SLAUGHTER AND MAY

Tax and the City Briefing for April

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Revised draft guidance on hybrids and other mismatches

HMRC published the (eagerly awaited?) updated draft guidance on hybrids and other mismatches on 31 March.

The changes are relatively modest, which many could see as disappointing given the extensive consultation exercise (which encompassed both written representations and meetings with interested bodies). Amongst the substantive changes is the addition of new guidance on the meaning of "reasonable to suppose" – the emphasis here (unsurprisingly) is that this will depend on the facts and circumstances, but that it is in the first instance for the taxpayer to determine what it is reasonable to suppose. HMRC has put down a marker that this looks for a "rational, justifiable and credible view of the likely outcome" - and this may involve obtaining information from other entities in the same control group or from other parties in a structured arrangement.

HMRC notes that ordinary income is defined (at section 259BC) as income that is brought into account when calculating taxable profits on which relevant tax is charged. In this context, HMRC confirms that withholding taxes applied to income are not relevant taxes, as they are applied to gross income and so are not brought into account when calculating taxable profits. This is consistent with the OECD's report.

However, maintaining HMRC's desired position that income which is subject to tax at 0% (or at a very low rate) is not ordinary income continues to challenge any attempt at a coherent interpretation of the legislation. The draft guidance states (at INTM 550520) that US federal taxes on income correspond to UK taxes on income, being imposed at national level, and so are regarded as foreign tax within Part 6A, whereas US state taxes are not foreign tax – they do not correspond to UK taxes on income because they are not imposed at national level and there is another tax in the US that is. This is an interesting statement in the light of section 259B(3) which provides that tax is not outside the scope of the definition of foreign tax "by reason only that it… is chargeable under the law of a province, state or other part of a country".

HMRC's summary of substantive changes to the guidance indicates that some specific areas are still being reviewed, namely certain examples on the application of the rules to interest free loans, dual inclusion income, the position where there is a hybrid payee, hybrid entity double deduction mismatches, and multinational double deduction mismatches. In addition, HMRC is considering additional scenarios relevant to the imported mismatches rules.

Now the updated draft hybrids guidance has been published, HMRC can focus on other areas such as drafting the remaining guidance on the corporate interest restriction.

Improvements to the corporate interest restriction

According to the OTS' papers on complexity published/reissued in March, the length of legislation and the number of definitions do not necessarily equate to complexity. But they certainly can be off-putting to anyone trying to understand the detail of the corporate interest restriction. The draft guidance published on 31 March described as an "initial tranche of guidance, focusing on the core rules and other aspects where guidance has been specifically requested" runs to 282 pages. And this is not all of it! Further draft

guidance will be issued by 31 May 2017. The volume of the guidance required to explain the legislation further illustrates its complexity.

It is good news then that some improvements have been made as a result of consultation so simplification has at least been achieved in some areas of this minefield. When calculating the "qualifying net group-interest expense" of the group for the purposes of the group ratio method, downward adjustments have to be made for liabilities owed to a "related party", results-dependant securities and equity notes. In the Tax and the City Briefing for March, we drew attention to the Spring Budget announcement that certain debt guarantees would not result in interest being treated as related party interest for the purposes of the group ratio test in certain circumstances. It is now clear from schedule 10 to the Finance Bill 2017 published on 20 March that:

- a third party loan with a parent company guarantee will not be treated as related simply because it is guaranteed by another member of the group; and

- guarantees from other related parties will still be an issue, but not if the guarantee is granted before 31 March 2017 or is a performance, rather than a financial, guarantee (a performance guarantee is a non-financial guarantee provided in respect of obligations to provide goods or services).

A couple of points about the downwards adjustments for equity-like debt are clarified:

- securities containing a reverse ratchet are not "results dependent securities" (TIOPA 2010, s 415(5)); and

- regulatory capital securities (within the meaning of the Taxation of Regulatory Capital Securities Regulations 2013) are not "results-dependent securities" or "equity notes" (TIOPA 2010, s415(8)).

Banking companies may welcome the clarifications on how banking companies dealing in financial instruments (defined as loan relationships, derivative contracts, shares and other securities) should determine the amount of their "tax interest" (new s450). In essence, debits and credits should be treated as "tax interest" if they arise directly from dealing in financial instruments (but not if they arise in respect of an impairment loss or the reversal of an impairment loss). Similarly, such credits and debits should be treated as "relevant expense matters" or "relevant income matters" in the calculation of the interest allowance.

