Erasmus School of Economics

Master Thesis Economics and Taxation

Mismatch bycatch: economic double taxation in the ATAD hybrid mismatch rules

Abstract
To address the double non-taxation that may result from hybrid mismatches, the EU Anti-Tax Avoidance Directive led to the implementation of hybrid mismatch rules in the Dutch Corporate Income Tax Act 1969. The objective of the hybrid mismatch rules is to neutralize the tax benefits that arise from differences in the tax characterization of entities and instruments. Under specific circumstances however, the hybrid mismatch rules go beyond neutralization of the hybrid mismatch and lead to economic double taxation. This research mathematically analyzes the economic incentive effects for investment and production of such economic double taxation, which suggests that the hybrid mismatch rules disincentivize economic activity. The result is a tax revenue trade-off between a reduction in hybrid mismatches and a reduction in economic activity. Through tax-legal analysis, it is concluded that it may be possible to interpret the hybrid mismatch rules in a manner that would allow the relief of economic double taxation. Therefore, this research provides recommendations for unilateral relief of economic double taxation. To effectively achieve the objective of neutralizing hybrid mismatches to prevent double non-taxation, it should be ascertained that such relief can only be invoked in case of de facto economic double taxation.

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Date final version	2 July 2022

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Chapter 1 Introduction

1.1 Introduction

1.1.1 Base erosion and profit shifting

Taxpayers can exploit inconsistencies and mismatches in tax legislation to gain tax advantages through international base erosion and profit shifting (hereinafter: BEPS). Since the 2008 financial crisis, attention for such tax avoidance and evasion has strongly increased.[1] According to the Organization for Economic Cooperation and Development (hereinafter: OECD), many taxpayers engage in legal tax avoidance schemes. Through such tax planning, multinational enterprises may achieve economic advantages over businesses that operate domestically, which works to undermine the fairness and integrity of tax systems and competition.[2] Therefore, the OECD emphasizes the urgency of restoring trust in tax systems, levelling the playing field for business, and providing governments with efficient instruments to ensure the effectiveness of tax legislation.[3]

To address BEPS, the OECD launched the Base Erosion and Profit Shifting project in 2013. The BEPS Action Plan consists of fifteen Action Points that serve to internationally coordinate the fight against harmful tax practices and tax avoidance.[4] Generally, countries are not required to implement the measures in the OECD BEPS Action Plan in domestic law. However, within the EU, Member States are obliged to implement specific BEPS measures in their national tax legislation as a result of the EU Anti-Tax Avoidance Directive (hereinafter: ATAD) that was adopted in 2016.[5] The ATAD forms a minimum harmonization of certain BEPS measures, including a general interest limitation rule, a provision for exit taxation, a general anti-abuse rule, controlled foreign company rules, and hybrid mismatch rules.

1.1.2 Hybrid mismatches

The OECD BEPS Action 2 Final Report specifically focuses on hybrid mismatch arrangements.[6] Through the ATAD, the EU has adopted harmonized hybrid mismatch rules based on OECD BEPS Action 2.[7] These hybrid mismatch rules were implemented in section 2.2a of the Dutch Corporate Income Tax Act 1969 (hereinafter: DCITA 1969).[8]

According to the OECD, hybrid mismatches have an overall negative impact on competition, efficiency, transparency, and fairness.[9] A hybrid mismatch occurs when there is an international disparity in the tax characterization of the same entity, arrangement, or instrument. These hybrid mismatches can result in base erosion if taxpayers exploit differences in the tax treatment of an entity or instrument to achieve double non-taxation including long-term deferral of tax payments.[10]

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[1] There is a difference between tax avoidance (legal) and tax evasion (illegal). Through the BEPS Project, also (legal) tax avoidance should be addressed. See OECD, *Background Brief – Inclusive Framework on BEPS*, Paris: OECD Publishing 2017, p. 7.

[2] OECD, *Addressing Base Erosion and Profit Shifting*, Paris: OECD Publishing 2013, p. 50.

[3] OECD, *Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project*, Paris: OECD Publishing 2015 (hereinafter: OECD BEPS Project Explanatory Statement), par. 3.

[4] OECD BEPS Project Explanatory Statement, par. 1.

[5] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (*OJ* 2016, L 193/1) (hereinafter: ATAD1).

[6] OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, Paris: OECD Publishing 2015 (hereinafter: OECD BEPS Action 2 Final Report).

[7] Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (*OJ* 2017, L 144/1) (hereinafter: ATAD2).

[8] Wet op de vennootschapsbelasting 1969, Stb. 1969, 445, BWBR0002672.

[9] OECD BEPS Action 2 Final Report, Executive summary, p. 11.

[10] *Ibid*. Long-term deferral is out of scope of this research, see *infra*, section 1.5.

Instead of harmonizing the qualification of hybrid entities and financial instruments, the BEPS Action 2 hybrid mismatch rules are aimed at neutralizing the tax benefits that arise from hybrid mismatches. Through neutralizing the outcomes of hybrid mismatches, the rules should effectively deny multiple deductions for a single payment and deny deductions without corresponding income taxation.

1.1.3 Elimination of double taxation

International tax law distinguishes between juridical and economic double taxation. Juridical double taxation occurs when different countries levy a similar tax, with respect to the same object, from the same taxpayer, within the same period.[11] Economic double taxation occurs when different taxpayers are taxed consecutively on the same taxable object, or when the same taxpayer is taxed on formally distinct but materially equivalent taxable objects.[12]

In the context of the BEPS measures, the OECD focuses not only on the elimination of double non-taxation, but also on the elimination of double taxation.[13] Because of the risk that unilateral anti-abuse measures lead to uncertainty and double taxation, the BEPS Actions constitute a coordinated international standard for the taxation of cross-border activities.[14] Despite the emphasis on the importance of coordinated BEPS measures, the OECD does not provide sufficient guidance with respect to the fact that the BEPS measures themselves may also introduce double taxation. To that extent, the BEPS project does not directly address the double taxation problem of uncoordinated unilateral anti-abuse measures.

At the EU level, the ATAD also emphasizes that in principle, if anti-abuse rules result in double taxation, relief should be provided.[15] However, in a Communication on anti-tax avoidance measures, the European Commission (hereinafter: EC) also indicated that double taxation should be tolerated for the greater good, i.e., combating BEPS.[16] The EC acknowledges that the hybrid mismatch rules may impose double taxation, but that this is not an objective of the ATAD and that Member States may provide relief at the national level.[17] In response however, the Permanent Committee of Finance in Dutch parliament has indicated that the legislator does not see any possibility to avoid economic double taxation resulting from the hybrid mismatch rules.[18] This has resulted in a situation where in specific situations, the ATAD hybrid mismatch rules can cause or aggravate economic double taxation, without providing effective relief.

1.1.4 The undesirability of economic double taxation

According to the OECD, double taxation has negative effects on multinational enterprises' contributions to international trade and investment, innovation, employment, economic growth, and poverty reduction, because double taxation could deter economic investments.[19] The neutralization approach in the hybrid mismatch rules is aimed at effectively eliminating BEPS through hybrid

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[11] Juridical double taxation particularly arises when different international tax principles, such as the residence, source and nationality principle, concur when countries exercise their taxing rights. See O.C.R. Marres, F.P.J. Snel and M.F. de Wilde (red.), '2. Internationale juridische dubbele heffing', in: *NDFR Delen Internationaal*, Amstelveen: SDU 2009.

[12] O.C.R. Marres, F.P.J. Snel & M.F. de Wilde (red.), '3. Internationale economische dubbele heffing', in: *NDFR Delen Internationaal*, Amstelveen: SDU 2009.

[13] OECD BEPS Project Explanatory Statement, par. 3.

[14] OECD, *Action Plan on Base Erosion and Profit Shifting*, Paris: OECD Publishing 2013, p. 10-11.

[15] ATAD1, preamble, par. 5.

[16] European Commission, Communication from the Commission to the European Parliament and the Council, Anti-Tax Avoidance Package: Next Steps Towards Delivering Effective Taxation and Greater Tax Transparency in the EU, COM(2016) 23 final (28 January 2016), par. 6.

[17] *Kamerstukken I* 2020/21, 35931, nr. B, p. 4.

[18] *Ibid.*

[19] OECD BEPS Project Explanatory Statement, par. 3.

mismatches without adversely impacting cross-border trade and investment.[20] However, there are instances where the hybrid mismatch rules may result in economic double taxation, which can be an impediment to economic efficiency.

Base erosion through hybrid mismatches can distort economic efficiency.[21] However, economic double taxation can also negatively impact economic efficiency and tax revenues, because the returns to investment and production are decreased as a result of the increased tax burden.[22] Based on these investment and production effects, when introducing anti-abuse measures, the legislator may consider the trade-off between the increased tax revenue from decreased tax abuse and the loss of tax revenue from decreased investment and production.[23]

1.2 Objective of this research

The objective of this research is to analyze the consequences of the economic double taxation that may result from the ATAD hybrid mismatch rules in the DCITA 1969. In my view, the prevention of tax abuse is a legitimate justification for the introduction of far-reaching anti-abuse measures including potential negative consequences for taxpayers and economic efficiency. However, the justification of economic double taxation in the hybrid mismatch rules should be carefully motivated and should be effective in achieving the goal of neutralizing hybrid mismatches.

Through tax-legal and economic analysis, this research evaluates whether economic double taxation resulting from the ATAD hybrid mismatch rules can and should be prevented. The hybrid mismatch rules in the DCITA 1969 are analyzed to determine under which circumstances they might result in or aggravate economic double taxation. Subsequently, economic analysis is used to examine the economic incentives that arise from the hybrid mismatch rules and to discuss the theoretical implications for economic efficiency and tax revenues. Furthermore, it should be examined how, under circumstances, the hybrid mismatch rules can be interpreted in a way that would allow the effective relief of economic double taxation.

1.3 Social and scientific relevance

The emergence of anti-tax abuse measures makes this research socially relevant, as the intensifying public debate on fighting tax avoidance is increasing the political commitment to internationally coordinate the prevention of tax abuse.[24] The public debate mostly focuses on the positive effects of anti-avoidance measures, including the increase in the amount of tax revenue resulting from a decrease in BEPS. In contrast, less attention is paid to the negative consequences of anti-avoidance measures, such as the loss of economic efficiency and the resulting potential loss of tax revenues because of double taxation.[25] Therefore, for taxpayers and their stakeholders, it is important to

[20] OECD BEPS Action 2 Final Report, Executive summary, p. 11.
[21] A distortion of economic efficiency implies that there is too much or too little production compared to the amount of production that would lead to an optimal allocation of production factors in the economy.
[22] Juridical double taxation also negatively affects economic efficiency, but the focus of this research is on economic double taxation.
[23] If capital and other production factors are complementary in production, there are both investment and production distortions.
[24] Tax avoidance receives regular attention, for example on the tax avoidance-focused webpage of the NOS https://nos.nl/zoeken?q=belastingontwijking. See also Brief van de Staatssecretaris van Financiën van 14 juni 2021, 32140, nr. 87, p. 2, which shares support for international agreements on the international tax system.
[25] Economic double taxation does not necessarily decrease social welfare, because higher tax revenue can increase social welfare. Whether economic double taxation can be justified depends on general equilibrium analysis, which is out of scope of this research.

examine whether the economic double taxation resulting from hybrid mismatch rules can be justified from a tax-legal perspective.

The scientific relevance of this research comes from the fact that there is no prior research that focuses on an economic-mathematical analysis of the consequences of economic double taxation from the ATAD hybrid mismatch rules in the DCITA 1969. Through analyzing the economic consequences of economic double taxation, this research connects tax-legal and economic arguments in assessing the effectiveness of the hybrid mismatch rules. The legislator may wish to trade off the positive consequences of preventing tax abuse (increased tax revenue) against a loss of economic efficiency (decreased tax revenue). By providing insight in these trade-offs and through providing recommendations for unilateral measures that could relieve economic double taxation resulting from the ATAD hybrid mismatch rules, this research additionally has policy relevance.

The scope of economic double taxation in the hybrid mismatch rules is relatively limited. In principle, the nature of the linking rules in the hybrid mismatches serves to prevent economic double taxation through the origin requirement, the ranking rule, and the pro rata rule.[26] The objective of this research could therefore be regarded as a marginal improvement to the hybrid mismatch rules. Nevertheless, this research contributes to the broader objective of improving the synthesis between tax-legal and economic analysis, which is important because of the negative efficiency effects of economic double taxation for economic efficiency.

1.4 Research design

The hybrid mismatch rules in OECD BEPS Action 2 and the ATAD can result in economic double taxation. This research focuses on the desirability of the economic double taxation caused by the hybrid mismatch rules. The ATAD does not include general rules for the prevention or relief of double taxation.[27] Furthermore, because the Dutch legislator has not introduced adequate unilateral double taxation relief measures to relieve economic double taxation in all instances, taxpayers may not receive effective relief from economic double taxation that may result from the hybrid mismatch rules. The research question therefore reads:

Should economic double taxation from the ATAD hybrid mismatch rules in Dutch tax law be relieved from a tax-legal and economic perspective? If so, how can relief of economic double taxation be achieved?

The research question is answered through five sub-questions. The first two sub-questions are descriptive and outline the theoretical framework. The other three sub-questions are analytical and serve to answer the central research question.

Sub-question 1. What are the objectives and the mechanisms of the ATAD hybrid mismatch rules that were implemented in the DCITA 1969?
Chapter 2 examines the hybrid mismatch rules in the DCITA 1969. To answer the first sub-question, the legislative background to the ATAD1 and the ATAD2 is briefly addressed, followed by an introduction to the objective and mechanisms behind the ATAD hybrid mismatch rules and the Dutch implementation of the rules.

[26] *Infra*, section 4.2.
[27] In some situations, the ATAD hybrid mismatch rules provide for relief of economic double taxation.

Sub-question 2. What is economic double taxation in the context of the hybrid mismatch rules, and is it generally relieved?
Chapter 3 sets out the distinction between juridical and economic double taxation. This distinction is relevant for the corresponding relief method. The relief methods which are analyzed are EU Directives, bilateral double taxation conventions, and unilateral relief including domestic law provisions and the Double Taxation Avoidance Decree 2001.[28] In the context of juridical double taxation, international tax principles for allocating taxing rights which are relevant to bilateral double tax conventions are discussed. In the context of economic double taxation, EU Directives, Dutch unilateral provisions, and art. 9 of the OECD Model Tax Convention are analyzed.

Sub-question 3. How does the dual inclusion exception in the ATAD hybrid mismatch rules result in economic double taxation?
Chapter 4 schematically analyzes how the hybrid mismatch in section 2.2a DCITA 1969 may result in economic double taxation. The neutralization of hybrid mismatch rules is assessed in light of the hybrid mismatch rules' mechanical approach. Specifically, the dual inclusion exception is meant to avoid economic double taxation from the hybrid mismatch rules but may not be adequate to relieve economic double taxation under all circumstances.

Sub-question 4. What are the economic incentive effects of the ATAD hybrid mismatch rules?
Chapter 5 discusses the economic theory behind the hybrid mismatch rules and answers the fourth sub-question through mathematical-theoretical analysis. The economic incentives from the hybrid mismatch rules are modeled in a profit maximization model to identify the hybrid mismatch rules' tax incentives with respect to investment and production. In principle, the mathematical derivations provide insight into the economic consequences of economic double taxation in the hybrid mismatch rules. These economic incentive effects for production and investment could provide reasons why the hybrid mismatch rules should not result in economic double taxation. Additionally, the tax revenue effects from the mechanism in the hybrid mismatch rules are analyzed.

Sub-question 5. How can economic double taxation resulting from the ATAD hybrid mismatch rules be effectively relieved?
Using the analysis of economic double taxation that results from the dual inclusion exception, chapter 6 interprets whether the ATAD could allow relieving economic double taxation from the hybrid mismatch rules. The research concludes with a recommendation to achieve effective relief in case of economic double taxation resulting from the hybrid mismatch rules.

Based on the above sub-questions, chapter 7 answers the central research question. Additionally, suggestions for future research are presented.

1.5 Scope and limitations of this research

In principle, the nature of hybrid mismatches implies that they could also generate juridical double taxation.[29] However, for simplicity, this research is concerned with economic double taxation, as there are at least two entities involved in the hybrid mismatch, which would result in economic double taxation.[30]

[28] Besluit van 21 december 2000, houdende vaststelling van het Besluit voorkoming dubbele belasting 2001, BWBR0012095, Stb. 2000, 642 (hereinafter: Double Taxation Avoidance Decree 2001).
[29] E.g., in a relationship between a head office and its permanent establishments.
[30] An entity is not a legally defined term and could for example also refer to transparent entities or permanent establishments.

