UK anti-hybrid rules and financial services groups

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Introduction

More than two and a half years since the anti-hybrid rules in Part 6A TIOPA 2010 were introduced, we are still seeing financial services groups continue to be challenged by a lack of certainty around their application. In part, this is because the rules are still relatively new (with HMRC's view of how to apply the legislation in practice still emerging) and they have continued to evolve since their original introduction. However, this of course is not itself a full explanation for why the rules remain so difficult to navigate, as these same challenges would arise in respect of any new legislation. What is unique about the anti-hybrid rules is that they sit within a perfect storm of considerable complexity, wide-reaching breadth of application and interaction with overseas tax rules that are in a state of flux.

In this article, we explore a number of areas of the rules that we have seen financial services organisations grapple with recently, including issues that have arisen due to changes in corporate structure or business models, whether linked to Brexit, US tax reform or other factors.

Entities disregarded for US tax purposes

Many US headed groups have made check-the-box elections to treat UK entities as disregarded for US tax purposes. In some cases, the disregarded entity has been in place many years before the anti-hybrid rules were introduced. However, we have recently seen a number of groups make such elections in response to US tax reform, specifically in response to the BEAT rules.

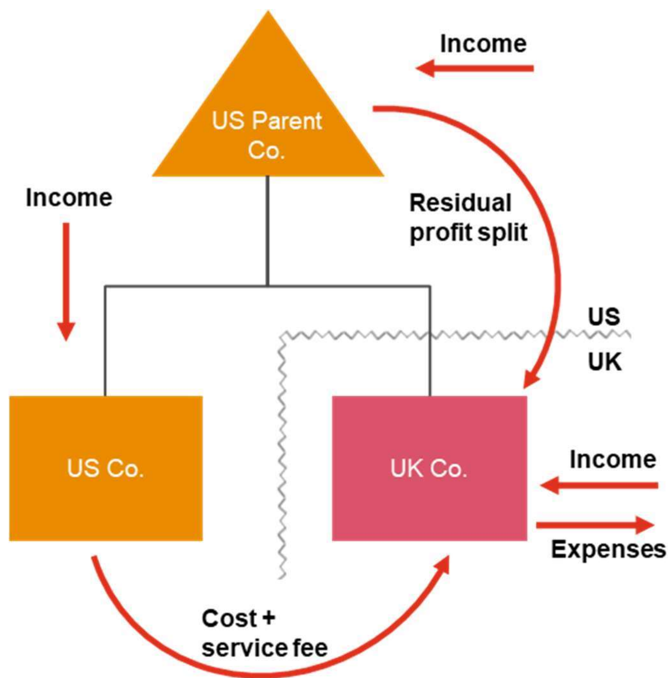
This generally has the consequence of making the UK company a hybrid entity for the purposes of the UK anti-hybrid rules. There might then be a double deduction mismatch within Chapter 9 in respect of payments made by the UK entity to third parties on the basis they give rise to deductions for both UK and US tax purposes, for example where the UK company is checked into a US parent. This would arise in relation to any such payments, however seemingly benign (e.g. wages and salaries, rent costs etc.).

If the UK entity has sufficient dual inclusion income (i.e. ordinary income subject to both UK corporation tax and subject to tax in the investor jurisdiction) to set its double deductions against, there may be no counteraction disallowance of UK deductions. (N.B. Where the entity is loss-making for UK tax purposes, this suggests by definition there will not be sufficient dual inclusion income, although there are some complexities around this point and this may not always be the case.) However, establishing what is and what is not dual inclusion income is not always easy.

The cleanest example of what does qualify is third party income directly earned by the UK entity. However, there are a number of financial services business models (whether an investment management sub-advisory fee or some form of residual profit split) which might mean the UK entity's income stream is paid to it from a related party entity. This issue is becoming increasingly common in certain market sectors, in particular where capital efficiencies are increasing the extent to which groups are operating cross-border booking models. Where an UK entity's income stream is disregarded for US purposes it may be excluded from being dual inclusion income.

The impact of section 259ID should be considered, since income within this provision can also reduce a counteraction. Unfortunately, on a plain reading, it could be too narrow to be of practical help to a number of commercial arrangements (albeit in certain circumstances a purposive interpretation may bring the provision into play). Prima facie, it does seem that the analysis could be particularly challenging in situations where the UK entity's income is as a result of it earning income on a cost plus basis. However, ultimately the question is one that can only be answered by a detailed consideration of the particular facts and circumstances.

This is illustrated in the diagram on the next page.



Overview

- UK Co. obtains a deduction for its third party expenses (e.g. salaries, rent etc.).
- UK Co. earns income from both its US parent Co. and its sister company (US Co.).
- Transfer pricing payments to UK Co.are disregarded transactions for US tax purposes.

