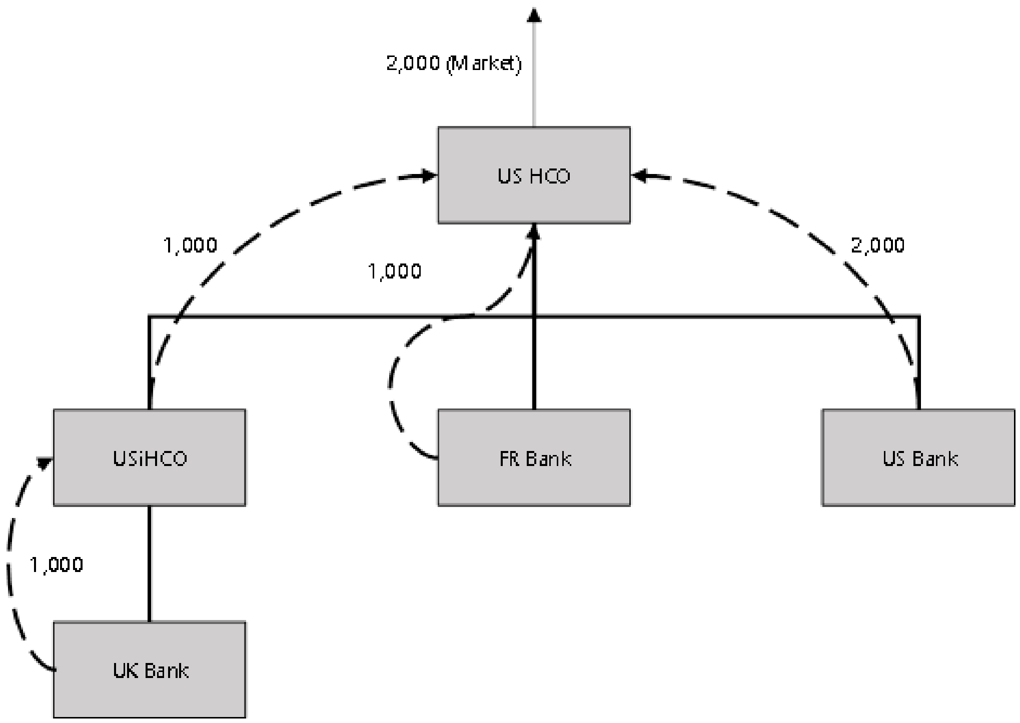
d The mismatch rule would apply to the remaining 500 of the UK bank's 1000.



Source: HMT

8.16 In practice, group structures are more complex than suggested above. They are likely to include: (a) intermediate holding companies which may act as pure conduits passing down capital throughout the group; and (b) banks that may pass down capital to subsidiaries, but also use capital within their own business.

8.17 The basic proposal above fails to accommodate this. As illustrated in chart 8.B, inserting an intermediate holding company (USiHCO) into the above arrangement would increase the amount of 'intra-group hybrid regulatory capital' from 4000 to 5000 (reducing the UK bank's deduction from 500 to 400) even though this company is acting as a pure conduit and has no impact on the substance of the arrangement.



Source: HMT

8.18 This could be addressed by saying that, in calculating intra-group hybrid regulatory capital, companies should deduct hybrid regulatory capital held in their subsidiaries, subject to a floor of zero. This means that the model would ignore entities that are being used to simply down-stream capital. In the above example, the US holding company would be ignored and intra-group hybrid regulatory capital (i.e. Amount B) would fall to 4000.

8.19 This netted approach should also deal with banks that down-stream hybrid regulatory capital to their subsidiaries, but also use hybrid regulatory capital within their own business. The amount of hybrid regulatory capital used by these banks can reasonably be approximated as hybrid regulatory capital they issue minus hybrid regulatory capital they hold in their subsidiaries.[1]

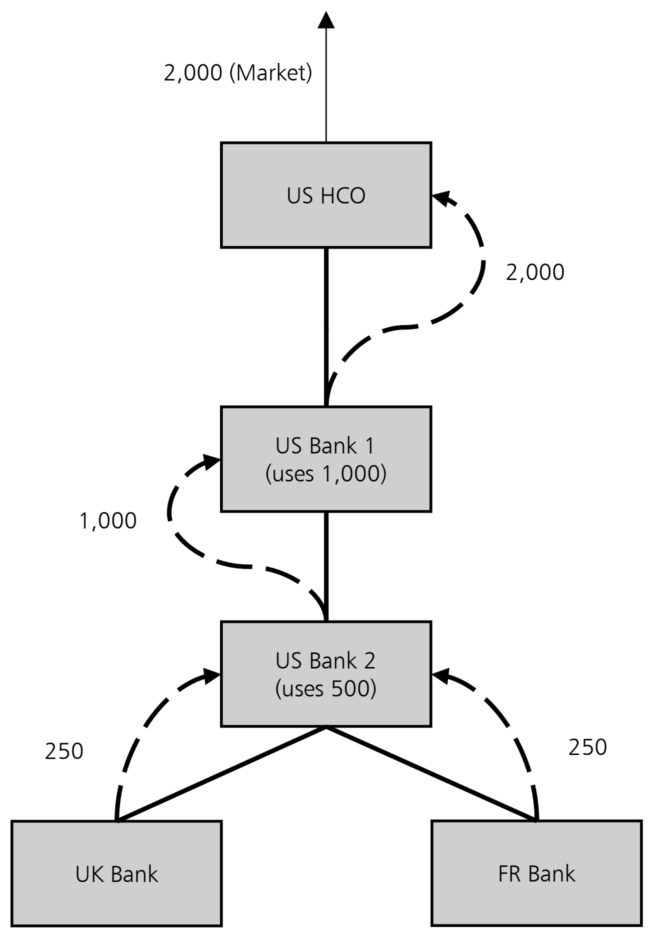
8.20 In the example below (chart 8.C), the application of this netted approach means that the UK bank is fully exempt from the mismatch rule.

a Amount A is 2000. This is the total amount of hybrid regulatory capital issued externally as at 31 December 2017.

b Amount B is 2000. This is the total intragroup hybrid regulatory capital issued by the UK, French and US banks, minus the amount of hybrid regulatory capital these banks hold in their subsidiaries.

c As Amount B does not exceed Amount A, the mismatch rule does not apply to the UK bank's hybrid regulatory capital issuance.

[1] This should align with the hybrid regulatory capital amounts included in these banks' regulatory capital resources.



Source: HMT

8.21 There are some additional points that need to be considered. Firstly, it may be possible for a proportion of the hybrid regulatory capital issued by the top holding company (Amount A) to be used or retained in its own business. As such, the definition of Amount A may need to be adapted to say 'hybrid regulatory capital issued externally out of the top holding company, capped at the amount of hybrid regulatory capital that the top holding company holds in its subsidiaries.[2]

8.22 Secondly, it may be that some banks are not required to issue external capital at top holding company level but are instead required to issue capital at an intermediate holding company (e.g. the top holding company of a regional sub-group, or the banking holding company of a non-banking group). The model may need to accommodate this, by allowing banking groups to designate the relevant company for Amount A purposes, provided that they can evidence the regulatory requirements that underpin this.