This research is limited to the taxation of income of legal entities in the DCITA 1969. The ATAD hybrid mismatch rules only apply in relationships between associated entities that are in principle in scope of the DCITA 1969 and groups of taxpayers that are acting together.[31] No attention is paid to the taxation of natural persons, because they do not fall within the scope of art. 1 ATAD and the DCITA 1969.[32] For convenience, taxpayers will be referred to as entities, even though art. 2 and 3 DCITA 1969 formulate circumstances under which different types of legal persons quality as taxpayers.[33]

In this research, it is assumed that bilateral double tax conventions primarily serve to prevent juridical double taxation, unless stated otherwise. The research does not analyze the application of double tax conventions in hybrid mismatch situations. Therefore, bilateral tax conventions are only analyzed with respect to the relief of economic double taxation resulting from the hybrid mismatch rules.

Reverse hybrid entities are out of scope of this research, since the mechanism to address such mismatches is different from the primary and secondary rule that are applied to other hybrid mismatches. Furthermore, the hybrid mismatch rules are additionally aimed at targeting long-term deferral. Before implementation of the hybrid mismatch rules, such deferral could be achieved through a Dutch CV/BV structure.[34] As this long-term deferral is targeted by the reverse hybrid mismatch rule, it is out of scope of this research. This implies that the analysis in this research cannot be applied to reverse hybrid entity mismatches.

Additionally, imported mismatches, dual residency mismatches, hybrid transfers and structured arrangements are out of scope, since an elaboration of this type of hybrid mismatch does not add to the discussion of economic double taxation resulting from the hybrid mismatch rules. For relief of economic double taxation in these situations, a similar approach to relieving economic double taxation as proposed in this research could be offered.

The discussion and mathematical modeling of the hybrid mismatch rules in in the DCITA 1969 focuses on the mechanisms of the deduction/no inclusion and double deduction rules in regular circumstances, based on the simplest situations where economic double taxation might occur. Stylized examples are used, involving entities situated in the Netherlands and in fictitious jurisdictions that do not apply hybrid mismatch rules. The hybrid mismatch rules are separately mathematically examined, i.e., not in conjunction with other anti-abuse provisions.[35] This poses an important limitation of this research, as this singular approach renders it impossible to assess the consequences of the concurrence of different anti-abuse rules for economic efficiency. This also precludes general equilibrium analysis, which is required to assess the tax revenue trade-offs that are discussed in this research. In principle, the mathematical analysis in this research is therefore too stylized to be generalized in a real-world context. Nevertheless, this research contributes to synthesizing tax-legal and economic analysis.

With respect to the types of hybrid mismatches that are discussed, it can be assumed that a similar analysis of economic double taxation in the dual inclusion exception can be carried out for all types of hybrid mismatches to which the dual inclusion exception applies. However, the general approach in this research implies that individual taxpayer situations are not discussed extensively. Indeed, there may be other situations in which economic double taxation results from a certain tax structure, which

[31] Art. 2(1)a, art. 2(6), and art. 3(1)a DCITA 1969.
[32] However, the association requirement does apply to natural persons, see art. 2(4) ATAD and art. 12ac(2) DCITA 1969. Therefore, hybrid mismatches involving associated natural persons do fall within the scope of the hybrid mismatch rules.
[33] It should be noted that *entity* does not have a legal definition, in line with the fact that hybrid mismatches can result in situations with different types of legal entities, including partnerships and arrangements.
[34] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 9.
[35] Except for deduction limitation rules, see *infra*, section 4.5.5.

cannot be addressed through the analysis. The research aims to address such threats to external validity by presenting a general approach to the relief of economic double taxation.[36] However, it is important to note that whether the proposed relief could be implemented depends on whether the ATAD can indeed be interpreted in a manner that would allow the prevention or relief of economic double taxation.

[36] *Infra*, section 6.7.3.

Chapter 2 The ATAD hybrid mismatch rules

2.1 Introduction

This chapter introduces the hybrid mismatch rules in the Dutch Corporate Income Tax Act 1969. The sub-question in this chapter is: **what are the objectives and the mechanisms of the ATAD hybrid mismatch rules that were implemented in the DCITA 1969?** First, the legislative background to ATAD1 and ATAD2 is briefly addressed (section 2.2). This is followed by an introduction to the mechanism behind the ATAD hybrid mismatch rules (section 2.3) and the Dutch implementation of the ATAD hybrid mismatch rules (section 2.4). The chapter is concluded with an answer to the above sub-question (section 2.5).

2.2 ATAD1 and ATAD2

2.2.1 Background: OECD BEPS Action 2

In October 2015, the OECD published its BEPS Action 2 Final Report on neutralizing the effects of hybrid mismatch arrangements. Hybrid mismatches occur when taxpayers exploit differences in the tax treatment of an entity or instrument under the national law of two or more jurisdictions to engage in tax base erosion in these jurisdictions. To prevent double non-taxation created by these hybrid mismatches, the OECD has developed model hybrid mismatch rules with the objective of neutralizing mismatches in its BEPS Action 2 Final Report.[37] Through the rules, the OECD addresses hybrid mismatches not by coordinating the tax treatment of entities and instruments, but instead through neutralizing the tax outcomes that result from such mismatches.

2.2.2 ATAD1

In December 2015, shortly after the publishing of the OECD BEPS Action 2 Final Report, the European Parliament addressed the EC by publishing a Recommendation to bring forward a legislative proposal on hybrid mismatches.[38] The Recommendation included two options. The first option was to harmonize the national definitions of debt, equity, transparency, the allocation of costs and profits between group entities, and the attribution of assets and liabilities to permanent establishments in all Member States. This option would ensure the complete harmonization between Member States of tax classification criteria so that within the EU, hybrid mismatches would be removed altogether, and double (non-)taxation would be effectively eliminated.[39] The second option suggested by the Parliament was to prevent double non-taxation in the event of a mismatch, in line with the neutralization approach in the OECD BEPS Action 2 Final Report.

The EC responded to the Recommendation of the Parliament by developing a proposal for an Anti-Tax Avoidance Directive to ensure a coordinated implementation of anti-abuse measures in the Member States' corporate tax systems.[40] As a result, the EU Council adopted the first Anti-Tax Avoidance Directive (hereinafter: ATAD1) in July 2016. The objective of the ATAD1 is to create a minimum level of protection for the Member States' national corporate tax systems against tax avoidance practices,

[37] OECD BEPS Action 2 Final Report, Executive summary, p. 11.
[38] European Parliament resolution of 16 December 2015 with recommendations to the Commission on bringing transparency, coordination and convergence to corporate tax policies in the Union (2015/2010(INL)), Recommendation C6.
[39] Interestingly, the proposal for ATAD1 indeed contained a rule based on the first option, that coordinated the qualification of hybrid entities and instruments. See Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM/2016/026 final, art. 10.
[40] The Recommendation also included recommendations for other anti-abuse measures.

to improve the resilience of the EU internal market against cross-border tax avoidance, and to ensure that taxes are paid where profits are generated.[41]

The ATAD1 also included hybrid mismatch rules that were based on the recommendations in the OECD BEPS Action 2 Final Report, i.e., the second option recommended by the European Parliament. To neutralize the effects from hybrid mismatches, art. 9 ATAD1 contained two linking rules.[42] The first linking rule was meant to neutralize double deductions by only granting a deduction in the Member State where the payment had its source.[43] The second linking rule was meant to neutralize deduction/no inclusion situations by requiring the Member State of the payer to deny the deduction of that payment.[44]

2.2.3 ATAD2

The hybrid mismatch rules in the ATAD1 were limited to application in intra-EU situations and to certain types of hybrid mismatches. Therefore, before the implementation deadline of the ATAD1 in national law, the directive was amended to additionally address hybrid mismatches between Member States and third countries and to broaden the scope with respect to the types of hybrid mismatches. This resulted in the adoption of the ATAD2 on 29 May 2017, with implementation deadline on 1 January 2020.

The aim of the ATAD2 is to provide rules that are consistent with and as effective as the recommendations in the OECD BEPS Action 2 Final Report.[45] The extension of the hybrid mismatch rules to third country situations and the introduction of primary and secondary rules brought the ATAD2 in line with the OECD's recommendations in BEPS Action 2. Accordingly, Member States should use the applicable explanations and examples in the OECD Report insofar these are consistent with the ATAD and with other EU law.[46] Because the ATAD2 replaced the hybrid mismatch rules in the ATAD1, in the remainder of this research, the consolidated directive will be referred to as the ATAD.[47]

2.3 Introduction ATAD hybrid mismatch rules

2.3.1 Scope of the ATAD hybrid mismatch rules

The ATAD states that hybrid mismatches result from the interaction between differences in the tax characterization of financial instruments, payments, or entities across two jurisdictions.[48] Essentially, the ATAD aims to neutralize all mismatches in qualification, classification, or allocation of payments that could result in a deduction in two jurisdictions (double deduction) or a deduction in one jurisdiction without inclusion in the tax base of another jurisdiction (deduction/no inclusion).

The scope of the ATAD hybrid mismatch rules is limited by the *origin requirement*.[49] This requirement implies that the hybrid mismatch rules in principle apply if there is a hybrid element that results in a

[41] ATAD1, preamble, recital 3 and 16.
[42] Because the hybrid mismatch rules in the ATAD1 were replaced by the ATAD2, these rules are not discussed in detail.
[43] Art. 9(1) ATAD1.
[44] Art. 9(2) ATAD1.
[45] ATAD2, preamble, recital 7.
[46] *Ibid*, recital 28.
[47] The ATAD2 was consolidated with the ATAD1, see *OJ* 2016, L 193.
[48] ATAD2, recital 9 and art. 2(9) ATAD.
[49] The origin requirement is mentioned explicitly in the Dutch implementation of the hybrid mismatch rules, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 6. The origin requirement follows implicitly from ATAD2, preamble, recital 16 and 18-20. The state secretary of Finance has indicated that the origin requirement only applies to D/NI situations, not to DD situations. See Besluit van 1 oktober 2021, nr. 2021-20014, BWBR0045683

tax benefit, i.e., through differences in the qualification of entities, instruments, permanent establishments, or places of residence.[50] Importantly, the hybrid mismatch rules are not intended to address mismatches that originate from non-hybrid elements.[51] Examples of such non-hybrid elements that may result in double non-taxation are a general tax exemption, the lack of a corporate income tax, or differences in the application of the arm's length principle.[52]

Furthermore, according to the ATAD, only when parties are associated, there is a substantial risk of tax abuse through hybrid mismatches.[53] Therefore, the ATAD addresses hybrid mismatches only in relationships between associated companies, between a natural person and an associated company, between a head office and its permanent establishments, between two or more permanent establishments of the same company.[54] Hence, hybrid mismatches between non-associated entities are in principle not addressed by the ATAD hybrid mismatch rules.

2.3.2 Linking rules

The hybrid mismatch rules do not link the domestic tax treatment of hybrid situations to the foreign tax treatment in the sense that the tax characterization of the hybrid entity or instrument is aligned. Instead, in accordance with BEPS Action 2, the ATAD prescribes the neutralization of hybrid mismatches through balancing tax effects to arrive at a single deduction, deduction plus inclusion, or non-deduction plus non-inclusion of a payment.[55] To achieve this, the linking rules generally include a primary and secondary rule that describes which jurisdiction should take action to neutralize the hybrid mismatch, as briefly summarized in Table 2.3.2.

(*Besluit Hybridemismatches*), section 2. This does not change the qualitative results in this research, so this distinction is not further discussed.

[50] The origin requirement is also acknowledged in the OECD BEPS Action 2 Final Report, see e.g., Recommendation 1.3 for determining whether a mismatch under a financial instrument is a hybrid mismatch.

[51] Non-hybrid elements could be a general tax exemption or the lack of a corporate income tax. See ATAD2, preamble, recital 16 and 18-20.

[52] See also ATAD2, preamble, recital 22.

[53] *Ibid*, recital 12-14.

[54] *Ibid*, recital 12. The only exception to the association requirement is that hybrid mismatches that result from a structured arrangement between non-associated parties are also targeted by the hybrid mismatch rules, see art. 12ac(1)f DCITA 1969 and *Kamerstukken II* 2018/19, 35241, nr. 3, p. 65.

[55] ATAD2, preamble, recital 5 and 15.

Table 2.3.2

Hybrid mismatch	Primary and secondary rule
Double deduction	The tax benefit is neutralized through only allowing a single deduction of the payment. The primary rule therefore stipulates that the deduction will be allowed in the Member State that is the payer jurisdiction, whereas the Member State that is the investor jurisdiction should deny the deduction.[56] However, if this still results in a double deduction, the secondary rule stipulates that the payer jurisdiction should deny deduction of the payment.[57]
Deduction/no inclusion	The primary rule requires that the Member State denies the deduction of the payment from the payer's tax base. If the primary rule cannot be applied because the other jurisdiction has not implemented hybrid mismatch rules, the secondary rule applies, which stipulates that the payment should be included in the recipient's tax base.[58]

2.4 Dutch implementation of the ATAD hybrid mismatch rules

2.4.1 Section 2.2a of the Dutch Corporate Income Tax Act 1969

In the Netherlands, the ATAD hybrid mismatch rules were implemented in section 2.2a of the DCITA 1969.[59] From the parliamentary history on the implementation of the hybrid mismatch rules in the DCITA 1969, it follows that the legislator holds the opinion that the Dutch implementation of the hybrid mismatch rules is in line with the ATAD.[60] Accordingly, six types of hybrid mismatches are targeted: hybrid entities, hybrid financial instruments, hybrid permanent establishments, hybrid transfers, imported hybrid mismatches, and dual residency situations.[61] Furthermore, the only opting out rule provided in the ATAD which the Netherlands has implemented is to not apply the secondary rule with respect to payments made to disregarded permanent establishments.[62] In the following, the Dutch hybrid mismatch rules are discussed briefly to facilitate the discussion of the rules in later chapters.

2.4.2 Associated entities

The hybrid mismatch rules should only apply between associated entities.[63] Therefore, the scope of the hybrid mismatch rules is limited to relationships between associated enterprises, between natural persons and associated enterprises, between head offices and their permanent establishments, between two or more permanent establishments of the same head office, or between non-related parties in case of a structured arrangement.[64]

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[56] The payer and investor jurisdiction are defined in *infra*, section 2.4.3.
[57] Art. 9(1) ATAD2.
[58] Art. 9(2) ATAD2.
[59] Wet van 18 december 2019 tot wijziging van de Wet op de vennootschapsbelasting 1969, de Wet inkomstenbelasting 2001 en de Wet op de dividendbelasting 1965 in verband met de implementatie van Richtlijn (EU) 2017/952 van de Raad van 29 mei 2017 tot wijziging van Richtlijn (EU) 2016/1164 wat betreft hybridemismatches met derde landen (PbEU 2017, L 144/1) (Wet implementatie tweede EU-richtlijn antibelastingontwijking).
[60] *Kamerstukken I* 2019/20, 35241, nr. E, p. 6.
[61] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 8.
[62] See art. 9(4) ATAD.
[63] *Infra*, section 2.3.1.
[64] Art. 12aa(2) DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 51-52.

Entities are considered associated if there is a participation relationship of at least 25 percent in voting rights, capital ownership, or entitlement to profit distributions.[65] The ownership or voting rights of persons who are acting together should be aggregated for the purposes of applying this requirement. If participants are acting together, they will be deemed associated if they hold an aggregate participation of at least 25 percent.[66]

2.4.3 Definitions

Art. 12ac DCITA 1969 contains relevant definitions for the hybrid mismatch rules, shown in Table 2.4.3.[67] An overview of the application of the hybrid mismatch rules in section 2.2a of the DCITA 1969 is provided in Table A1 of the Structural Appendix.

