We have a client operating in the global investment management industry. Its main presence is in the US, but it has a London based team employed by a UK subsidiary. A fee is paid by the US parent business to the UK subsidiary by way of arm’s length reward for the contribution of the UK team to the group’s business. The client has heard that there may be a problem under the UK’s new hybrid mismatch regime introduced by FA 2016 because the UK subsidiary is a ‘disregarded entity’ for US federal tax purposes. The US tax treatment of the subsidiary has never been considered relevant to its UK tax affairs before. How are the hybrid mismatch rules relevant, and is there a problem here?

The UK’s hybrid mismatch regime implements the principles of the October 2015 final report on OECD BEPS Action 2 (hybrid mismatch arrangements). It was introduced into the UK tax system as TIOPA 2010 Part 6A by FA 2016, with a commencement date of 1 January 2017. The operative provisions run across nine separate chapters, contain many traps for the unwary, and often cannot be easily discounted as inapplicable even in apparently benign circumstances. This can have potentially serious results for those affected.

Hybrid mismatch rules: interpretation and guidance

Despite the fact that the regime has already been law for several months, it seems fair to say that its impact and application are still not well understood. Advisors appear to have conflicting views on the interpretation of some aspects, and the only guidance available from HMRC at the time of writing is in draft form and is itself contradictory in places. We understand that work is ongoing on a revised version, with advisors and representative bodies closely involved. In the meantime, however, many taxpayers are left facing unfortunate levels of uncertainty.

The disregarded UK subsidiary

The structure of the client business described here is a good example of a situation in which the impact of the new rules requires careful consideration. The potential problem is best understood by reference to the diagram below, representing the issues at their simplest.

As a result of a ‘check the box’ election, the UK subsidiary is a ‘disregarded entity’ for US federal tax purposes, being treated for those purposes as a tax transparent branch of its US parent. However, the US election has no direct effect under UK tax law, with the UK subsidiary remaining a taxable entity for UK corporation tax purposes, rather than a branch. It is this difference in tax treatment which means that the UK subsidiary is a ‘hybrid entity’ for the purposes of Part 6A.

It is worth noting that a US entity status election such as this would not generally be considered to be particularly aggressive tax planning. The choice of establishing an overseas presence as a branch or a subsidiary is one which UK businesses are, uncontroversially, free to make when expanding abroad; and the use of US entity status elections can be seen as comparable in that context. In the authors’ experience the decision of a US parent to treat a UK operating subsidiary as a branch is usually motivated by a wish to reduce the risks of double taxation on the group’s economic profits or of UK tax suffered not being creditable against US taxes on the same profits, while obtaining the benefits of limited liability and of operating locally in a familiar form, rather than by an intention to achieve an arbitrage benefit due to a mismatch in tax treatment.

Application of the mismatch regime to the structure

Of the nine operative chapters of Part 6A, three seem potentially relevant to the UK subsidiary (being Chapters 5, 7 and 9), and Chapter 9 appears to be the most likely to cause a problem in practice here. Chapter 9 (hybrid entity double deduction mismatches) broadly reflects Chapter 6 of the OECD’s final report on Action 2 (deductible hybrid payments rule), and is in general terms designed to counteract ‘double dipping’ through a hybrid entity by means of a tax deduction being taken in more than one jurisdiction in respect of a single item of expense.

The conditions for Chapter 9 to apply (as listed at TIOPA 2010 s 259IA) are, in very general terms, that:

- Condition A: it is reasonable to suppose (ignoring certain of the hybrid mismatch rules themselves) that a payment could be deducted in the calculation of the taxable profits of a hybrid entity (here the UK subsidiary) and also in the calculation of the taxable profits of an ‘investor’ in the hybrid (here the US parent);
- Condition B: either the hybrid entity or the investor is in the charge to UK corporation tax during the relevant period (here the UK subsidiary meets
This condition); and
• Condition C: the hybrid entity and the investor are related in the relevant period (here that condition is clearly met), or are party to a ‘structured arrangement’ (consideration of which is not required here as the related party limb is already met).

Looking at our simple example, conditions B and C will be met, and it quickly becomes apparent that condition A is likely to be met in respect of third party expenses of the UK subsidiary, such as salary costs and rent. As typical revenue account business expenses, these items are likely to be tax deductible in the computation of the UK subsidiary’s profit for UK corporation tax purposes, and also in the computation of the profit of the US parent for US federal income tax purposes, because the UK subsidiary is treated as a branch for those purposes.