Option 2

8.23 The model above assumes that a UK bank can access information from elsewhere in the group, besides from its parent company, in order to calculate intra-group hybrid regulatory capital. This may give rise to difficulties.

[2] The alternative approach would be to include the top holding company in the allocation of Amount A i.e. increase Amount B as opposed to decreasing Amount A.

8.24 The government would therefore like to explore alternative approaches for identifying (or more reasonably approximating) how much of an intra-group hybrid regulatory capital instrument originates from a top holding company issuance.

8.25 One approach would be to allocate hybrid regulatory capital issued externally from the top holding company around the group's subsidiaries according to their risk-weighted assets (which are used by regulators to determine banks' capital requirements and should be more accessible source of group-level information).

8.26 For example, where a UK bank issues a hybrid regulatory capital instrument to its US parent giving rise to a mismatch outcome, we would:

a. Calculate the risk weighted assets across the worldwide consolidated group (Amount A).

b. Calculate the risk weighted assets in the UK subsidiary (Amount B).

c. Calculate the amount of hybrid regulatory capital issued by the top holding company and multiply it by Amount B/Amount A (Amount C)

d. Apply the mismatch rule to hybrid regulatory capital issued by the UK subsidiary in excess of Amount C.

8.27 The example below shows how this model would work at a high-level. The hybrid regulatory capital instrument issued from the UK bank to the US holding company gives rise to a mismatch outcome. The model therefore allocates a proportion of externally issued hybrid regulatory capital from the US top holding company to the UK subsidiary based on the UK subsidiary's relative proportion of group risk weighted assets. That allocated proportion would not be subject to the hybrid mismatch rule.

8.28 In the Risk Weighted Assets ('RWA') example below (chart 8.D) the UK Bank, French "(FR") Bank and US Bank have equal risk weightings of 100,000. This means that:

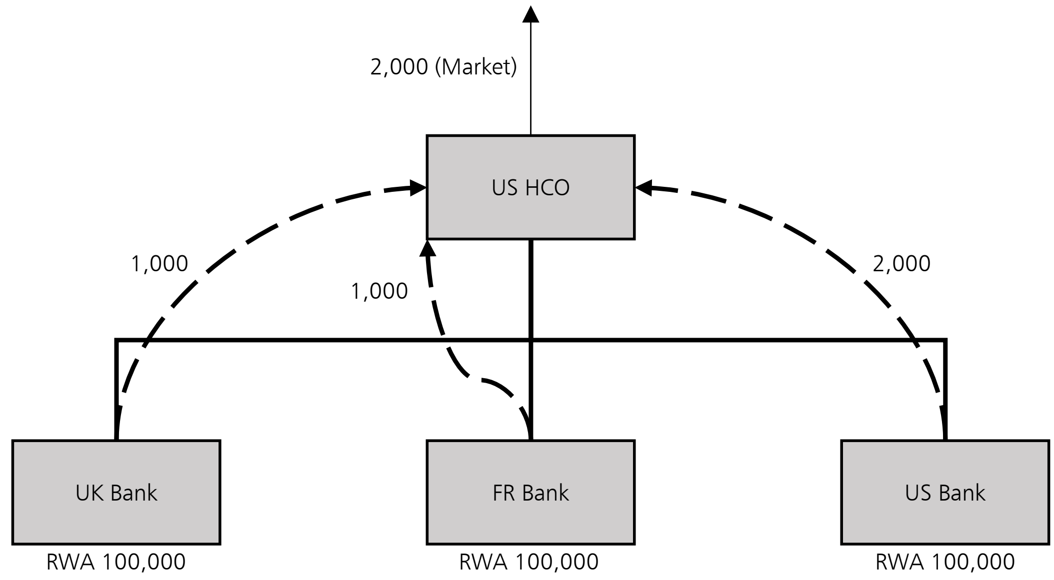
a. total RWAs across the group equals 300,000 (excluding the US HCO);

b. UK RWAs is 100,000;

c. UK RWAs/Group RWAs is 33.33%; and

d. the UK bank is therefore exempt from the mismatch rule on 2000*33.33% = 667

This is different from Option 1.



Source: HMT

8.29 In the above example, Option 2 would provide a more beneficial outcome to the UK bank than Option 1, which would only allocate 500 to the UK subsidiary (meaning that the mismatch rule applies on 500 as opposed to 333). This is not always the case, however.

Insurance groups

8.30 This chapter has so far focused on banks' hybrid regulatory capital, on the basis that the banking regulatory regime is more clearly developed. However, representations to the OECD consultation suggested that the same issues could be relevant to the **insurance sector**.

8.31 The similarities include a regulatory requirement to hold capital (in this case against liability risk as opposed to asset risk), an ability to meet a proportion of this capital through hybrid instruments, and an increasing regulatory drive under both Dodd-Frank and Solvency II towards issuance of this capital at top holding company level.

8.32 We may therefore need to ensure that special provisions for hybrid regulatory capital accommodate both of these regulated sectors, ideally avoiding a dual-layered solution which would introduce additional complexity (particularly for groups engaged in both banking and insurance activities).

Wider points

8.33 We need to consider the **definition of hybrid regulatory capital** to which the solutions above apply. The differences in countries' regulatory regimes may prevent a universal CRD IV or Solvency II definition.[3]

8.34 We also need to consider the **frequency of measurement** of hybrid regulatory capital in the above solutions. It may be appropriate to measure hybrid regulatory capital in issue at the year-end. However, a quarterly or monthly measurement may reduce the scope for groups to manipulate the rules and help to ensure that an atypical year-end snapshot does not have a disproportionate impact.

[3] These differences may also create issues in the adoption of a risk-weighted asset allocation metric.

8.35 Finally, we will need to consider how the solutions above fit with the wider OECD work to identify best practices on **interest deductibility**. The government is keen to ensure that solutions on different BEPS actions are consistent.

Q14. To what extent does Option 1 provide an appropriate solution to the issues around hybrid regulatory capital? What issues and/or difficulties can you identify with this approach (e.g. the identification of intra-group hybrid regulatory capital)?

Q15. To what extent does Option 2 provide an appropriate solution to the issues around hybrid regulatory capital? What issues and/or difficulties can you identify with this approach (e.g. the use of risk-weighted assets?

Q16. To what extent are the issues around hybrid regulatory capital relevant to insurers? How would Options 1 and 2 need to be changed in order to take account of this?

Q17. What definition of hybrid regulatory capital should be used in the above solutions?

9 Commencement and transitional provisions

9.1 The UK formally announced its commitment to implement the G20-OECD report recommendations on 5 October 2014. This consultation exercise is intended to provide stakeholders with an opportunity to contribute to consideration of the remaining issues set out in chapter 4 and to comment on any implementation issues on the proposals as a whole so that officials can fully understand the domestic implications.

9.2 The OECD work on the accompanying commentary will be completed by September 2015.

9.3 The UK will introduce the hybrids mismatch rules to apply to payments made on or after 1 January 2017.

9.4 The advanced announcement of the UK rules will provide a transitional period for businesses currently using hybrids to unwind their structures. No additional transitional rules (e.g. grandfathering) are contemplated.

10 Administrative aspects

Self-assessment

10.1 The government's intention is that the hybrid mismatch arrangement rules will operate within the United Kingdom's existing self-assessment regime.

