PUBLICATIONS

Changes to the UK's Anti-Hybrid Regime

SRZ Private Funds Tax Update for UK Managers

April 2021

HMRC has now closed its second consultation on draft legislation proposing changes to the United Kingdom's "hybrid and other mismatches" rules. The draft legislation generally makes welcome changes to the United Kingdom's anti-hybrids regime, and these changes will be, in most cases, retrospective to the commencement of the regime on 1 January 2017.

The United Kingdom's anti-hybrids regime implements Action Point 2 of the OECD's BEPS report and is aimed at denying UK taxpayers tax advantages from "tax mismatches" that arise from arrangements involving hybrid entities (where the same entity is regarded as a "tax-transparent" or "flow-through" entity by one jurisdiction, but as a "tax-opaque" or "blocker" entity by another jurisdiction) or hybrid instruments (where the same financial instrument is regarded as debt for purposes of one jurisdiction but as equity by another jurisdiction). Other OECD jurisdictions either have implemented or are in the process of implementing their own hybrid mismatch rules. In particular, EU Member States were required to introduce hybrid mismatch rules from 1 January 2020 by the Anti-Tax Avoidance Directive (ATAD).

As an example, a common form of hybrid tax mismatch is the "deduction/non-inclusion mismatch" where the interposition of a hybrid entity as recipient of a payment means that a payment which is deductible for UK tax purposes is not included as taxable income in another jurisdiction. In these circumstances, the United Kingdom, under its anti-hybrid rules, would apply a "counteraction" to the payment,

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising

denying the payer a tax deduction for the payment to the extent of the "non-inclusion".

The draft legislation proposes changes in three key areas that are relevant to funds and alternatives managers:

1. HMRC implicitly concedes that the current "acting together" rules are too broad and can result in lenders and borrowers that are genuine third parties being regarded as in a control relationship (and so being brought within the scope of the hybrid mismatch rules where the lender is a hybrid). This has been a particular issue where a hybrid lender is a party to inter-creditor arrangements or where a lending transaction is combined with or has some element of equity participation. Under the proposals, the "acting together" test will be disapplied where the hybrid party itself has only a 5% or less equity interest (by votes or economic entitlement) of its own in the payer entity.

2. The draft legislation creates a new category of "inclusion/non-deduction" income — which will replace the current concept of section 259ID income — in order to prevent there being a counteraction to deny a deduction where the amount for which a deduction is claimed by a UK hybrid entity is matched by an amount which is included as income by the UK hybrid entity but for which the payer of that income has no deduction. This has been a particular issue for US managers with a UK affiliate which they fund through a sub-advisory fee. Where the UK sub-manager checks- the-box to be treated as a disregarded entity for US tax purposes (which has the effect of making it a hybrid entity for purposes of the UK's anti-hybrid rules), so that the UK's sub-manager's expenses are deductible for both US and UK tax purposes, this creates a double deduction that would in principle be subject to a counteraction in the United Kingdom. However, under the proposed changes, the sub-advisory fee should be treated as "inclusion/non-deduction" income — it is included as income by the UK sub-manager, but there is no deduction for the payment for the US manager. Accordingly, the double deduction can be matched with the inclusion/non-deduction income and so there should be no counteraction.

3. The rules governing deduction/non-inclusion mismatches will be amended so that a deduction/non- inclusion mismatch will not be treated as arising where the investor in the hybrid entity is in a category of tax-exempt "qualifying institutional investors" (broadly pension funds,

Copyright © 2024 Schulte Roth & Zabel LLP

life assurance schemes, charities and sovereign wealth funds). The broad aim of the changes is to ensure that there is no counteraction for a deduction/non-inclusion mismatch where a payment would not have been included as taxable income — because of the tax-exempt status of the investor — even if the direct recipient of the payment had not been a hybrid entity.

Once these retrospective changes have been introduced by Finance Act 2021, funds and managers should examine the structure of their management group to determine whether any changes are appropriate. Because of the retrospective nature of some of the changes, it may also be possible in some cases to revisit existing structures and to recover any tax leakage suffered as a consequence of the application of the (now amended) anti-hybrid rules.

This article appeared in the April 2021 edition of SRZ's Private Funds Tax Update for UK Managers. To read the full Update, click here.

This communication is issued by Schulte Roth & Zabel LLP and Schulte Roth & Zabel International LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising. ©2021 Schulte Roth & Zabel LLP and Schulte Roth & Zabel International LLP.

All rights reserved. SCHULTE ROTH & ZABEL is the registered trademark of Schulte Roth & Zabel LLP.

Related People

Nick Fagge

Partner

London

Practices

TAX

INVESTMENT MANAGEMENT

Attachments

Read Article

Read Full Update

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising