# INTM551220: Hybrids: Financial instruments (Chapter 3): Example: Interest payment – payee is under-taxed

This example looks at situations where a company issues a loan to a related company and it is treated as debt in one country and equity in the other. The company paying interest gets a deduction and the dividend receipt is taxed on the company making the loan but at a lower rate than applies to interest receipts.

The example considers whether the under-taxed interest payment is within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Counteraction in the UK is likely to be limited to the primary response (disallowing part of the deduction). Where the UK is the payee jurisdiction, the UK’s distribution exemption rules are expected to apply so that no mismatch arises (see [INTM551170](https://www.gov.uk/hmrc-internal-manuals/international-manual/intm551170)).

Co. 2 is a company resident in Country Y
Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
Co. 1 lends money to Co. 2 on arm’s length terms (the ‘Loan’), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements. 
Under the laws of Country Y the Loan is treated as a debt instrument, and the payments of interest under the Loan are deductible in calculating Co. 2’s taxable profit for a taxable period.
Under the law of Country X the Loan is treated as an equity instrument (i.e. as shares), and so the payments of interest under the Loan are treated as dividends. 
Country X taxes dividends from wholly owned subsidiaries at a lower rate than it taxes interest. 
If the instrument had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts at the normal rate applicable to interest income. 


## Background

* Co. 2 is a company resident in Country Y
* Co. 1 is a company resident in Country X, and owns all the shares in Co. 2
* Co. 1 lends money to Co. 2 on arm’s length terms (the ‘Loan’), but the terms of the Loan are such that it is subordinated to the ordinary creditors of Co. 2 and can be suspended in the event Co. 2 fails to meet certain solvency requirements.
* Under the laws of Country Y the Loan is treated as a debt instrument, and the payments of interest under the Loan are deductible in calculating Co. 2’s taxable profit for a taxable period.
* Under the law of Country X the Loan is treated as an equity instrument (i.e. as shares), and so the payments of interest under the Loan are treated as dividends.
* Country X taxes dividends from wholly owned subsidiaries at a lower rate than it taxes interest.
* If the instrument had been treated as a debt instrument in Country X then ordinarily Co. 1 would be taxable on those receipts at the normal rate applicable to interest income.
* The payee is not a relevant investment fund as defined in s259NA.
* The loan is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

## Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest payments satisfy the relevant conditions and thus fall within the scope of the hybrid and other mismatches from financial instruments rules?

### Condition A: Are the payments of interest made under, or in connection with, a financial instrument?

There are payments of interest made in satisfaction of the obligations arising under the Loan. The Loan is defined as a financial instrument for the purposes of UK GAAP, and therefore falls within the definitions provided in s259N.

Condition A is satisfied.

### Condition B: Is either Co. 1 or Co. 2 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

### Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will permit Co. 2 a deduction (relevant deduction) for the payment of interest against its ordinary income. It is also reasonable to suppose that Co. 1 will treat the receipt as dividend income of Co. 1, chargeable to tax at the lower rate for dividends.

This reduced rate is less than the highest rate applicable to income arising from a financial instrument (the full marginal rate).

This creates a Case 2 mismatch, as defined in s259CB(7), as

* there is an amount of ordinary income that arises, by reason of the payment, to the payee for a permitted taxable period, and
* the income is under taxed by reason of the terms or other features of the financial instrument – being a combination of the terms of the loan and the recognition of the relationship between Co. 1 and Co. 2 in Country X

Note: If Country X is the UK or, like the UK, has adopted distribution exemption rules, you will need to consider how those rules treat the distribution received by Co. 1.

If the UK is in the position of Country X, the rules at s931B(c) and s931D(c) CTA 2009 apply. Those provisions deny the distributions exemption for Co. 1 where the dividends have been allowed as a deduction for a company outside the UK - see [INTM650000](https://www.gov.uk/hmrc-internal-manuals/international-manual/intm650000) for more details.

This changes the amount of ordinary income arising to Co. 1, and the calculation of whether any mismatch arises. Where the provisions at s931B(c) and s931D(c) CTA09 (or a non-UK equivalent provision) apply and result in the entire dividend receipt being treated as taxable income of Co. 1, the receipt will also be ordinary income of Co. 1.

The result is that if the UK is Country X, then the application of the distributions exemption rules will result in ordinary income matching the deduction allowed in Country Y. Condition C will not be satisfied.

### Condition D: Are the two companies related or is the Loan, or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

### Conclusion

All the conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, and the relevant counteractions need to be considered.

## Extent of the mismatch

As there is a Case 2 mismatch, the amount of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ is calculated by means of the formula in s259CB(8)-

*(UTA multiplied by (FMR minus R)) divided by FMR*

Where:

* UTA is the under-taxed amount. This is the amount of dividend charged at a reduced rate in Country X
* FMR is the payee’s full marginal rate (expressed as a %) for the permitted taxable period in which the under-taxed amount is included in taxable profit. This is the highest rate which would have been charged on income from a financial instrument in Country X
* R is the rate (expressed as a %) at which the relevant tax is charged on the ordinary income in which the under taxed amount is included. This is the lower rate being applied to the dividend income.

## Counteraction

The counteraction applied will depend upon whether the UK is in the position of Country X or Country Y (or both).

### Counteraction where the UK is in the position of Country Y (the payer jurisdiction)

#### Primary response

Where the UK is in the position of Country Y (the payer jurisdiction), s259CD will apply. Co. 2’s allowable deduction in relation to the payments of interest must be reduced to the extent that the deduction is a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’.

The ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ is calculated using the formula above. This amount is the amount disallowed in Co. 2 by s259CD.

### Counteraction where the UK is in the position of Country X (the payee jurisdiction)

Note: The following will only apply where, exceptionally, the dividend receipt by Co.1 is not treated as ordinary income (as detailed under Condition C above).

#### Secondary Response

Where the UK is Country X (the payee jurisdiction) and the mismatch has been fully counteracted by s259CD or an equivalent provision, no further action will be taken by the UK.

if the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted, the UK will generally apply the rules at s931B(c) and s931D(c) CTA 2009. Those provisions deny the distributions exemption for Co. 1 where the dividends have been allowed as a deduction for a company outside the UK - see [INTM650000](https://www.gov.uk/hmrc-internal-manuals/international-manual/intm650000) for more details.

If for whatever reason s931B(c) or s931D(c) do not apply, s259CE TIOPA 2010 applies. The UK will counteract the remaining ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ by treating that amount as taxable income of the payee arising in the counteraction period. The ‘hybrid or otherwise impermissible deduction/non-inclusion mismatch’ is calculated using the formula shown above.

Note: If, exceptionally, the UK is in the position of both Country X and Country Y (i.e. the transaction is not cross-border but wholly domestic, and UK law results in a mismatch) counteraction is applied to the payer. S259CD takes priority over s259CE by virtue of s259CE(1)(b)(i).

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