

EXPLANATORY MEMORANDUM TO

THE HYBRID AND OTHER MISMATCHES (FINANCIAL INSTRUMENTS: EXCLUDED INSTRUMENTS) (AMENDMENT) REGULATIONS 2022

2022 No. 1144

1. Introduction

- 1.1 This explanatory memorandum has been prepared by His Majesty's Revenue and Customs (HMRC) on behalf of His Majesty's Treasury and is laid before the House of Commons by Command of His Majesty.

2. Purpose of the instrument

- 2.1 These regulations will retain an exemption in the hybrid and other mismatches rules in section 259N(3)(b) of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010) and the Hybrid and Other Mismatches (Financial Instruments: Excluded Instruments) Regulations 2019 (SI 2019/1345) for certain regulatory capital instruments issued by banks.
- 2.2 This exemption will otherwise fall away after 31 December 2022 due to a 'sunset clause' in SI 2019/1345. These regulations will remove the sunset clause using existing negative procedure regulation-making powers so that the exemption continues to apply after 31 December 2022.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

- 3.1 None.

4. Extent and Territorial Application

- 4.1 The extent of this instrument (that is, the jurisdiction which the instrument forms part of the law of) is the United Kingdom.
- 4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is the United Kingdom.

5. European Convention on Human Rights

- 5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation no statement is required.

6. Legislative Context

- 6.1 Upon introduction in 2016, the United Kingdom's (UK's) hybrid and other mismatches rules provided an exemption for financial instruments that were regulatory capital securities for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).
- 6.2 Following the repeal of SI 2013/3209, Finance Act 2019 introduced a power (section 259N(3)(b) TIOPA 2010) to amend the hybrid and other mismatches rules by secondary legislation. This regulation-making power was used when the Hybrid and

Other Mismatches (Financial Instrument: Exclusions) Regulations 2019 (SI 2019/1251) were laid in September 2019 with effect from 1 January 2019.

- 6.3 It was necessary to repeal and replace these regulations with effect from 1 January 2020 in order to give effect to amendments to the European Union's Anti-Tax Avoidance Directive (ATAD). These amendments required the scope of the hybrid and other mismatches exemption to be limited to certain regulatory capital issued by the banking sector only, and for its duration to be limited. These requirements applied from 1 January 2020, and European Union (EU) Member States (including the UK at that point) were not able to apply any exemption after 31 December 2022.
- 6.4 The current ATAD-based exemption is contained in SI 2019/1345 and has effect from 1 January 2020 until 31 December 2022.
- 6.5 This amending instrument is made using the powers contained within section 259N of TIOPA 2010 to remove the time limitation, so that the exemption continues to apply from 1 January 2023.

7. Policy background

What is being done and why?

- 7.1 The hybrid and other mismatches rules in Part 6A of TIOPA 2010 are an anti-avoidance regime that seeks to counteract mismatches in tax treatment of instruments and structures across jurisdictions. Banks issue regulatory capital instruments in exchange for funding that is recognised by regulators as part of their capital. As a result of regulatory requirements some regulatory capital instruments contain 'hybrid' features, meaning that they have some equity-like as well as debt-like characteristics. This may mean there is a mismatch in tax treatment across jurisdictions.
- 7.2 The UK's general approach is that interest paid on regulatory capital instruments should be allowable as a deductible expense for tax purposes, on the basis that the hybrid features are regulatory requirements which provide stability for the financial sector and for the entire UK economy.
- 7.3 The exemption from the hybrid and other mismatches legislation supports this policy by allowing a deduction for interest paid on these instruments. It was not intended that this treatment should be displaced by the hybrid and other mismatches rules. This position is supported by the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting (BEPS) Project recommendations, which give countries freedom in their policy choices as to whether their hybrid and other mismatches rules should be applied to tax mismatches that arise on intra-group hybrid regulatory capital.
- 7.4 There is currently an exemption from the hybrid and other mismatches rules for certain regulatory capital instruments. However, this will fall away on 31 December 2022 due to a sunset clause in the current regulations required by an EU directive. If the sunset clause is not removed the resulting change in tax treatment from 1 January 2023 would affect some regulatory capital instruments issued by some banks. The UK is no longer obliged to comply with the EU Directive requiring the sunset clause now that it has left the EU.
- 7.5 These amending regulations will therefore remove the sunset clause ensuring the existing exemption continues to apply after 31 December 2022.

8. European Union Withdrawal and Future Relationship

8.1 This instrument is not being made under a specific EU exit power and does not require any statement under the European Union (Withdrawal) Act 2018.

9. Consolidation

9.1 There are no plans to consolidate the legislation.

10. Consultation outcome

10.1 Draft regulations were published for a six-week consultation from 19 May 2022 to 30 June 2022. A small number of responses were received welcoming the draft regulations. No changes were made to the draft regulations.

11. Guidance

11.1 HMRC's International Manual explains this exemption at INTM551060 (<https://www.gov.uk/hmrc-internal-manuals/international-manual/intm551060>).

11.2 The guidance will be updated when the instrument comes into force.

12. Impact

12.1 The impact on business, charities or voluntary bodies is limited to a small number of banks. These regulations simply ensure that the existing exemption for these hybrid regulatory capital instruments continues to apply after 31 December 2022. Businesses impacted by this change will incur insignificant one-off costs of familiarisation with the amendment. There are not expected to be any continuing costs to those businesses from the amendment.

12.2 There is no, or no significant, impact on the public sector.

12.3 A Tax Information and Impact Note covering this instrument will be published on the website at www.gov.uk/government/collections/tax-information-and-impact-notes-tiins.

13. Regulating small business

13.1 The legislation does not apply to activities that are undertaken by small businesses.

14. Monitoring & review

14.1 HMRC will monitor the impact of the regulations through information collected on tax returns and through communications with affected taxpayer groups.

14.2 The regulations do not include a statutory review clause. They amend UK tax legislation and therefore fall within the exceptions at section 28(3)(a) of the Small Business, Enterprise and Employment Act 2015.

15. Contact

15.1 Samuel Louks or Andrew Martel at HMRC, email: financialservicesbai@hmrc.gov.uk can be contacted with any queries regarding the instrument.

15.2 Richard Thomas, Deputy Director for Financial Products and Services, at His Majesty's Revenue and Customs can confirm that this Explanatory Memorandum meets the required standard.

15.3 Andrew Griffith MP, Economic Secretary to the Treasury can confirm that this Explanatory Memorandum meets the required standard.