HM Revenue & Customs

Tackling aggressive tax planning: implementing the agreed G20-OECD approach for addressing hybrid mismatch arrangements

Summary of Responses
December 2015

Contents

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1. Executive Summary

In 2013 the Organisation for Economic Co-operation and Development (OECD) and G20 countries adopted a 15-point Action Plan to address Base Erosion and Profit Shifting (BEPS).

The government is committed to introducing new rules to tackle hybrid mismatch arrangements in accordance with the recommendations of Action 2 of the G20-OECD Base Erosion and Profit shifting (BEPS) project.

The aim is to neutralise aggressive tax planning, typically involving a multinational group, where either one party gets a tax deduction for a payment while the other party does not have a taxable receipt, or there is more than one tax deduction for the same expense. Introduction of the proposed rules will largely eliminate any tax advantage arising from the use of hybrid entities and instruments and should encourage businesses to adopt less complicated and more transparent cross-border investment structures.

The government issued a Consultation Document on 3 December 2014 seeking comments on the implementation of rules to neutralise the effect of hybrid mismatch arrangements and on the G20-OECD recommendations in relation to tax treaties.

The Consultation Document referred to a few areas where further work was to be undertaken during 2015. The Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements was published on 5 October 2015 and includes the outcomes of this further work. This document provides a summary of responses received in response to the consultation including those where further work was carried out.

The areas in which respondents were generally most interested were as follows:

- treatment of stock loans and repos
- nature and extent of the exclusion for hybrid regulatory capital
- inclusion of income subject to a charge under controlled foreign company regimes
- definition of “structured arrangements”, and
- a number of administrative issues.

The government recognises the need to minimise the impact of the proposed hybrid mismatch rules on the capital market and the proposed rules have been designed to reflect this.

The draft legislation excludes banks’ and insurers’ regulatory capital instruments, but references an existing regulation making power which will allow the government to apply the hybrid rule (or a modified rule) to these instruments at a future date once it has had more time to consider the issues/options in this area.

Alongside this document, the government is publishing draft legislation for Finance Bill 2016 which is designed to implement the recommendations of the Final Report, taking into account the responses to the consultation document. Where appropriate, this document includes references to the relevant chapters of the draft legislation.

The government is grateful to those who took the time and effort to respond to this consultation. The government would particularly like to thank those who have engaged further on particular aspects of the new hybrid mismatch rules, in order to determine the potential impact of the draft legislation on particular business sectors.

2. Introduction

2.1 Action 2 of the G20/OECD Action Plan calls for the development of “model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities.” The Action item states that this may include:

- “changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident companies) are not used to obtain the benefits of treaties unduly;
- domestic law provisions that prevent exemption or non-recognition for the receipts of payments that are deductible for the payer;
- domestic law provisions that deny a deduction for a payment that is not included in income by the recipient (and is not subject to taxation under the controlled foreign company (CFC) or similar rules);
- domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and
- where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure”.

2.2 The G20-OECD’s report recommends aligning the tax treatment of an instrument or entity with the tax outcomes in the counterparty jurisdiction.

2.3 The recommended rules target two types of payment:

- payments under a hybrid mismatch arrangement that are deductible under the rules of the payer jurisdiction and not included in the ordinary income of the payee or a related party investor (deduction/ no- inclusion or “D/NI” outcomes); and
- payments under a hybrid mismatch arrangement that give rise to duplicate deductions for the same single payment (double deduction or “DD” outcomes)

2.2 To avoid double taxation and to ensure that the mismatch is eliminated even where not all the jurisdictions adopt the rules, the recommended rules are divided into a primary response and a secondary response.

2.3 The primary response is to deny the deduction in the payer’s jurisdiction where there is a deduction and no inclusion, and to deny a deduction in the investor’s parent jurisdiction where there is a double deduction.

2.4 The secondary response applies where there are no hybrid mismatch rules in the other jurisdiction or the primary rule does not apply to the entity or arrangement. In such circumstances the payment should be included as ordinary income in the payee’s jurisdiction.

2.5 The consultation document posed a wide range of general and specific questions regarding the introduction of hybrid mismatch rules in line with the OECD recommendations. Fourteen written responses were received; most of these were detailed, and all were taken into account in drafting the legislation to implement the OECD recommendations. A list of the respondents to the consultation is included at Annex A.

