

Hybrid mismatches (ATAD2)

Under §§ 54⁶–54⁹ of the Income Tax Act, these situations are taxed, which are caused by **hybrid mismatches**, i.e. **differences**

- ✓ in qualification of financial instruments, payments and entities in different jurisdictions (hereinafter also referred to as 'countries'); or
- ✓ in the attribution of payments between the head office or permanent establishment or between two or more permanent establishments of the same entity.

Hybrid mismatches can result in:

- ✓ the same payment, expense or loss (hereinafter also referred to as 'expense') being deducted in more than one country, i.e. 'double deduction', or
- ✓ the same payment or deemed payment (hereinafter also referred to as 'payment') being deducted in one country without being included as income in another country, i.e. 'double non-taxation'.

Depending on the situation:

- ✓ **an expense or payment** that has been deducted in another country is **taxed**, or
- ✓ **an income tax exemption is not applied to income** that is exempt from income tax in another country.

For example, the Estonian Tax and Customs Board has issued a binding preliminary tax ruling in 2025 on the **tax qualification of hybrid financial instruments (in Estonian)**.

The tax authority agreed in its ruling that the tax qualification of a hybrid financial instrument and the treatment of a payout to the holder of the hybrid instrument may differ in different countries. For example, in one country, a hybrid financial instrument is considered a debt obligation of the issuer, while in another it is considered equity and is taxed accordingly.

This is because there are no specific characteristics, the existence of which, even at the same time, would provide a definite and precise answer as to whether one or another hybrid financial instrument should be qualified as a liability or as equity. In other words, the 'hybrid' nature of a financial instrument must take into account the fact that both capital and liability characteristics may be present simultaneously and inevitably (so-called equity-like debt and debt-like equity).

In the specific binding preliminary tax ruling, the tax authority took the view that, where a hybrid financial instrument qualifies under tax law:

- ✓ as a debt liability of the issuer, the payment made to the holder of a hybrid financial instrument must be regarded as interest income subject to income tax at the level of a resident natural person on the basis of subsection 1 of § 17 of the Income Tax Act. The issuer (a company resident in Estonia) withholds income tax on interest paid to a natural person (clause 4 of § 41 of the Income Tax Act).
- ✓ as the equity of the issuer, the payment made to the holder of the hybrid instrument must be treated as dividends or other income from a holding subject to income tax at the level of the issuer (resident company) on the basis of subsection 2 of § 18 and subsection 1 of § 50 of the Income Tax Act. There is no taxation at the level of resident natural person.

The basis of taxation therefore depends on the economic substance of the individual transactions.

Declaration and payment of income tax

Income tax on the amount giving rise to the tax mismatch (§ 54⁷ of the Income Tax Act) is to be declared in Annex 6 to the tax declaration TSD with the code "6000". The TSD declaration is submitted and the tax liability is paid by the 10th day of the month following the tax period.

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