Analysis

How ordinary loans become surprise hybrids

Speed read

The new UK anti-hybrid rules were swiftly enacted following recommendations from the OECD as part of the BEPS project. The rules were advertised as being aimed at aggressive tax planning schemes that exploit mismatches in international tax law. However, they go much further than this. An offshore arrangement by a UK company's 'related' parties could catapult it into the hybrid rules – even if the company is completely unaware. This creates a challenging compliance burden on UK companies, as well as the risk that deductions are ultimately denied. The only practicable solution is for borrowers to obtain contractual protection, but this is not straightforward.

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The hybrid rules can be found at TIOPA 2010 Part 6A. They were enacted in 2016 in response to Action 2 of the OECD BEPS Project and came into force on 1 January 2017. The hybrid rules are designed to neutralise the effects of certain 'mismatch arrangements'; in particular, by denying a deduction for a payment at the level of a UK payer where a corresponding amount of income is not subject to tax at the level of the payee, whether in the UK or elsewhere.

It's hard to feel too sorry for anyone whose intentional tax arbitrage is kiboshed by the hybrid rules. However, the hybrid rules go much further than that – and the broad 'related party' definitions mean that a company's normal commercial lending arrangements could be caught for reasons that are entirely outside its knowledge and control.

What is a 'mismatch'?

A 'mismatch' arises either where:

- a payer recognises a deduction for an expense but the corresponding amount is not fully taxed in the hands of the recipient; or
- a deduction arises to more than one person or with respect to more than one tax for the same expense.

The hybrid rules contemplate a variety of scenarios in which a mismatch might arise, but for the purposes of this article we will focus on just two: hybrid financial instruments (Chapter 3 of the hybrid rules); and imported hybrids (Chapter 11).

How do the rules work?

Chapter 3 contains four conditions. The first two require that a UK corporation taxpayer makes a payment on a financial instrument: both would be satisfied by a UK borrower under a normal commercial loan.

Next, it must be 'reasonable to suppose' that (very broadly) the payment gives rise to a deduction at the level of the payer which exceeds the taxable income arising to the payee and which results from specific features of the payer, payee, financial instruments or connected arrangements. This will catch a number of scenarios, such as the financial instrument being treated as equity for the payee. The final condition is satisfied if both the payer and the payee are 'related' or the financial instrument (or an arrangement connected with it) is a 'structured arrangement'.

Chapter 11 is aimed at financial instruments that would not be caught by Chapter 3, but are part of arrangements giving rise to a mismatch that is not otherwise countered, such as back-to-back lending. The 'imported hybrid' rules could apply in a commercial lending context, where a UK corporation taxpayer makes interest payments on a loan that forms part of a 'series of arrangements' and it is 'reasonable to suppose' that one of the arrangements (other than the loan) gives rise to a mismatch. In other words, there is some hybrid arrangement in another jurisdiction, the benefit of which is indirectly passed to a UK company. The rules counter this by denying a deduction for the UK company.

A further condition of the imported hybrid rules is that the jurisdictions of the other parties must not have equivalent anti-hybrid rules. This is rather likely, given that the UK is one of the first jurisdictions to have enacted the recommendations of BEPS Action 2. It must also be the case that, if the UK corporation taxpayer were the payer under the arrangement giving rise to the mismatch, the hybrid rules would apply. The final condition is that the relevant parties must be part of the same 'control group' or there must be a 'structured arrangement'.

How might a mismatch arise in the course of a normal commercial lending arrangement?

It's helpful to consider an example (see the boxed illustration opposite). A UK manufacturing company (WidgetCo) borrows from two non-bank lenders. WidgetCo's enterprise value is £100m, and it borrows £55m in total.

The first loan ('good loan') of £40m is advanced by an overseas debt fund ('Good Lender'). The second loan ('bad loan') of £15m is also advanced by an overseas debt fund ('Bad Lender'), but what WidgetCo does not know is that Bad Lender is ultimately financed by its non-UK parent ('Bad Parent') via a loan (the 'hybrid loan').

Both the good loan and bad loan are on standard commercial terms. They are negotiated together, with Good Lender and Bad Lender cooperating so that both loans are pari passu and share the same security package. However, as the name suggests, the hybrid loan is not on standard terms: it was structured so that it is regarded as debt in Bad Lender's jurisdiction (and gives rise to a tax deduction), but as equity in Bad Parent's jurisdiction (so the interest is untaxed in Bad Parent's hands).