Key considerations

- Could a counteraction arise under the anti-hybrid rules?
- Does UK Co. have sufficient dual inclusion income to offset its expenses against?
- Could the income UK Co. earns from US Parent Co. or US Co. constitute dual inclusion income or section 259ID income?

Key considerations

- Groups with UK entities that are checked into a US parent will need to consider whether they have any double deduction issues under Chapter 9 for any third party payments (e.g. wages, rent etc.).
- To the extent that there is a double deduction, it will need to be determined whether the UK entity has sufficient dual inclusion income or section 259ID income to avoid a disallowance counteraction.
- This analysis may be complex in the context of certain financial services business models where the UK entity's income is received from a related party entity (e.g. under a transfer pricing arrangement) rather than directly from third parties. N.B. It is not necessarily sufficient to merely demonstrate that all third party income is ultimately taxed in the US and UK entities earning it.

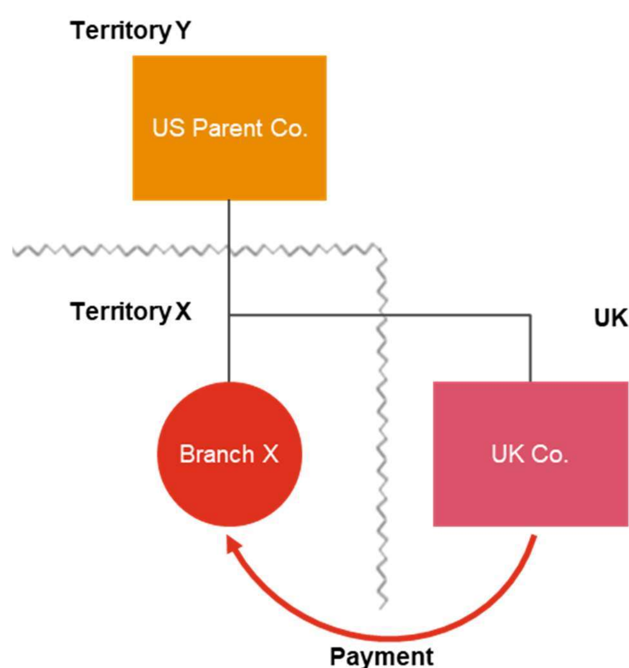
Foreign branches

The provisions in Chapter 8 concerning a multinational payee (i.e. a company with a branch that receives income) are complex and can give rise to certain outcomes that appear to be contrary to the policy aims of the OECD BEPS Action 2 paper.

Essentially, under the rules currently in force[1] , there could potentially be an issue to the extent that there is a deduction/non-inclusion mismatch that arises in situations where:

- An entity subject to UK corporation tax obtains a deduction for a payment made to the branch of another company; and
- The receipt is not subject to tax.

This is illustrated in the diagram below.



Overview

- Branch X is not subject to tax in territory Y. For example, this could be due to territory Y operating a branch exemption system or a territorial tax system.
- UK Co. obtains deduction in respect of its payment to Branch X.
- Branch X is subject to tax in Territory X, however, income received from UK Co. is not taxable. This could be due to a specific exemption in Territory X.

Key considerations

- Could a counteraction arise under the anti hybrid rules?
- The key question is how would the income be treated it if were earned by Y Co. in Territory Y (i.e. the income was not attributable to Branch X)?

The complexity arises in how to determine whether such a tax mismatch arises ‘by reason of’[2] the payee being a multinational company as the rules require.

In certain circumstances, the rules can deem a deduction/non-inclusion mismatch to arise ‘by reason of’ a payee being a multinational company. Specifically, one is required to apply the assumptions that:

1. The company does not have a PE; and
2. All of the company’s income is regarded as arising in the head office jurisdiction and nowhere else[3]

If, on applying those assumptions, the deduction/non-inclusion mismatch would not arise, then section 259HB(2A) deems the mismatch to arise ‘by reason of’ the payee being a multinational company. A potential counteraction would then need to be considered.

There may be situations where the head office territory applies a branch exemption, but the branch does not tax receipts (e.g. consider a Hong Kong branch which may not tax offshore source income). Section 259HB(2A) could potentially have the

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[1] See the ‘Foreign branch exemption’ section below for rules coming into force from 1 January 2020, which mean that Chapter 8 will no longer be limited to applying where a payment is made by an entity within the charge to UK corporation tax.

[2] Section 259HB(1).

