

UK Consults on Changes to Hybrid-Mismatch Rules to Address Disproportionate Outcomes

The UK Government announced in the Budget on 11 March 2020 that it would publish a consultation on certain aspects of the UK hybrid-mismatch rules. The consultation was published on 19 March 2020 and considers three particular areas where stakeholders have raised concerns that the rules are not working as expected.

The hybrid-mismatch rules have been in force since 1 January 2017 and are aimed at counteracting tax mismatches where the same item of expenditure is deductible in more than one jurisdiction (double deduction mismatches) or where expenditure is deductible but the corresponding income is not fully taxable (deduction / non-inclusion mismatches). The rules were introduced in response to the OECD's BEPS project, with the UK being the first to adopt the OECD's recommendations. Many EU member states have only recently introduced hybrid-mismatch rules in line with the mandated EU implementation date of 1 January 2020.

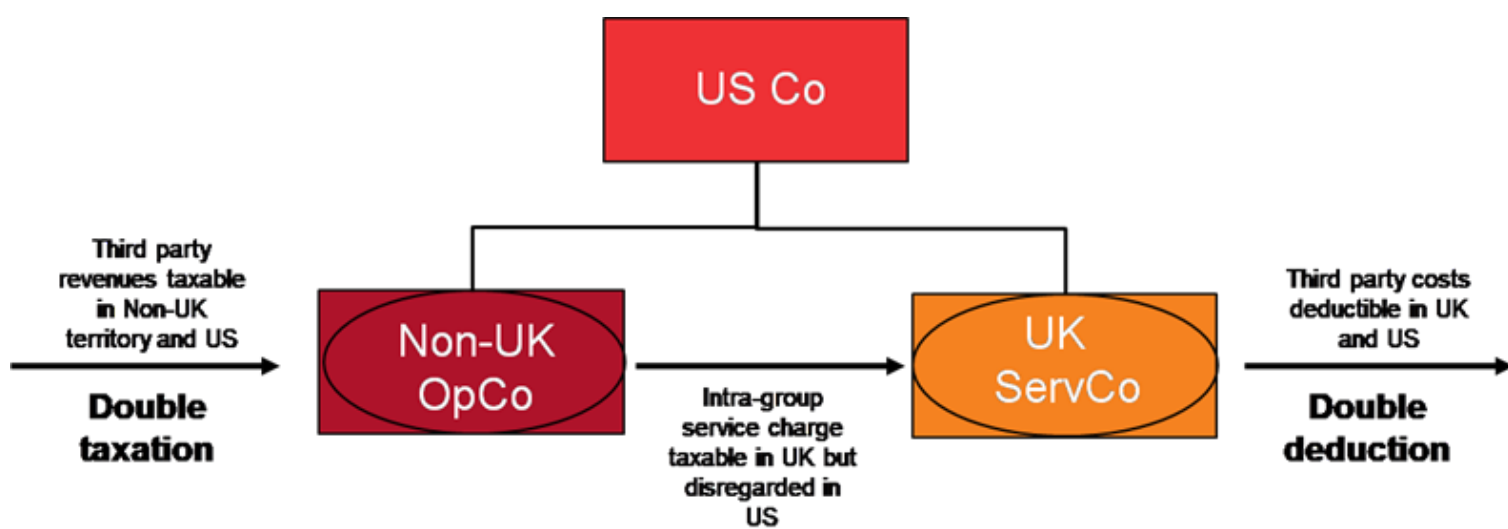
HMRC is actively auditing taxpayer positions on the hybrid-mismatch rules for FY2017 and FY2018 and, in particular, considering the application of the targeted anti-avoidance provision to taxpayer structures. The consultation therefore provides a welcome opportunity for taxpayers to engage with the Government to ensure that the hybrid-mismatch rules are applied by HMRC proportionately and within the policy objectives of the rules.

The consultation considers the application of the UK hybrid-mismatch legislation in the following areas:

- The double deduction rules
- The "acting together" provisions
- The application of the rules to exempt investors in hybrid entities

The double deduction rules

The mechanical operation of the double deduction rules has resulted in unexpected material disallowances for some taxpayers, in particular US multinationals with UK entities that are "checked" as disregarded entities of a US taxpayer, even in cases where there is no tax advantage being obtained. The rules have prevented UK taxpayers from claiming tax deductions in some common benign commercial structures, typically involving supplies between a UK service provider and a related overseas customer (see figure below).



If third party costs are incurred by a "checked" entity then these costs will not only result in a UK tax deduction, but will also result in a US tax deduction (because the US regards the entity as tax transparent), thereby giving rise to a "double deduction" mismatch. UK ServCo will only be protected from a disallowance where it has sufficient income that is taxable in both the UK and the US. In this scenario, the income taxed in the US (third party revenues received by Non-UK OpCo) is not the same income taxed in the UK (intra-group service charge disregarded in the US) so UK ServCo will suffer a disallowance under the current operation of the rules.

In response to an informal consultation on the double deduction rules, some initial changes were made to the legislation back in 2018 to try and address this issue. These changes applied retroactively to 1 January 2017. However, those changes (in particular section 259ID Part 6A TIOPA 2010) were extremely narrowly drawn. The rules are still not operating as intended. In some cases this is leading to effective double taxation.

The consultation document outlines that the Government is receptive to exploring the case for change in this area and in order to do so would like to better understand the structures for which this issue is most relevant and the obstacles to those structures being adjusted.

The "acting together" provisions

The "acting together" provisions are intended to ensure that the hybrid-mismatch rules can apply to certain arrangements where parties are connected via commonality of ownership, or are otherwise acting as if they are. This is to ensure that full effect is given to the provisions in a situation where the effective control of an entity is split between different persons who "act together".

The rules are currently widely drawn, with the consequence that the legislation can apply in cases where there is no real cooperation between parties. In addition, it is often very difficult for taxpayers to obtain information on their counterparties' structures which is necessary in order to fully comply with the legislative requirements. For example, in debt funding scenarios, an external lender will usually refuse to provide a borrower with any information about its structure.

The Government recognises that the provisions are broad, and would like to appreciate the extent and form of arrangements where it is believed that the rules apply disproportionately.

The application of the rules to exempt investors in hybrid entities

The application of the hybrid-mismatch rules to exempt investors in hybrid entities has caused difficulties for investment funds. Under the rules, a payment from a UK company would not typically be disallowed if the income is received directly by an exempt investor such as a pension fund. However, the hybrid-mismatch rules could apply if the investor makes their investment through a hybrid entity, even if the hybridity of the intermediate entity offers no potential tax advantage. This is the case where the intermediate entity is characterised as transparent in the UK and opaque in the jurisdiction of the exempt investor.

The Government is sympathetic to the view that this outcome is not desirable where the exempt entity is a pension fund or similar body which is not subject to tax for wider public policy reasons. The consultation outlines that the Government is considering potential options for amending the legislation as follows: (a) a "white list" of entities which would be accepted as qualifying to prevent counteractions; (b) a blanket exemption from counteraction for entities which would not be subject to tax on a direct payment, coupled with a "black list" of entity types which would not qualify for the exemption; or (c) a principles-based definition of the characteristics of an entity that would qualify as not giving rise to counteractions.

Consultation running until 29 May 2020

The Government is seeking comments in response to specific questions on these areas in the consultation. The consultation document outlines that submissions should be supported by detailed numerical examples illustrating entity types, transactional flows and associated tax effects to demonstrate any disproportionate effects of the legislation. HMRC are also engaging directly with existing stakeholder networks.

We would encourage all taxpayers who are adversely impacted by these specific areas of the hybrid-mismatch rules to make representations as part of the consultation process. Comments from taxpayers are likely to be persuasive in determining whether the Government will propose amendments to the hybrid-mismatch legislation.

The closing date for comments on the consultation is 29 May 2020.

For ease of reference, the consultation document can be found [here](#).

Please do not hesitate to get in touch with your usual Baker McKenzie contact if you would like to discuss these proposals.

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