2.6 This document provides a summary of the responses, and comments on how the draft legislation deals with the issues raised. The consultation document contained a full account of the relevant issues and options, and this summary of responses should be read in conjunction with it.

2.7 Although the summaries necessarily omit the detail provided by individual responses, the government has carefully considered the responses made to the consultation document in the development of policy and drafting of the legislation.

2.8 The draft legislation aims to give effect to the design principles and specific recommendations set out in the final BEPS Action 2 report and commentary which was published on 5 October 2015. The government intends to introduce a new Part 6A TIOPA 2010, which will deal with hybrids and other mismatches, essentially replacing Part 6 TIOPA 2010. The structure of the draft legislation is as follows.

Chapter 1	Introduction
Chapter 2	Key Definitions
Chapter 3	Hybrid and other Mismatches from Financial Instruments
Chapter 4	Hybrid Transfer Deduction/Non-inclusion Mismatches
Chapter 5	Hybrid Payer Deduction/Non-Inclusion Mismatches
Chapter 6	Hybrid Payee Deduction/Non-Inclusion Mismatches
Chapter 7	Hybrid Entity Double Deduction Mismatches
Chapter 8	Dual Resident Company Double Deduction Cases
Chapter 9	Imported Mismatches
Chapter 10	Adjustment of Reasonable Suppositions
Chapter 11	Interpretation

2.9 The legislation follows the overall structure of the BEPS Action 2 Report. Although the legislation covers a wide range of hybrid and other mismatches, the chapters which deal with specific types of mismatches (Chapters 3 to 9) adopt the same internal structure for ease of reference. Each of these main chapters is divided into three parts – introduction, application and counteraction. The introduction sets out an overview of each chapter; the application sets out the conditions which have to be met in order for the chapter to apply; and the final section sets out how each chapter counteracts particular mismatches.

3. Responses

3.1 As draft legislation is being published alongside this response document, the approach adopted is to cover the main topics raised by consultation responses in separate sections.

3.2 For ease of reference, the relevant questions in the December 2014 Consultation Document are included as a sub-heading to each section.

General Comments

3.3 There was widespread support from respondents for the aims of the BEPS project, and the particular aims of the Action 2 Hybrid Mismatches report. There was a similar level of support for UK stance in taking a leading role in the BEPS process.

3.4 Respondents agreed with the broad aims of the BEPS project, and with the aim of eliminating the unfair tax advantages that MNEs can obtain from the international tax system. More specifically, they also agreed that hybrid mismatches can provide unfair advantages of this nature.

3.5 Several respondents raised the issue of co-ordination of international co-operation, and pointed out that there could be an uneven playing field if some states only adopted partial measures, or significantly delayed the implementation of BEPS proposals.

3.6 The government remains committed to implementing the recommendations of the OECD Action 2 report on Hybrids mismatches. The UK has taken a leading role in tackling BEPS and together with the other G20 countries has endorsed the final OECD BEPS outputs. The UK is committed to clamp down on aggressive tax planning and support fair tax competition, and expects other countries to introduce similar measures in line with their commitments to the BEPS project. The government decision to implement the Action 2 recommendations was announced in the Autumn Statement 2014. The proposed implementation date of 1 January 2017 provides over two years for UK companies to assess the impact of these rules and, where appropriate, move towards simpler, non-hybrid arrangements.

4 Interaction of Hybrid and CFC Rules

<u>Questions 1 -3 of the Consultation Document</u>

4.1 The consultation document asked for views and comments in relation to how and to what extent CFC charges should be taken into account when assessing hybrid mismatches – and whether there were particular practical problems in relation to CFCs.

4.2 Respondents raised the issue of whether, and how, a CFC charge should be reflected in the UK hybrids rules. There was widespread support for the approach suggested in the OECD Report, which was that income included in a CFC charge should be taken into account when assessing the extent of a mismatch.

Although responses tended to focus on the interaction with the UK CFC rules, the draft legislation covers all CFC rules. In practice, it may well be the case that the income that has not been included in the ordinary income of a non-UK company does not fall within the scope of the UK CFC rules – most obviously because the non-UK company is not controlled by UK persons. However, such income may well be picked up by other CFC rules.

4.3 Several responses suggested that there should be an additional exemption in the UK CFC rules to deal with entities that were dealt with under the hybrid rules. This was on the basis that new BEPS rules should take precedence over existing anti-avoidance rules such as the CFC regime.