[3] Section 259HB(2A)

consequence of requiring a counteraction in the circumstances where there is a UK corporation tax deduction for a payment to that branch. The legislation requires applying an assumption that the income would have otherwise arisen in the head office territory. If it would have been subject to tax there, then as above, the rules deem the reason the income is not subject to tax to be because the company has established a foreign branch.

Further, section 259HB(2A) could potentially lead to unclear outcomes in two situations.

Firstly, take the example of a company with a head office jurisdiction that has a territorial tax system. Ignore any branch income. Assume the head office's tax system does not tax receipts which have an offshore source or which are not remitted back to the jurisdiction. One interpretation of the assumptions above is that they require one to assume these receipts do arise in the head office jurisdiction, and consequently section 259HB(2A) would deem the mismatch to arise by reason of the payee being a multinational company. This is notwithstanding that arguably the reason for the mismatch is the head office's territorial tax system, and nothing to do with the existence of the company's branch.

Secondly, there is a lack of certainty regarding branches located in certain territories such as those with a 0% corporate income tax rate, or those with no such tax regime at all. This arises due to an unclear interaction between section 259HB(2A) and section 259HB(3)(a). The latter effectively provides an exemption. It states that, to the extent the PE jurisdiction does not charge tax on any company in the jurisdiction, the mismatch is deemed not to arise by reason of the payee being a multinational company. How does this exemption fit with section 259HB(2A)? One interpretation might be that this specific exemption in section 259HB(3)(a) takes precedence. However, this is not certain based on a plain reading of the legislation. It would therefore be helpful if this point were clarified in the next iteration of HMRC guidance. We note that the existing HMRC guidance has not yet been updated to reflect the insertion of section 259HB(2A)[4] .

Key considerations

- Groups with foreign branches will need to take particular care in working through the implications of Chapter 8 where:
  - A UK entity makes a deductible payment to a multinational company; and
  - There is a deduction/non-inclusion mismatch because that payment is not taxed by the multinational company (i.e. neither in the head office nor the branch).
- Even if prima facie that deduction/non-inclusion mismatch does not arise 'by reason of' the payee being a multinational company, the effect of the assumptions in section 259HB(2A) will require careful consideration.
- Where a branch is located in a non-taxing jurisdiction, a view will need to be taken on the interaction of 259HB(2A) and section 259HB(3)(a).

[4] INTM556080

Foreign branch exemption

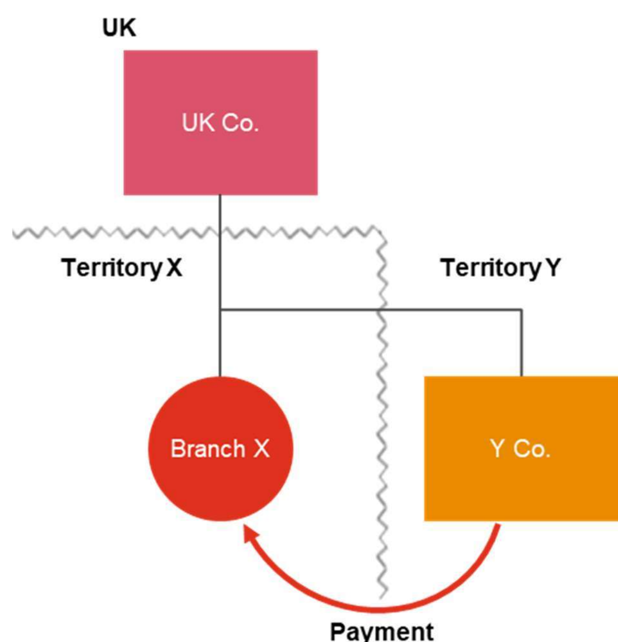
While the UK considered its anti-hybrid rules ATAD compliant for the most part, some changes were identified as necessary to ensure conformity with the Directive requirements.

One such change[5] extends the rules with effect from 1 January 2020[6] to apply to situations where:

- A UK tax resident company has a branch in another territory ('the PE territory');
- A deductible payment is made to the branch;
- The branch's receipt is not taxable in the UK (e.g. due to application of the foreign branch exemption); and
- The branch is not taxable in the PE territory because that jurisdiction does not regard a business as being carried on through a permanent establishment.

Where this change applies, it would effectively override the UK foreign branch exemption and require the gross income to be brought into account for UK tax purposes. It would appear that the rules ignore any expenses attributed to the branch, even to the extent that these would have been deductible in the absence of a branch exemption election.

This is illustrated in the diagram below.



Overview

- UK Co. recognises a permanent establishment in territory X ("Branch X").
- UK Co. makes a branch exemption election for UK corporation tax purposes.
- Y Co. claims a deduction for payment to UK Co.'s Branch X.