10.2 This will mean that companies will be responsible for considering the application of the hybrid mismatch rules when filing their self-assessment tax returns.

10.3 This will ensure that the new rules will operate in a way that is familiar to taxpayers and advisers.

Evidence to support self-assessment

10.4 Companies are required to be able to provide evidence to support any deductions in their returns. However, it is recognised that the evidence needed under the proposed rules may involve knowledge of either the tax rules of another jurisdiction or the tax affairs of a company in another jurisdiction.

10.5 In many cases it will be clear from public information about the other tax system how a payment should be treated by the other entity involved. However, where the treatment is not clear, it will be necessary to find out how the payment has in fact been treated by the counterparty. This will also be necessary where a taxpayer is required to apply Rule B unless it can ascertain that a deduction has been denied in another entity. The government considers that as the information concerns a related entity or a counterparty in a structured arrangement it will be possible for the UK company to obtain the information it needs to prepare its return

10.6 The government does not wish to be prescriptive on the evidence required.

Exchange of information

10.7 The UK will undertake where appropriate to exchange information with other tax authorities on the treatment of different types of financial instruments and entities, as well as of particular transactions. All exchanges of information will take place under the terms of our existing tax treaties and Tax Information Exchange Agreements.

Penalties

10.8 Under these proposals, companies will be responsible for considering the application of the new hybrid rules when making their returns. This means that existing penalty provisions and the criteria for their application would apply to any errors in the returns.

> Q18. In which specific situations might taxpayers encounter difficulties in complying with the proposed rules?

11 Tax impact assessment

Summary of impacts

Exchequer impact (£m)	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
	-	-	+15	+70	+85	+90
	These figures were set out in Table 2.1 of Autumn Statement 2014 and have been certified by the Office of Budget Responsibility. More detail can be found in the policy costings document published alongside the Autumn Statement.					
Economic impact	This measure may have an effect on the cost of capital for some large businesses that have undertaken aggressive tax planning, reducing incentives to invest. The measure is not expected to have any other significant economic effects.					
Impact on individuals, families and households	There is no direct impact on individuals, families and households. The measure only applies to corporations, however if increased liabilities are not absorbed by shareholders, this may lead to increased costs for customers and/or reduced wages for employees.					
Equalities impacts	We expect no equalities impacts.					
Impact on businesses and Civil Society Organisations	No firm quantification of the effect on business is available at this time. We expect the measure to have an impact on the largest multinational businesses, across all sectors. There is likely to be an initial burden in training and familiarisation with the new rules, as well as an ongoing burden in self-assessing each group's tax liability, to ensure that they correctly reflect the new rules. We hope to gather more information on the administrative impact through the consultation process.					
Impact on HMRC or other public sector delivery organisations	The additional costs for HMRC are anticipated to be negligible.					
Other impacts	Other impacts have been considered and none have been identified.					

12 Summary of consultation document questions

Chapter 4 – Further OECD work

Q1. Should income taxed under a CFC or other offshore regime be treated as included in ordinary income?

Q2. If included, what steps could be taken to ensure that inclusion of the hybrid payment gave an equivalent outcome to inclusion of a CFC charge on the payment.

Q3. If included, how could the compliance burden of determining the relevant CFC charge be reduced?

Q4. What practical issues could arise in distinguishing between stock loan and repo transactions within the scope of the proposed rules and those outside their scope?

Q5. Can you suggest any change(s) to the proposed rules that might allow this distinction to be made more easily (Note that the G20-OECD recommendations cannot accommodate a "purpose test" as the rules are intended to apply automatically)?

Chapter 5 – Proposals for hybrid mismatch arrangements legislation

Q6. Can you give examples of transactions that you think are, or may be, structured arrangements, and transactions that you think are not structured arrangements?

Q7. Under UK law, some financing arrangements involving transfers of securities are taxed on the basis that risk and rewards of ownership of the securities remain with the transferring entity, even though under UK law that entity is not treated as holding the securities. The economic effect of such arrangements is the same as being treated as holding the securities. Should the definition of "hybrid transfer" be expanded to include arrangements that are taxed on this basis? If not, why not?

Q8. Are there any entities not shown on the list in paragraph 5.58 that should be included? If so, please explain why they should be treated as special status entities.

Q9. Could the situation described in paragraph 5.84 arise with entities other than UK LLPs?

Q10. Would treating the UK LLP as opaque only in respect of these transactions be an administrative burden? Would it be preferable to treat the UK LLP as opaque for all its activities for that period?

Chapter 6 – Proposals for dual resident rules

Q11. Do you consider that the definition for dual resident companies set out at section 109 (1) CTA 2010 is appropriate? If not, can you suggest alternative definition, with reasons?

Q12. Could the proposals as set out in paragraphs 6.12 to 6.15 inclusive be modified to achieve the same effect with a lower administrative burden?

Chapter 7 – Proposals for treaty provisions

Q13. Do you agree with the conclusion that tax treaties will not interfere with the operation of Rule A and Rule B?

Chapter 8 – Hybrid regulatory capital

Q14. To what extent does Option 1 provide an appropriate solution to the issues around hybrid regulatory capital? What issues and/or difficulties can you identify with this approach (e.g. the identification of intra-group hybrid regulatory capital)?

Q15. To what extent does Option 2 provide an appropriate solution to the issues around hybrid regulatory capital? What issues and/or difficulties can you identify with this approach (e.g. the use of risk-weighted assets)?

Q16. To what extent are the issues around hybrid regulatory capital relevant to insurers? How would Options 1 and 2 need to be changed in order to take account of this?

Q17. What definition of hybrid regulatory capital should be used in the above solutions?

Chapter 10 – Administrative aspects

Q18. In which specific situations might taxpayers encounter difficulties in complying with the proposed rules?

Box 12.A: Annex C – How the hybrid rules would operate

Example A – Hybrid mismatch involving two jurisdictions

Treatment in the counterparty jurisdiction

Q19. Are there any difficulties for the UK Co establishing the treatment of the hybrid instrument in the counterparty jurisdiction?

Evidence

Q20. What evidence could be obtained to confirm that the deduction has been denied in the situation described in paragraph C.5?

Q21. How could that evidence be obtained? What would be the process?

Example D – Hybrid mismatch involving a sale and repurchase (repo) arrangement

Q22. Do you think that in an arrangement like this, disallowing the interest deduction is an appropriate response? If not, what would be an appropriate response and why?

Q23. Are there any arrangements involving hybrid financial instruments or hybrid transfers that produce a similar outcome and that you would not consider to be structured arrangements? Please give your reasons. (Note that if such a transaction were between related parties, the rule would apply irrespective of whether the arrangement is a structured arrangement or not).

Example H – Hybrid mismatch arrangement involving indirect hybrid payments

Q25. How might a group most readily identify which of the funding arrangements made with Z Co and the other subsidiaries are subject to the proposed hybrid rules and what difficulties might arise?

Q26. Would it be preferable to have rules which do not rely on tracing the on-lending funding arrangements? If so, can you suggest an alternative method of establishing the disallowance which meets the policy objectives?

A Consultation process

A.1 This consultation is being conducted in line with the tax consultation framework.