The government is adopting the ordering rule proposed in the Action 2 Report, so that a new exemption in the UK CFC rules is not necessary. However, the draft legislation includes a mechanism to ensure that the UK hybrid mismatch rules take account of CFC charges (from both foreign and UK CFC rules).

4.4 It was also suggested that a longer period may be required to determine whether a mismatch has occurred, to take account of the fact that a CFC charge may be levied later than other tax charges, or out of line with normal income recognition rules.

No special rules in relation to time limits are envisaged in respect of CFC charges. However, the draft legislation does provide general hybrid time limit rules, which will also cover CFC charges. Similarly, the "reasonable supposition" adjustment rules in Chapter 10 of the draft legislation will also apply to CFCs.

4.5 Respondents agreed with the general proposition that income taxed under CFC and other offshore investment taxation regimes should be treated as included in ordinary income under the hybrid rules.

4.6 Respondents made the point that income taxed under a CFC regime may be difficult to trace, and that an option not to trace would be helpful.

The draft legislation ensures that amounts included as ordinary income in the territory of residence, and amounts included in a CFC charge are both taken into account.

In practice, it should be possible for companies to identify where amounts have been included under a CFC regime.

4.7 Respondents pointed out that differences in tax rates are outside the scope of the measure, so the fact that a CFC charge may be at a lower rate should not be relevant in determining if a payment has been taxed.

The relevance of tax rates within the draft legislation depends on whether the rules are being applied to hybrid entities or hybrid financial instruments. With regard to hybrid entities, the CFC inclusion mechanism does not consider the rate of tax in relation to a CFC charge. It considers the extent to which income which has not been included in ordinary income in one territory has been taken into account in computing a CFC charge in another territory.

In relation to financial instruments, the draft legislation does pick up cases where either amounts are not included in the ordinary income of a CFC, or where the tax rate applied to a CFC's income which arises from a financial instrument is at a lower rate than the full marginal rate for that territory. This latter amount is termed an "under-taxed amount".

4.8 Respondents also pointed out that an amount included in a CFC charge should still qualify as included in ordinary income, even if the parent company can cover the CFC charge with losses. A CFC charge has still arisen – and the use of losses is not determined by hybridity.

The draft legislation works by considering the extent to which amounts have been included in computing CFC chargeable profits, rather than by reference to the actual amount of CFC tax paid. The use of losses by the parent company will not create or maintain a mismatch.

4.9 Respondents raised a number of practical points in relation to CFC charges, including how CFC inclusion will be evidenced, and whether taxpayers could opt out of the CFC inclusion rules.

In general terms, the extent to which amounts have been taken into account by a foreign CFC regime will fall within normal self-assessment rules.

Whilst taxpayers cannot opt out of the CFC inclusion rules, consideration of CFC charges can only benefit taxpayers, as a CFC charge can only reduce or eliminate a hybrid mismatch.

5 Stock Loans and Repos

Questions 4 - 7, 22 and 23 of the Consultation Document

5.1 The Consultation document asked for views on the extent to which stock loans and repo arrangements should be included within the scope of the rules, and whether different types of arrangements could be distinguished for the purposes of the legislation.

5.2 A number of respondents raised concerns that widely drawn tests, and the lack of a purpose-based exemption, will lead to a heavy compliance burden. In addition, concerns were expressed that the hybrid rules could have an impact on high volume “flow” business, which provides liquidity to the market, and where the risk of hybrid mismatches is low.

5.3 Respondents also expressed the view that the hybrid risk from repos and stock loans is low, as most on-market transactions were between unconnected parties.

5.4 With regard to intra- group or connected party repos and stock loans, the view was expressed that these were often for risk management and regulatory reasons. Respondents felt that if such arrangements can be traced back to external funding, they should also be considered low risk.

5.5 In general, a number of respondents expressed concerns that the potential compliance burden on the financial sector was considerable, and not commensurate with the risk.

The government recognises the concerns expressed and officials have actively engaged with business to ensure that the legislation does not adversely impact on the functioning of the market.

The draft legislation provides a targeted exclusion for financial traders.

The hybrid transfer rules are restricted to related parties and structured arrangements. The vast majority of daily trades are with unconnected parties and do not form part of structured arrangements. As such they will be outside of the scope of these rules.

5.6 Several respondents suggested that further work is needed to identify and exclude flow business, and indicated that they would seek to outline workable proposals to HMRC officials in due course.

