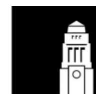

UNIVERSITY OF LEEDS

This is a repository copy of *Section 36 and Schedule 7: hybrid and other mismatches*.

White Rose Research Online URL for this paper:
https://eprints.whiterose.ac.uk/192418/

Version: Accepted Version

**Article:**

Parada, L (2021) Section 36 and Schedule 7: hybrid and other mismatches. British Tax Review, 2021 (4). pp. 399-404. ISSN 0007-1870

This is an author produced version of a paper published in British Tax Review. Uploaded in accordance with the publisher's self-archiving policy.

**Reuse**
Items deposited in White Rose Research Online are protected by copyright, with all rights reserved unless indicated otherwise. They may be downloaded and/or printed for private study, or other acts as permitted by national copyright laws. The publisher or other rights holders may allow further reproduction and re-use of the full text version. This is indicated by the licence information on the White Rose Research Online record for the item.

**Takedown**
If you consider content in White Rose Research Online to be in breach of UK law, please notify us by emailing eprints@whiterose.ac.uk including the URL of the record and the reason for the withdrawal request.

eprints@whiterose.ac.uk
https://eprints.whiterose.ac.uk/

**Schedule 7: Hybrid and Other Mismatches**

**Introduction**

Schedule 7 introduces a series of modifications to the already existing anti-hybrid regime in the United Kingdom, imposing also a retroactive application to 1 January 2017 in some of the cases.[1] The UK anti-hybrid regime implements the OECD BEPS Action 2 and is aimed to target hybrid mismatch arrangements that may result in a deduction/non-inclusion or double deduction outcome.[2] The key amendments are detailed below.

**Modification to the concept of "acting together"**

A relevant modification to the UK anti-hybrid rules refers to the modification of the concept of "acting together".[3] The idea is to restrict the broad concept of "acting together" in section 259ND(7A), bringing into the scope of the anti-hybrid rules true third parties in a lender/borrower relationship.[4] In this regard, the "acting together" test will be now applied when the hybrid party itself has only a 5% or less ownership —by votes or economic entitlement— of its own in the payor entity.[5]

The original intent of the concept of acting together under the OECD Action 2 was to avoid a potential abuse of the control group requirement, which could be done by transferring votes interests or equity to another person who continues to be under their direction, or simply by a group of minority shareholders that enter into an agreement to act together and benefit from a hybrid mismatch.[6]

In spite of the above, and contrary to the original announcement, no changes were made as regards the concept of acting together as it relates to investors in transparent funds with sub-10% interests in those funds. That is, the acting together rules remain in place for participants in transparent funds, bringing transparent funds within the scope of the UK anti-hybrid rules by reason of their participants acting together, but the new measure will then effectively take them out again except to the extent mismatches are attributable to participants with interests of over 10%.[7] As explained in the explanatory notes "t[]he policy decision to exclude sub-10%

---

1. Committee of the whole House of Finance Bill 2021. See also Explanatory Notes to the Bill, prepared by HM Revenue & Customs and HM Treasury, published separately as Bill 270–EN; and Resolution 33, Finance (No.2) Bill, Clause 36, Schedule 7.
2. OECD, *Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2-2015 Final Report* (OECD Publishing, Paris, 2015).
3. Explanatory Notes to the Bill, above fn. 1, paras 135-137, pp. 97-98.
4. Nicholas Fagge, "Changes to the UK's Anti-Hybrid Regime", Schulte Roth & Zabel LLP (26 April 2021).
5. Explanatory Notes to the Bill, above fn. 1, para. 136, p. 97.
6. Id., 117. See also, Leopoldo Parada*, Double Non-Taxation and the Use of Hybrid Entities: An Alternative Approach in the New Era of BEPS,* p.306 (Alphen aan den Rijn: Kluwer Law International, 2018).
7. Explanatory Notes to the Bill, above fn. 1, para. 137, p. 98.

investors in transparent funds from counteractions is instead being implemented via the introduction of the new Chapter 13A of Part 6A".[8]