Substantial shareholding exemption (SSE)

The Finance Bill provisions relating to the changes to the SSE differ from the December draft legislation in some favourable respects. For the purpose of satisfying the substantial shareholding requirement, the period that a UK company is treated as having held the shares is extended so as to include the period when they were held by a non-resident group company. This is good news as it will save taxpayers having to argue with HMRC (with varying degrees of success) about the scope of TCGA 1992, Sch 7AC, paragraph 9, which deems the taxpayer company concerned to hold any shares held by other members of the group. HMRC has tended to argue that this did not apply where the other member of the group held the shares before the UK taxpayer, but only where, for example, the UK taxpayer owned 5% but other members of the group took the group holding over 10%.

Some changes have been made to the qualifying institutional investor exemption, including:

- enabling a qualifying institutional investor to trace ownership of the investing company through a UK REIT established by qualifying institutional investors;

- setting out when the two subsidiary exemptions in TCGA 1992, paragraph 3 (Subsidiary exemption: disposal of shares or

related asset where main exemption conditions previously met) and paragraph 3A (Subsidiary exemption: qualifying institutional investors) apply in a case where 25% of the ordinary share capital of the investing company is owned by qualifying institutional investors. In this situation the requirement for a substantial shareholding to be at least 10% of ordinary share capital of the company invested in is relaxed if the shareholding was acquired for at least £20m. The December version referred only to the exemption in paragraph 3A, not 3, and stipulated the acquisition cost should be at least £50m.

GAAR guidance

Revised GAAR guidance has been published with effect from 31 March 2017. The changes mainly reflect new legislation introduced in Finance Act 2015 and Finance Act 2016 (including bringing DPT and apprenticeship levy within the rules and explaining HMRC's new powers to make provisional counteractions, pool cases and request one generic ruling from the Panel binding on all pooled cases and impose specific GAAR penalties). The reference to B share schemes is omitted from paragraph D2.3.2 (such schemes were previously given as an example of an acceptable established practice but schemes offering shareholders a choice were stopped by Finance Act 2015).

Double Tax Treaty Passport Scheme (DTTPS)

The DTTPS avoids some of the administrative complexities for overseas lenders to UK borrowers seeking to rely on tax treaties for reduced withholding tax rates/exemptions. The DTTPS was originally restricted to UK corporate borrowers and to overseas corporate lenders but, for loans entered into on or after 6 April 2017, the parties no longer need to be corporates. Revised terms and conditions and guidance (revised guidance) published on 6 April provide that the DTTPS is, where the relevant conditions are satisfied, now available to UK borrowers which are partnerships, individuals and charities and to a broader range of lenders (transparent entities (including partnerships), sovereign wealth funds and pension funds, but in each case only if all the constituent beneficial owners of the income are entitled to the same treaty benefits under the same treaty). It is particularly disappointing that mixed-jurisdiction partnerships are unable to use the scheme. According to the consultation response document, consideration had been given to allowing mixed-jurisdiction partnerships but the organisational and compliance constraints were considered to outweigh the benefits of allowing additional lenders access to the scheme.

In addition to extending the scope of the scheme, another couple of changes are worthy of a mention:

- The previous guidance continues to apply to loans with a commencement date prior to 6 April 2017 but where an existing loan is transferred by the existing lender to a new lender it is treated as a new loan so the new DTTPS can apply to it (DTTP30170). Similarly, a new loan relationship to which the new DTTPS may apply will be created where a UK guarantor is called upon and assumes liability for payments (DTTP30180).
- The previous guidance (helpfully contained as DTTP31000 Appendix A of the revised guidance) suggested a turnaround time of 30 working days within which a direction would be given but the revised guidance does not commit to any particular time period, which is probably reflective of the current backlog experienced by HMRC in dealing with applications.

Consultation on non-resident companies chargeable to income tax and non-resident CGT

As promised, the consultation document on extending corporation tax to non-resident companies who are chargeable to income tax and/or non-resident CGT was published on 20 March and the consultation runs until 9 June. It confirms that the focus is on UK source property income. The idea of extending the corporation tax

charge to residual UK source trading income (i.e., that which arises other than through a permanent establishment - or an avoided permanent establishment caught by the Diverted Profits Tax) is expressly rejected. It is proposed that the non-resident CGT charge might be brought within the scope of corporation tax - but not chargeable gains generally, indicating that this is really about ensuring that the new interest restriction (and, to a lesser extent, the new carry-forward losses rules) apply across the board rather than an attempt at broader reform of the taxation of non-resident land owners.

What to look out for:

- VAT and holding companies updated guidance by the end of April 2017
- Taxation of partnerships: The response document published on 20 March confirms that the government intends to introduce legislation in the second Finance Bill 2017 to implement the proposed changes to the taxation of partnerships for accounting periods starting on or after 5 April 2018. Draft legislation and guidance will be published for consultation at a later date

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