5.7 Some responses suggested a grandfathering period, excluding existing arrangements from the new legislation, would significantly reduce the burden on businesses.

5.8 Some responses acknowledged that the proposed rules will meet their objectives without a purpose test, but only if implemented and applied consistently.

5.9 Other respondents expressed concerns that commercial transactions could be disrupted, particularly if they involve pre-requisite internal transactions undertaken on a cross-border basis. Ideally, respondents felt that such transactions should be excluded from the regime.

5.10 Suggestions to reduce the compliance burden in this area included:

- an exemption for transactions in the “ordinary course of business”;

- a white list proposal, to exclude jurisdictions with sophisticated tax systems where BEPS risk from repos and stock loans is low;

- an exemption for transactions where, for all related parties, there is no aggregate material tax benefit.

The government acknowledges that this is a difficult and complex area. The draft legislation aims to ensure that ordinary commercial transactions between unconnected parties are excluded. The government is willing to consider any further representations from the financial sector which will assist in achieving an acceptable balance between efficacy and complexity.

6 Hybrid Mismatch Arrangements

Question 6 of the Consultation Document

6.1 The consultation document asked for views on which type of arrangements should fall within the definition of “structured arrangements” for the purposes of the legislation.

6.2 Several respondents suggested that the rules should include a condition which considered whether there was a reasonable expectation of knowledge of the hybridity, and that any test should refer to whether a taxpayer “knowingly” sought to share in the tax benefit.

The draft legislation includes a condition that in order to be a structured arrangement, it has to be “reasonable to suppose” that an instrument or arrangement is designed to produce a hybrid mismatch, or that the terms of the instrument or arrangement include the parties sharing the economic benefit of a mismatch. (See Section 259CA(7) in Chapter 3 as an example of this condition.)

6.3 Respondents pointed out that the treatment of a temporary transfer may differ from country to country – for example, as either a loan or a sale.

Unless the difference in treatment results in a mismatch, such differences will remain outside the scope of the legislation.

6.4 Respondents felt that certain types of transaction, such as a public issue of securities to the market, should be excluded from any structured transaction definition.

It is not clear how such a transaction would give rise to a material hybrid mismatch.

6.5 With regard to timing differences, some respondents felt that companies should be allowed to claim a deduction whenever the income is brought into charge.

The draft legislation provides both a 12 month safe harbour, and a longer period, if taxpayers can provide evidence to justify the timing difference.

6.6 Respondents expressed the view that certain standard tax provisions found in nearly all loan documents should not result in them being identified as structured transactions.

Whilst it is reasonable to expect tax provisions in financing documentation, the key issue is whether such provisions consider specific tax advantages, and the sharing of such advantages between the parties. In such cases, it is appropriate that such arrangements are considered under the new hybrid rules.

6.7 Several respondents felt that grandfathering rules should be included, to ensure that taxpayers were not penalised in relation to transactions where there is no UK tax avoidance motive, and which were in compliance with the rules at the time they were entered into.

The aim of the Action 2 Report is to remove the tax mismatches arising from hybrid arrangements which fall within the scope of the rules. The introduction of rules was announced in Autumn Statement 2014, and the new regime is due to come into force on 1 January 2017. It is considered that this provides sufficient time for schemes and arrangements to be unwound, and for transactions to be restructured.

Grandfathering would not achieve the desired policy objectives, as it would extend the benefit of certain existing hybrid arrangements beyond 1 January 2017. As some hybrid instruments can be issued for 10 or 20 years, this is not seen as an acceptable policy outcome.

6.8 Respondents suggested that stock lending by exempt bodies such as pension funds should not be treated as structured transactions, as in such transactions the price is not dependent on the extent of any hybrid mismatch, or tax deduction obtained by the stock borrower.

The draft legislation does include provisions in relation to certain exempt bodies at Section 259BF. See "Permitted Mismatches" section below.

6.9 Respondents raised the issue that mezzanine finance may have a hybrid element, but this could be a consequence of commercial funding, rather than any tax planning.

It is not immediately clear that such mezzanine finance arrangements depend on the tax advantages offered by any hybrid instruments used. In line with the general approach, the rules will neutralise the tax effects of such instruments. The draft legislation does not contain any special rules in relation to mezzanine finance.

6.10 Some respondents expressed the view that knowledge of the counterparty's tax position does not, of itself, create a structured transaction.

