A knotty problem

International Tax Large Corporate

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Tom Blessington reviews the issues surrounding anti-hybrid legislation and how commercial arrangements may fall within them even without a tax avoidance motive

Key Points

What is the issue?

The breadth and strength of anti-hybrid rules are causing legitimate concern among auditors regarding tax risk and certainty, in particular for US parented groups.

What does it mean for me?

While it is unlikely that normal commercial arrangements will carry significant tax risk, it is important for tax advisers to be able to quantify this risk in internal tax documentation or as part of the statutory audit process.

What can I take away?

Tax advisors who advise UK subsidiaries of US groups should ensure that they are familiar with these rules to ensure that they can recognise and provide advice on potential hybrid transactions that their clients are party to.

Back in July 2017, Tax Adviser published an article on the UK's forthcoming anti-hybrid rules. Now the rules have been in force for a few years, it is worth revisiting what a hybrid is and how commercially unremarkable arrangements, without a tax avoidance motivation, may fall within the UK's anti-hybrid legislation. These rules are legislated within Part 6A of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010).

The breadth and strength of these anti-hybrid rules are causing legitimate concern among auditors regarding tax risk and certainty, in particular for US parented groups. While it is unlikely that normal commercial arrangements will carry significant tax risk, it is important for tax advisers to be able to quantify this risk in internal tax documentation or as part of the statutory audit process.

While the most common tax adjustment arising from the anti-hybrid rules is likely to be the ringfencing of losses, an understanding of how the rules operate in respect of normal commercial arrangements will ensure that both internal and third party auditors are adequately supported.

What is a hybrid?

A tax hybrid is an entity that is governed by the tax legislation of two jurisdictions, which is tax transparent under the tax laws of one jurisdiction and tax opaque under the tax laws of the other. Hybrid entities have, in the past, played an important role in international tax planning, with hybrid entities often being created for the express purpose of exploiting tax arbitrage opportunities.

OECD members raised concerns over tax planning arrangements involving the use of hybrid entities over a decade, culminating in the recommendations in OECD Base Erosion and Profit Shifting (BEPS) Action 2.

In response to BEPS Action 2, the UK repealed its rules regarding tax arbitrage (the old Part 6 of TIOPA 2010) and introduced rules specifically dealing with hybrid entities. These new anti-hybrid rules introduced by the UK are slightly broader than the OECD's recommended measures.

Why are there special rules?

Due to the inconsistency in how hybrid entities are taxed between jurisdictions, it may be possible to create arrangements whereby deductions can be taken for the same expenses in both jurisdictions, or income is subject to little or no tax in either jurisdiction.

Over the years, the exploitation of these inconsistencies has taken a number of forms, including the insertion of hybrid entities into international groups, having hybrids as party to intra-group financial instruments or share lending arrangements involving hybrids.

This systematic exploitation of hybrids has served to reduce international groups' tax bases, much to the displeasure of tax authorities.

Hybrids and situations in which rules can be triggered

There are a number of ways in which a hybrid can be created, with a very common occurrence of hybrids being where either a UK LLP or UK limited company is part of a US group.

Under the US 'default classification' rules, an LLP is automatically deemed to be a tax opaque corporate entity for US purposes due to its members having limited liability. This means that unless a US member of a UK LLP makes an appropriate election, a UK LLP will be a hybrid entity by default (noting that a UK LLP is only tax transparent if it is trading, per ITTOIA 2005 s 863).

The US tax classification of a foreign member of a US group can be changed through the making of an entity classification election on IRS Form 8832. This is commonly known as a 'check the box' election and is typically used to make the taxation of UK entities (e.g. limited companies) consistent with their US equivalent (for UK limited companies this is often LLCs).

At a high level, the effect of the 'check the box' election being made in respect of a UK subsidiary of a US parent is for the UK company to be 'disregarded' (tax transparent) for US purposes. As a result of this, a normal UK company, which is tax opaque under UK law, becomes tax transparent under US law and therefore a hybrid entity.

Most business costs incurred by a trading company will qualify as a tax deduction under both UK and US tax legislation, meaning that the expenses of a UK company subject to a check the box election will be deductible under both UK and US tax law.

This means that this election – perhaps made for administrative simplicity – can lead to a 'double-deduction' that is squarely within the UK's anti-hybrid rules, potentially subject to counteraction.