A.2 There are 5 stages to tax policy development:

Stage 1 Setting out objectives and identifying options.

Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.

Stage 3 Drafting legislation to effect the proposed change.

Stage 4 Implementing and monitoring the change.

Stage 5 Reviewing and evaluating the change.

A.3 This consultation is taking place during stage 2 of the process. The purpose of the consultation is to seek views to inform the development of legislation in the UK and the ongoing OECD work on a commentary and on refinement of certain aspects of the recommendations.

How to respond

A.4 This consultation will run from for 10 weeks from 3 December 2014 until 11 February 2015.

A.5 Written responses should be submitted by 11 February 2015, preferably by email, to: bepsresponses.condoc@hmrc.gsi.gov.uk

Yasmin Ali HM Revenue and Customs Room 3/21 3rd Floor 100 Parliament Street London SW1A 2BQ	David Howell HM Treasury 1st Floor 1 Horse Guards Road London SW1A 2HQ

A.6 Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be accessed from HMRC Inside Government (www.hmrc.gov.uk). All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

A.7 When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

A.8 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

A.9 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentially can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs (HMRC).

A.10 HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

B Consultation principles

B.1 This consultation is being run in accordance with the government's consultation principles, which are available on the Cabinet Office website: http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance

B.2 If you have any comments or complaints about the consultation process please contact:

Oliver Toop
Consultation Coordinator
Budget Team
HM Revenue & Customs
100 Parliament Street
London
SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

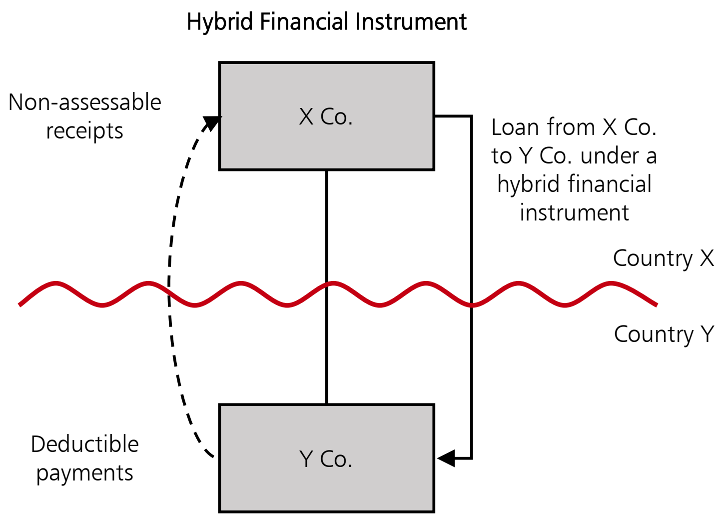
Please do not send responses to the consultation to this address.

C How the hybrid rules would operate

Arrangements that produce deduction/no-inclusion outcomes

Arrangements involving hybrid financial instruments (including hybrid transfers)

Chart C.1: Example A – Hybrid mismatch involving two jurisdictions



Source: OECD

Background

C.2 Y Co (an entity resident in Country Y) issues a hybrid financial instrument (for example a convertible loan note) to X Co (an entity resident in Country X). The hybrid instrument is treated as debt for the purposes of Country Y law and Country Y grants a deduction for interest payments made under the instrument. Country X law does not tax the payment resulting in a deduction/no-inclusion outcome.

Qualifying criteria

C.3 X Co and Y Co are related parties. Y Co makes a payment to X Co. The payment is a hybrid payment as it is made under a hybrid financial instrument which results in a D/NI outcome.

Exceptions

C.4 None of the exceptions apply to this arrangement.

Effect of the hybrid mismatch rules

C.5 The mismatch rules will counteract the D/NI mismatch by aligning the tax treatment outcome of the payer and payee under the hybrid financial instrument.

C.6 Rule A will apply where Y Co (the payer) is a UK resident company and Rule B where X Co (the payee) is a UK resident company and is unable to determine that a deduction has been denied.

Treatment in the counterparty jurisdiction

Q19. Are there any difficulties for the UK Co establishing the treatment of the hybrid instrument in the counterparty jurisdiction?

Evidence

Q20. What evidence could be obtained to confirm that the deduction has been denied in the situation described in paragraph C.5 above?

Q21. How could that evidence be obtained? What would be the process?

Rule A

C.7 The UK will deny a deduction for the payment made under the financial instrument to the extent that it gives rise to a D/NI outcome. As Country X does not tax the income, the UK deduction will be denied entirely.

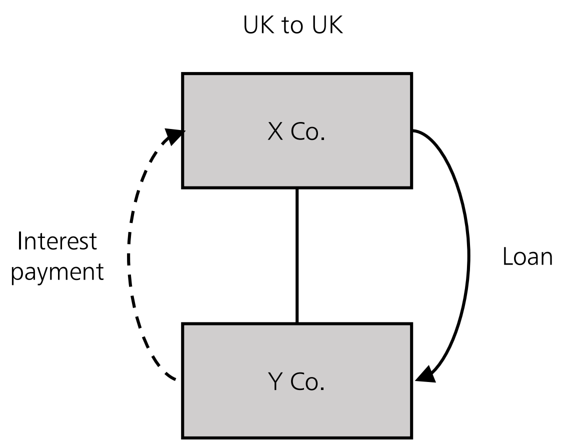
Rule B

C.8 Rule B will apply where X Co is unable to determine that a deduction has been denied in Y Co.

C.9 The UK will require the payment to be included in the ordinary income of X Co to the extent that the payment gives rise to a D/NI outcome. The amount taxed as income in X Co will be the amount of the deduction in Y Co.

Example B – involving UK payee and UK payer

Chart C.2: Hybrid mismatch involving UK payee and UK payer



Source: OECD

Background

C.10 X Co and Y Co are related UK companies. Y Co issues a note to X Co. The terms of the note are such that at maturity, X Co has the option to receive either a cash payment or shares in Y Co to an equivalent value. The note therefore possess "hybrid features" in that it can be converted to equity.

C.11 At the end of the term, the loan is redeemed. Y Co is able to claim a deduction for the value of the embedded option providing for the conversion of the loan, even though the loan has not converted. X Co, however, ignores the value of the option component. A D/NI mismatch outcome has arisen because of the specific terms of the financial instrument.

Qualifying criteria

C.12 X Co and Y Co are related parties involved in a hybrid mismatch arrangement. Y Co makes a payment to X Co. The payment is a hybrid payment as it is made under a hybrid financial instrument which results in a D/NI outcome.

Exceptions

C.13 None of the exceptions apply to this arrangement.

Effect of the hybrid mismatch rules

C.14 The mismatch rules will counteract the D/NI mismatch by aligning the tax treatment outcome of the payer and payee under the financial instrument.

C.15 Rule A will apply to Y Co (the payer) and Rule B to X Co (the payee).

Rule A

C.16 Rule A will deny a deduction for the payment made under the financial instrument to the extent that it gives rise to a D/NI outcome.

Rule B

C.17 Rule B will apply where X Co is unable to determine that a deduction has been denied in Y Co.