Whilst this is true, it is also the case that if the counterparty takes advantage of certain transactions to obtain a hybrid tax benefit, then such transactions should be within scope of the new regime.

Aside from structured arrangements, transactions between unrelated parties will be outside the scope of the new rules.

It is recognised that different underlying mechanics give rise to mismatches involving stock loans and repos. This is why the draft legislation deals with these separately, and proposes very tightly defined responses to ensure that the impact is targeted upon those specific transactions giving rise to policy concerns.

6.11 Respondents raised various concerns in relation to hybrid mismatch arrangements.

6.12 If the rules applied to related parties, where there was no control test, UK counterparties may be caught in arrangements they cannot exit. Respondents suggested that the rules should only apply intra-group.

The scope of the rules and the application to related parties is in line with the OECD recommendations. With regard to exiting arrangements, the rules will not be in force until 1 January 2017. This should provide sufficient time to withdraw from or re-structure arrangements, irrespective of whether the UK is a controlling party.

6.13 Several respondents suggested that the rules should include a purpose-based defence for taxpayers. The scope of any purpose-test could be limited – possibly to cases involving regulatory capital, repos and stock loans.

The draft legislation does not include any purpose-based exemption. This is in line with the OECD recommendations. The mechanical rules should be sufficiently clear and well-targeted to ensure that the policy objectives of the anti-hybrids initiative are met. The draft legislation contains specific provisions for dealing with repos and stock loans (Chapter 4) and the issue of regulatory capital is dealt with below.

6.14 Respondents sought clarification of the distinction between a purpose test and a condition which asks whether an instrument or arrangement was designed for a particular purpose.

There is no purpose-based exemption in the draft legislation, but to ensure that the legislation meets its policy objective, the conditions in relation to structured arrangements clarify that the existence of commercial purpose does not prevent an arrangement from falling within the scope of the rules.

6.15 Several respondents suggested that a UK tax benefit test could be included. This would not be a purpose test, but would mean that the rules only applied if the UK tax benefits outweighed the non-tax benefits.

The draft legislation does not include a tax benefit test – this is outside the scope of the OECD recommendations. The mechanical rules which identify hybrid mismatches should ensure that the counteraction is appropriate in each case, without the need to compare tax and non-tax benefits.

6.16 Respondents suggested that the definition of investor should be limited to group/related party investors, so that normal portfolio investors were excluded.

The scope of the rules for investors is limited to related parties and structured arrangements. Normal, unconnected portfolio investors will be outside the scope of the rules.

6.17 Respondents raised a practical concern as to whether UK companies will actually have sufficient knowledge of overseas tax legislation. This was a particular concern regarding the UK tax penalty regime.

In the context of cross-border financing arrangements, it is expected that related parties should be aware of the relevant aspects of the tax regime in jurisdictions in which they operate. There are no specific penalties which apply to the new hybrids rules – the normal UK penalty rules will apply.

7 Permitted Reasons for Mismatches

Question 8 of the Consultation Document

7.1 The consultation document asked for views on special purpose entities which respondents considered should be excluded from the scope of the new hybrid rules.

7.2 Respondents suggested that the following entities should be included, on the grounds that they do not pose any significant risks in terms of hybrid mismatches.

- Venture Capital Trusts
- Seed Enterprise Investment Scheme companies
- Securitisation vehicles
- UK Pension funds – because investment income is not taxable in the hands of the pension fund, any mismatch would be as a result of this general exemption, not as a result of hybridity
- Real Estate Investment Trusts

The draft legislation contains a limited number of exclusions in relation to particular types of entity. The OECD Action 2 Report does not specify particular entities which should be exempt from hybrid rules. The government will continue to keep this issue under review.

Section 259BF of the draft legislation sets out a limited number of circumstances where mismatches will be outside the scope of the rules – these are termed "permitted reasons".

8 **Treatment of UK LLPs**

Questions 9 and 10 of the Consultation Document

8.1 The consultation document asked for views on the inclusion of certain arrangements involving UK LLPs, and whether any similar entities should be included within the scope of the rules.

8.2 Respondents suggested that the situation may arise in relation to reverse hybrids, where partnerships have a separate legal personality. This would include UK LLPs, Scottish limited partnerships, and foreign partnerships with UK partners.