Table 2.4.3

Definition	Explanation
Hybrid entity	Any entity or arrangement that is treated as a taxable entity by one jurisdiction, while it is simultaneously treated as a taxpayer in another jurisdiction. Hence, the entity must be characterized as non-transparent for tax purposes by one jurisdiction, and non-transparent for tax purposes by another jurisdiction.[68]
Reverse hybrid entity	Any entity that is treated as transparent by its jurisdiction of residence, establishment, or registration, and is treated as non-transparent by the jurisdiction of its participants.[69]
Disregarded permanent establishment	A permanent establishment[70] that is not recognized as such by the jurisdiction in which the head office jurisdiction deems it to be situated.[71]
Hybrid financial instrument	A financial instrument[72] that leads to hybrid mismatches through a difference in the classification of the instrument or in the classification of the remuneration that is paid with respect to that financial instrument insofar the recipient is not taxed within a reasonable timeframe.[73]
Deduction/no inclusion	A situation that would result in a fee, payment or deemed payment (hereinafter: payment) that is deducted from the tax base in one jurisdiction, whereas the recipient jurisdiction does not subject the same payment to tax by

[65] Art. 12ac(2)a DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 67.
[66] Art. 12ac(2)b-d DCITA 1969. The *acting together* criterion is assessed based on facts and circumstances. See *Kamerstukken II* 2018/19, 35241, nr. 3, p. 67-68. According to the ATAD, being associated means that one of the entities has effective control over the others, see ATAD2, preamble, recital 13-14. For a discussion, see J.C. van der Have and L.C. van Hulten, 'De samenwerkende groep in de context van hybride mismatches', *WFR* 2020/237.
[67] More detailed explanations are found in the parliamentary history.
[68] Art. 12ac(1)g DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 65-66.
[69] This is not defined in art. 12ac DCITA 1969, but in art. 2(9) DCITA 1969. See *Kamerstukken II* 2021/22, 35931, nr. 3, p. 2-3.
[70] In the remainder of this research, the terms permanent establishment and PE are used interchangeably.
[71] Art. 12ac(1)b DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 60.
[72] A financial instrument is any instrument that results in a financial (i.e., debt or equity) return. See art. 12ac(1)e DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 64.
[73] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 13.

	including it in the recipient's tax base.[74] The payment can be fictitious or actual and direct or indirect (hereinafter: D/NI).
Double deduction	A situation which would result in the deduction of the same fee, payment, costs, or loss from the tax base of several jurisdictions (hereinafter: DD).[75]
Dual inclusion income	An item of income that is de facto included in the tax base of both jurisdictions between which there is a D/NI or DD situation, which can be in a later year.[76]
Recipient jurisdiction	The recipient of a payment is the entity that receives a payment or is deemed to receive a payment according to the laws of its residence jurisdiction or according to the laws of any other jurisdiction.[77]
Investor jurisdiction	The investor jurisdiction is the jurisdiction where a participant of a hybrid entity is resident for tax purposes.[78]
Payer jurisdiction	The payer jurisdiction is the jurisdiction where a payment has its source, where costs arise, or where losses are incurred.[79]

2.4.4 The definition of a deduction

The definition of the term deduction is essential for the hybrid mismatch rules. From a Dutch perspective, it is assumed that a payment is deducted if the payment is by nature deductible from a profit tax base in another jurisdiction.[80] This includes economic equivalents of tax-deductibility.[81] Whether the payment is de facto deducted is irrelevant.[82]

Furthermore, the legislator has stated that if a deduction limitation applies while in principle, the nature of that payment allows deducting the payment from the payer's tax base, this can still result in the qualification as a double deduction for purposes of the hybrid mismatch rules. [83] This is despite the fact that the deduction limitation would imply that there is no de facto deduction of the payment from the tax base, so that there is no de facto tax benefit in the form of a DD or D/NI situation.

[74] Art. 12ac(1)a DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 58. The definition of when a payment is deemed to be included in a tax base is provided in *infra*, section 4.4.2.
[75] Art. 12ac(1)c DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 60-62.
[76] Art. 12ac(1)d DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 62-64.
[77] Art. 12ac(1)a DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 58.
[78] This definition is not clarified in the DCITA 1969 or the ATAD but can be deduced from the parliamentary history. See *Kamerstukken II* 2018/19, 35241, nr. 3, p. 12.
[79] Art. 12ac(1)c DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 61.
[80] Art. 12ac(1)e DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 55.
[81] An economic equivalent would be a credit for paid dividends (i.e., a notional interest deduction). Art. 12ac(1)e DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 58.
[82] For example, if there is a double deduction with respect to interest where one of the jurisdictions applies a general interest deduction limitation, that interest payment remains deductible by nature in that jurisdiction, so that a double deduction hybrid mismatch is presumed as the origin requirement in *infra*, section 2.3.1 is satisfied. See *Kamerstukken I* 2017/18, 34306, nr. B, p. 6.
[83] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 55. The legislator does not motivate this statement, but from a normative standpoint on tax abuse, it may be warranted to additionally impose hybrid mismatch rules, since the hybrid mismatch rules has an additional prohibitive effect. The legislator has supported such prohibitive effects with respect to the CFC rule (*Kamerstukken II* 2018/19, 35030, nr. 7, p. 15), and the conditional withholding tax on interest and royalties (*Kamerstukken II* 2019/20, 35305, nr. 3, p. 2).

2.4.5 Deduction/no inclusion

Art. 12aa DCITA 1969 contains the primary rule for D/NI situations and applies to both factual and deemed payments.[84] The primary rule is applied to hybrid mismatches resulting from hybrid financial instruments, hybrid entities, allocation mismatches and deemed payments with permanent establishments, and disregarded permanent establishments. To neutralize the hybrid mismatch, the primary rule stipulates that the payment is non-deductible for the payer insofar the payment remains untaxed. If the payment is taxed in a future year, the payment will be deductible in that year.[85]

The primary rule results in effective taxation in the payer jurisdiction.[86] This is interesting, as the OECD BEPS Action 2 Final Report states that it is often difficult to unequivocally determine which individual jurisdiction experiences a loss in the tax base through a hybrid mismatch.[87] The OECD does not specifically mention why the primary rule is designed as a deduction limitation in the jurisdiction where the payment has its source, instead of an income inclusion approach with the requirement to include the income in the tax base of the deemed recipient.[88]

The payer jurisdiction is likely the jurisdiction where production takes place. From an economic perspective, it is more efficient to allow a deduction from the tax base of all production costs.[89] However, this is different when these costs are artificial, i.e., if the costs are related to intra-group transactions that do not result in an actual receipt of goods or services related to an economic outflow of capital from the group.[90] This might be an argument for a deduction limitation as a primary rule.

Another argument for a deduction limitation instead of an income inclusion has a practical nature. It can be argued that de facto, the hybrid mismatch results from the fact that the jurisdiction that is deemed to receive the payment by the payer does not include the payment in its tax base. Indeed, it would not be necessary to have hybrid mismatch rules if the recipient jurisdiction would include the payment in its tax base. It can therefore be argued that the payer jurisdiction sees its tax base eroded through the payment, whereas the (deemed) recipient jurisdiction did not include the payment in its tax base, so that its tax base is unaffected by the hybrid mismatch.[91]

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[84] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 40. E.g., deemed payments may result from transfer pricing corrections.

[85] See art. 12af DCITA 1969, and *Kamerstukken II* 2018/19, 35241, nr. 3, p. 53. This is the dual inclusion exception that is discussed in *infra*, section 4.3 and 4.4.

[86] OECD BEPS Action 2 Final Report, p. 17.

[87] *Ibid*, p. 15.

[88] In the first discussion draft for the BEPS Action 2 Report, the OECD states: "The choice of primary and [secondary] rules is based on ensuring that the hybrid mismatch rules are effective and relatively easy to apply, rather than looking to compensate the jurisdiction that has lost tax revenue under the arrangement." See OECD, *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements* (Recommendations for Domestic Laws) 19 March 2014 – 2 May 2014 (hereinafter: BEPS Action 2 Public Discussion Draft), par. 52.

[89] This was also mentioned in the public consultation to the BEPS Action 2 Report, where Deloitte provided the following commentary: "[…] our view is that the primary rule should be to tax income and that the secondary rule should be to disallow deductions. Economically the appropriate answer is to permit a company a tax deduction for its finance costs […]. The country of the investor will be better placed to investigate hybridity and impose taxation." See OECD, *Comments received on Public Discussion drafts BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements*, 7 May 2014, p. 160.

[90] The double deduction does not by definition relate to artificial costs. The example in *infra*, section 5.3 relates to a productive entity that engages in economic activity by producing external services. In that case, the argument remains that the payment should primarily be included the investor jurisdiction.

[91] This happens, e.g., because the jurisdiction that is deemed to be the recipient jurisdiction by the payer jurisdiction does not consider itself to be the recipient jurisdiction.

If the primary rule cannot be applied and the other jurisdiction does not apply hybrid mismatch rules, the ATAD prescribes a secondary rule for D/NI situations.[92] The secondary rule in art. 12ab DCITA 1969 states that the payment must be included in the tax base of the (deemed) recipient in the Netherlands.[93] The secondary rule only applies to hybrid financial instruments, hybrid entities, allocation mismatches with permanent establishments, and allocation mismatches and deemed payments with permanent establishments. Therefore, hybrid mismatches resulting from disregarded permanent establishments are left out of scope for the secondary rule.[94] Similar to the primary rule, for certain types of hybrid mismatches, the secondary rule does not apply insofar there is dual inclusion income.[95]

2.4.6 Double deduction

The primary rule for DD situations is different from D/NI situations. A DD situation is primarily addressed through the non-deductibility of the payment in the investor jurisdiction, so that the payment should effectively only be tax-deductible in the subsidiary's jurisdiction, i.e., the payer jurisdiction.[96] Similar to D/NI situations, under certain circumstances, if the payment is deducted against dual inclusion income, the primary rule does not apply.[97]

The primary rule for D/NI situation results in effective taxation in the payer jurisdiction, whereas in DD situations, the deduction is instead primarily allowed in the payer jurisdiction. However, it seems reasonable to address the hybrid mismatch by denying the additional deduction in the investor jurisdiction, as this is generally where the tax base is eroded through a double deduction.[98] The investor jurisdiction should primarily deny the deduction of the payment, since this is the jurisdiction where the hybrid mismatch originates from the transparency of the subsidiary entity or permanent establishment.[99] Moreover, from an economic point of view, the payer jurisdiction is likely the jurisdiction where production takes place, so it is economically efficient for the payment to be tax-deductible there.

A practical argument for applying the primary rule in the investor jurisdiction, is that the investor jurisdiction usually has more information on the deductibility of the payment at the level of the subsidiary than the other way around.[100] The approach of applying the primary rule in the investor jurisdiction also allows preventing economic double taxation, as the degree of ownership does not play a role in denying the deduction.[101] For example, if a hybrid entity is owned for 25% by an investor that characterizes the entity as non-transparent and the other 75% is held by an investor that characterizes the entity as transparent, it could be the case that the payment is only deducted twice for 75% of the

[92] This implies the secondary rule should not be applied with respect to EU countries. Member States are not obliged to implement the secondary rule with respect to all hybrid mismatches, see art. 9(4)a ATAD2. The opting out rule allows Member States to decide not to address hybrid mismatches arising outside of their jurisdiction and to avoid economic double taxation as well as issues with respect to double tax conventions.
[93] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 55-56.
[94] Art. 9(4)a ATAD2 jo. art. 2(9)d ATAD2 (opting out rule).
[95] Art. 12ab(3) DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 57. Further discussion of dual inclusion income and the scope of the dual inclusion exception is found in *infra*, section 4.3 and 4.4.
[96] Art. 12aa(1)g DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 51.
[97] *Infra*, section 4.3 and 4.4.
[98] For example, the double deduction can be achieved through tax transparency of the subsidiary entity. Then, the parent's tax base is eroded. This cannot occur the other way around since the parent's income of the parent is not attributed to the subsidiary.
[99] However, the subsidiary is the level where production takes place. See *infra*, section 2.4.5 on economic efficiency in production and deduction limitations.
[100] This information asymmetry was mentioned in OECD BEPS Action 2 Public Discussion Draft, par. 55 and 196.
[101] This follows from OECD BEPS Action 2 Public Discussion Draft, par. 196.

amount. In that case, applying a deduction limitation for the full amount of the payment at the level of the hybrid entity would create double taxation.

If the primary rule for DD situations cannot be applied, the secondary rule applies. The secondary rule for DD situations differs from D/NI situations. In DD situations, if the Netherlands is not the investor jurisdiction, the deduction of the payment will not be denied to the extent that another jurisdiction denies the deduction of the payment.[102] However, if this still results in a double deduction, the secondary rule stipulates that the payer jurisdiction (i.e., not the investor jurisdiction) should deny deduction of the payment. This specific ranking between the primary and secondary rule serves to avoid double non-deductibility that would result in economic double taxation.[103]

2.4.7 Documentation obligation

To increase the effectiveness of the hybrid mismatch rules, the Dutch legislator has introduced a specific documentation obligation.[104] This documentation obligation requires taxpayers to record information on the extent to which the hybrid mismatch rules should apply with respect to any fee, payment, deemed payment, costs, or losses.[105] The information requirement depends on the facts and circumstances regarding the transaction and is specifically meant to resolve the information asymmetry between taxpayers and the Dutch tax authorities (hereinafter: DTA).[106]

If the taxpayer does not fulfil the documentation obligation, the burden of proof is increased and reversed, as the taxpayer must then prove that the hybrid mismatch rules should not be applied.[107] This implies that the taxpayer must keep extensive documentation of all transactions, including transactions that do not contain hybrid elements.[108] Hence, the documentation requirement increases the taxpayer's administrative costs, as the taxpayer must prove that none of its transactions result in a hybrid mismatch.[109]

2.5 Sub-conclusion

Hybrid mismatches result from the interaction between differences across jurisdictions with respect to the tax characterization of financial instruments, payments, or entities. The objective of the hybrid mismatch rules in the ATAD is to neutralize double non-taxation that results from hybrid mismatches through the deduction of a payment in one jurisdiction without inclusion of the payment in the tax base of another jurisdiction (deduction/no inclusion) or the deduction of a payment in two jurisdictions (double deduction). Instead of addressing hybrid mismatches through harmonizing the qualification of entities and instruments, the ATAD uses linking rules to neutralize the tax benefits that result from mismatches in qualification, classification, or allocation of payments.

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[102] Art. 12aa(4) DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 54-55.
[103] Art. 12aa(4) DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 54.
[104] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 31. The ATAD does not require implementing such documentation obligation, see *Kamerstukken II* 2018/19, 35030, nr. 7, p. 24.
[105] Art. 12ag(1) DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 73.
[106] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 74 and *Kamerstukken II* 2021/22, 35931, nr. 8, p. 3.
[107] Art. 12ag(2) DCITA 1969, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 32.
[108] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 73. Hence, the documentation obligation does not introduce costs per transaction, but rather raises overall administrative costs. This becomes relevant in *infra*, section 5.2.2.
[109] The state secretary of Finance mentioned that costs are low in case of non-hybrid transactions, see *Kamerstukken II* 2019/20, 35241, nr. 7, p. 21. However, the taxpayer must still include documentation proving that the hybrid mismatch rules do not apply, see D.P.J.G. van Kappel and G.K. Fibbe, 'De nieuwe documentatieplicht in art. 12ag Wet VPB 1969', *MBB* 2020/4, section 3.1.

For all hybrid mismatches that result in a tax benefit, a ranking between primary and secondary rules serves to balance the tax outcomes from the hybrid mismatch and achieve a single deduction, deduction plus inclusion, or non-deduction plus non-inclusion of a payment. In deduction/no inclusion situations, the primary rule stipulates a deduction limitation for the payer and the secondary rule requires the inclusion of the payment in the tax base of the recipient. In double deduction situations, the primary rule stipulates a deduction limitation for the investor and the secondary rule stipulates a deduction limitation for the payer.

Chapter 3 Economic double taxation

3.1 Introduction

Before analyzing how the hybrid mismatch rules may result in economic double taxation, this chapter introduces the concept of economic double taxation and its current treatment in the international tax system. The sub-question in this chapter is: **what is economic double taxation in the context of the hybrid mismatch rules, and is it generally relieved?** To address this question, the distinction between juridical and economic double taxation is explained (section 3.2). This distinction is of importance for the prevention and relief of juridical and/or economic double taxation resulting from the hybrid mismatch rules. As a mechanism to relieve juridical double taxation, the unilateral Dutch Double Taxation Avoidance Decree 2001 is discussed (section 3.3). Because tax treaty law prevails over national law in the international legal order, the prevention and relief of economic double taxation through bilateral double tax conventions is discussed, including Dutch treaty policy (section 3.4).[110] Furthermore, EU law prevails over national and tax treaty law.[111] Therefore, both primary EU law and relevant secondary EU law are analyzed, including specific CJEU case law with respect to the EU fundamental freedoms in the context of the relief of economic double taxation (section 3.5). The chapter ends with a sub-conclusion (section 3.6).

3.2 Economic and juridical double taxation

3.2.1 Juridical double taxation

International tax law generally distinguishes between juridical and economic double taxation.[112] Juridical double taxation occurs when different jurisdictions levy a similar tax, on the same object, within the same period, from the same taxpayer.[113] Juridical double taxation particularly arises when there is a concurrence of different international taxation principles where countries exercise their taxing rights with respect to the same income. These international tax principles are the residence, nationality, and source principle, which play an important role in allocating taxing rights. These international tax principles are discussed in section A2.1 of the Double Taxation Appendix. Examples of how juridical double taxation might arise are discussed in section A2.2 of the Double Taxation Appendix.

3.2.2 Economic double taxation

Because juridical double taxation is based on taxes levied from the same entity, the prevention of juridical double taxation is focused on the subjective taxpayer.[114] Economic double taxation is less clearly defined than juridical double taxation, because economic double taxation in principle does not depend on the concurrence of specific international tax principles and usually involves several taxpayers. In principle, economic double taxation arises due to a lack of taxable subject identity and occurs when different taxpayers are taxed consecutively on the same object of taxation.[115]

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[110] The Netherlands has a monist system, see art. 93 Grondwet.

[111] CJEU 15 July 1964, C-6/64, ECLI:EU:C:1964:66 (Flaminio Costa v E.N.E.L.).

[112] Even though the exact definitions of juridical and economic double taxation are somewhat unclear, there is a generally accepted definition in international tax law, see R. Ismer and J. Ruß, 'What Is International Double Taxation?', *Intertax* (48) 2020, nr. 6, p. 555.

[113] *Ibid,* p. 556-557.

[114] For example, this is the definition that the OECD uses in its Model Tax Convention. See: OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Paris: OECD Publishing 2017, Introduction, par. 1.

[115] R. Ismer and J. Ruß, op. cit. p. 555; and W. Haslehner, 'Introduction', in: E. Reimer and A. Rust (eds), *Klaus Vogel on Double Taxation Conventions*, 5th edition, Alphen aan den Rijn: Wolters Kluwer 2021, at m.nr. 4.

The lack of taxable subject identity originates from the fact that more than one taxpayer is confronted with economic double taxation. As a result of this lack of taxable subject identity, it is relatively more difficult to eliminate economic double taxation than to eliminate juridical double taxation, as in some cases it may be difficult to identify the taxpayers involved.[116] Therefore, economic double taxation is usually resolved through unilateral measures that do not require identifying subjective taxpayers, for example through a general exemption or a tax credit with respect to a certain type of income.[117]

Four examples to illustrate situations in which economic double taxation arises are presented in section A2.3 of the Double Taxation Appendix.[118]

3.2.3 Assessing the role of economic double taxation in the hybrid mismatch rules

In the context of hybrid mismatches, economic double taxation might arise from the hybrid characterization of an entity or instrument.[119] In the following, it is analyzed whether legislative sources would currently allow for relieving economic double taxation in the hybrid mismatch rules.

3.3 Unilateral relief of economic double taxation

The Netherlands provides unilateral double tax relief for Dutch resident taxpayers in the Double Taxation Avoidance Decree 2001.[120] The Decree specifically addresses juridical double taxation of income from states that have not concluded a double tax convention with the Netherlands. The Decree does not contain provisions that specifically focus on relieving economic double taxation. Therefore, it currently has relatively little relevance for the relief of economic double taxation that may result from the hybrid mismatch rules. Furthermore, the DCITA 1969 does not contain additional provisions that prevent economic double taxation resulting from the hybrid mismatch rules specifically.[121]

3.4 Elimination of economic double taxation in bilateral double tax conventions

3.4.1 The OECD Model Tax Convention[122]

Around 1920, the League of Nations agreed that both juridical and economic double taxation resulting from the interaction between national tax systems can have adverse effects for international trade, economic growth, and global welfare.[123] To relieve juridical double taxation, countries often conclude bilateral double tax conventions based on the OECD Model Tax Convention (hereinafter: OECD MTC), which is based on the 1928 Model Tax Convention of the League of Nations.[124] The OECD MTC is meant to be a model for the conclusion of new tax conventions or for the revision of existing conventions, both with OECD member countries and with non-member countries.[125]

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[116] R. Ismer and J. Ruß, op. cit., p. 562.
[117] See, e.g., the participation exemption in art. 13 DCITA 1969.
[118] These examples are not specifically related to the hybrid mismatch rules in the ATAD.
[119] E.g., when an entity is considered transparent in the investor jurisdiction and non-transparent in the residence jurisdiction, income may be included in the tax base of both jurisdictions.
[120] Double Taxation Avoidance Decree 2001.
[121] In some instances, the hybrid mismatch rules themselves do provide relief, see *infra*, section 4.2.
[122] For the sake of brevity, this research only focuses on the OECD Model Tax Convention. For the UN, US or ILADT Model Tax Convention, see R. Rohatgi, *On International Taxation – Volume 1: Principles,* USA: IBFD 2018, p. 58-61.
[123] M. Kobetsky, 'History of tax treaties and the permanent establishment concept', in: *International Taxation of Permanent Establishments: Principles and Policy*, Cambridge: Tax Law Series 2011, p. 106-151.
[124] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Paris: OECD Publishing 2017.
[125] OECD Council, *Recommendation of the Council concerning the Model Tax Convention on Income and on Capital of 23 October 1997*, C(97) 195/Final(1997), par. 2.

3.4.2 Economic double taxation in the OECD Model Tax Convention

The OECD MTC is mostly concerned with relieving juridical double taxation that results from the concurrence of the international tax principles. Therefore, the OECD MTC in principle does not relieve economic double taxation, because economic double taxation is more difficult to capture in general methods of double tax relief.[126]

In case the hybrid mismatch rules lead to economic double taxation that remains unaddressed by a double tax convention, the OECD's Commentary would imply that this should be resolved through unilateral measures or through bilateral negotiations. Furthermore, the OECD MTC is limited to economic double taxation resulting from transfer pricing adjustments.[127] Since transfer pricing should be out of scope of the origin requirement, this provision cannot relieve economic double taxation resulting from the hybrid mismatch rules.[128] Therefore, the OECD MTC is unsatisfactory to deal with economic double taxation generated by the hybrid mismatch rules.

3.4.3 Dutch double tax conventions

The Netherlands has concluded around one hundred bilateral double tax conventions.[129] In the 2011 Memorandum on Tax Treaty Policy, it is stated that the Ministry of Finance aims to provide relief for economic double taxation through bilateral tax conventions but recognizes that it is difficult to provide a general solution.[130]

In absence of a general strategy to negotiate treaty provisions that relieve economic double taxation, the 1998 Memorandum on Tax Treaty Policy mentions that the Netherlands strives to relieve economic double taxation through bilateral consultation between competent authorities of contracting states.[131] All bilateral tax conventions signed by the Netherlands contain a provision that allow the Dutch competent authorities to consult with the other contracting state, i.e., a Mutual Agreement Procedure (hereinafter: MAP). Furthermore, within the EU, a taxpayer can invoke the EU Tax Dispute Resolution Directive in case of economic double taxation.[132] However, in practice, MAPs are costly,[133] lengthy,[134] and often unsatisfactory, since MAPs do not require effective relief from double taxation unless contracting states have agreed on mandatory arbitration[135] and the double taxation results from taxation that is inconsistent with the double tax convention.[136]

The Netherlands has historically taken a practical approach with respect to hybrid entities, for example through determining treaty access depending on specific circumstances and allowing a pro rata application of tax conventions for hybrid entities and their participants.[137] Currently, the Netherlands

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[126] Introduction to the OECD MTC, par. 15.3.
[127] Art. 9(2) OECD MTC. See OECD Commentary on art. 9 OECD MTC, par. 5 and 6.1.
[128] See also *infra*, section 2.3.1 and 4.5.3 for a discussion on how the hybrid mismatch rules lead to economic double taxation in case of transfer pricing mismatches.
[129] Ministry of Finance, *Verdragen op het gebied van directe belastingen per 1 januari 2022*.
[130] *Kamerstukken II* 2010/11, 25087, nr. 7, p. 16. The most recent 2020 Memorandum on Tax Treaty Policy does not elaborate the relief of economic double taxation, except for the disposal of shareholding participation, see *Kamerstukken II* 2019/20, 25087, nr. 256, p. 21 and 32.
[131] *Kamerstukken II* 1997/98, 25087, nr. 4, p. 26.
[132] Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union (*OJ* 2017, L 265/1) (hereinafter: TDRD). See *infra*, section 3.5.3.4.
[133] Both for taxpayers in terms of legal advice and for authorities in terms of administrative capacity.
[134] Art. 25(5)a OECD MTC proposes a period of two years for the competent authorities to reach agreement.
[135] As in art. 25(5) OECD MTC.
[136] A. Soom, 'Double Taxation Resulting from the ATAD: Is There Relief?', *Intertax* (48) 2020, nr. 3, p. 280.
[137] *Kamerstukken II* 1997/98, 25087, nr. 4, p. 54-55. See also Besluit van 11 december 2009, nr. CPP 2009/519M, *Stcrt.* 2009, 19749.

aims to actively seek solutions for double taxation resulting from hybrid mismatches.[138] However, these efforts are aimed at allocating taxing rights with respect to hybrid entities and are therefore insufficient to relieve economic double taxation that may result from the hybrid mismatch rules.

3.5 Elimination of economic double taxation in EU law

3.5.1 Primary EU law

The EU is governed by primary and secondary law. Among other legal sources, primary EU law consists of the Treaty on European Union (hereinafter: TEU) and the Treaty on the Functioning of the European Union (hereinafter: TFEU).[139] For corporate tax purposes, the EU fundamental freedoms in the TFEU are most relevant, more specifically the EU freedom of establishment[140] and the freedom of capital movement.[141] The freedom of establishment requires that economic activities are not effectively discouraged through discriminatory treatment of comparable domestic and cross-border situations. The freedom of capital movement requires that cross-border payments should not be treated less favorably than domestic payments.

International double taxation fundamentally compromises cross-border economic activities within the EU, and the EC deems double taxation incompatible with the internal market.[142] However, primary EU law cannot oblige the relief of international double taxation insofar this is a result of a lack of coordination or from the interaction between two or more of Member States' tax systems.[143]

3.5.2 The Court of Justice of the European Union's interpretation of primary EU law

Case law from the Court of Justice of the European Union (hereinafter: CJEU) is important in understanding whether situations are comparable and whether the hybrid mismatch rules in the ATAD are in accordance with primary EU law.[144] Generally, the CJEU confirms that, in absence of unification or harmonization of direct taxation within the EU, Member States remain sovereign to define criteria for the allocation of taxing rights to eliminate double taxation.[145] Therefore, double taxation is in principle not in conflict with primary EU law, but only insofar it does not lead to discrimination of taxpayers that engage in cross-border activities.

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[138] *Kamerstukken II* 2010/11, 25087, nr. 7, p. 23.

[139] Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union (*OJ* 2016 C-202).

[140] Art. 49 and 54 TFEU.

[141] Art. 63 TFEU.

[142] See, e.g., Commission of The European Communities, Taxation in the European Union, SEC(96) 487 final (20 March 1996), par. 13. Art. 293 of the Treaty establishing the European Community (Consolidated version 2002) contained a provision requiring Member States to negotiate the abolition of double taxation. However, the current TEU and TFEU do not contain similar provisions. For a discussion, see E.C.C.M. Kemmeren, 'After Repeal of Article 293 EC Treaty under the Lisbon Treaty: the EU objective of eliminating double taxation can be applied more widely', *EC Tax Review* (17) 2008, nr. 4, p. 156-158.

[143] G. Bizioli and E. Reimer, 'Equality, ability to pay and neutrality', in: C. HJI Panayi, W. Haslehner and E. Traversa (eds), *Research Handbook on European Union Taxation Law*, Cheltenham/Northampton: Edward Elgar Publishing 2020, p. 35.

[144] The CJEU could in principle rule that a Directive is contrary to primary EU law. However, this may be justified by a rule of reason. The rule of reason test is out of scope of this research. For a discussion, see P. Benéitez Régil, 'International /European Union - BEPS Actions 2, 3 and 4 and the Fundamental Freedoms: Is There a Way Out?', *European Taxation* (56) 2016, nr. 6, section. 2.2.

[145] See, e.g., CJEU 13 July 2016, C-18/15, ECLI:EU:C:2016:549 (*Brisal*), par. 35-36; and CJEU 20 May 2008, C-194/06, ECLI:EU:C:2008:289 (*Orange European Smallcap Fund*), par. 37. This CJEU's case law concerns economic double taxation with respect to profit distributions in parent-subsidiary relationships.

The CJEU has ruled that the fact that taxpayers can gain tax advantages does not justify measures that offset such benefits through less favorable tax treatment.[146] This allows concluding that situations in which a payment is not subject to taxation is not considered comparable to a situation where the payment is subject to taxation.[147] With respect to situations that result in the deduction of a payment in one Member State which is not correspondingly subject to tax in another Member State, the CJEU has ruled that the deductibility of such payments can be made conditional on these payments being subject to tax at the level of the recipient.[148]

Economic double taxation could lead to a higher tax burden in cross-border situations compared to domestic situations. This can be viewed as a restriction of the EU fundamental freedoms. However, based on CJEU case law, it seems that the CJEU lets tax sovereignty prevail over the obligation to remove restrictions on the fundamental freedoms.[149] The reason might be that economic double taxation could in principle also arise in purely domestic situations, so that economic double taxation does not constitute an a priori impediment to the internal market.[150] Hence, if economic double taxation can also arise in purely domestic situations, it does not necessarily constitute discrimination.[151] Therefore, the EU fundamental freedoms in principle do not oblige Member States to relieve economic double taxation.[152]

The CJEU acknowledges that economic double taxation requires different relief systems within the same jurisdiction.[153] This distinction originates from the characteristics of economic double taxation, where taxes are levied from different taxpayers instead of from one single taxpayer. With respect to double tax relief, economic double taxation implies comparability between residents and non-residents, as they are subject to the same relief system within that Member State.[154] However, complying with the EU fundamental freedoms does not require that the same system of alleviating economic double taxation must be applied with respect to domestic and foreign economic double taxation.[155]

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[146] CJEU 12 September 2006, C-196/04, ECLI:EU:C:2006:544 (*Cadbury Schweppes*), par. 49, with reference to previous case law with the same ruling by the CJEU.

[147] R. de Boer and O.C.R. Marres, 'BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements', *Intertax* (43) 2015, nr. 1, p. 34.

[148] See CJEU 12 July 2005, C-403/03, ECLI:EU:C:2005:446 (*Schempp*), par. 32-36. This concerns a disparity with respect to economic double taxation.

[149] A. Maitrot de la Motte, 'Taxation of business in the EU: General issues', in: C. HJI Panayi, W. Haslehner and E. Traversa (eds), *Research Handbook on European Union Taxation Law*, Cheltenham/Northampton: Edward Elgar Publishing 2020, p. 189.

[150] Hybrid mismatches in principle do not occur in domestic situations, because differences in tax treatment of entities and instruments are less likely to occur in a purely domestic situation. Therefore, the conditionality on corresponding taxation of a payment should not constitute a differential treatment of cross-border payments.

[151] See for example, CJEU 10 February 2011, C-436/08 and C-437/08, ECLI:EU:C:2011:61 (*Haribo Salinen*) and D.S. Smit, 'The Haribo and Österreichische Salinen Cases: To What Extent Is the ECJ Willing To Remove International Double Taxation Caused by Member States?', *European Taxation* (51) 2011, nr. 7, p. 275–284.

[152] This prevalence of tax sovereignty can be justified by the fact that direct taxation is not a shared competence of the EU, and harmonization through EU legislation requires unanimity, see art. 115 of the Treaty of the Functioning of the European Union (hereinafter: TFEU).

[153] P.J. Wattel, O.C.R. Marres and H. Vermeulen, op. cit., section 19.3.

[154] CJEU 12 December 2006, C-446/04, ECLI:EU:C:2006:774 (*Test Claimants in the FII Group Litigation*), par. 62, and CJEU 21 December 2016, C-592/14, ECLI:EU:C:2016:984 (*Maxco & Damixa*), par. 42 with reference to CJEU 30 June 2011, C-262/09, ECLI:EU:C:2011:438 (*Meilicke*), par. 29.

[155] The CJEU has ruled that Member States can only apply different methods to relieve economic double taxation if this does not lead to less favorable treatment of foreign source income, i.e., that the tax burden on foreign source income may not be higher, see CJEU 12 December 2006, C-446/04, ECLI:EU:C:2006:774 (*Test Claimants in Class IV of the ACT Group Litigation*), par. 57 and 72-75 and CJEU 10 February 2011, C-436/08 and C-437/08, ECLI:EU:C:2011:61 (*Haribo Salinen*), par. 86-90.

Whether relief of economic double taxation is contrary to the fundamental freedoms in primary EU law depends on whether a cross-border situation is treated less favorably than an objectively comparable domestic situation.[156] Therefore, if a Member State were to relieve economic double taxation from the hybrid mismatch rules, it is obliged to do so without discriminating between domestic and cross-border situations.[157]

3.5.3 Secondary EU law

Because primary EU law does not oblige effective relief of international economic double taxation that results from a lack of coordination in Member States' tax systems, there has been some harmonization in secondary EU law to provide relief for economic double taxation.[158] These harmonization efforts only cover specific areas of direct taxation, i.e., with respect to dividends in the Parent-Subsidiary Directive[159] and with respect to interest and royalty payments in the Interest and Royalty Directive.[160] The ATAD itself also provides limited solutions for economic double taxation. Furthermore, the EU has adopted the EU Tax Dispute Resolution Directive, which applies to disputes arising from the interpretation and application of double tax conventions.[161]

3.5.3.1 Parent-Subsidiary Directive

The objective of the Parent-Subsidiary Directive (hereinafter: PSD) is to exempt profit distributions paid by subsidiary entities to parent entities with an ownership interest of at least ten percent from withholding taxes to eliminate double taxation.[162] In principle, the PSD prevents juridical and economic double taxation through eliminating withholding taxes in the source country[163] and through requiring a tax exemption or a tax credit at the level of the parent entity.[164]

The PSD also contains a hybrid mismatch provision, which requires that payments that are deductible from the tax base of the payer may not be exempted at the level of the recipient.[165] The hybrid mismatch provision in the PSD does not address economic double taxation that might result from the hybrid mismatch rules, but the ATAD hybrid mismatch rules do not apply insofar the PSD serves to neutralize the hybrid mismatch.[166]

3.5.3.2 Interest and Royalty Directive

The objective of the Interest and Royalty Directive (hereinafter: IRD) is to eliminate double taxation and to ensure that interest and royalty payments are subject to tax once in the Member State of the

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[156] E.g., CJEU 12 December 2006, C-446/04, ECLI:EU:C:2006:774 (*Test Claimants in the FII Group Litigation*), par. 45. For a comprehensive overview of this topic, see P.J. Wattel, 'Non-Discrimination à la Cour: The ECJ' s (Lack of) Comparability Analysis in Direct Tax Cases', *European Taxation* (55) 2015, nr. 12.

[157] The proposed relief method in *infra*, section 6.7.3 is aimed to not discriminate cross-border situations.

[158] G. Bizioli and E. Reimer, op. cit., p. 73.

[159] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, (*OJ* 2011, L 345/8).

[160] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, (*OJ* 2003, L 157/49).

[161] C. HJI Panayi, 'The relationship between EU and international tax law', in: C. HJI Panayi, W. Haslehner and E. Traversa (eds), *Research Handbook on European Union Taxation Law*, Cheltenham/Northampton: Edward Elgar Publishing 2020, p. 130.

[162] PSD, preamble, recital 3.

[163] Art. 5 PSD.

[164] Art. 4 PSD. Member States are allowed to differentially grant an exemption in domestic situations versus a credit in cross-border situations, requiring equivalence in tax consequences. See CJEU 12 November 2012, C-35/11, ECLI:EU:C:2012:707 (*Test Claimants in the FII Group Litigation*), par. 65.

[165] Art. 4(1)a PSD. Furthermore, the Dutch legislator provides rules for concurrence of the PSD hybrid mismatch rule and the ATAD hybrid mismatch rules. For a discussion, see J. Versluis, 'Asymmetrie bij samenloop anti-mismatchbepalingen en renteaftrekbeperkingen wegens het ruime begrip aftrek', *WFR* 2021/179.

[166] This is further discussed in *infra*, section 6.3.2.

beneficial owner of the payment.[167] To achieve this, the IRD requires an exemption of both withholding and corporate taxes of interest and royalty payments that arise in a source Member State.[168]

Even though the IRD refers to "any taxes imposed […] whether by deduction at source or by assessment", the CJEU has decided that the IRD solely aims to avoid juridical double taxation.[169] Hence, interest deduction limitations that result in economic double taxation are in principle out of the IRD's scope.[170] This also implies that insofar the hybrid mismatch rules deny the deduction of interest payments, this would not be contrary to the IRD.

3.5.3.3 Anti-Tax Avoidance Directive

The objective of the Anti-Tax Avoidance Directive (hereinafter: ATAD) is to harmonize a minimum level of protection against BEPS in the Member States' national corporate tax systems.[171] The ATAD's preamble acknowledges that such anti-BEPS measures may generate double taxation.[172] Therefore, the preamble states that taxpayers should receive relief through a deduction for the tax paid in another Member State or third country. However, this has not been translated into a general relief provision in the ATAD.[173] Furthermore, despite the aim to provide relief of double taxation, the ATAD does not oblige Member States to provide effective relief through national legislation.

The ATAD only provides limited relief for economic double taxation, and only for the Controlled Foreign Company (hereinafter: CFC) rule,[174] or in case of certain circumstances concerning hybrid mismatches.[175] Therefore, economic double taxation that may result from the ATAD hybrid mismatch rules cannot be guaranteed to be resolved through the ATAD.

3.5.3.4 Tax Dispute Resolution Directive

The objective of the Tax Dispute Resolution Directive (hereinafter: TDRD) is to ensure the effective resolution of disputes concerning the interpretation and application of bilateral double tax conventions to remove tax obstacles for cross-border activities within the EU internal market.[176] Under the TDRD, Member States are obliged provide a resolution for double taxation, either through a MAP between the Member States, or through a dispute resolution procedure through an independent Advisory Commission.[177]

The TDRD defines double taxation as the imposition of taxes over the same income by several Member States that gives rise to an additional tax charge, an increase in tax liability, or a cancellation or reduction of losses.[178] Therefore, the TDRD implicitly also allows taxpayers to request a resolution procedure for economic double taxation.

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[167] IRD, preamble, recital 3.
[168] Art. 1(1) IRD.
[169] CJEU 21 July 2011, C-397/09, ECLI:EU:C:2011:499 (*Scheuten Solar Technology*), par. 28.
[170] C. HJI Panayi, 'The relationship between EU and international tax law', in: C. HJI Panayi, W. Haslehner and E. Traversa (eds), *Research Handbook on European Union Taxation Law*, Cheltenham/Northampton: Edward Elgar Publishing 2020, p. 151.
[171] ATAD, preamble, recital 2-3.
[172] ATAD, preamble, recital 5.
[173] *Ibid.*
[174] Art. 8(5) and 8(6) ATAD.
[175] Art. 9(1) ATAD. The provision avoids economic double taxation in the sense that the deduction will not be denied in both states, but only in the state where the payment does not have its source. See also *infra*, chapter 4 on the dual inclusion exception.
[176] TDRD, preamble, recital 1-2.
[177] TDRD, preamble, recital 6.
[178] Art. 2(1)c TDRD.

The deduction limitation and income inclusion in the hybrid mismatch rules could be interpreted as the imposition of taxes over the same income insofar this results in economic double taxation. However, the TDRD only focuses on bilateral tax conventions.[179] Therefore, the TDRD remains unsatisfactory to address economic double taxation that may result from the hybrid mismatch rules.[180]

3.6 Sub-conclusion

Economic double taxation generally involves different taxpayers that are taxed consecutively on the same taxable object. In the context of hybrid mismatches, economic double taxation might arise from the hybrid tax characterization of an entity or instrument. Due to the lack of taxable subject identity, economic double taxation is relatively more difficult to relieve than juridical double taxation.

Double tax conventions in principle focus on juridical double taxation. The OECD's Commentary to the OECD Model Tax Convention acknowledges that economic double taxation poses an impediment to cross-border activities but states that relief can be provided unilaterally or through consultation between competent authorities. In the DCITA 1969, other than in the hybrid mismatch rules, the Netherlands does not provide specific unilateral relief of economic double taxation in case of hybrid mismatches. Furthermore, in negotiating bilateral double tax conventions, the Netherlands does not aim to negotiate a general bilateral relief of economic double taxation with respect to hybrid mismatches, and therefore does not address economic double taxation that may result from the hybrid mismatch rules.

Primary EU law in the form of the EU fundamental freedoms does not oblige Member States to provide relief for economic double taxation, conditional on there being no less favorable treatment of cross-border situations. Within secondary EU law, the Parent-Subsidiary Directive requires effective relief from economic double taxation, but only with respect to dividends. The Interest and Royalty Directive only focuses on juridical double taxation. The Tax Dispute Resolution Directive only provides relief from economic double taxation insofar this is a result of differences in interpretation or application of bilateral double tax conventions between Member States. Furthermore, the ATAD itself does not contain a general provision to relieve economic double taxation resulting from the hybrid mismatch rules.

Summarizing, based on the analysis in this chapter, it is concluded that economic double taxation that may result from the application of the hybrid mismatch rules is not generally relieved in the current international tax system.

[179] R. Ismer and J. Ruß, op. cit., p. 562.

[180] However, Member States retain sovereignty in direct taxation and therefore do not have to adjust align their tax systems with other Member States.

Chapter 4 Economic double taxation in the ATAD hybrid mismatch rules

4.1 Introduction

This chapter examines the hybrid mismatch rules in the DCITA 1969 to schematically assess how the ATAD hybrid mismatch rules can result in economic double taxation. The sub-question in this chapter is: **how does the dual inclusion exception in the ATAD hybrid mismatch rules result in economic double taxation?** To address this question, the methods of preventing economic double taxation in the hybrid mismatch rules are introduced (section 4.2). Specifically, the dual inclusion exception is meant to prevent economic double taxation, so the definition of dual inclusion income (section 4.3) and the scope of the exception (section 4.4) are analyzed. Further analysis assesses whether the narrow definition of dual inclusion income makes the exception insufficient to prevent economic double taxation in all circumstances (section 4.5). The chapter ends with a sub-conclusion to summarize the scope of economic double taxation from the hybrid mismatch rules (section 4.6).

4.2 Preventing economic double taxation in the hybrid mismatch rules

4.2.1 The mechanical approach

The OECD recommends the automatic application of the primary and secondary rule, without regard for specific facts and circumstances regarding the hybrid mismatch.[181] According to the OECD, the automatic application of hybrid mismatch rules avoids practical and conceptual difficulties in distinguishing mismatches that are the result of acceptable tax planning from mismatches that result in unacceptable tax base erosion.[182] The ATAD hybrid mismatch rules therefore presume the existence of tax abuse, without the opportunity to adduce evidence to the contrary.[183]

It is difficult to determine which jurisdiction qualifies as the jurisdiction that loses tax revenue from the hybrid mismatch.[184] Since the hybrid mismatch rules do not require the jurisdiction applying the rules to establish that it has lost tax revenue through the hybrid mismatch, the aim of preventing double non-taxation appears to prevail over the question of which jurisdiction should be allowed to tax certain income.[185] Hence, even if no tax revenue is lost in a certain jurisdiction, due to the mechanical nature of the hybrid mismatch rules, this jurisdiction is still required to apply the primary or secondary rule to neutralize the hybrid mismatch. The ATAD hybrid mismatch rules therefore imply a general preference for the avoidance of economic double non-taxation over the prevention of economic double taxation.[186]

4.2.2 Preventing economic double taxation in the hybrid mismatch rules

The mechanical approach in the hybrid mismatch rules is the fundamental reason why the hybrid mismatch rules may impose economic double taxation.[187] Such economic double taxation is contrary to the objective of the rules to neutralize the hybrid mismatch by removing the tax benefit. Therefore,

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[181] OECD BEPS Action 2 Final Report, par. 276-278 states that the hybrid mismatch recommendations in BEPS Action 2 are intended to improve coherence in neutralizing hybrid mismatches without imposing undue burdens on taxpayers and tax administrations.

[182] *Ibid*, par. 279.

[183] J.J.A.M. Korving and C. Wisman, 'ATAD Implementation in The Netherlands', *Intertax* (49) 2021, nr. 11, p. 926.

[184] See R. de Boer and O.C.R. Marres, op. cit., p. 14.

[185] OECD BEPS Action 2 Final Report, par. 278. See also F. Vanistendael, 'Chapter 6 Single Taxation in a Single Market?', in: J. Wheeler, *Single Taxation*, Amsterdam: IBFD 2018, p. 194-197.

[186] See also L. Parada, 'Hybrid Entity Mismatches and the International Trend of Matching Tax Outcomes: A Critical Approach', *Intertax* (46) 2018, nr. 12, p. 986.

[187] The scope of economic double taxation is discussed in *infra*, chapter 4.5.

the hybrid mismatch rules contain three measures to prevent economic double taxation, which are equally mechanical as the hybrid mismatch rules.

4.2.2.1 The ranking and pro rata rule

The main measure to prevent economic double taxation is a coordinated *ranking* in hybrid mismatch rules, i.e., the primary and secondary rule.[188] In addition to the ranking rule, the hybrid mismatch rules follow a *pro rata* approach, which means that to avoid double taxation with respect to part of a payment, the rules should only apply insofar there is a hybrid mismatch.[189]

The ranking and pro rata rule serve as a primary identification of hybrid mismatches, which means that these rules prevent or partially prevent the application of the hybrid mismatch rules.[190] This can be seen from the fact that the secondary rule only applies if the primary rule cannot apply (ranking rule), and the hybrid mismatch rules only apply insofar there is a hybrid mismatch (pro rata rule). Essentially, the ranking and pro rata rule identify *exemptions* from the application of the hybrid mismatch rules.[191] If the hybrid mismatch rules do not apply in the first place, they cannot result in economic double taxation either.

4.2.2.2 The dual inclusion exception

In situations where the ranking and pro rata rule do not preclude the application of the hybrid mismatch rules, the dual inclusion exception means that for specific types of hybrid mismatches, the deduction of a payment is only denied or a payment is only included in the tax base, insofar there is no dual inclusion income.[192]

In contrast to the ranking and pro rata rule, the dual inclusion exception can only apply once the hybrid mismatch rules are in principle already applicable, i.e., if the origin requirement is satisfied.[193] This means that a hybrid mismatch is first neutralized through the primary or secondary rule. Subsequently, the dual inclusion exception allows the application of the hybrid mismatch rules to be reversed, insofar the requirements of the exception are satisfied.[194]

The dual inclusion exception implies that the deduction of the payment is not exempted from the hybrid mismatch rules, but instead *excepted*.[195] Because the dual inclusion exception allows the application of the hybrid mismatch rules in the first place, the exception may be insufficient to prevent economic double taxation in all circumstances.

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[188] The ranking in linking rules is discussed in *infra*, section 2.3.2.

[189] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 5. This is based on art. 9 ATAD and recital 29 of the preamble, which states: "The hybrid mismatch rules […] only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustment [under the hybrid mismatch rules]."

[190] Instead of first applying the hybrid mismatch rules and then effectively undoing the application, like the DI-exception.

[191] According to the Oxford Dictionary, an exemption is "The process of freeing or state of being free from an obligation or liability imposed on others." This definition is suitable, as the ranking and pro rata rule regulate when the hybrid mismatch rules should apply.

[192] *Infra*, section 4.4.1.

[193] *Infra*, section 2.3.1.

[194] This follows from the order of paragraphs in the hybrid mismatch provisions in art. 12aa-12af DCITA 1969.

[195] According to the Oxford Dictionary, an exception is "A person or thing that is excluded from a general statement or does not follow a rule." This definition is suitable, as the DI-exception means that the hybrid mismatch rule should not be followed insofar the payment can be set off against dual inclusion income.

4.3 Scope of the dual inclusion exception

In the Structural Appendix, stylized examples are used to explain the basic mechanism behind the DI-exception outlined for the hybrid mismatches to which this exception applies.

The DI-exception cannot be applied to every type of hybrid mismatch. With respect to the primary rule, the DI-exception only applies in certain situations, namely in case of:

- payments made by hybrid entities insofar these result in D/NI situations;[196]
- allocation mismatches between permanent establishments or between a permanent establishment and its head office insofar these result in D/NI situations;[197]
- DD situations;[198]
- dual residency situations;[199]
- the imported mismatch rule;[200] and
- hybrid financial instruments.[201]

With respect to the secondary rule, the DI-exception only applies to:

- payments made by hybrid entities insofar these result in D/NI situations;[202] and
- allocation mismatches between permanent establishments or between a permanent establishment and its head office insofar these result in D/NI situations.[203]

Restricting the scope of the DI-exception in the Dutch implementation of the hybrid mismatch rules is in line with the ATAD, as the ATAD also only includes the above types of hybrid mismatches in the DI-exception.[204] In the BEPS Action 2 Final Report, the OECD also limits the application of the DI-exception to double deductions,[205] payments made by hybrid entities,[206] dual residents,[207] and the BEPS Action 2 Report on Branch Mismatches also only focuses on payments made by hybrid permanent establishments.[208]

The fact that the Dutch hybrid mismatch rules do not allow a DI-exception for payments made to hybrid entities, payments to the head office of a permanent establishment that result in allocation mismatches, and payments to a disregarded permanent establishment is in accordance with both the ATAD and OECD BEPS Action 2.[209] The reason for this limited scope is that the exception is not relevant in these situations, as shown in Table 4.3.[210]

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[196] Art. 12aa(3) DCITA 1969.
[197] *Ibid*.
[198] *Ibid*.
[199] *Ibid.*
[200] Art. 12ad(1) DCITA 1969. This is left out of scope of this research.
[201] In this case, it is required that the payment itself must be included in the tax base within a reasonable timeframe, which is resemblant to the DI-exception. See art. 12aa(1)a jo. art. 12ac(3) DCITA 1969.
[202] Art. 12ab(2) DCITA 1969.
[203] *Ibid*.
[204] See ATAD2, preamble, recital 20-21. See also art. 9(1), 9b and 2(9) ATAD2.
[205] OECD BEPS Action 2 Final Report, Recommendation 3.1(c), 3.1(d), and 3.3, see also par. 115-118 and 124-127.
[206] *Ibid*, Recommendation 6.1(d) and 6.3, see also par. 181-185, 197-199 and 211-214.
[207] *Ibid*, Recommendation 7.1(c) and 7.3, see also par. 216-219 and 225-226.
[208] *OECD, Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, Paris: OECD Publishing 2017.*
[209] Art. 12aa(1)b, 12aa(1)c and 12aa(1)d DCITA 1969.
[210] The Dutch legislator confirms this, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 54.

Table 4.3

Type of hybrid mismatch	Reason why the DI-exception is not applied
Payments made to hybrid entities	Dual inclusion income is unlikely to occur for payments made to hybrid entities, because these situations usually only involve D/NI situations in case of reverse hybrid entities in which case there is never any inclusion of income.[211] In contrast, in case of a regular hybrid entity, a payment made to this entity would in principle result in dual inclusion income, in which case there would be no tax benefit from making such payments.[212]
Allocation mismatch with PE	Payments to a head office with one or more permanent establishments that result in allocation mismatches also cannot result in dual inclusion income, as the payment is not included in any tax base because of the allocation mismatch.
Payments made to disregarded PE	With respect to payments made to disregarded permanent establishments, the nature of the disregarded permanent establishment implies that there cannot be dual inclusion income, as the permanent establishment is deemed non-existent by the jurisdiction where it is deemed to be situated according to the jurisdiction of the head office.
Double deductions	The only type of hybrid mismatch that is in scope of the DI-exception for the primary rule, but out of scope for the secondary rule, is a DD mismatch. However, this can be explained by the mechanism behind the secondary rule for DD situations, as the linking rule only applies insofar another state does not deny the deduction of the double-deducted payment. Therefore, in DD situations, the ranking of the primary and secondary rule already prevents economic double taxation.[213]

4.4 Preventing economic double taxation through the dual inclusion exception

4.4.1 Introduction to the dual inclusion exception

To prevent economic double taxation, the hybrid mismatch rules do not apply in case of dual inclusion income.[214] Like the hybrid mismatch rules, the DI-exception follows a pro rata approach, as the payment that relates to the hybrid mismatch remains tax-deductible *insofar* the payment is deducted

[211] A reverse hybrid entity is an entity that is characterized as non-transparent by the jurisdiction of its participants but is characterized as transparent by its residence jurisdiction. Therefore, a reverse hybrid entity's profit would be taxed nowhere.

[212] Even though there is no tax benefit, in practice, these structures may still exist in case the hybrid entity's participant grants a tax credit for the taxes paid by the hybrid entity. In that case, the hybridity does not cause double taxation.

[213] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 54.

[214] The ATAD and the Dutch parliamentary history do not explicitly state that the DI-exception is meant to prevent economic double taxation but mention double taxation in general. In principle, the nature of hybrid mismatches implies that they could also generate juridical double taxation, e.g., in a relationship between a head office and its PE. However, for simplicity, this research uses the term economic double taxation, as there are always two entities involved in the hybrid mismatch rules. An entity is not a legal term and could for example also refer to transparent entities or PEs. See *Kamerstukken II* 2018/19, 35241, nr. 3, p. 51.

against dual inclusion income. If the amount of dual inclusion income is lower than the amount relating to the hybrid deduction of the payment, the surplus remains non-deductible.[215]

The rationale behind the dual inclusion exception (hereinafter: DI-exception) is that to the extent that the payment is included in the tax base of another jurisdiction, there is no reason to deny the deduction or to additionally tax the payment because the hybrid nature of the entity or arrangement de facto does not result in a tax benefit in the form of a D/NI or DD situation.[216]

To understand how the DI-exception can prevent economic double taxation, the definitions of dual inclusion income as stated in the OECD BEPS Action 2 Final Report, in the ATAD, and in the Dutch hybrid mismatch rules are outlined in Table 4.4.1.

Table 4.4.1

Source	Definition (***emphasis added***)
OECD BEPS Action 2 Final Report	"Dual inclusion income, in the case of both deductible payments and disregarded payments, refers to *any item of income* that is *included as ordinary income* under the *laws of the jurisdictions where the mismatch has arisen*. An item that is treated as income under the laws of both jurisdictions may, however, *continue to qualify* as dual inclusion income *even if that income benefits from double taxation relief*, such as a foreign tax credit (including underlying foreign tax credit) or a domestic dividend exemption, to the extent such relief ensures that income, which has been subject to tax at the full rate in one jurisdiction, is not subject to an additional layer of taxation under the laws of either jurisdiction."[217]
ATAD	"Any item of income that is *included* under the laws of *both jurisdictions where the mismatch outcome has arisen*".[218]
DCITA 1969	"An item of income that has been *subjected to an income tax* by or under the laws of the *States between which a deduction/no inclusion or a double deduction situation arises*".[219]

The Dutch implementation of the definition of dual inclusion income appears linguistically in line with the definition in the ATAD, but cannot be substantively compared to the ATAD's definition because of the lack of legislative history and interpretative guidance.[220] However, since the ATAD2 requires Member States to use the explanations and examples in the OECD BEPS Action 2 Final Report insofar these are consistent with the ATAD and with other EU law, the Dutch implementation can also be interpreted in light of the OECD's definition of dual inclusion income.[221]

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[215] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 5.
[216] *Ibid*, p. 11.
[217] OECD BEPS Action 2 Final Report, Recommendation 12.
[218] Art. 2(9) ATAD.
[219] Unofficial translation of art. 12ac(1)d DCITA 1969, see also *Kamerstukken II* 2018/19, 35241, nr. 3, p. 62-64.
[220] The Working Document for the ATAD2 does not discuss the scope of dual inclusion income, see Commission Staff Working Document accompanying the document Proposal for a Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, COM(2016) 687 final. The Proposal for ATAD1 also does not elaborate on the definition of dual inclusion income, see Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM(2016) 26 final, since the ATAD1 proposal still included a harmonization of hybrid classifications.
[221] *Ibid*, recital 28.

4.4.2 Inclusion in a tax base

Essentially, dual inclusion income is income that is included in the tax base of both jurisdictions between which there is a hybrid mismatch in the form of a DD or a D/NI situation.[222] Two requirements stand out, namely *inclusion in the tax base* and *both jurisdictions between which the hybrid mismatch occurs*.[223] Hence, the income must be de facto included in the tax base of the jurisdictions that are involved in the hybrid mismatch.[224]

The parliamentary history does not require a relationship between the payment that results in a hybrid mismatch and the dual inclusion income.[225] Implicitly, the dual inclusion exception requires that the income is included in the tax base of a taxpayer that is involved in the hybrid mismatch. This follows from the fact the DI-exception implies that the hybrid mismatch rules do not apply insofar the payment is deducted against dual inclusion income, so the payment must be deducted against income of a taxpayer that is directly involved in the hybrid mismatch.

According to the OECD, the qualification as dual inclusion income should primarily be a legal question.[226] It therefore appears that a legal interpretation should prevail over an economic interpretation of dual inclusion income. This is interesting, as the approach of identifying a hybrid mismatch outcome seems to rely on an economic approach.[227] Namely, the neutralization approach in the hybrid mismatch rules is based on the outcome of the hybrid mismatch, as the rules assess whether the mismatch results in a tax benefit in the form of a D/NI or DD situation.[228]

In other words, the BEPS Action 2 Final Report does not address the legal system that allows the hybrid mismatch to exist, but determines whether a de facto tax benefit arises from the hybrid mismatch.[229] Therefore, a strictly legal interpretation of dual inclusion income seems contrary to the broader context of the BEPS Action 2 Final Report. The OECD's statement on dual inclusion income can also be interpreted as being aimed at broadening the interpretation of dual inclusion income, in the sense that the OECD would not require an actual inclusion of income. In that interpretation, the qualification of income as taxable and as being ordinarily included in the tax base would be sufficient, regardless of whether the income is de facto taxed. In this interpretation, if income is by nature included in the tax base, the income could constitute dual inclusion income.

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[222] Art. 12ac(1)d DCITA 1969.

[223] The problems with these requirements become clear in *infra*, section 4.5.

[224] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 62.

[225] For example, this means that in case of a hybrid financial instrument, the fact that the income is not included in the tax base because it qualifies as equity does not mean that the DI-exception can never be applied insofar there is other income that is included in the tax base of both jurisdictions that are involved in the hybrid mismatch. See *Kamerstukken II* 2020/21, 35573, nr. 6, p. 16.

[226] OECD BEPS Action 2 Final Report, par. 125 states: "[…] The identification of whether an item should be treated as dual inclusion income is primarily a legal question that requires an comparison of the treatment of the income under the laws of the payer and payee jurisdictions […] even if there are differences in the way those jurisdictions value that item or in the accounting period in which the income is derived."

[227] For example, OECD BEPS Action 2 Final Report, par. 137 states: "Regardless of the mechanism used to achieve the offset, if the effect of the structure is to create the opportunity for a deduction under a disregarded payment to be set-off against income that will not be brought into account as ordinary income under the laws of the payee jurisdiction, this will be sufficient to bring the payment within the scope of the disregarded hybrid payments rule."

[228] The identification of the hybrid mismatch (i.e., the origin requirement) does require a legal assessment of whether the entity or instrument is characterized differently under the laws of the jurisdictions involved. See, for example, OECD BEPS Action 2 Final Report, par. 85, 165, 193, and 225.

[229] The BEPS Action 2 Final Report does not harmonize the tax treatment of hybrid entities and instruments, see also J. Versluis, op. cit., section 3.1 and *infra*, section 6.2.

With respect to the requirement of inclusion in a tax base, the Dutch interpretation seems in line with the OECD's approach. Income is still regarded as included in the tax base when it is not effectively taxed as a result of loss compensation. Furthermore, the legislator acknowledges that tax consolidation regimes allow that income is not included at the level of the recipient of the payment, but at the level of the group to which the consolidation regime applies.[230]

4.4.3 Type of tax and tax rate

To apply the DI-exception, the income must be de facto taxed.[231] This requires that the income is not objectively exempt from taxation and that the recipient is not subjectively exempt.[232] Furthermore, according to the Dutch legislator, the entity being subjectively liable to tax is insufficient, as the criterion for dual inclusion income is whether the income would in principle be objectively included in the tax base and taxed at the regular statutory rate.

If the qualification of a payment means that a tax exemption, a lower tax rate, or a credit or refund of taxes[233] applies, the payment is characterized as not being subject to an income tax.[234] The Dutch interpretation seems in line with the OECD definition of dual inclusion income, which also requires that income is included as ordinary income in a corporate income tax.[235] Furthermore, with respect to the type of tax, the tax must qualify as an income tax. Withholding taxes do not qualify as income taxes.[236]

4.4.4 Timing differences

Because the DI-exception does not require a direct relationship between the payment and the dual inclusion income, the economic approach in the hybrid mismatch rules implies that a timing difference can result in dual inclusion income insofar this difference results from a discrepancy in the timing of income recognition or in tax accounting periods.[237] This approach is in accordance with the OECD's interpretation, which requires that the hybrid mismatch rules only apply to the extent a hybrid mismatch results in a DD or D/NI situation, and that countries coordinate to address differences in rules for the timing of income recognition.[238]

To prevent double taxation, the taxpayer will be allowed to deduct the payment in the year in which the dual inclusion income is de facto taxed.[239] Income only qualifies as dual inclusion income once it is included in the tax base of both jurisdictions that are involved in the hybrid mismatch, i.e., when the income is recognized for tax purposes.[240] It is not required that both jurisdictions include the income

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[230] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 59.
[231] *Ibid*, p. 62.
[232] *Ibid*, p. 58. Besides from this statement in the parliamentary history, a subjective exemption implies that the origin requirement is not satisfied, so that there is no hybrid mismatch, see also Besluit van 1 oktober 2021, nr. 2021-20014, BWBR0045683, *Stcrt*. 2021, 42915, par. 2.
[233] Not a credit or refund of withholding taxes.
[234] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 58.
[235] OECD BEPS Action 2 Final Report, par. 425.
[236] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 58. On the one hand, this seems logical, as withholding taxes are levied from the recipients of a payment, not from the paying entity. However, withholding taxes are regarded as a pre-levy over the income of the recipient and would therefore sensu stricto also be a tax on income.
[237] E.g., a hybrid entity is considered non-transparent in the Netherlands and transparent in Country X. In year T=1, the entity claims a double deduction of -/- 80. The entity receives income of + 100 which is recognized in year T=1 in the Netherlands. Country X recognizes the income in year T=2. Then, in year T=2, the income constitutes dual inclusion income. See BEPS Action 2 Final Report, par. 118.
[238] OECD BEPS Action 2 Final Report, par. 307.
[239] This also serves to also eliminate any cash flow advantage resulting from the hybrid mismatch. See art. 12af(1) DCITA 1969 and *Kamerstukken II* 2018/19, 35241, nr. 3, p. 72-73.
[240] Therefore, the prospect of future taxation of income alone is insufficient to qualify as dual inclusion income. *Kamerstukken II* 2018/19, 35241, nr. 3, p. 53.

in a different period.[241] Therefore, sensu stricto, a timing difference between jurisdictions is not required, so a timing difference between taxation of the payment and inclusion of the income in the tax base is sufficient.

There is no temporal restriction with respect to the period in which the income is included in the tax base.[242] However, the DI-exception can only apply if the income is included in the tax base in a year *after* the hybrid mismatch rule is applied.[243] This is not necessarily in line with the OECD's approach, which allows dual inclusion income to be recognized in any other period.[244]

4.4.5 Concurrence with CFC rules

The OECD suggests that income that is included in the tax base as a result of the application of CFC rules should qualify as dual inclusion income.[245] The legislator acknowledges the role of anti-avoidance rules that lead to the inclusion of income at the level of a different entity.[246] For the application of the hybrid mismatch rules, the Dutch legislator has clarified that income is deemed included in the tax base if it is not taxed at the level of the receiving entity, but – as a result of the application of a CFC rule – the income is taxed at the level of another group entity instead.[247]

To qualify as dual inclusion income under CFC rules, the income must be regularly and entirely included in the tax base and taxed against the general statutory rate. Furthermore, there should be no right to receive a tax credit for taxes that were paid at the level of the CFC.[248] This is in line with the OECD's approach, which states that double taxation relief means that the DI-exception cannot be applied if such relief de facto results in a hybrid mismatch outcome.[249]

4.4.6 Concurrence with deduction limitation rules

The hybrid mismatch rules can in principle apply in case of a deduction limitation.[250] Deduction limitation rules require that payments which are in principle deductible from the tax base are no longer tax-deductible. This can be a *specific* deduction limitation, such as the hybrid mismatch rules, or a *general* deduction limitation, such as a general interest deduction limitation.[251]

Deduction limitations do not by definition lead to the inclusion or deemed inclusion of income, but rather result in a denial of the deduction of costs. Effectively, deduction limitation rules impose an implicit tax on the income from which the costs are usually tax-deductible, so that the payment is de

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[241] E.g., a hybrid entity is considered non-transparent in the Netherlands and transparent in Country X. In year T=1, the entity claims a double deduction of -/- 80. If in year T=2, the entity has + 60 income which is included in the tax base in both the Netherlands and Country X, this can constitute dual inclusion income in year T=2. In this example, both the Netherlands and Country X include the income in the same year.

[242] *Kamerstukken II* 2020/21, 35573, nr. 6, p. 15.

[243] *Ibid*, p. 17. This may result in economic double taxation, see *infra*, section 4.5.4.

[244] OECD BEPS Action 2 Final Report, par. 129, 201 and 228 state "Because the hybrid mismatch rules are generally not intended to impact on, or be affected by, timing differences, the disregarded hybrid payment rules contain a mechanism that allows the payer jurisdiction to carry-forward (or back if permitted under local law) a hybrid deduction to a period where it can be set-off against surplus dual inclusion income."

[245] See OECD BEPS Action 2 Final Report, Example 6.4.

[246] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 44.

[247] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 59 and *Kamerstukken I* 2019/20, 35241, C, p. 5.

[248] *Ibid.* These requirements are strict, which implies that the exception for CFC rules is rarely applied. This may be justified by the argument without the requirements, there would still be a substantial tax benefit from the hybrid mismatch. Nevertheless, it can be considered to include these situations in the proposed relief in *infra*, section 6.7.3.

[249] OECD BEPS Action 2 Final Report, par. 126, 198, and 226.

[250] See *infra*, section 2.4.4.

[251] With respect to *specific* interest deduction limitation rules, see e.g., art. 8c, 10(1)d, 10a, 10b, and 15ba DCITA 1969. The Netherlands has also implemented a general deduction limitation in art. 15b DCITA 1969.

facto included in the tax base. Therefore, it should be assessed whether deduction limitations can result in dual inclusion income.

The OECD BEPS Action 2 Final Report seems to use an economic approach in assessing whether deduction limitation rules result in dual inclusion income, rather than a strict approach based on the nature of the payment.[252]

- With respect to *specific* deduction limitations, the OECD recommends that the hybrid mismatch rules are not applied to the extent the payment is not allowed to be deducted from the tax base.[253]
- With respect to *general* deduction limitations, the OECD states that these should not be considered when determining whether there is dual inclusion income, because *general* deduction limitation rules should apply after the hybrid mismatch rules, as the hybrid mismatch rules are *specific* anti-abuse rules.[254]

The OECD further states that domestic law should achieve an overall outcome that avoids double taxation and that deduction limitations should not result in denying a deduction twice for the same item of expenditure.[255]

The Dutch legislator has not explicitly included deduction limitations in the scope of dual inclusion income. Based on the Dutch interpretation of the hybrid mismatch rules, it is decisive whether a payment is deductible by nature, so that *general* deduction limitations do not result in dual inclusion income.[256] Furthermore, only if a *specific* deduction limitation implies that the payment is not deductible by nature, there would be no deduction for the purpose of the hybrid mismatch rules.[257] However, these statements only relate to application of the hybrid mismatch rules themselves (i.e., the pro rata rule), not to the DI-exception.[258]

4.4.7 Transfer pricing adjustments

Transfer pricing rules adjust transfer prices between associated entities to represent arm's length prices that would have been negotiated between independent third parties.[259] These transfer pricing rules should be applied when determining the payment that should be targeted a primary or secondary hybrid mismatch rule (i.e., a deduction limitation or an income inclusion).[260] Therefore, the hybrid mismatch rules are applied after making arm's length adjustments.

In the OECD's interpretation, transfer pricing adjustments could in principle fall within scope of the DI-exception.[261] Within the mechanical nature of the hybrid mismatch rules, the origin requirement serves to only target hybrid mismatches, which means that transfer pricing mismatches should in principle not be targeted by the hybrid mismatch rules.[262]

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[252] OECD BEPS Action 2 Final Report, par. 190, 223, 284, and 290.
[253] *Ibid*, par. 290.
[254] *Ibid*, par. 291-292 and 317.
[255] *Ibid*, par. 292.
[256] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 54-55 and 61.
[257] *Kamerstukken II* 2015/16, 34306, nr. 6, p. 13.
[258] This is further discussed in *infra*, section 4.5.5.
[259] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 40 illustrates this with the following example: "Suppose a taxpayer owes 10 in interest on a hybrid financial instrument, but the arm's length price is 100. Then it is possible to deduct 100 based on the transfer pricing rules. If, the interest on the hybrid financial instrument is targeted by the hybrid mismatch rules, a deduction of 100 will be denied."
[260] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 40-41.
[261] OECD BEPS Action 2 Final Report, par. 197 adds that "An amount should still be treated as dual inclusion income even if there are differences between jurisdictions in the way they value that item or in the accounting period in which that item is recognised for tax purposes."
[262] *Ibid*, p. 6. The importance of this statement becomes clear in *infra*, section 4.5.3.

4.4.8 Double tax conventions

According to the Dutch legislator, determining whether income is taxed in both jurisdictions also depends on the applicability of a bilateral double tax convention, because the method of double tax relief is relevant in determining whether there is dual inclusion income.[263] If income is de facto included in the tax base, it qualifies as dual inclusion income, regardless of whether a tax exemption or tax credit is applied to relieve double taxation.[264] However, if a tax exemption or tax credit de facto results in a D/NI or DD situation, the DI-exception cannot be applied.[265]

The position of the Dutch legislator on double tax relief is in line with the OECD's approach. The OECD notes that income could also qualify as dual inclusion income if the income benefits from double tax relief insofar such relief ensures that the income is not subject to an additional layer of taxation under the laws of either jurisdiction.[266]

4.5 Economic double taxation in the hybrid mismatch rules

4.5.1 Introduction

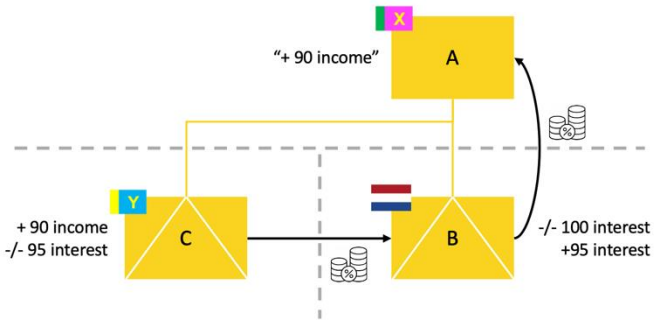
The Dutch legislator emphasizes that it is not the aim of the ATAD to impose double taxation.[267] However, in certain circumstances, the ATAD hybrid mismatch rules may in fact cause or aggravate economic double taxation. In principle, the nature of the linking rules in the hybrid mismatches serves to prevent economic double taxation through the origin requirement, the ranking rule, and the pro rata rule.[268] Therefore, the scope of economic double taxation is relatively limited.

The following analyzes economic double taxation in situations with dual inclusion income in a third country, mismatches in transfer pricing adjustments, timing differences, and concurrence with deduction limitation rules.[269]

4.5.2 Third country involvement

Figure 4.5.2 contains an example to illustrate how economic double taxation might result from the narrow definition of dual inclusion income with respect to the involvement of third countries, i.e., a country that is not directly involved in the hybrid mismatch.[270]

[263] *Kamerstukken II* 2019/20, 35241, nr. 7, p. 40.
[264] *Ibid*, p. 41.
[265] *Ibid* and *Kamerstukken I* 2019/20, 35241, nr. C, p. 15.
[266] OECD BEPS Action 2 Final Report, Recommendation 12. See also par. 126 and 198.
[267] *Ibid*, nr. 3, p. 3-4.
[268] *Infra*, section 4.2.
[269] In all examples below, Countries X and Y and their respective flags are fictitious, and it is assumed that these countries do not have hybrid mismatch rules in place. Furthermore, the examples only discuss the primary rule, but the examples could be extended to applying the secondary rule. Hence, the examples serve as a simple illustration of the problem of economic double taxation. The examples were inspired by L.R. Jacobs, P.G.H. Albert and G.K. Fibbe, 'Overkill bij ATAD2: wat gaat de Hoge Raad of staatssecretaris doen?', *MBB* 2021/4; M.M. Makkinje, 'ATAD2 in hoofdlijnen, deel 1', *NTFR-B* 2020/30; and J.J.A.M. Korving and W.R. Kooiman, 'Hybride interpretatie', *MBB* 2021/18, and the Dutch legislative history as cited in the rest of this research.
[270] Third country does not refer to non-Member States but refers specifically to a country that is not directly involved in the transaction to which the hybrid mismatch rules are applied. Hence, this situation could also occur with respect to Member States.



- For tax purposes in Country X, both B and C are transparent
- For tax purposes in the Netherlands and Country Y, both B and C are non-transparent
- A grants a loan to B, for which A owes B 100 in interest
  - The interest is deductible from B's tax base
  - The interest is not included in A's tax base
- C receives 90 income from external transactions
  - The income is included in C's tax base
  - The income is included in A's tax base
- B grants a loan to C, for which C owes B 95 in interest
  - The interest is deductible from C's tax base
  - The interest is included in B's tax base
  - The transaction is not recognized by A

Figure 4.5.2

From the perspective of Country X, both B and C are fiscally transparent, whereas the Netherlands and Country Y consider B and C to be fiscally non-transparent.[271] The hybrid qualification of B in the Netherlands results in a D/NI situation, where the interest payment is deductible in the Netherlands but not included in the tax base in Country X.

If all entities would be characterized as transparent, the overall profits of the group would be 90, but due to the hybrid transparency of B and C, only 80 is effectively taxed.[272] This is the result of the losses of 5 that both B and C incur due to their hybrid transparency. Hence, the hybrid tax benefit is 10, shown in Table 4.5.2. The Netherlands targets the tax benefit through the hybrid mismatch rules, as the primary rule denies the deduction of the interest payment of 100 that B makes to A.[273]

Table 4.5.2

Example 1: dual inclusion income in third country	**A**	**B**	**C**	**Group**
Income	90	95	90	275
Costs	0	-/- 100	-/- 95	-/- 195
Taxable profit without hybrid mismatch rules	90	-/- 5	-/- 5	80
Hybrid benefit without hybrid mismatch rules				**10**
Deduction limitation		100		100
Taxable profit with hybrid mismatch rules	90	95	-/- 5	180
Economic double taxation with hybrid mismatch rules				**90**

Application of the DI-exception would require that B's income is included both in the tax base of the Netherlands and Country X.[274] The 95 interest is only taxed once at the level of B and can therefore not qualify as dual inclusion income from the perspective of the Netherlands. Furthermore, C's income of 90 that is also included in A's tax base does not constitute dual inclusion income, because it does

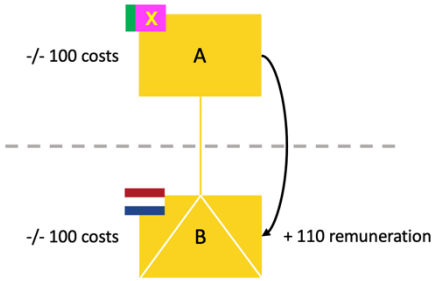
[271] Example taken from *Kamerstukken II* 2018/19, 35241, nr. 3, p. 64.
[272] If all entities would be characterized as non-transparent, B and C would both make a loss of -/- 5. This does not change the result with respect to economic double taxation.
[273] Art. 12aa(1)e DCITA 1969.
[274] Art. 12aa(3) DCITA 1969.

not arise in the relationship between the Netherlands and Country X, but in the relationship between Country X and Country Y.[275]

Because of the application of the hybrid mismatch rule in the Netherlands, B's tax base will be 95, instead of a loss of 5. Therefore, the deduction limitation for the interest amount of 100 in the Netherlands effectively leads to economic double taxation over an amount of 90 for the group, since C's hybrid loss of 5 persists.[276] Hence, the application of the hybrid mismatch rules results in moving from the tax benefit of 10 from the hybrid mismatch, towards economic double taxation over 90.

4.5.3 Transfer pricing mismatch

Transfer pricing also plays a role in potentially imposing economic double taxation in hybrid mismatch situations. Whereas the origin requirement serves to prevent the hybrid mismatch rules from targeting non-hybrid elements such as transfer pricing mismatches, this may effectively worsen economic double taxation in case of disparities or differences in the application of transfer pricing rules.[277] Figure 4.5.3 shows an example where the hybrid mismatch rules aggravate economic double taxation because of a mismatch in transfer pricing adjustments.[278]



- For tax purposes in Country X, B is transparent
- For tax purposes in the Netherlands, B is non-transparent
- B produces goods and makes 100 production costs
  - The production costs are deductible from B's tax base
  - The production costs are deductible from A's tax base
- B sells goods to A with cost-plus value of 110
  - The Netherlands includes a deemed arm's length payment of 110 in B's tax base
  - The arm's length payment is not recognized in Country X and therefore not deducted from A's tax base

Figure 4.5.3

B's hybrid transparency results in a DD mismatch.[279] Without application of the hybrid mismatch rules, B would make a profit of 10, because B receives a deemed (cost-plus) arm's length payment from A. Without application of the hybrid mismatch rules, the structure results in a tax benefit of 90, which is shown in Table 4.5.3.

[275] The state secretary of Finance confirms that C's income does not constitute dual inclusion income, see *Kamerstukken II* 2018/19, 35241, nr. 3, p. 64. It should be noted that if Country Y is a Member State, C's income would constitute dual inclusion income in Country Y, so that Country Y would not apply hybrid mismatch rules.
[276] It is assumed that Country Y does not apply hybrid mismatch rules.
[277] This may generate economic double taxation if there is a mismatch, where one jurisdiction makes a primary adjustment but the other jurisdiction refrains from making a corresponding adjustment. See also *infra*, section 4.4.7.
[278] Authors J.J.A.M. Korving and W.R. Kooiman, op. cit., section 2, are critical of this example, as there is economic double taxation in the first place. The arm's length payment is non-deductible at the level of A and is included in the tax base of B. Hence, the arm's length payment is subject to economic double taxation, since it is de facto included in both A's and B's tax base. This economic double taxation can in principle be offset by a hybrid mismatch. However, the hybrid mismatch rules can aggravate such economic double taxation.
[279] Example taken from *Kamerstukken I* 2019/20, 35241, nr. C, p. 15-16 and *Kamerstukken I* 2019/20, 35241, nr. E, p. 12-13. Fundamentally, this example results in a double deduction and abstracts from any other income that A might receive. Hence, the fact that A incurs a loss does not mean that the hybrid mismatch is unviable, since A may be able to compensate this loss with other income.

Table 4.5.3

Example 2: transfer pricing adjustment	A	B	Group
Income	0	110	110
Costs	-/- 100	-/- 100	-/- 200
Taxable profit without hybrid mismatch rules	-/- 100	10	-/- 90
Hybrid benefit without hybrid mismatch rules			**90**
Deduction limitation		100	100
Taxable profit with hybrid mismatch rules	-/- 100	110	10
Economic double taxation with hybrid mismatch rules			**10**

To target the hybrid mismatch, the primary rule applies, which stipulates that the production costs are non-tax-deductible for B.[280] As a result, B is taxed over 110 instead of 10. Since Country X qualifies B as transparent, the payment of 110 is invisible from the perspective of Country X and thus non-tax-deductible in Country X. A's loss thus remains at 100 after application of the hybrid mismatch rule. This results in economic double taxation over 10.

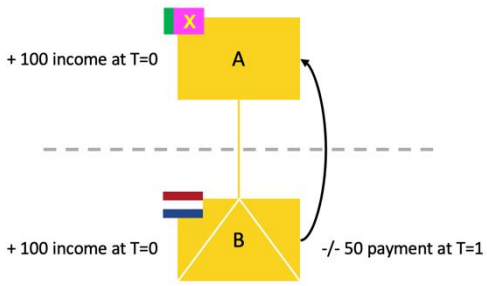
In this example, the transfer pricing mismatch leads to economic double taxation, which is aggravated by the hybrid mismatch rules.[281] The arm's length payment only qualifies as dual inclusion income if it is recognized for tax purposes from the perspective of A and it is therefore also included in A's tax base as B's profits accrue to A.[282] Hence, the DI-exception cannot be applied, because the income from the arm's length payment is only included in B's tax base.[283]

Even though the payment of 110 is an arm's length remuneration, the state secretary of Finance has indicated that the ATAD does not offer an opportunity for rebuttal to prove such economic double taxation, and that there would be no possibility to deviate from the ATAD.[284]

4.5.4 Timing differences

Even though timing differences are recognized for the DI-exception, such differences can generate economic double taxation, as illustrated in Figure 4.5.4.[285]

[280] Art. 12aa(1)g DCITA 1969.
[281] The economic double taxation from the transfer pricing adjustment does not completely undo the tax benefit from the hybrid mismatch, which makes the example practically plausible.
[282] See example 6.2 in Besluit van 1 oktober 2021, nr. 2021-20014, BWBR0045683 (*Besluit Hybridemismatches*).
[283] With a different opinion, J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.2, argue that the transfer pricing adjustment can never constitute double inclusion income. My opinion is that it could, since the non-deduction of the arm's length payment could be interpreted in such a way that it remains in A's income. This interpretation is in line with the OECD's view on deduction limitations, see OECD BEPS Action 2 Final Report, par. 291.
[284] *Kamerstukken I* 2019/20, 35241, nr. C, p. 16 and *Kamerstukken I* 2019/20, 35241, nr. E, p. 13.
[285] Timing differences are comparable to transfer pricing mismatches; hence a similar analysis applies.



- For tax purposes in Country X, B is transparent
- For tax purposes in the Netherlands, B is non-transparent
- In year T=0, B derives 100 income
  - The income is included in B's tax base
  - The income is included in A's tax base
- In year T=1, B makes a payment to A
  - The payment is deductible from B's tax base
  - The payment is not included in A's tax base

Figure 4.5.4

B is a hybrid entity. This results in a D/NI situation to which the hybrid mismatch rules apply.[286] In this example, the income is included twice *before* the hybrid mismatch occurs. Therefore, there is no dual inclusion income since the DI-exception can only apply if the income is included in the tax base *after* the hybrid mismatch is applied.[287] Hence, the result is economic double taxation over the payment of 50.

4.5.5 Deduction limitation rules

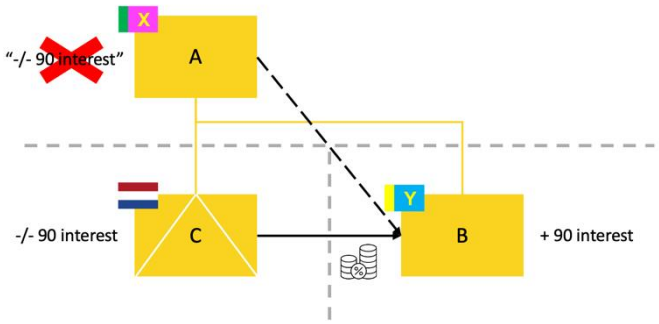
If the origin requirement is satisfied because a payment is deductible by nature, the hybrid mismatch itself is deemed to result in a DD or D/NI situation, so that the hybrid mismatch rules are in principle applicable.[288] The concurrence of deduction limitation rules and the hybrid mismatch rules may generate economic double taxation because of the limited scope of the DI-exception.

4.5.5.1 Double deduction situations

In case of a DD situation, a *general* deduction limitation rule can lead to the non-tax-deductibility of a payment from a payer's tax base.[289] The Dutch implementation of the hybrid mismatch rules implies that in case of DD situations, it is relevant to which taxpayer the deduction limitation applies.