US statutory auditors are therefore becoming increasingly interested in how UK entities are affected by these rules, and are requesting tax notes that support the UK tax position in respect of the anti-hybrid legislation.

While UK LLPs that have not made elections for US purposes – classified as 'reverse hybrids' by the IRS – can theoretically generate hybrid non-inclusion income, this is significantly less common than UK companies that have made an election to be disregarded entities. For this reason, reverse hybrids have not been considered here.

Legislation and guidance

The rules in TIOPA 2010 Part 6A seek to counteract deduction/non-inclusion mismatches and double deduction mismatches arising from arrangements involving hybrids.

Chapters 3 through Chapters 11 of TIOPA 2010 Part 6A contain rules that counteract the advantages produced by various hybrid mismatch scenarios, with the rules regarding double deduction being found in TIOPA 2010 Part 6A Chapter 9.

HMRC's guidance on the application of the double deduction rules can be found at INTM557000.

It should be borne in mind that the anti-hybrid rules operate alongside other cross border anti-avoidance rules, such as the transfer pricing rules within TIOPA 10 Part 4 and the reporting obligations contained within The International Tax Enforcement (Disclosable Arrangements) Regulations 2020, commonly known as DAC6.

This means that any transaction between an investor and a hybrid will be taxed as if it had taken place on an arm's length basis, and any cross border planning may need to be disclosed before even considering the application of the anti-hybrid rules. This 'triple whammy' of anti-avoidance means that HMRC is likely to enforce the hybrid legislation vigorously, leading to audit concerns over hybrid entities. It may, however, be that there is no material impact of the anti-hybrid rules where hybrids do not give rise to a tax advantage.

The operation of the double deduction rules

The rules in TIOPA 2010 Part 6A Chapter 9 apply when the following three conditions are met:

A. An amount could be taken as a deduction both against the income of an entity and against the income of an investor in that entity.

For a UK company that is disregarded for US tax purposes, any expenditure is relieved at both the UK company level (for UK purposes) and the US parent level (for US purpose). This means that UK companies subject to a check the box election meet this condition.

B. Either the hybrid entity or an investor in the hybrid entity is within the charge to UK tax.

A UK incorporated company is automatically tax resident in the UK. This means that – subject to treaty residence issues – the UK company subject to a check the box election would meet this condition.

C. The hybrid entity and the investor are related or there is a structured arrangement designed to exploit the hybrid mismatch.

In this instance 'related' is defined as being under common control: one party to a transaction owning at least 25% of the other; or both parties to a transaction being at least 25% owned by a third party. While a check the box election does not require a minimum ownership to be made, in practice most US investors in unlisted UK companies are likely to hold at least a 25% interest. However, if an investor does not hold 25% they will be outside of the anti-hybrid rules.

Why the rules often don't apply in practice

When a hybrid meets all three conditions, the UK party (be that the investor or the hybrid entity itself) is subject to the rules that require any double deduction to only be deducted from double included income.

Where there is insufficient income to cover the double deduction amount, any excess double deduction is carried forward for relief against future double included income.

For UK companies making taxable profits, the income being generated in any given year is exceeding the deductions (for UK tax purposes at least). The question of whether a double deduction is taking place must therefore be considered at the parent level.

Where the hybrid and the investor do not trade with each other, the double included income is easy to identify: if the profits of the UK company are consolidated into the investor's results, and taxed, then it has been double included.

Where the hybrid and the investor do trade with each other, the question of double inclusion is slightly more complicated because the intercompany revenue ‘disappears’ on consolidation.

In this scenario, the deduction also disappears on consolidation, meaning that no double deduction is occurring in the investor’s tax computation.
The position for loss making (or historically loss making) companies is slightly different. As the legislation specifies that ‘double deduction’ expenses can only be used against double included income, it is not possible for UK based loss making hybrids to actually generate losses; the amount that would be a loss for a non-hybrid is instead ringfenced for use against future double-included income.

The practical effect of this is that a loss making hybrid is not able to get relief for losses in the year through group relief surrenders or carryback. It should be noted, however, that the surrender of losses for group relief may carry penalties for the investor under its domestic tax laws.

Conclusion

While many UK corporate entities that are part of US groups will be hybrids for the purpose of the anti-hybrid legislation, it is likely that they will be subject to limited counteraction. It may therefore be possible to forecast low levels of tax risk inherent in commercial arrangements involving UK members of US groups for the purpose of supporting the group tax position in an audit context.