8.3 Some respondents felt that it would be simpler if UK LLPs were treated as opaque for all UK tax purposes.

8.4 It was also suggested that in relation to mixed LLPs – that is, where there were both individual and corporate members, so that not all members are subject to hybrid rules – it would be better to use existing partnership rules to allocate income to partners.

The draft legislation includes a specific provision in relation to reverse hybrids (hybrid payees) which would apply where neither the primary nor the secondary rules have counteracted the mismatch. This would enable the UK to limit the tax transparency of the hybrid structure to the extent of the mismatch by bringing that amount into receipt as corporation tax profits of the LLP.

The draft legislation provides for consideration of the partnership agreement to determine the allocation of income to partners.

9 Dual Resident Companies

<u>Questions 11 and 12 of the Consultation Document</u>

9.1 The consultation document asked for views on the inclusion of dual resident companies, and in particular whether existing UK tax definitions could be employed in the hybrids legislation. In the event, the draft legislation takes an approach more directly in line with the OECD recommendations.

9.2 Respondents were generally content with the existing definition in section 109(1) CTA 2010.

9.3 Some respondents pointed out that using a tie-breaker approach would result in more dual resident companies. This was not due to tax planning, but to a mobile senior workforce. A suggested solution was to carve out UK companies which are treaty non-resident, provided no deduction is in fact claimed in the other territory.

9.4 Respondents also pointed out that the dual resident rules could be an important issue for groups which want to move their headquarters to the UK. This was often achieved by moving residence via control and management, which was simpler and quicker than a share exchange.

9.5 Respondents suggested that using a Competent Authority approach rather than place of effective management could lead to uncertainty and additional compliance costs.

9.6 Respondents also raised a practical concern that if a dual resident company is not entitled to any deduction until the residence issue is settled, there would be no incentive for tax authorities to expedite the case.

9.7 Respondents commented that there were some jurisdictions where application of dual resident rules may be difficult – and suggested that those jurisdictions could be covered in guidance.

The government has considered the comments received during consultation, and concluded that, rather than employ a tie breaker approach to resolve the dual residency of the company, the rules will follow the recommendations of the OECD report. The draft legislation will therefore apply to restrict any mismatch to the extent of dual inclusion income.

The approach set out in Chapter 8 of the draft legislation is in line with the OECD approach and replicates the rules involving double deductions for hybrid entity payers, which involve a similar mismatch outcome.

10 Hybrid Regulatory Capital

Questions 14-17 of the Consultation Document

10.1 The consultation document presented two main options for dealing with hybrid regulatory capital, and sought views on the suitability of both proposed approaches.

10.2 Respondents raised a number of concerns in relation to regulatory capital.

10.3 Respondents felt it would be preferable to have a financial sector exemption similar to the exemption in the UK debt cap rules.

10.4 Some respondents felt that regulatory capital should be excluded from the rules, and pointed out that the Taxation of Regulatory Capital Securities Regulations 2013 included an anti-avoidance rule.

10.5 Alternatively, some respondents felt that the issue should be considered under BEPS Action 4 (interest) and the hybrid rules should not apply.

10.6 Respondents expressed concerns that option 1 could be manipulated, due to the fact that not all jurisdictions allow a tax deduction in respect of hybrid debt. For example, an overseas subsidiary issuing vanilla equity instead of hybrid regulatory capital could skew the numbers, and could create larger deductions in the UK.

10.7 Respondents suggested that both options in the Consultation document would operate mechanically and indiscriminately, rather than being targeted at attempts to abuse the regime. In the examples given it is implicit that the regulatory capital issued by the UK Bank does not form part of arrangements to secure a tax advantage, as the targeted anti-avoidance rule in Taxation of Regulatory Capital Securities Regulations 2013 is assumed not to apply.

10.8 It was pointed out that the Taxation of Regulatory Capital Securities Regulations 2013 were enacted specifically to provide continuity and certainty for the banking industry and to avoid disadvantaging the UK's financial sector.

10.9 A number of respondents proposed that the most straightforward solution would be to provide that the hybrid mismatch arrangement tax provisions should not apply to hybrid instruments which constitute regulatory capital securities to which the 2013 Regulations apply.

10.10 Respondents accepted that there may be timing differences in relation to regulatory capital (funds may be raised early, or bridge-funded internally prior to raising external capital). However, such timing differences would be market condition driven, not tax driven.

10.11 Insurance companies may hold hybrid regulatory capital as a portfolio investor. For this reason, a controlling interest test would be better than a 25% interest test.

