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Hybrid mismatches – new element of corporate tax base 2/9/22

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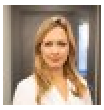

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The Corporate Income Tax (CIT) Act has been recently amended to bring in a new element of the tax base arising from hybrid mismatches. This article explains what hybrid mismatches are and how we identify them.

We can already see that this is a challenge for companies and the State Revenue Service (SRS) alike. Yet the SRS is expected to dedicate increasingly more resources for understanding and identifying possible types of hybrid mismatches because the CIT base has shrunk considerably since the new regime was adopted. So we recommend that companies reassess their existing transactions with related foreign companies and pay special attention to contracts supporting any complex arrangements and to the rules governing how those transactions should be reported in each party's tax returns. To find a hybrid mismatch, the transaction must be transparent and information available on the tax treatment in the other jurisdiction. The CIT Act requires Latvian companies to make sure that the transaction does not result in a hybrid mismatch, or on finding one, adjust the CIT return accordingly and pay additional CIT.

What is a hybrid mismatch?

This is basically a payment being deducted for CIT purposes in the payer's country and not being included in taxable income in the payee's country (deduction without inclusion) or a payment being deducted for CIT purposes in both the payer's and the payee's country (double deduction).

A hybrid mismatch may arise from differences in tax treatment under the laws of two or more countries allowing a company to avoid paying income tax or to benefit from a double tax treaty. How do we figure out if a hybrid mismatch has occurred? Who is liable to neutralise its consequences? Let us look at a practical example.

An example

A Latvian-registered company A provides IT services based on cutting-edge artificial intelligence solutions. A's assets are mostly machinery and technology. Shares in A are held by X, a company incorporated in country X. X has a permanent establishment (PE) in country B. Staff having competences and qualifications appropriate for providing A's services actually work in country B using remote work opportunities, for which A makes payments to the PE and recognises those as its expenses. X recognises the presence of a PE in country B, yet its national law contains no PE provisions, so the PE does not include the payments received in its tax base, and X does not allocate this revenue to its taxable income in country X.	Risk area: deduction without inclusion
Company A owns 100% shares in company D, which is incorporated in country D and owns company C incorporated in country C. In 2020, D made a loan to C under a loan agreement stipulating interest charged as a portion of profits (the so-called profit participating loan). In 2021, C paid interest based on the profit reported in its annual accounts for 2020. C treats the payments as interest and deducts them from taxable income in its books, while D treats the payments as dividends and claims a participation exemption under the law of country D, without including them in taxable income.	Risk area: deduction without inclusion
C has used the loan to buy all the machinery and technology needed for A's operations. So company A has received the machinery and technology it needs under a lease from C. The machinery and technology are depreciated in both the lessor's and the lessee's jurisdiction under their national law.	Risk area: double deduction

These circumstances lead to a number of hybrid mismatches that have to be resolved by neutralising any discrepancies in the tax treatment, i.e. adding the relevant amount to the tax base or refusing a deduction for the payer or the payee depending on the type of hybrid mismatch identified.

Types of hybrid mismatches

There are three types of hybrid mismatches:

- Deduction without inclusion denotes a payment that is deductible under the rules of the payer's jurisdiction and not included in the payee's ordinary income. This mismatch usually arises if some or all of the payment is considered deductible for tax purposes in one jurisdiction and not included as taxable income on the other country's tax returns.
- A double deduction denotes a payment creating deductions in two jurisdictions.
- Deductions or non-inclusion payments arise from a hybrid entity being involved in the arrangement.

(to be continued)