Naturally, neither Good Lender nor Bad Lender is a member of WidgetCo's group.

As the good loan and the bad loan are on standard commercial terms, it is most unlikely they will fall within Chapter 3 (although perhaps not impossible). What's more likely is that the hybrid loan could cause the bad loan to be an 'imported hybrid' within Chapter 11.

We say 'could' because Chapter 11 will only apply if the bad loan and the hybrid loan form part of the same 'series of arrangements'. It's an attractive proposition to say that they don't, given that WidgetCo knows nothing of the hybrid loan – but that's not necessarily correct, given the broad definition of the term (see s 259KA(5)). HMRC then muddied the waters still further, asserting in its draft guidance that there will be a 'series of arrangements' between a loan to a UK borrower and a foreign loan if it is 'reasonable to assume that the funds provided under the [UK loan] became available as a result of the [foreign loan]'. We wrote to HMRC on behalf of the Loan Market Association seeking clarification on this point – unfortunately, none was forthcoming, and the revised HMRC guidance maintains the broad interpretation of 'series of arrangements'.

WidgetCo is entering into loans with third party lenders and therefore it must be safe to assume it isn't 'related' to them. Mustn't it? Unfortunately not

But don't panic yet – the rules in Chapter 3 and Chapter 11 only apply if WidgetCo satisfies the relevant 'related' or 'structured arrangement' test. At this point, any adviser would hope they could tell WidgetCo to chill. The loans are sufficiently boring and straightforward that they shouldn't be 'structured arrangements'. That means WidgetCo is only in the hybrid rules if it is 'related' (in the case of Chapter 3) or in the same 'control group' (in the case of Chapter 11) as the lenders. WidgetCo is entering into loans with third party lenders and therefore it must be safe to assume that it isn't 'related' to them. Mustn't it?

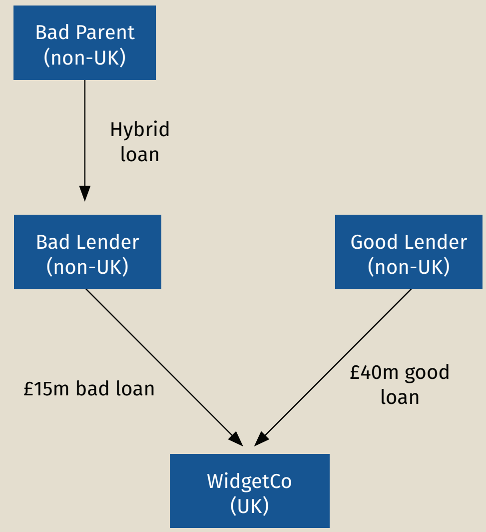
Unfortunately not.

What is a 'related' party?

The definition of 'related' can be found at TIOPA 2010 s 259NC, which provides that two persons are related if they are in the same 'control group' (which includes the 50% investment condition) or if they meet the 25% investment condition.

Two persons are in the same 'control group' (which is relevant to both Chapter 3 and Chapter 11) if they are consolidated for accounting purposes or they meet the 'participation condition'. WidgetCo clearly will not be consolidated with either of the lenders for accounting purposes. The participation condition is borrowed from the transfer pricing rules and broadly applies where one person controls another, both persons are controlled by the same person or one person is one of a number of 'major participants' controlling a company. This looks happily irrelevant.

Illustration



However, the hybrid rules contain two much broader 'investment' tests. The first (again relevant to both Chapter 3 and Chapter 11) puts two persons in the same 'control group' if the 50% investment condition is satisfied. This will be the case if a person possesses or is entitled to acquire/receive more than 50% of the share capital, voting power, proceeds on disposal of share capital or distribution of income or assets available for distribution on winding up of another person. The definition is further expanded by certain 'attribution rules', which apply where a person 'acts together' with another person. The second (which is only relevant to Chapter 3) sets out that two persons are 'related' if they meet the 25% investment condition, which is the same as the 50% investment condition, except that the relevant threshold is 25% rather than 50%.

There is no exemption to the investment conditions where the only connection between the parties is that they have entered into a loan relationship in the lender's ordinary course of business. That is a surprising result – many anti-avoidance rules would provide an exemption for this kind of scenario (see, for example, the recent revision to the 'related party' definition in the draft interest barrier rules).