10.12 Some respondents felt that an allocation based on the Risk Weighted Assets ("RWAs") used for regulatory purposes conceptually makes more sense. However it would still be very complicated to administer and would be an administrative burden for those groups affected. In particular, RWAs are measured differently in different countries.

10.13 With regard to the insurance industry, respondents stressed the need for sufficient flexibility to cater for the changing regulatory environment. Although respondents did not think that either option was necessary where the issue of regulatory capital took place within the parameters of the regulatory regime, they expressed a preference for a modified option 1 approach for the insurance sector.

10.14 Other respondents expressed concerns that neither option would work well for insurance regulatory capital, and in particular that any allocation approach may not match Solvency II requirements.

The consultation document set out proposals to introduce special provisions for banks' hybrid regulatory capital in order to reduce the scope for these instruments to be used for tax-planning purposes, while continuing to accommodate regulatory-driven arrangements to ensure a level playing field within the UK financial sector.

The government wants to give further consideration to the hybrid rule's application to regulatory capital, taking into account the concerns raised by respondents and the ongoing considerations around interest restriction rules for the financial sector.

The legislation therefore:

- *excludes from the hybrid rule any financial instruments that are regulatory capital securities for the purposes of the Taxation of Regulatory Capital Securities Regulations (SI 2009/3209 and any subsequent amendments to that instrument); and*

- *references the existing power within under Section 221 FA 2012 that will allow the hybrid rule, or some modification of the rule, to be applied to regulatory capital securities at a later date if considered appropriate.*

The government will continue to consider which options provide the most appropriate solutions, in conjunction with the further work being undertaken by the OECD on financial sector interest restriction rules. It is the intention that the appropriate treatment of hybrid regulatory capital securities can be set out in regulations made at later date. Such regulations will enable the hybrid rules to focus on specific risks with regard to regulatory capital.

11 Commencement and Transitional Provisions

Question 18 of the Consultation Document.

11.1 The consultation document sought views on practical issues in relation to the introduction of the new rules, and whether any transitional rules were required.

11.2 Introduction in 2017 following an announcement in 2014 was seen as a sensible and positive step. However, several respondents raised the issue of whether the implementation date be reviewed to ensure consistency with the UK's major trading partners given the possible consequences for the UK's competitiveness.

11.3 Some respondents felt that the proposed start date was too early, and suggested a further transitional period, or alternatively a light touch approach to compliance for the first twelve months.

11.4 Respondents also noted that no grandfathering was proposed. In the absence of formal grandfathering rules for existing arrangements, some respondents suggested that there should be a process for HMRC to provide certainty on any restructuring steps – and ideally to provide a mechanism within the rules to allow restructuring.

11.5 Respondents were concerned that because the related parties rule fell short of control, companies could be caught in transactions that they cannot unwind. It would therefore be helpful to include either a purpose defence for existing arrangements, in circumstances where a UK company cannot exit arrangements, and can show that its cost of funds was the same as it would have been under a non-hybrid arrangement.

11.6 Many respondents emphasised the need for ongoing consultation and discussion after the publication of the draft legislation.

The government has considered these points but wishes to avoid the additional complexity of grandfathering and transitional provisions. However, the government is committed to ongoing consultation and discussion with interested parties to ensure that the legislation meets the policy objectives without having an adverse impact on commercial transactions.

12 Administrative Aspects

<u>Questions 18 - 21 of the Consultation Document</u>

12.1 The consultation document asked respondents to provide examples of specific compliance and administrative issues which may arise in relation to the proposed legislation.

12.2 Respondents pointed out that a practical solution would be needed for the financial services sector, due to the high daily volume of intra-group stock lending and repo transactions.

As covered in the section on stock lending and repos above, the draft legislation provides a targeted exclusion for financial traders.

12.3 Respondents also raised a general concern that the rules will require UK companies to understand in detail the non-UK tax treatment of numerous transactions and entities – and that this was a complex new burden.

Hybrids which are within the scope of the rules will either be structured arrangements or involve related parties. In such circumstances, it is a reasonable assumption that parties undertaking cross-border transactions will have an understanding of the relevant tax rules. The government would expect companies to understand the tax implications of such transactions as part of their normal compliance process.

12.4 Some respondents felt that UK companies may not even know if there are hybrid arrangements in place. A purpose test would help here.