Key considerations

- Could a counteraction arise under the anti-hybrid rules?
- Does Territory X regard Branch X as carrying on a business through a permeant establishment in Territory X?
- Does Territory X tax the income earned by Branch X from Y Co?

Key considerations

- Groups will need to consider the potential impact of the new rules for any exempt foreign branch that is not taxed locally, and consider the rationale as to why the branch is not subject to tax.

[5] New Condition C in Chapter 8, as introduced by Finance Act 2019.

[6] Subject to transitional provisions where a period straddles that date.

Illegitimate overseas deductions: Disregarded UK entities and UK branches

As discussed above, a UK entity that is disregarded for US tax purposes could have double deduction issues under Chapter 9. A UK branch of a company based in a jurisdiction which taxes on a worldwide income basis could also have double deduction issues (due to third party or related party payments being deductible in both the UK and the head office jurisdiction), though under Chapter 10 instead.

To the extent a disallowance counteraction arises under either Chapter, it will be necessary to work through the complex provisions governing the potential future usage of the attribute in relation to the disallowed amount. In particular, careful analysis of the illegitimate overseas deduction provisions will need to be undertaken, since these could lead to a permanent disallowance of the attribute.

In the context of a UK branch, the attribute might arise where the branch has been loss-making so that it is has insufficient dual inclusion income (i.e. here the 'excess' loss is, prima facie, carried forward and set against future dual inclusion income of that entity). However, the attribute will be permanently reduced to the extent of any 'illegitimate overseas deduction'[7].

An 'illegitimate overseas deduction' could arise where a 'dual territory double deduction amount' is set against income that is not dual inclusion income – e.g. income other than that generated by the UK branch.

The same issue of permanent disallowance could also arise for US groups with disregarded UK entities. Where a deduction is denied in the UK under Chapter 9 (for example, assume the UK entity is loss-making and therefore has insufficient dual inclusion income), the US consolidated tax system may permit relief for it against the income of another group company. If that is the case, the UK entity's losses will effectively become permanently disallowed under the UK anti-hybrid rules.

The illegitimate overseas deduction provisions appear to be highly punitive. It is not immediately clear why groups should not be allowed to carry forward an amount disallowed in the UK provided it is subsequently set off against dual inclusion income. In particular, whilst there may be a timing mismatch, in most cases this would be expected to wash out in the parent jurisdiction (i.e. when the UK disallowance is reversed, it should reduce the UK tax liability and consequently increase the amount of tax paid in the investor jurisdiction). It is possible that these rules could leave entities exposed to double taxation.

Key considerations

- For UK branches with a disallowance attribute, it will be necessary to find a way for the multinational company to distinguish between those profits/losses earned by its head office and those earned by its UK branch. The aim should be to find a practical and reasonable approach towards monitoring usage of losses generated by the UK branch for the purposes of the foreign tax applying to its head office jurisdiction, and to ensure they are not set against head office income (but rather only UK branch income).
- For disregarded UK entities, understanding and monitoring how deductions are used for US tax purposes will be key.

[7] As defined in section 259JD(6)

Credit funds

The anti-hybrid rules could potentially be interpreted to apply to restrict tax deductions for finance expenses on loans to unrelated UK borrowers, even where the only hybrid issues (whether hybrid instruments or hybrid entities) are within the credit fund structure. The issue could arise even where the credit fund has a minimal equity stake, or even just warrants, in the borrowing entity.

Key considerations

- We have come across situations where the UK hybrid rules have applied such that:
  - UK borrowers from a credit fund had to disallow interest costs on lending from the credit fund;
  - The economic burden of the tax disallowance was suffered by the credit fund (through reduced exit economics on equity); and
  - Credit funds have lost bids to debt finance a deal because of the above issues.
- It will therefore be important to analyse the impact of the anti-hybrid rules for both existing portfolios or when bidding for a new deal.

The target anti-avoidance rule ('TAAR') and restructuring

In certain cases where a counteraction arises under the anti-hybrid rules in relation to entirely commercial arrangements, the effect can be to create double taxation. Consequently, groups have considered restructuring options (which might involve business model changes and/or legal structure changes). Equally, some groups have also chosen to restructure where there was insufficient certainty over how the rules applied to their existing arrangements. Wherever restructuring is being contemplated as an option, it will be important to assess the potential application of the TAAR and to document the position taken.

If you would like to discuss any of the above in further detail, please contact one of our Financial Services International Tax specialists listed below or your usual PwC contact.

Shezad Aleem
E: shezad.aleem@pwc.com
M: 07718978976

Chris Maycroft
E: chris.maycroft@pwc.com
M: 07724224072

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