### New category of "inclusion/non-deduction" and deemed double inclusion

Another important amendment refers to the interpretation of one of the conditions that needs to be met for considering a deemed dual-inclusion income, adding for this purpose a new category of "inclusion/non-deduction".[9] This is particularly important to avoid triggering the UK anti-hybrid rules in the case of an apparent double deduction which actually corresponds to an "inclusion/non-deduction". A good example of it could be the case of a US manager who has a UK affiliate that is fund through a sub-advisory fee.[10] Let's assume that the US manger elects to treat the UK affiliate as a tax transparent entity for US tax purposes.[11] This election will trigger a double deduction (sub-advisory fee) that would be within the scope of the UK anti-hybrid rules. However, that fee is now treated as an "inclusion/non-deduction" staying outside of the scope of it.[12]

### Imported mismatches

One of the peculiarities of the OECD BEPS Action 2 was to consider arrangements that may indirectly achieve a deduction/non-inclusion outcome using for this purpose a hybrid arrangement between two other countries and shifting the effect of that offshore hybrid mismatch into a domestic jurisdiction through the use of non-hybrid instruments, such as an ordinary loan. These are the so-called "imported mismatches".[13]

---

[8] Id.

[9] Section 259ID income.

[10] Fagge, "Changes to the UK's Anti-Hybrid Regime", above fn. 4 (making this example).

[11] Generally speaking, the US elective system to characterise legal entities (known as "check-the-box") provide that an eligible (foreign) entity, that is, an entity not listed as a per se corporation in Treas. Reg. Sec. 301.7701-2(b)(8)), may elect to be classified either as an association, which is taxable as a corporation in the United States, or as a partnership, which is taxable only at the level of the partners. US Treas. Reg. Sec 301.7701-3(a). If an eligible foreign entity has only one member, it may choose to be classified either as an association or as a disregarded entity. The election may be made at any time and it must accomplish with the formal requirements established by law ("entity classification election") jointly with its federal tax or information return of the taxable year in which the election is made (Form 8832). US: Treas. Reg. Sec 301.7701-3(c)(1)(ii). See more of this in: Parada, *Double Non-Taxation and the Use of Hybrid Entities* (2018), above fn. 3, pp. 129-157. For a further analysis on the check-the-box rules, see also, Kenan Mullis, "Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities" (2011) 64(5) Tax Notes Int'l 371; Steven A. Dean, "Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification" (2005) 35 Hofstra L. Rev. 405; David M. Benson et al., "'Hybrid' Entities: Practical Application Under the Check-the-Box Regime" (1997) 26(8) Tax Management International J.363; Monica Gianni, "International Tax Planning After Check-the-Box" (1999) 2 J. Passthrough Entities 39, and Patrick Hobbs, "Entity Classification: The One Hundred-Year Debate" (1995) 44 Cath. U.L. Rev. 437.

[12] Fagge, above fn. 4.

[13] OECD, *Neutralizing the Effects of Hybrid Mismatch Arrangements* (2015), p 83. See also, Parada, *Double Non-Taxation and the Use of Hybrid Entities* (2018), above fn. 3, pp. 297-299 (explaining imported mismatches in relation to reverse hybrid entities).

The Financial Bill introduces a new wording for one of the conditions stated in section 259KA(7)– Condition E— referred to imported mismatches. The amendment basically states that disallowance of a deduction will occur in the UK under the imported mismatches rules to the extent that the mismatch is counteracted in a country abroad (relevant territory) which also applies anti-hybrid mismatches under the OECD Action 2 recommendations, that is, a country that is considered as 'OECD compliant'.[14] The amendment tests establishes an equivalence of a jurisdiction's hybrid regime as a whole rather than regarding to specific provisions, making clear that there is no requirement for the mismatch to be actually counteracted in the relevant territory.[15] In other words, it is sufficient that the relevant territory simply complies with the OECD recommendations to satisfy the requirement.[16]