The rules are restricted to related parties and structured arrangements – situations where it is expected that the company would be aware of the counterparty arrangement.

12.5 Respondents raised the issue of whether a UK company will know whether the primary rule has been applied to deny a deduction in another jurisdiction? It could be uncertain at the time that the UK company needs to submit a tax return. Respondents suggested a provision to allow HMRC to amend the return if in fact the primary rule has been engaged elsewhere.

The draft legislation includes a provision to enable amendments to be made when it becomes apparent that there is no hybrid mismatch – see Chapter 10 (Adjustment of reasonable suppositions).

12.6 A number of respondents suggested that establishing the treatment of a hybrid instrument in the counterparty jurisdiction could be an area of difficulty. For existing arrangements, the concern was that there would be no stipulation in any form of contract that the relevant information must be supplied. Respondents were concerned that UK companies would be entirely reliant on the counterparty complying with requests for information.

12.7 Some respondents felt that even when two entities were related, it should not be assumed that information would flow freely between them.

12.8 In addition, respondents expressed concerns that the application of the rules to related parties and third party structured arrangements will require new reporting systems, and counterparties may not be willing to share information.

Discussions with stakeholders during the BEPS process indicated that it was not unreasonable to expect UK companies to know how counterparty jurisdictions treated particular financial instruments. This information would be important for both tax and regulatory reasons.

Whilst it is recognised that there may be challenges in the exchange of information within particular structures, it is expected that information requirements will be included in contractual terms once the legislation is in force, as similar requirements are built in for regulatory and other reasons. The start date of 1 January 2017 provides time for suitable arrangements to be agreed between parties.

12.9 Some respondents expressed the view that non-compliance with requests for information, particularly from unrelated parties, would make the rules unworkable.

12.10 Several respondents requested detailed guidance on level of evidence expected.

12.11 Respondents also suggested that where the taxpayer and tax authority were in dispute over the tax treatment of an instrument or entity, or the treatment was otherwise uncertain, then the outcome should be treated as being in the taxpayer's favour, subject to any further evidence that comes to light.

Once a hybrid mismatch within the scope of the rules has been identified, the UK will apply the appropriate counteraction. However, as indicated above, the draft legislation does include a provision to allow a subsequent adjustment in the light of additional information regarding the tax treatment in the counterparty jurisdiction.

With regard to the provision of information, HMRC will rely in the first instance upon the UK entity. However, in cases of dispute HMRC could use Exchange of Information powers to establish the tax treatment of the counterparty.

13 Miscellaneous Points

Interaction with Transfer Pricing.

13.1 Respondents sought clarification in relation to the interaction with transfer pricing rules. In particular, if an interest deduction was restricted due to the application of transfer pricing rules, would this be taken into account, or do hybrid rules take precedence?

Transfer pricing rules will take precedence. The restriction of an interest deduction as a result of the application of transfer pricing rules would not, in itself, give rise to a mismatch which would be within the scope of the hybrid regime. However, any such restriction would be taken into account when applying the hybrid regime.

Treaty Provisions

Question 13 of the Consultation Document

13.2 There was general agreement with the analysis set out in the consultation document. In particular, respondents did not think that UK treaty obligations would interfere with the application of the proposed hybrid mismatch rules.

Further work in relation to this aspect of the Final Report will be taken forward as part of the implementation of the other related BEPS Actions.

4. Next steps

Draft Legislation and further consultation

The draft legislation in relation to hybrid mismatch arrangements has been published alongside this document as part of the draft Finance Bill 2016.

The government invites comments on this draft legislation as part of Stage 3 of the tax policy development process, which is concerned with drafting legislation to effect the proposed change. This further consultation period will run until 3 February 2016.

Written responses should be submitted by 3 February 2016, preferably by email, to: bepsresponses.condoc@hmrc.gsi.gov.uk

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Annexe A: List of stakeholders consulted

1. AFME
2. Allen & Overy LLP
3. Association of Accounting Technicians
4. Association of British Insurers (ABI)
5. Chartered Institute of Taxation (CIOT)
6. Clifford Chance LLP
7. Confederation of British Industry's (CBI)
8. Deloitte LLP
9. Ernst & Young LLP
10. Freshfields Bruckhaus Deringer LLP
11. International Underwriting Association of London Ltd
12. KPMG LLP
13. Lloyd's Richard Baron UBS Investment Bank
14. Mazars