# INTM551350: Hybrids: Financial instruments (Chapter 3): Example: Payment for cancellation of a financial instrument

This example looks at situations where a company pays a premium to cancel a loan from a related company in exchange for payment. The payment is deductible and the premium is taxed as a capital gain.

The example considers whether capital gain is ordinary income within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Co. 1 is resident in Country X.
Co. 1 owns 100% of the equity of Co. 2, which is resident in Country Y.
Co. 2 has borrowed money from Co. 1 (the ‘Loan’), but now acquires that Loan at a premium, effectively cancelling the Loan.
Under the law of Country Y, Co. 2 treats the premium as deductible expenditure.
The receipt of the premium received by Co. 1 in Country X is treated as a gain on the disposal of the Loan.


## Background

* Co. 1 is resident in Country X.
* Co. 1 owns 100% of the equity of Co. 2, which is resident in Country Y.
* Co. 2 has borrowed money from Co. 1 (the ‘Loan’), but now acquires that Loan at a premium, effectively cancelling the Loan.
* Under the law of Country Y, Co. 2 treats the premium as deductible expenditure.
* The receipt of the premium received by Co. 1 in Country X is treated as a gain on the disposal of the Loan.
* 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

Does the payment satisfy the relevant conditions to fall within the scope of the hybrid or other mismatches arising from financial instruments rules?

### Condition A: Is the payment of the premium made under, or in connection with, a financial instrument?

There is a payment representing the acquisition cost of a financial instrument that has the effect of cancelling Co.2‘s indebtedness under that instrument. The payment is considered to be made in connection with a financial instrument as it discharges Co. 2’s obligations under the Loan. The Loan falls within the definition of a financial instrument for the purposes of UK GAAP, and so is a financial instrument within the meaning of s259N.

The transfer of the financial instrument is not a hybrid transfer arrangement within the meaning given by s259DB and so is dealt with under the financial instrument provisions (s259N(3)(a)).

Condition A is satisfied.

### Condition B: Is Co. 2 or Co. 1 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.

Note: The loan relationship legislation (at s307 CTA 2009) would usually apply where the UK is in the position of Country X to ensure that the amounts are brought into account. Where the Loan satisfies the definition of a financial instrument for the purposes of UK GAAP but does not fall within the definition of a loan relationship or related transaction within CTA09/Part 5, then there may be a mismatch as reflected here.

### 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) equal to the payment of the premium. If Country X treats the receipt as a gain on the disposal of the loan, there will be a mismatch if either none of the receipt will be taxed as ordinary income or it will be taxed at lower rate (i.e. under-taxed).

If Country X subjects the receipt to tax on capital then it will not be treated as included in ordinary income of the payee. However, credit for the tax suffered may be given when determining whether the income is under-taxed.

In either of these circumstances, Condition C is satisfied.

The quantum of the hybrid or otherwise impermissible deduction/non-inclusion mismatch is determined under the provisions of s259CB(2)(b) where Case 1 applies (that is, where the relevant deduction exceeds the sum of the amounts of ordinary income arising to each payee, and all or part of that excess arises by reason of the terms, or any other feature, of the financial instrument). Case 2 applies where there is an amount of ordinary income which arises by reason of the payment or quasi-payment and is under-taxed by reason of the terms, or any other feature, of the financial instrument, and the amount of the Case 2 hybrid or otherwise impermissible deduction/non-inclusion mismatch is determined under s259CB(11).

### Condition D: Are the two companies related or is there a structured arrangement?

As Co. 1 owns 100% of the equity in Co. 2, the companies are related within the definition at s259NC.

Condition D is satisfied.

### Conclusion

As Conditions A to D are satisfied, there is a ‘hybrid or otherwise impermissible deduction/non-inclusion mismatch’.

## Counteraction

The appropriate response to counteract this mismatch will depend upon whether the UK is in the position of Country X or Country Y.

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

#### Primary response

If the UK is Country Y, s259CD will apply and the UK will deny the deduction for the premium paid by Co. 2 to the relevant extent necessary to address the mismatch.

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

#### Secondary response

If the UK is Country X, the counteraction will depend on whether or not the deduction has been fully counteracted under a provision equivalent to s259CD in Country Y. If so, no further action will be taken by the UK.

If however, under the law of Country Y, the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted, then s259CE will apply and the UK will counteract the remaining mismatch by including that amount as income arising for the counteraction period.

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