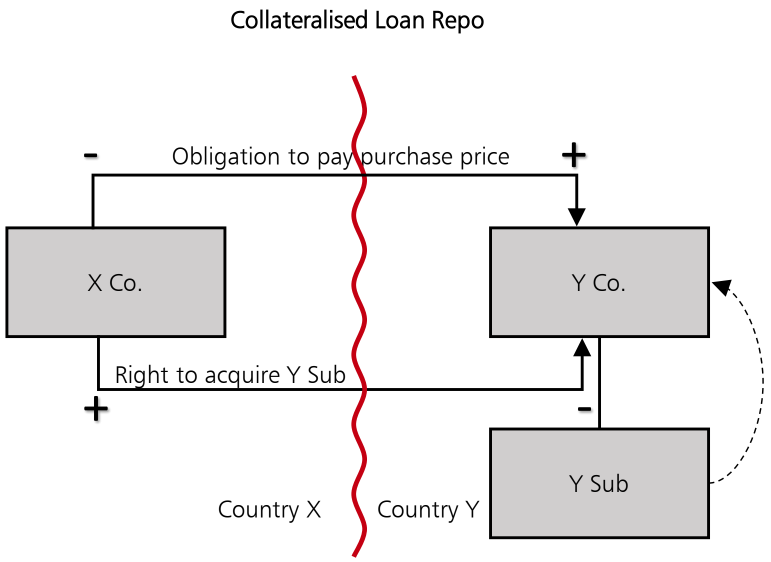
C.18 Rule B will require the payment to be included in the ordinary income of X Co to the extent that the payment gives rise to a D/NI outcome.

Example C – Hybrid mismatch involving a sale and repurchase (repo) arrangement

C.19 A repo is a type of financial instrument that is in economic substance a form of secured lending. One party sells an asset (usually shares or other securities) to another party with an agreement to buy them back at a specified higher price at a specified later date. The difference between the purchase and sale prices is in economic substance interest.

C.20 Cross-border repos can produce mismatches in tax outcomes where both the selling and buying companies' jurisdictions treat the companies as owning the asset. Specifically, where the selling company's jurisdiction taxes the transaction in accordance with its economic substance and treats the company as continuing to own the asset, and the buying company's jurisdiction taxes the transaction in accordance with its legal form as a purchase and sale of an asset giving rise to a capital gain (often exempt).

Chart C.3: Hybrid mismatch involving a sale and repurchase (repo) arrangement



Source: OECD

Background

C.21 X Co resident in Country X owns a subsidiary Y Sub resident in Country Y. X Co sells its shares in Y Sub to Y Co under an arrangement that X Co or an affiliate of X Co will acquire those shares at a later date for an agreed price. In the period between the sale and reacquisition of the shares, Y sub makes a distribution in respect of these shares to Y Co.

C.22 The net cost of this arrangement is treated as a deductible financing cost. X Co's costs include Y sub's dividends paid to Y Co (i.e. the income foregone by X reflects Y's lending return). Country Y will typically grant some form of tax relief to Y Co on the dividends Y Co received. Y Co treats the sale of the shares back to X Co as a genuine sale of shares and may be exempt from any gain on the disposal.

C.23 The effect of the transaction is that a deduction is generated for X Co but there is no corresponding inclusion for Y Co, resulting in a deduction/no inclusion outcome.

Qualifying criteria

C.24 X Co and Y Co (who need not be related parties) are involved in a hybrid mismatch arrangement that is a structured arrangement under BEPS Recommendation 1.4(a) of the Action 2: 2014 Deliverable. X Co obtains a deduction for the payment, but Y Co does not include the payment in its ordinary income. The payment is a hybrid payment as it is made under a hybrid financial instrument and a hybrid transfer which results in a D/NI outcome.

Exceptions

C.25 None of the exceptions apply to this arrangement.

Effect of the hybrid mismatch rules

C.26 The mismatch rules will counteract the D/NI mismatch by aligning the tax treatment outcome of the payer and payee under the financial instrument.

C.27 Rule A will apply where X Co (the payer) is a UK Company and Rule B where Y Co (the payee) is a UK company.

Rule A

C.28 The UK will deny a deduction for the payment made under the financial instrument to the extent that it gives rise to a D/NI outcome.

Rule B

C.29 Rule B will apply where the taxpayer is unable to evidence that a deduction has been denied in X Co.

C.30 The UK will require the payment to be included in the ordinary income of X Co to the extent that the payment gives rise to a D/NI outcome.

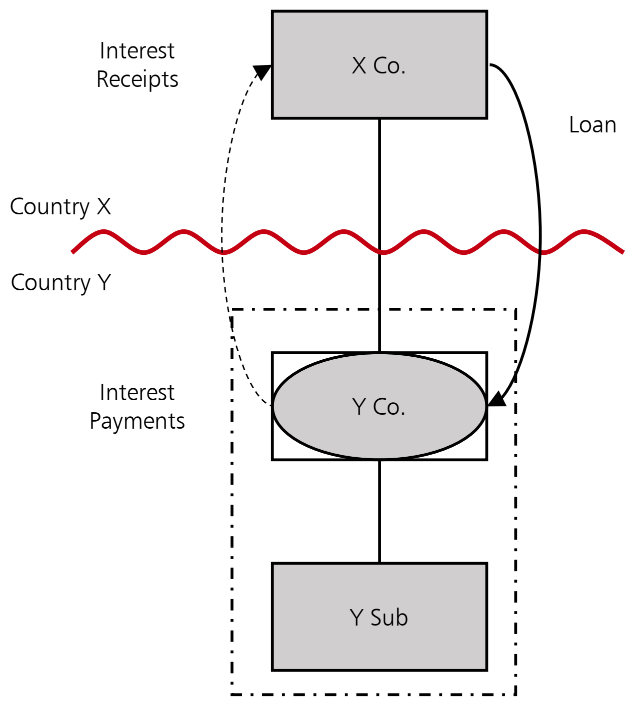
Q22. Do you think that in an arrangement like this, disallowing the interest deduction is an appropriate response? If not, what would be an appropriate response and why?

Q23. Are there any arrangements involving hybrid financial instruments or hybrid transfers that produce a similar outcome and that you would not consider to be structured arrangements? Please give your reasons. (Note that if such a transaction were between related parties, the rule would apply irrespective of whether the arrangement is a structured arrangement or not).

Arrangements involving hybrid entities

Example D – Payments made by a hybrid entity resulting in a D/NI outcome

Chart C.4: Payments made by a hybrid entity resulting in a D/NI outcome



Source: OECD

Background

C.31 X Co (an entity resident in Country X) holds all the shares issued in its foreign subsidiary Y Co (an entity resident in Country Y). Y Co has a subsidiary in Country Y (Y Sub).

C.32 Y Co borrows from X Co and pays interest on the loan. Y Co is treated as transparent under the laws of Country X which accordingly ignores the existence of Y Co. This means that the loan between X Co and Y Co is disregarded under the laws of Country X.

C.33 Y Co claims an interest deduction in Country Y. As it is consolidated with its subsidiary, it is able to surrender the tax benefit of the deduction through the consolidation regime allowing the interest expense to be set off against income that will otherwise be taxable under the laws of Country Y. This results in a deduction/no-inclusion outcome where there is a deduction in Country Y but no inclusion (i.e. no taxable receipt) in Country X.