It is worth pausing for a moment here to consider the position should the UK subsidiary also pay its US parent under a cost sharing arrangement, for services provided to it by the US parent. In that case Chapter 9 does not appear relevant, as there would not be a ‘double deduction.’ The payments would not be recognised for US federal tax purposes, and so condition A of s 259IA would not be satisfied. However, that is not the end of the story. In these circumstances, consideration should be given to Chapter 5 (hybrid payer deduction/non-inclusion mismatches), although given space constraints we don’t consider this point further in this article.

Counteraction under Chapter 9
Having established that the conditions in s 259IA have been satisfied, we then move on to the possible counteraction which may be required under Chapter 9, as set out in s 259IC (which applies where, for the purposes of condition B, it is the hybrid entity which is subject to corporation tax rather than the ‘investor’ in it).

Under s 259IC we must first check whether it is reasonable to suppose that the law of the ‘investor’ jurisdiction (here the US) will disallow a deduction for the relevant payments under local implementation of hybrid mismatch rules. In relation to the US, this would not be a reasonable supposition at the moment, so we must continue to consider the possible impact of s 259IC.

Next, s 259IC requires us to establish whether the hybrid entity and the investor are in a ‘control group’, or party to a ‘structured arrangement’. As the ‘control group’ test is clearly met on our facts, we need not consider these requirements further here.

The effect of s 259IC is then to restrict UK tax deductions in the relevant period for the relevant payments to the extent that such deductions exceed so-called ‘dual inclusion income’ of the hybrid entity. Any excess may be carried forward for possible relief against dual inclusion income in a future period, and there is provision for relief for carried forward restricted deductions at such time as there no longer appears to be a possibility of dual inclusion income arising.

What is ‘dual inclusion income’?
The question of what ‘dual inclusion income’ is becomes critical, as it is by reference to this concept that deductions may be permitted or disallowed/deferred under Chapter 9. The use of the concept is intended to make the rule reasonable, by permitting a double deduction to the extent that it is being taken against income which is also being doubly taxed. This inherently acknowledges that the existence of a hybrid entity can simply be a product of the overlap of different tax systems, and is not always a product of unacceptable tax planning which needs to be counteracted. It is clear that the OECD report does not require a deduction in a hybrid to be disallowed simply because it is taken twice. The OECD report (Chapter 6 para 200) suggests that: ‘The adjustment … should result in an outcome that is proportionate and that does not lead to double taxation.’

Dual inclusion income of the UK subsidiary
Section 259IC defines (in very general terms) ‘dual inclusion income’ as an amount which is both income of the hybrid entity for UK corporation tax purposes and also taxable income (determined under investor jurisdiction rules) of an investor (here the US parent) in the hybrid entity. Turning to our example, this would clearly include income arising to the UK subsidiary directly from third party clients, which would be taxable in the US for the US parent as income of a branch, and also taxable in the UK for the UK subsidiary. However, in our example the UK subsidiary does not, from a legal perspective, earn fees directly from third party clients. It earns its fee from its own parent, the ‘investor’ for Chapter 9 purposes, via a payment which is disregarded for US federal tax purposes. The question is whether the UK subsidiary will, as a result, have no dual inclusion income, with the consequence that it cannot deduct any of its expenses for UK corporation tax purposes.

That would appear to be an extraordinary outcome, and we believe that ‘dual inclusion income’ in these circumstances should be interpreted as including the fee earned from the US parent because that fee is not deductible for US tax purposes. The US income out of which the fee is paid is not reduced for US tax purposes by the payment to the UK, so that element is in fact included as income of both the US parent and the UK subsidiary. If the fee were not considered to be dual inclusion income, the group would be taxable on profit in excess of its actual commercial profit.

Future guidance
We have had the opportunity to discuss this interpretation with HMRC as part of the team representing the Transatlantic Tax Group, and are optimistic that it will be confirmed in revised draft guidance in due course. As a result, it may be unnecessary for the client which raised this issue to have to consider restructuring in response to the hybrid mismatch regime. However, the practical impact of the detailed rules in Chapter 9 and the other chapters of Part 6A will need to be carefully worked through before a final conclusion can be reached.

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