Similarly, there is a possibility of a proportionate satisfaction of new Condition E.[17] That is, when only a portion of the imported mismatch is counteracted in the relevant territory, which is OECD compliant.[18] The rationale behind is to avoid the disapplication of the rule just because a part of the relevant mismatch is counteracted abroad.[19] Let's assume an example in which a UK company pays 100 to a company in a non-OECD mismatch compliant country. That company pays 90 to another company in another non-OECD mismatch compliant country, and 10 to a company in an OECD mismatch compliant country. Subsequently, the two payee companies pay 90 and 10 to a company in a non-OECD mismatch compliant country which is the payer in relation to the relevant mismatch of 100. This means that only 10 of the relevant mismatch will be treated as capable of counteraction in the overseas relevant territory, and Condition E will therefore be considered as satisfied regarding the relevant mismatch of 90.[20]

There are two other relevant modifications regarding imported mismatches as well. First, there is a modification in section 259KA –Condition G, which attempts to align the effects of this provision after the deletion of section 259KA–Condition F where P is in a control group with the payer of the mismatch payment, but all payees of the mismatch payment are unrelated.[21] The old Condition F would have prevented a counteraction in this case if there is not a structured arrangement. After the amendment, Condition G simply tests whether P is

---

[14] New subsection 259KA(7A). See also, Resolution 33 Finance (No. 2) Bill Clause 36, Schedule 7, above fn. 1, para. 14.

[15] Explanatory Notes to the Bill, above fn. 1, para. 131, p. 97.

[16] Id.

[17] New subsection 259 KA(7B). See also, Resolution 33 Finance (No. 2) Bill Clause 36, Schedule 7, above fn. 1, para. 15.

[18] New subsection 259 KA(7D) defines what an OECD compliant territory means. In practical terms, it is just necessary that the OECD Action 2 recommendations were implemented, regardless of whether the outcome is the same that the UK rules would provide in a similar situation. See Resolution 33 Finance (No. 2) Bill Clause 36, Schedule 7, above fn. 1, para 17.

[19] Resolution 33 Finance (No. 2) Bill Clause 36, Schedule 7, above fn. 1, para. 14.

[20] New subsection 259 KA(7C). See also, Resolution 33 Finance (No. 2) Bill Clause 36, Schedule 7, above fn. 1, para. 16 (providing this example).

[21] Explanatory Notes to the Bill, above fn. 1, para. 3.1 (new subsection 4), p. 97.

in a control group with any of those payees.[22] Second, a new section 259KE is inserted in order to establish a cap for counteraction under Chapter 11 in relation to "a given imported mismatch payment at the amount the relevant mismatch would have been had the mismatch payment been in an amount equal to that imported mismatch payment".[23] That is, where an imported mismatch payment is subject to transfer pricing adjustments. In this case, the new provision prevents that those that are subject to these adjustments may obtain a more beneficial tax outcome than those which pay arm's length amounts.[24]

**Meaning of foreign tax and exempt investors in hybrid entities**

A new section 259(3ZA) is introduced in the TIOPA 2010 providing that a tax should not be regarded as a foreign tax if it is charged on income that has arisen "to an entity that is not subject to the tax on that income, but is assessed on another entity which is subject to the potential foreign tax".[25] The explanatory notes states that the exclusion only affects the definition of foreign tax, so if a tax is levied due to the application of foreign CFC rules, "it will still constitute a tax within the meaning of the hybrid rules".[26] This exclusion may have important implications in the interpretation of new foreign regimes that operate in a similar way as traditional CFC regimes, or an extension of CFC regimes, but that are not properly CFC regimes. In particular, one could think about the US global intangible low-taxed income (or GILTI), which is a category of income that is earned abroad by CFCs and which is subject to a special treatment under the U.S. tax code.[27] An interpretation of this new provision would be that GILTI would not count as a foreign tax, and therefore, as an "inclusion of income" for purposes of the anti-hybrid provisions.[28] Although this interpretation is restrictive and contradicts the intuition of some taxpayers to consider this and other similar regimes as CFC regimes, this seems to be the official interpretation adopted by the Government. That is, GILTI (as similar regimes) would not be capable of being treated as an "inclusion of income".[29]

In addition, a new section 259BC(8A) is introduced into Part 6A TIOPA. This provision provides that income of "qualifying institutional investors (QII)" is to be regarded as ordinary income, notwithstanding that it is not in fact subject to tax.[30] New section 259ND establishes the