Qualifying criteria

C.34 X Co and Y Co are related parties involved in a hybrid mismatch arrangement. Y Co obtains a deduction for the payment made to X Co, but X Co does not include the payment in its ordinary income. The payment is a hybrid payment as it is made by a hybrid entity and results in a D/NI outcome.

Exceptions

C.35 No mismatch will arise to the extent that the deduction claimed in the payer jurisdiction Country Y is set-off against income that is included in the ordinary income under the law of both the payee and the payer jurisdictions (e.g. income arising from Y Co on-lending the sum borrowed from X Co).

Effect of the hybrid mismatch rules

C.36 The mismatch rules will counteract the D/NI mismatch by aligning the tax treatment outcome of the payer and payee under the financial instrument.

C.37 Rule A will apply where Y Co (the payer) is a UK Company and Rule B where X Co (the payee) is a UK company.

Rule A

C.38 The UK will deny a deduction for the payment made by the hybrid entity to the extent that it gives rise to a D/NI outcome.

Rule B

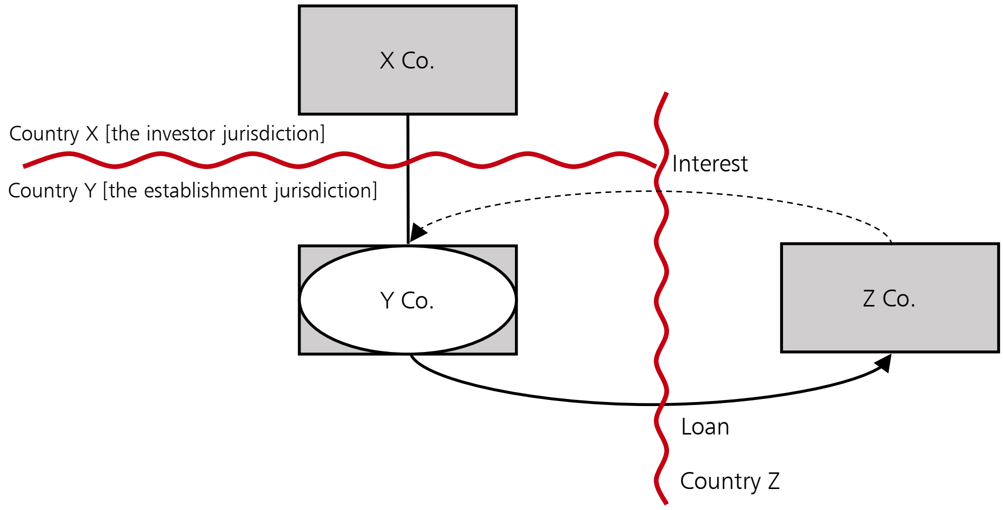
C.39 Rule B will apply where the taxpayer is unable to evidence that a deduction has been denied.

C.40 The UK will require the payment to be included in the ordinary income of X Co to the extent that the payment gives rise to a D/NI outcome.

Arrangements involving payments to hybrids

Example E – Payments received by a hybrid entity resulting in a D/NI outcome

Chart C.5: Payments received by a hybrid entity resulting in a D/NI outcome



Source: OECD

Background

C.41 X Co (an entity resident in Country X - the investor jurisdiction) holds all the shares issued in a foreign subsidiary Y Co (an entity resident in Country Y - the establishment jurisdiction). Z Co is a company resident in Country Z (the payer jurisdiction).

C.42 Z Co borrows from Y Co and pays interest under the loan. Z Co is able to claim a deduction for the interest payment. However, the income is not included in taxable income of neither Y Co nor X Co because neither the investor jurisdiction (Country X) nor the establishment jurisdiction (Country Y) treat the payment as income of a resident. This results in a deduction/no-inclusion mismatch outcome.

C.43 Country X sees Y Co as an entity resident in Country Y so does not tax the income, while Country Y sees Y Co as the branch of X Co and therefore will not tax the income (a similar situation would arise in the case of a partnership in Country Y, with partners resident in Country X).

Qualifying criteria

C.44 X Co, Y Co and Z Co are either related parties or involved in a structured arrangement. Z Co makes a payment to a hybrid entity which results in a D/NI outcome, so this is a hybrid payment.

Exceptions

C.45 None of the exceptions apply to this arrangement.

Effect of the hybrid mismatch rules

C.46 Rule A will apply where Z Co, the payer, is a UK company.

C.47 If X Co is a UK company then the payment should be subject to charge under the UK's CFC regime. Y Co will be seen as a CFC and its profits attributed to X Co.

C.48 If Y Co is a UK resident partnership (please see paragraph 5.82) and the payment has not been taxed under the laws of Country X nor subject to charge under Country X's CFC regime, then the UK will require the payment received to be included in the ordinary income of Y Co (a partnership) to the extent that the payment gives rise to a D/NI outcome.

Rule A

C.49 If Z Co is UK resident, the UK will deny a deduction for the payment by Z Co to the extent that it gives rise to a D/NI outcome.

Rule B

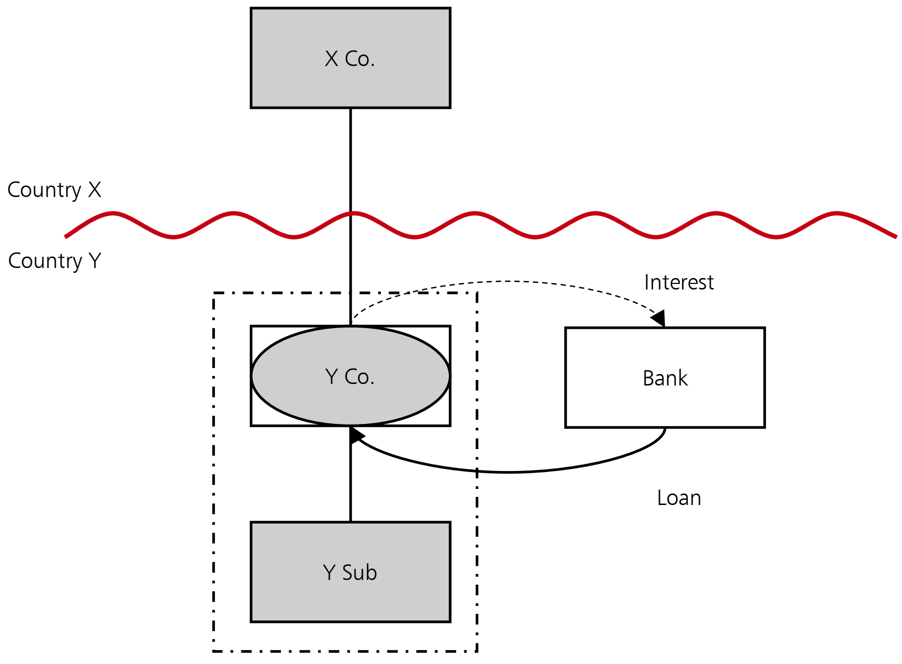
C.50 Rule B will apply where Y Co is resident in the UK and is unable to evidence that (i) a deduction has been denied in Country Z; and (ii) the payment has not been subject to tax or been subject to charge under any CFC regime in Country X.

C.51 Where Rule B applies, the UK will regard Y Co (a partnership) as a company and require the payment to be included in Y Co's ordinary income.

