BDO Seidman, LLP
Accountants and Consultants

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International Tax Alert

Issue: Tax Arbitrage: Hybrid Entities

Further to our March 23 Tax Alert, the post-Election Finance Bill was issued on May 26 including legislation relating to Tax Arbitrage. At the same time, HMRC has issued draft Guidance Notes, Examples and FAQs.

- The new rules apply to cross-border planning structures that include Hybrid Entities. While the legislation also seeks to counteract schemes involving Hybrid Instruments, it is Hybrid Entities that are primarily utilised in cross-border tax planning and that are the subject of this note.

- The legislation will only apply to counteract U.K. tax advantages if **all** of the following four factors apply:

  A. The structuring scheme involves a Hybrid Entity (or Hybrid Instrument).

  B. The result of the structuring scheme is that a double deduction is obtained for an expense; or a single deduction is obtained but is not matched by a taxable receipt.

  C. At least one of the main purposes of the structuring scheme is to obtain a U.K. tax advantage.

  D. The U.K. tax advantage arising from the scheme is more than a minimum amount (HMRC states that this would normally be £50,000 or more).

- The legislation will apply to U.K. companies or branches. It will not operate on a self-assessment basis, but rather by HMRC issuing a notice. There are technical provisions to enable a company to make disclaimers of deductions.

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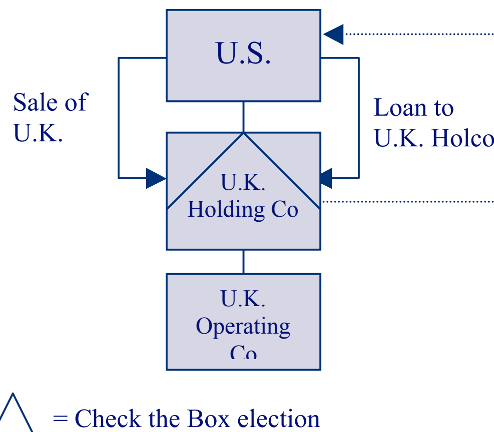
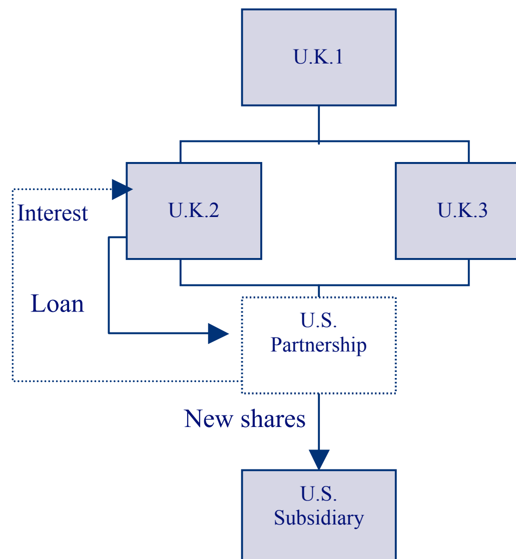
- The legislation differs very little from that in the pre-Election Finance Bill. However there is one subtle amendment which catches tax structuring schemes involving partnerships and LLCs. It was thought that the pre-Election legislation did not apply to these entities.

- Two of the main targets of the new rules included in HMRC's Examples are two classic double dip structures that have been used many times to structure U.K./U.S. outbound investment, and U.S./U.K. inbound investment. In simple terms, these structures are broadly as follows, although there are many variations:.

Inward: Drop-down of U.K. Opco



Outward: Financing U.S. Subsidiary



- The most important new feature in the revised draft Guidance Notes is HMRC's comments on Condition C above. The Guidance Notes and Examples are quite helpful in establishing how the Revenue will view whether the structure has been set up to achieve a U.K. tax advantage that would be caught by the new rules; rather than to achieve a purely foreign tax advantage that would not be caught by the new rules.

- For example, the dropping down of a subsidiary currently owned by a U.S. parent into a U.K. check-the-box subsidiary of the U.S. parent, resulting in interest paid to the U.S. parent (see 'Inward' above) would likely be caught by the new rules.

- On the other hand, having the same U.K. subsidiary borrow from its U.S. parent to acquire a new company from an unconnected party, is considered to be outside the new rules. This is provided the UK company can demonstrate it would have borrowed the same amount from a third party lender on the same conditions.

- The revised draft Guidance Note also makes it clear that HMRC's International Business Tax Group will operate a clearance procedure on a 28-day turnaround basis. It is understood that this procedure will be available in relation to existing structures, as well as applying to proposed transactions.

- The new rules will clearly apply to a number of structures where one of the main objectives is to reduce U.K. corporation tax. However it is our view that there are a considerable number of cross-border planning techniques that remain unaffected by the new legislation.

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