---

22 Id.

23 Id., para. 134, p. 97.

24 Id.

25 Id., para. 3, p. 84.

26 Id.

27 26 US §951A. See also, Public Law 115-97, Tax Cuts and Jobs Act of 2017, available at https://www.congress.gov/bill/115th-congress/house-bill/1

28 Mark Eaton, "Proposed FB 2021 changes to the UK hybrid mismatch rules", KPMG Insights (2021), available at https://home.kpmg/uk/en/home/insights/2021/03/tmd-proposed-fb-2021-changes-to-the-uk-hybrid-mismatch-rules.html#

29 EY, "UK proposes to amend hybrid and other mismatches regime – implications for US multinationals", EY Global Tax Alert, 3 (17 Nov. 2020), available at https://www.ey.com/en_gl/tax-alerts/uk-proposes-to-amend-hybrid-and-other-mismatches-regime-implications-for-us-multinationals

30 Explanatory Notes to the Bill, above fn. 1, para. 139, p. 98.

requirements to be regarded as a QII.[31] This new provision is relevant for generally exempt entities, such as pension funds, sovereign wealth funds or charity entities, confirming that any deduction/non-inclusion outcome attributable to those entities will not fall within the scope of counteraction.[32] This amendment is very much in line with the OECD Action 2 final report, which also suggested a similar exemption,[33] and it is also aligned with the EU Anti-Tax Avoidance Directive (ATAD).[34]

**Other minor amendments**

Most of the other amendments announced refer to modifications made with the purpose of ensuring consistency among the different provisions of the law, as well as readability of some of them. For example, the words "or body" have been removed from text introduced by paragraph 11 of Schedule 7 which provides for new subsections to section 259EC TIOPA 2010, ensuring consistency with existing provisions within Part 6A TIOPA 2010. Similarly, new subsection 259MC(1(a) TIPOA 2010 includes the word "entity", previously omitted, and a new wording has been proposed for new subsection 259NEF(3) TIOPA 2010, making a minor clarification to the conditions for one of the corporate rescue circumstances introduced to help prevent certain loan releases becoming taxable for a borrower as a result of a hybrid counteraction.[35]

An interesting modification to mention here also is that referred to the removal of the definitions of "hybrid entity" and "investor" from section 259BE of TIOPA 2010.[36] The removal is welcome due to the interpretation issues that could arise. However, certainly is not entirely satisfied since revised provision will be included in Finance Bill 2022, with the same effective date of 1 January 2017.[37] This will create uncertainty as regards the application of the rules at least until the new definitions are settled.

**Final remarks**

The amendments introduced to the current UK anti-hybrid rules are the best representation of the complexities that may arise with the interpretation and practical application of the OECD *linking rules* in a particular jurisdiction. The system introduced in the UK to counteract hybrid mismatch arrangements has become a complicated puzzle where uncertainty seems to prevail. Although the modifications aim to fill out this gaps clarifying the system, it is

31 Id., para. 145-150, p. 99.
32 Fagge, above fn. 4.
33 OECD, *Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2-2015 Final Report,* above fn. 2, para. 13, p. 18; para. 96, p. 43; para 166, p. 60, among others.
34 Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries [2017] OJ L 144/1, Recital 17-18.
35 Resolution 33 Finance (No. 2) Bill Clause 36, Schedule 7, above fn. 1, para. 3.
36 Id., para. 2
37 Id.

unavoidable that further questions will still come up in the future. Perhaps true approaches to simplification can still be explored, especially for the sake of administrability both for taxpayers and for the HMRC.[38]

**Leopoldo Parada**

[38] See, for example, Parada, *Double Non-Taxation and the Use of Hybrid Entities: An Alternative Approach in the New Era of BEPS* (2018), above fn. 6, pp. 353-398 (arguing for a domestic solution to deal with hybrid entity mismatches, taking as a starting point in the policy design of the rules the alignment of the different tax characterisation of entities rather than the tax outcomes that they may generate). For a variation of this proposal considering the MLI as an instrument of coordination, see Leopoldo Parada, "Hybrid Mismatches and the MLI: A Tax Policy Assessment", Intertax (2021-forthcoming)