Arrangements that produce double deduction outcomes

Example F – Payments made by a hybrid entity resulting in a double deduction outcome

Chart C.6: Payments made by a hybrid entity resulting in a double deduction outcome



Source: OECD

C.52 A double deduction can arise where a deductible payment is made by a hybrid payer triggering a duplicate deduction under the laws of the parent jurisdiction.

Background

C.53 Y Co is treated as transparent under the tax laws of the jurisdiction of its parent (X Co), making it a disregarded entity.

C.54 Y Co borrows money from a bank and pays interest on the loan claiming a deduction in Country Y. Because Y Co is disregarded under the tax law of Country X, X Co is treated as the borrower under the tax law of Country X.

C.55 If Y Co is consolidated for tax purposes, it is able to surrender the tax benefit of the deduction to its subsidiary (Y Sub). Two deductions are allowed for the same interest expense, in Country X as the parent jurisdiction, and in Country Y as the payer jurisdiction.

Qualifying criteria

C.56 X Co and Y Co are related parties that both obtain deductions for a payment made by Y Co (a hybrid entity). The payment is a hybrid payment as it results in a double deduction outcome.

Exceptions

C.57 No mismatch will arise to the extent that the deduction in the payer jurisdiction (Country Y) is set-off against income that is included in the ordinary income of both X Co and Y Co.

Effect of the hybrid mismatch rules

Rule A

C.58 Rule A will apply if X Co, is a UK resident company. The UK, as the parent jurisdiction of X Co, will deny the duplicate deduction to the extent that it gives rise to a double deduction outcome.

C.59 In a situation where Y Co is a UK resident company and is unable to evidence that a deduction has been denied by Country X, the UK (as the payer jurisdiction of Y Co) will deny the duplicate deduction to the extent that the payment gives rise to a double deduction outcome

Rule B

C.60 Rule B cannot be applied here as the only "payee" is the Bank which already brings the interest into account as income.

Example G – Hybrid mismatch arrangement involving a hybrid payer, dual inclusion income and losses

C.61 The facts and qualifying criteria are the same as in example H.

C.62 Y Co has income of 500 and deductions for interest paid of 1000.

Exceptions – dual inclusion income

C.63 No mismatch will arise to the extent that the deduction in the payer jurisdiction (Country Y) is set-off against income that is included in the ordinary income of both X Co and Y Co.

Carry forward of losses

C.64 Y Co has income of 500 against which it sets off the1000 deduction relating to the interest paid on the bank loan, leaving it with an excess deduction of 500.

C.65 X Co is treated as the borrower under the laws of Country Y so it is able to claim a deduction for the payment of 1000. Under the laws of Country X, Y Co is treated as a branch of X Co so any income arising in Y Co is treated as the income of X Co.

C.66 X Co will therefore recognise income of 500 against which it deducts 1000 interest paid, leaving it with an excess deduction of 500.

C.67 As the same income has been included in both the payee and payer jurisdictions the excess deduction can be carried forward to be set off against any future dual inclusion income in both X Co and Y Co.

Stranded losses

C.68 In the following year Y Co ceases to trade and is not able to use the excess deductions of 500 carried forward from the previous year.

C.69 As only one deduction can now be used, X Co is no longer restricted in its use of the excess deduction of 500.

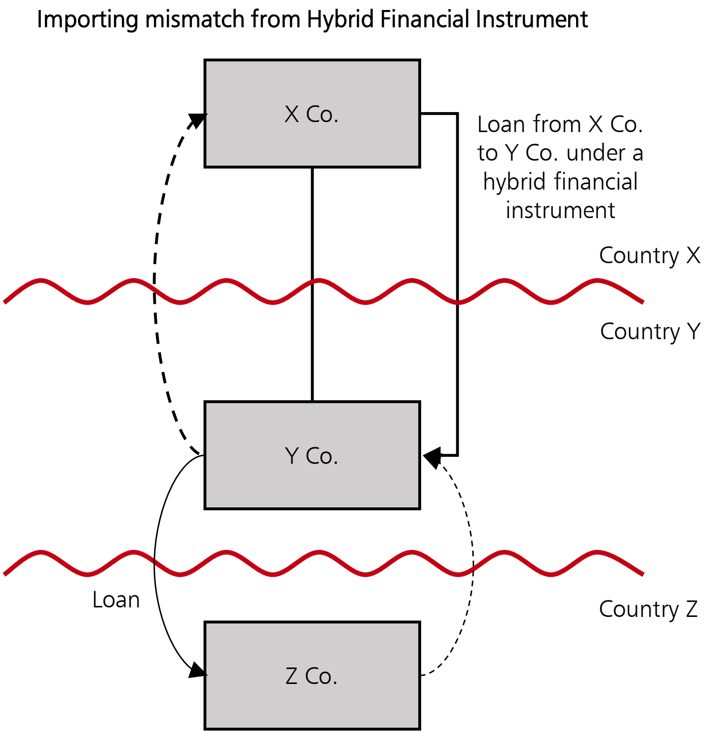
Arrangements that produce imported mismatch outcomes (indirect deduction/ no-inclusion)

Example H – Hybrid mismatch arrangement involving indirect hybrid payments

C.70 An indirect mismatch arrangement is an arrangement that gives rise to a hybrid mismatch and the effect of that mismatch is imported into the payer jurisdiction, in that the intermediate party can offset the deduction under the hybrid mismatch arrangement against the income it in turn receives from the payer, while the payer also receives a deduction for its payment.

C.71 In the example provided below, this would only be relevant where Country X and Country Y did not have any hybrid mismatch rules.

Chart C.7: Hybrid mismatch arrangement involving indirect hybrid payments



Source: OECD

Background

C.72 Y Co (an entity resident in Country Y) is a subsidiary of X Co (an entity resident in Country X).

C.73 X Co lends money to Y Co using a hybrid financial instrument. The receipts under this instrument are exempt from tax under the laws of Country X, but deductible under the laws of Country Y.

C.74 The money is on-lent to Z Co (a borrower) in a third jurisdiction. The interest payable under the loan is deductible under the laws of Country Z and included in taxable income by Y Co under the laws of Country Y.

C.75 This results in an indirect deduction/no-inclusion outcome between Country Z and Country X.

C.76 Arrangements involving indirect D/NI outcomes can also be structured using hybrid entities.

Qualifying criteria

C.77 X Co, Y Co and Borrower Co are involved in a structured arrangement (see paragraph 5.12). Borrower Co makes a payment indirectly to X Co which is not included in X Co's ordinary income.

C.78 The payment is a hybrid payment as it is made under a hybrid financial instrument and results in a D/NI outcome.

Exceptions

C.79 There are no exceptions relating to this rule.

Effect of hybrid mismatch rules

C.80 There are a number of different permutations possible dependent upon which of Countries X, Y or Z have adopted hybrid mismatch rules.

C.81 If only Country X (the UK) has adopted these rules, then (if X Co is a UK company) the UK will apply Rule B to counteract the mismatch.

C.82 If only Country Y (the UK) has adopted these rules and Y Co is a UK company, then Rule A rule will apply to deny the deduction in Y Co.

