

Hybrid mismatches – new element of corporate tax base (2) 3/10/22



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This article completes what [we wrote last week](#).

The hybrid mismatch rules govern transactions between related EU companies and apply also where a third country is involved and at least one of the parties to the transaction is a corporate tax payer (or an EU-established hybrid entity in the case of a reverse hybrid) in transactions –

- between the taxpayer and a related company
- between related companies
- between the head office and a permanent establishment (PE)
- between two or more PEs of the same head office
- with the taxpayer's participation in a structured arrangement

Eliminating the consequences

The rules provide for primary and secondary adjustments. A secondary adjustment applies where the other country involved in a transaction, which is not an EU member state and has not adopted measures for neutralising hybrid mismatches, does not make a primary adjustment.

When it comes to eliminating a double deduction, the rules state that if both countries involved in the transaction are member states, the payee will have to include in its tax base an appropriate amount that has been deducted under the law of the payer's country. Assuming all the companies mentioned in the example from our previous article are established in the EU, company "C" receiving the rental fee will make an adjustment. If the other party is located in a third country, the hybrid mismatch will have to be eliminated by the EU company regardless of the payer's or payee's status.

To neutralise a deduction without inclusion, the payer will have to increase his tax base if the parties to the transaction are EU companies. If the payer is established in a third country, the EU payee has to ensure the payment is duly added to his taxable income. In the example from our previous article, taxable income should be adjusted by Latvian company "A" having made payments to an unrecognised PE and by EU company "C" having paid interest to a company that did not include that in its tax base.

There are special rules governing a chain of transactions in which an EU company does not technically create a hybrid mismatch if the chain implies that a hybrid mismatch arises in a third country, i.e. a payment received and included in the third-country tax base is offset against another payment within the chain that creates a double deduction. The EU taxpayer must eliminate this by adding to his tax base the deduction that has been used in the third country to offset the hybrid mismatch.

The taxpayer is also liable to add to his tax base the income of his unrecognised PE, with a separate set of rules governing hybrid entities, such as partnerships and trusts.

Paying Latvian tax

The result of a hybrid mismatch is one of the elements of a deemed profit distribution the company must report on its tax return for the last tax period of the financial year.

However, when it comes to examining each situation (including our example) for a hybrid mismatch, we need to analyse the statutory requirements of the two countries involved in the transaction because hybrid mismatches tend to arise from differences in national law.