My client is a private equity fund that has debt funded a UK company (UKCo) through a Luxembourg holding company (LuxCo). LuxCo is funded using preferred equity certificates (PECs), interest will accrue under the PECs until the investment is disposed of. The fund is a Luxembourg SCSp, the limited partners are a mixture of US taxable and tax exempt and UK taxable investors. I am concerned that the UK anti-hybrid rules may apply to this structure but I’m not sure where to start.

You are right to be concerned. A number of warning flags arise under this structure:

- PECs may constitute a hybrid financial instrument because, although classed as debt instruments for Luxembourg tax purposes, can be structured to obtain equity treatment in the US. The hallmarks that you need to look for in the PEC instrument are (we assume for the purposes of this advice that the hallmarks are present):
  - Interest is paid only when declared by board (interest may accrue and roll over);
  - There are limited creditor rights on default, typically just ability for the lender to elect a new board; and
  - Interest is paid only if it won’t lead to the borrower’s insolvency; and
- There is an overarching arrangement that links a UK taxpayer to the PECs.

Where to start

Part 6A of the Taxation (International and Other Provisions) Act 2010 (the ‘rules’) identifies eight standalone impermissible mismatches, together with the potential to import all eight of these offences into the UK where there is an overarching arrangement in place that somehow links a UK corporation tax payer to any of the eight mismatch behaviour. A methodical approach is therefore essential.

Your first step is to separate out the potentially problematic transactions:

1. Interest paid by UKCo in respect of the loan from LuxCo; and
2. LuxCo’s interest accrual in respect of the PECs.
We recommend drawing out your structure and labelling each problematic transaction to keep yourself focused:

Once the transactions are identified we suggest that you analyse each as follows:

1. What type of mismatch activity exists (bearing in mind that more than one mismatch activity may attach to each transaction);
2. If there is more than one activity, in what order should you consider them (the chapters should be considered as follows: 4, 3, 5 to 11 sequentially);
3. Is there the requisite UK connection;
4. Does the transaction’s mismatch activity give rise to a prohibited tax result; and
5. Do the parties satisfy the relationship test or are the arrangements ‘structured’; and
6. At any point during points 3 to 5, if the anti-hybrid rules are not triggered, do you need to consider any other activities triggered by the relevant transaction.

If you conclude that the anti-hybrid rules apply, you will need to consider the applicable counteraction.

Interest paid by UKCo

Mismatch activity: Payment under a financial instrument (chapter 3 of the rules).

Priority: Chapter 3.

UK connection: Payer within the charge to UK corporation tax.

Tax result: The interest will form part of LuxCo’s ordinary income, therefore, it is not reasonable to suppose that a hybrid or otherwise impermissible deduction/no inclusion mismatch arises.

Counteraction: None required.

Interest accrual in respect of the PECs

Mismatch activity(ies): LuxCo will receive a deduction in respect of the accrual, therefore, even though there is no payment, there is a quasi-payment under a financial instrument (chapter 3 of the rules), there is also a payment (interest paid by UKCo to LuxCo) made as part of an overarching arrangement (chapter 11 of the rules).

Priority: Chapter 3.

UK connection: None.

Priority: Chapter 11.
**UK connection**: Payer under an overarching arrangement is within the charge to UK corporation tax.

**Tax result**: A payment is made by UKCo that is part of a series of arrangements pursuant to an overarching arrangement (the investment by the fund in UKCo). Looking to whether the PECs give rise to a hybrid or otherwise impermissible deduction/no-inclusion mismatch in respect of the PECS; for each investor you need to determine whether LuxCo’s deduction exceeds ordinary income by reason of the terms or feature of the PECs. The UK investors are unlikely to trigger these rules because the interest should form part of their ordinary income. The US taxable investors may have a mismatch because LuxCo will receive an interest deduction on an accruals basis but US taxable investors will not have a corresponding inclusion in their ordinary income until interest is declared. The hybrid rules expressly exclude short term deferral (12 months) from their remit and also make provision for HMRC to grant approval for longer deferral periods, where just and reasonable (s 259CC(2) of the rules). You will need to find out more from your client to establish whether an extended deferral period is just and reasonable and then make a claim with HMRC.

The US tax-exempt investors are trickier. The BVCA has asked HMRC to confirm that, for the purposes of calculating ordinary income, amounts allocated to a tax exempt investor should be deemed to be ordinary income on the basis that is not being brought into account by virtue of an exemption that applies to a particular type of receipt (s 259BC(3) of the rules). Absent confirmation, the rules state that ‘it does not matter whether the excess ... arises for another reason as well as the terms, or any other feature of the financial instrument’. To determine if the mismatch would arise by reason of the terms of the PECs we need to analyse what would happen if the tax exempt investors were fully taxable (s 295CB(4)(5) of the rules). As above, a fully taxable US investor would achieve a mismatch, therefore, counterintuitively, the US tax-exempt investors’ sharing percentage of the PECs also gives rise to a no-inclusion result. We note that, if an extended deferral period is granted by HMRC, this should also cover the US tax exempt investors.

**Relationship**: UKCo is in the same control group as LuxCo.

**Counteraction**: Absent receiving consent from HMRC to extend the permitted tax period for calculating the deduction/ordinary income mismatch (ideally to match the period that the PECs are likely to run), UKCo will have the part of its interest deduction excluded corresponding to the proportion of the interest receivable under the PECs that has resulted in the mismatch outcome (the US investors’ collective sharing percentage). Your client is required to take a just and reasonable approach to determining this proportion. This is obviously very difficult in some fund situations, especially where there are fund of fund investors. You should speak to your client and work out a justifiable methodology.

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