C.83 If only Country Z (the UK) has adopted these rules and Z Co is a UK company, the UK will operate Rule A to deny the deduction in Z Co as the arrangement has resulted in an indirect hybrid mismatch between Z Co and X Co.

C.84 It should be noted that where Z Co is a UK resident company were Y Co to make a disclaim of deduction in the amount of the mismatch or were X Co to include the amount of the mismatch within its ordinary income, there would no longer be a mismatch and the hybrid rules would not need to be applied.

Original hybrid loan on-lent to a number of companies or to companies in different jurisdictions

C.85 Where Y is a group finance company, Country Z (UK in this example) is the only country to have the proposed hybrid rules, and the loan has been on-lent by Y Co to a number of group companies in the same or different jurisdictions, then Z Co (UK resident Co) and any other UK resident companies would need to identify what part of any disallowance relating to the tax mismatch between X Co and Y Co should be included in their tax returns. In identifying this, the treatment of any subsidiaries in other jurisdictions would also be relevant (to ensure that aggregate disallowance does not exceed the hybrid mismatch between X Co, and Y Co), as would the ability of the companies involved to establish the amount of the original hybrid loan between X Co and Y Co that has provided the funding for the loan made by Y Co to Z Co and the other subsidiaries.

Q25. How might a group most readily identify which of the funding arrangements made with Z Co and the other subsidiaries are subject to the proposed hybrid rules and what difficulties might arise?

Q26. Would it be preferable to have rules which do not rely on tracing the on-lending funding arrangements? If so, can you suggest an alternative method of establishing the disallowance which meets the policy objectives?

Application of the rule where the UK (Country Z) has adopted the hybrid mismatch provisions

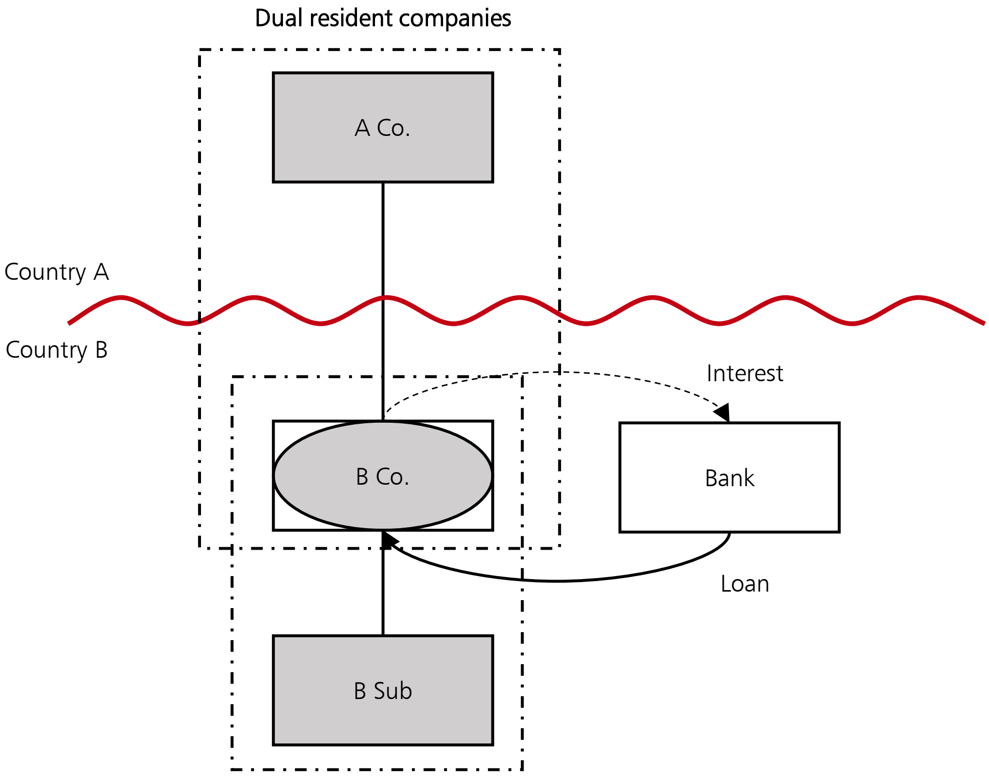
Rule A

C.86 The UK will deny a deduction for the payment made by Z Co under an indirect mismatch arrangement in the amount of the mismatch between X Co and Y Co to the extent that that loan is on-lent to Z Co.

D How the dual resident rule would operate

Example A

Chart D.1: Example A



Source: OECD

Background

D.2 A Co (a company incorporated and tax resident in Country A (the UK) holds all the shares in B Co (a company incorporated in Country B, but tax resident in both the UK and Country B). B Co is part of the Group Relief group of A Co (under the UK's Group Relief rules and also consolidated with its subsidiary B1 (under the laws of Country B). B Co pays interest to Bank which generates a deduction.

D.3 B Co is a dual resident company, resident in both the UK and Country B. It is subject to tax on its worldwide income in both jurisdictions on a net basis and it is able to surrender any net losses under the consolidation group relief regimes of both countries.

Qualifying criteria

D.4 B Co is a dual resident company. It claims a deduction for interest paid to the bank of 1000.

D.5 The deduction has not been subject to an agreement between the competent authorities of the UK and Country B.

Exceptions

D.6 There is no dual inclusion income recognised by the UK and Country B and therefore no exception

Effect of the dual resident rule

D.7 The deduction of 1000 will be denied in the UK where B Co is a UK resident company.

Example B – Dual inclusion income

Background

D.8 The facts are the same as in example A apart from B Co has dual inclusion income of 1000.

Qualifying criteria

D.9 B Co, a dual resident company, claims a deduction for interest paid to the bank of 1000.

D.10 The deduction has not been subject to an agreement between the competent authorities of the UK and Country B.

Exceptions

D.11 B Co has dual–inclusion income of 1000 and deductions for interest paid of 1000 recognised in both the UK and Country B.

Effect of the dual resident rule

D.12 As the income of 1000 is included in the ordinary income of B Co in both Country A and Country B. The interest deduction of 1000 can be set-off against income of 1000 in the UK (and Country B).

Example C – The carry forward of losses

Background

D.13 The facts are the same as in example A.

Qualifying criteria

D.14 B Co, a dual resident company, claims a deduction for interest paid to the bank of 1000.

D.15 The deduction has not been subject to an agreement between the competent authorities of the UK and Country B.

Exceptions

D.16 B Co has dual–inclusion income of 500 recognised in both the UK and Country B.

Effect of the dual resident rule

D.17 B Co has income of 500 recognised in both the UK and Country B. As this is dual inclusion income it can set-off the interest deduction of 500 in both jurisdictions, leaving it with 500 that has not been deducted in Country B and the UK. This is the excess deduction.

D.18 As the same income has been included in both jurisdictions the excess deduction can be carried forward to be set off against any future dual inclusion income.

Example D – Stranded losses

D.19 In the following year B Co ceases to trade and in Country B is not able to use the excess deductions of 500 carried forward from the previous year.

D.20 B Co is no longer restricted in its use of the excess deduction of 500 and can use the deduction against dual inclusion income in earlier years or against non-dual inclusion income in the year of cessation of trade subject to the UK's normal rules on the use of or in respect of dual inclusion income carry back of losses.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gsi.gov.uk