It is also an unfortunate result. If WidgetCo was wound up, then Bad Lender would be entitled to £15m of its £100m of assets; however, the fact that Bad Lender was cooperating with Good Lender means that we also attribute to Bad Lender the £45m to which Good Lender would be entitled. The 50% investment condition is therefore satisfied and WidgetCo is within the scope of Chapter 11.

What are the consequences?

Now that WidgetCo knows it is 'related' to Bad Lender for the purposes of Chapter 11, it must consider whether the other conditions are met. In particular, WidgetCo must assess whether 'it is reasonable to suppose' that there is a 'series of arrangements' giving rise to a mismatch involving Bad Lender that is not countered by other legislation. In accordance with the draft guidance, this requires WidgetCo to take 'all reasonable actions' (see HMRC's *International Manual* at INTM551100); and 'it may be reasonable to expect that further facts or information are obtained in order for a reasonable supposition to be made' (INTM550640). This puts a high burden of investigation on WidgetCo. Of course, WidgetCo could simply ask Bad Lender for the necessary information, but it is unlikely to find Bad Lender in a sharing mood.

Let's assume for the sake of argument that WidgetCo employs psychics in its tax compliance department and therefore becomes aware of the hybrid loan and its tax treatment. At that point, it would have to self-assess a denial of deduction on its interest paid to Bad Lender.

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WidgetCo is likely to be most unhappy at this. It had no idea of what Bad Lender and Bad Parent were up to, and certainly didn't intend to achieve a clever tax result. However there is no motive test (unlike the old tax arbitrage rules in TIOPA 2010 Part 6) – and ignorance is no defence.

What could WidgetCo have done in practice?

WidgetCo probably wishes it had been more paranoid as soon as it realised it was borrowing more than 50% of its enterprise value from a non-bank. At that point, what could WidgetCo have done?

In a world where tax drives all commercial considerations, WidgetCo could have borrowed less, so that the 50% investment condition was not met. Or it could have borrowed from banks (as banks are in practice less likely to be funded by a hybrid arrangement).

Alternatively, and more realistically, WidgetCo could have demanded some kind of contractual assurance from the Bad Lender that it wasn't funded by hybrid arrangements. Lenders aren't likely to be very happy to reveal information they probably regard as commercially sensitive. They'll be even less happy at being asked to make statements as to the technical UK tax treatment of non-UK arrangements (particularly as that may necessitate the time and cost of obtaining UK tax advice). And, of course, most of the time, all of this would be a waste of effort, as there would be no hybrid.

These are two terribly impractical solutions. There is a better one: HMRC could confirm that there is no 'series of arrangements' for the purposes of Chapter 11 when a company borrows from third party lenders on commercial terms. Here's hoping. ■

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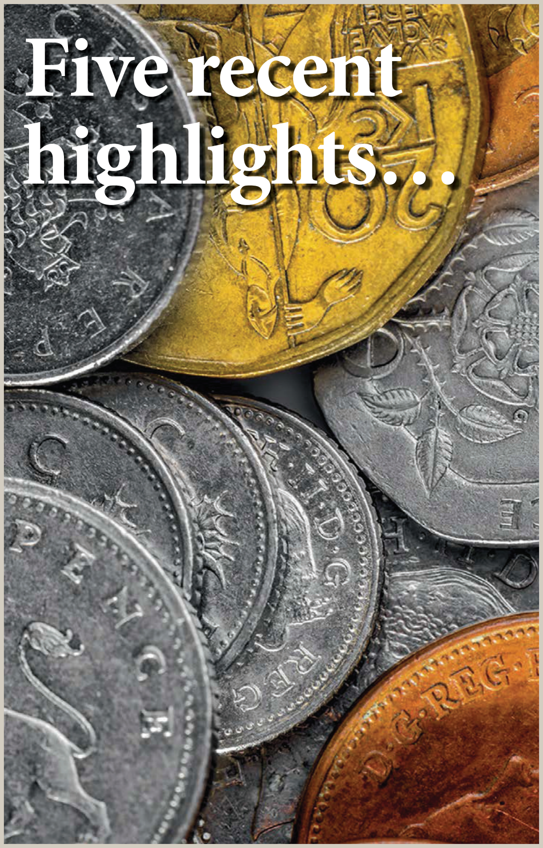

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