Corporate tax amendments to neutralise hybrid mismatches (2/35/19)

We have written earlier about proposals for amending the Corporate Income Tax (CIT) Act. This article explores amendments dealing with hybrid mismatches and ways of neutralising them in CIT treatment.

What is a hybrid mismatch?

One of the OECD BEPS[1] actions was preventing the consequences of hybrid mismatches, which was resolved by Council Directives (EU) 2016/1164 and 2017/952, whose rules Latvia is to pass into its national law before 1 January 2020. The hybrid mismatch rules are to be adopted by adding to section 4 of the CIT Act and inserting section 7.1.

Hybrid instruments are arrangements that allow a company to deduct costs in two countries or to tax income in neither country by taking advantage of differences in their CIT treatment. For example, a hybrid mismatch arises if the payor's country treats loan interest as a payment for capital (and it is deductible for CIT purposes), while the payee's country treats it as a dividend that is not taxable. In this case the payment is taxed in neither country.

So a hybrid mismatch means –

- deducting a payment for CIT purposes in the payor's country and excluding the same payment from taxable income in the payee's country ("deduction without inclusion") or
- deducting one and the same payment for CIT purposes in both the payor's country and the payee's country ("double deduction").

Applying the rules

The hybrid mismatch rules apply to a transaction between related EU companies and to a transaction that involves a non-EU country with at least one of the parties paying CIT (in the case of reverse hybrids, a hybrid unit set up in a member state[2]), i.e. the following 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 company;
- the taxpayer's involvement in a structured arrangement.

For the purpose of applying these rules, section 7.1(5)(13) of the CIT Act is to include a definition of related companies.

Neutralising the consequences of a hybrid mismatch

The amendments put the taxpayer under an obligation to neutralise the consequences of a hybrid mismatch by increasing the tax base. It is proposed to have a secondary adjustment as well as a primary one (a secondary adjustment will be made when the other party to the transaction, who is not an EU member state and has not adopted measures for neutralising hybrid mismatches, fails to make a primary adjustment).

To neutralise a double deduction, the proposals provide that if both countries involved in the transaction are EU member states, the payee will have to increase the tax base by an appropriate amount deducted under the law of the payor's country. If the other party is in a non-EU country, the EU company will have to resolve the hybrid mismatch regardless of the payor's/payee's status.

To neutralise a deduction without inclusion, the onus of increasing the tax base will lie with the payor if the parties are EU-registered companies. If the payor is established in a non-EU country, the EU payee will have to ensure the payment is properly included in taxable income.

Special rules will govern a chain of transactions where the EU company technically does not create a hybrid mismatch, but assessing that chain leads to the conclusion that a hybrid mismatch arises in the non-EU country, i.e. the payment received and included in the tax base is offset by another payment for that transaction in the non-EU country, which creates a double deduction. The EU taxpayer should eliminate this by adding to the tax base the deduction taken in the non-EU country for offsetting the hybrid mismatch.

The amendments also place the taxpayer under an obligation to increase the tax base by the income of an unrecognised foreign PE, with separate rules for transparent (hybrid) units.

Paying tax

A hybrid mismatch will result in a deemed profit distribution to be included in the tax return for the last tax period of the financial year.

---

[1] A set of measures coordinated by the OECD against base erosion and profit shifting (BEPS)

[2] A situation when one country treats the unit as a taxpayer that can make a deduction for a payment made to a member, but the member's country treats the unit as transparent for tax purposes so that the member neither recognises nor includes the payment received from the unit in the tax base.