- The primary rule in DD situations does not generate economic double taxation in the Netherlands, because the order of articles in the DCITA 1969 stipulates which deduction limitation applies.[290]
- If the secondary hybrid mismatch rule applies in the Netherlands, the application of a deduction limitation at the level of the foreign entity results in economic double taxation, as shown in Figure 4.5.5.1.

[286] Note that there is no timing difference in the sense that the Netherlands and Country X include the income in a different year. Here, the timing difference originates from the inclusion of the income in both tax bases in a different period than the period in which the payment that relates to the hybrid mismatch occurs.
[287] *Infra*, section 4.3.1.3.
[288] Deduction limitation rules are not always considered when determining whether the hybrid mismatch rules apply. See *infra*, section 4.4.6.
[289] Under certain circumstances, *specific* deduction limitation rules can also result in concurrence with the hybrid mismatch rules. See J. Versluis, op. cit., section 4.2.
[290] Dutch interest deduction limitation rules cannot lead to concurrence with the hybrid mismatch rules. See *Kamerstukken II* 2018/19, 35241, nr. 3, p. 6.



- For tax purposes in Country X,
  - C is transparent
  - B is non-transparent
- For tax purposes in the Netherlands and Country Y, B and C are non-transparent
- B grants a loan
  - Country X deems the loan to be granted to A
  - The Netherlands deems the loan to be granted to C
- Country X applies an interest deduction limitation

Figure 4.5.5.1

Country X qualifies C as transparent and B as non-transparent. This results in a double deduction that is targeted by the hybrid mismatch rules. Country X applies a *general* or *specific*[291] interest deduction limitation, which results in the denial of the interest deduction for A.[292] However, as the hybrid mismatch between the Netherlands and Country X persists, the secondary rule will deny the interest deduction for C as well. As shown in Table 4.5.5.1, this results in economic double taxation over 90, because the application of the interest deduction limitation at the level of A would not constitute dual inclusion income, even though there was no tax benefit from the hybrid mismatch in the first place.[293]

Table 4.5.5.1

Example 1: dual inclusion income in third country	**A**	**B**	**C**	**Group**
Income	0	90	0	90
Costs	-/- 90	0	-/- 90	-/- 195
Interest deduction limitation	90			90
Taxable profit without hybrid mismatch rules	0	90	-/- 90	0
Hybrid benefit without hybrid mismatch rules				**0**
Deduction limitation			90	90
Taxable profit with hybrid mismatch rules	0	90	0	90
Economic double taxation with hybrid mismatch rules				**90**

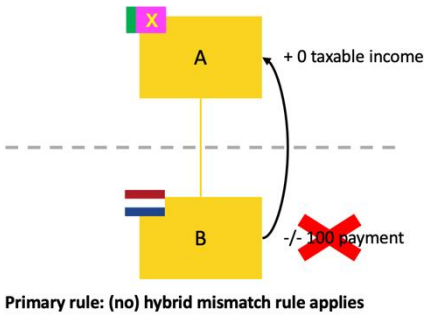
[291] The secondary hybrid mismatch rule may apply in the Netherlands if Country B's deduction limitation rule is not comparable to the primary hybrid mismatch rule. See also *infra*, section 4.5.5.2 and J. Versluis, op. cit., section 4.3.

[292] If B would use the interest to make a capital contribution to another group entity (not shown here), if A were situated in the Netherlands, art. 10a DCITA 1969 could deny the deduction of the interest if the two transactions are grounded on non-commercial reasons and the interest would not be taxed at a reasonable level. In line with J. Versluis, op. cit., section 2.1, I assume here that a *general* deduction limitation means that the payment is still deductible by nature.

[293] It should be noted that the legislator has not specifically addressed the application of deduction limitation rules at the level of the foreign entity.

4.5.5.2 Deduction/no inclusion situation: deduction limitation at the level of the payer

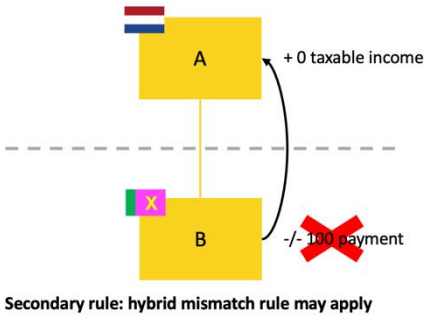
Figures 4.5.5.2.a and 4.5.5.2.b show a deduction limitation applied at the level of the payer.[294]



- Both entity A and B are fiscally non-transparent
- B makes a payment to A with respect to a hybrid financial instrument
  - From the perspective of Country X, the instrument qualifies as equity, so the payment is not included in A's tax base
  - From the perspective of the Netherlands, the instrument qualifies as debt, so the payment is deductible from B's tax base
- The Netherlands applies an interest deduction limitation

Figure 4.5.5.2.a

If A is situated in Country X (Figure 4.5.5.2.a), in a D/NI situation, the DI-exception does not have to be applied when a *specific* deduction limitation applies at the level of the payer in the Netherlands, because the deduction of the payment cannot be denied twice by the provisions in the DCITA 1969. Furthermore, if the hybrid mismatch rules apply, the *general* earnings stripping rule will not be applied. Hence, neither a *general* nor a *specific* deduction limitation can lead to concurrence with the primary hybrid mismatch rules in the Netherlands.[295]



- Both entity A and B are fiscally non-transparent
- B makes a payment to A with respect to a hybrid financial instrument
  - From the perspective of the Netherlands, the instrument qualifies as equity, so the payment is not included in A's tax base
  - From the perspective of Country X, the instrument qualifies as debt, so the payment is deductible from B's tax base
- Country X applies an interest deduction limitation

Figure 4.5.5.2.b

If A is situated in the Netherlands (Figure 4.5.5.2.b), the secondary hybrid mismatch rule may apply if Country B's deduction limitation rule is not comparable to the primary hybrid mismatch rule, even if Country X would have hybrid mismatch rules in place but first applies another deduction limitation rule.[296] This concurrence could result in economic double taxation over A's income of 100 with respect to the hybrid payment made by B, even though the deduction limitation implies there is no de facto hybrid tax benefit. This economic double taxation cannot be resolved by the DI-exception, because in the interpretation of the Dutch hybrid mismatch rules, there is no dual inclusion income.[297]

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[294] The deduction limitation is irrelevant if it applies to the recipient of the payment.

[295] *Infra*, section 4.4.6.

[296] Art. 12ab(1) DCITA 1969. With respect to foreign *general* deduction limitation rules, the state secretary of Finance has indicated that taking such rules into account would make the hybrid mismatch rules impracticable. See *Kamerstukken I* 2017/18, 34306, nr. 6, p. 3-4. See also *Kamerstukken II* 2019/20, 35241, nr. 8, p. 2 and J. Versluis, op. cit., section 4.2.

[297] *Infra*, section 4.4.6.

4.6 Sub-conclusion

The hybrid mismatch rules operate mechanically by coordinating which jurisdiction should take action to neutralize the hybrid mismatch. This mechanical approach suggests a general preference for preventing economic double non-taxation over preventing economic double taxation.

The methods to prevent economic double taxation in the hybrid mismatch rules are equally mechanical as the hybrid mismatch rules. The ranking and pro rata rule serve as a primary identification of hybrid mismatches and lead to exemption of the hybrid mismatch rules. The ranking rule stipulates that the secondary rule applies only if the primary rule is not applied by another jurisdiction. The pro rata rule implies that a payment is only targeted by the hybrid mismatch rules insofar there is a hybrid mismatch. In contrast, the dual inclusion exception is not an exemption, as it can only be applied once the hybrid mismatch rules are in principle already applicable. Because of these relief mechanisms, the scope of economic double taxation resulting from the hybrid mismatch rules is relatively limited.

The dual inclusion exception stipulates that the hybrid mismatch rules do not apply insofar a payment is deducted against dual inclusion income. However, the definition of dual inclusion income in the ATAD that was implemented by the Netherlands appears too strict to prevent economic double taxation in all circumstances. Essentially, the hybrid mismatch rules can cause or aggravate economic double taxation that cannot be prevented by the dual inclusion exception in four situations:

1. When a **third country is involved**, the definition of dual inclusion income is too narrow with respect to the requirement that the income is included in the tax bases of both jurisdictions involved in the hybrid mismatch.
2. The definition of dual inclusion income does not include mismatches in **transfer pricing adjustments**, i.e., arm's length corrections that are not recognized in both jurisdictions involved in the hybrid mismatch.
3. The dual inclusion exception can only be applied after the hybrid mismatch rules, which implies that **timing differences** may result in economic double taxation in case the dual inclusion income occurs before the deduction of a payment that results in a hybrid mismatch.
4. **Deduction limitation rules** may result in economic double taxation caused by the hybrid mismatch rules in double deduction situations in case of foreign deduction limitation rules that are not comparable to the hybrid mismatch rules. With respect to deduction/no inclusion situations, if the payer is situated in the Netherlands, the hybrid mismatch rules provide for concurrence rules to prevent double taxation. However, if the payer is situated in another jurisdiction that does not apply a primary hybrid mismatch rule, the secondary hybrid mismatch rule may impose economic double taxation.

Chapter 5 Economic analysis

5.1 Introduction

Through modeling the consequences of economic double taxation, this chapter analyzes whether economic double taxation resulting from the hybrid mismatch rules should be relieved. The following sub-question is addressed: **what are the economic incentive effects of the ATAD hybrid mismatch rules?** First, a mathematical model that allows analyzing tax incentives from economic double taxation is introduced (section 5.2). The model is adjusted to analyze production and investment decisions in deduction/no inclusion situations (section 5.3) and double deduction situations (section 5.4). Subsequently, tax revenue considerations are discussed (section 5.5). In the conclusion, the above sub-question is addressed (section 5.6).

5.2 Economic theory and tax incentives

5.2.1 Introduction

The OECD emphasizes the importance of ensuring that the BEPS Action Plan has a multilateral and coordinated scope because unilateral anti-abuse measures may lead to uncertainty and double taxation.[298] According to the OECD, double taxation has negative consequences for the contribution of multinational enterprises to international trade, investment, innovation, employment, economic growth, and poverty reduction.[299] Hence, the reason that the OECD also focuses on the elimination of double taxation – in addition to double non-taxation – is motivated by economic arguments.[300]

The hybrid mismatch rules can affect economic investments and production, not only when the hybrid mismatch rules impose double taxation, but also when they serve to neutralize hybrid mismatches. Direct effects on investment result from increasing the effective cost of investment capital through an increased tax burden. As a result, the marginal after-tax productivity of capital decreases and therefore, the taxpayer is incentivized to invest less.[301] Indirect effects on investment originate from distortions in the use of other production factors insofar capital and other production factors are complementary in production. Through the hybrid mismatch rules, the private marginal after-tax benefits of production decrease compared to the social marginal benefits of production.[302] Then, from an economic point of view, there may be too much or too few production, which would result in a loss of economic efficiency.[303]

5.2.2 Model of profit maximization

To analyze the economic double taxation that may result from the hybrid mismatch rules, consider a simple profit maximization model with a multinational enterprise (hereinafter: MNE) that holds

[298] OECD, *Action Plan on Base Erosion and Profit Shifting*, Paris: OECD Publishing 2013, p. 10-11.
[299] OECD BEPS Project Explanatory Statement*,* p. 4.
[300] *Ibid,* p. 5.
[301] M.A. King, 'Taxation and the Cost of Capital', *The Review of Economic Studies* (41) 1974, nr. 1, p. 21–35.
[302] Profit-maximizing firms equate the marginal benefits of production equal to the marginal costs of production. The social marginal benefits of production are based on the firm's production technology, i.e., the firm's productiveness. CITs decrease the private marginal benefits below the social marginal benefits of production because the firm must give up part of its revenues to the CIT. This distorts production decisions since the firm no longer maximizes economic profit. See also B. Jacobs, *Principles of Public Finance – Part 1*, Rotterdam 2021, section 2.7.
[303] The hybrid mismatch rules reduce production efficiency, but that does not necessarily imply reduced social welfare. Distortive taxation can be optimal e.g., if it allows income redistribution, in which case eliminating the distortion from the hybrid mismatch rules would reduce social welfare. However, this research is not concerned with the effects of distorted production and investment decisions on social welfare. Instead, the focus is on delineating the production and investment effects of the hybrid mismatch rules.

participations in associated entities in several jurisdictions.[304] The model includes two subsidiaries as part of this MNE group, with a parent entity in Country X, and a wholly owned subsidiary entity in the Netherlands.[305] It is assumed that both jurisdictions $i = X, NL$ have a proportional corporate income tax (hereinafter: CIT) rate $t_i > 0$.[306]

The model assumes that the MNE's decision-making is centralized, so that the cross-border structuring of associated entities allows maximizing profits at the level of the MNE group. A perfectly competitive market is assumed, with a price taking MNE that produces homogeneous services through its subsidiaries in different jurisdictions.[307] These services can be sold both to external markets and as intra-group services. Within the MNE, transactions should be priced at arm's length.[308] For simplicity, a perfect capital market is assumed.[309] Affiliates are financed through equity (i.e., no debt) with the costs of equity being non-tax-deductible.[310]

It is assumed that the MNE does not incur transaction-based tax planning costs for concealing the hybrid mismatch. Instead, the tax planning costs are incurred as fixed costs at the level of the parent entity.[311] The reason is that in practice, Dutch entities must keep extensive documentation of whether the corporate MNE structure involves hybrid mismatches.[312] Therefore, in principle, hybrid mismatches must be disclosed in the CIT return. In that case, the application of the hybrid mismatch rules is certain. If the taxpayer does not disclose the hybrid mismatch in its tax return, the hybrid mismatch is not neutralized, unless the DTA discover the mismatch.[313]

The modeling of the tax planning costs is in line with criticisms that have been raised with respect to the effectiveness of the documentation obligation.[314] Questions have been raised regarding whether the reversal of the burden of proof with respect to the applicability of the hybrid mismatch rules is an effective means of ensuring compliance.[315] Assessing the tax characterization of entities and

[304] The model is inspired by S.B. Nielsen, D. Schindler and G. Schjelderup, 'Abusive transfer pricing and economic activity', *CESifo* Working Paper Series 2014, nr. 4975, p. 1-22.
[305] In practice, most MNE structures include more entities. However, to isolate the hybrid transaction, this model focuses on two entities that may be part of a larger MNE group. It can be assumed that the MNE is making profits in other parts of its corporate structure as well.
[306] The Netherlands has a progressive CIT rate with two tax brackets (art. 22 DCITA 1969). However, for large amounts of profits, the CIT rate converges to the high CIT rate of 25.8% (2022).
[307] Price-taking implies the MNE cannot influence market prices and that adequate comparables are available for establishing arm's length prices. This eliminates profit shifting through transfer pricing from the model to isolate the hybrid mismatch.
[308] This implies that intra-group transactions should have the same conditions as between independent parties (art. 8b DCITA 1969).
[309] It is assumed that the individual jurisdiction cannot affect the global capital market interest rate and that global capital markets are well-functioning.
[310] Intra-group debt is excluded from the model to eliminate profit shifting through debt and isolate the hybrid mismatch.
[311] This fixed cost aspect is confirmed in *Kamerstukken II* 2018/19, 35241, nr. 3, p. 35. These fixed costs are not included in the model, because they would not alter the results qualitatively.
[312] *Infra*, section 2.4.7.
[313] Any costs for the taxpayer are assumed to be included in the fixed costs that are not included in the model. Correspondingly, no probability of detection is included in a function of expected profits for the MNE. This requires assuming there are no concealment costs for the taxpayer. However, in case of an audit, this would constitute additional costs for the MNE. Future research could incorporate such audit costs based on the probability of detection in the model.
[314] E.g., Nederlandse Orde van Belastingadviseurs Commissie Wetsvoorstellen*, NOB-commentaar wetsvoorstel Wet implementatie tweede EU-richtlijn antibelastingontwijking (35 241),* Amsterdam 2019, par. 35; D.P.J.G. van Kappel and G.K. Fibbe, op. cit., and C.J.D. Warren, op. cit.
[315] *Kamerstukken I* 2019/20, 35241, nr. E, p. 4-6.

instruments requires knowledge of foreign tax law.[316] However, foreign tax law is outside of the factual evidence requirement.[317] Hence, taxpayers cannot be legally obliged to provide evidence of foreign tax law, which means that the documentation obligation relies on taxpayers to reveal hybrid mismatches.[318] In that case, it remains the DTA that must assess the application of foreign tax law.[319]

The Mathematical Appendix provides intuition for all profit equations that are used in the remainder of this chapter. Fundamentally, the tax-deductibility of production costs allows the MNE to engage in base erosion through hybrid mismatches in the form of a D/NI or DD situation, which serves to minimize its overall tax payments and maximize after-tax profits. These incentives can be analyzed with respect to investment and production decisions.

5.3 Deduction/no inclusion situation

5.3.1 Introduction

Figure 5.3.1 illustrates a D/NI situation with a parent entity A in Country X that provides intra-group services S to the hybrid entity B, resulting in a D/NI situation.

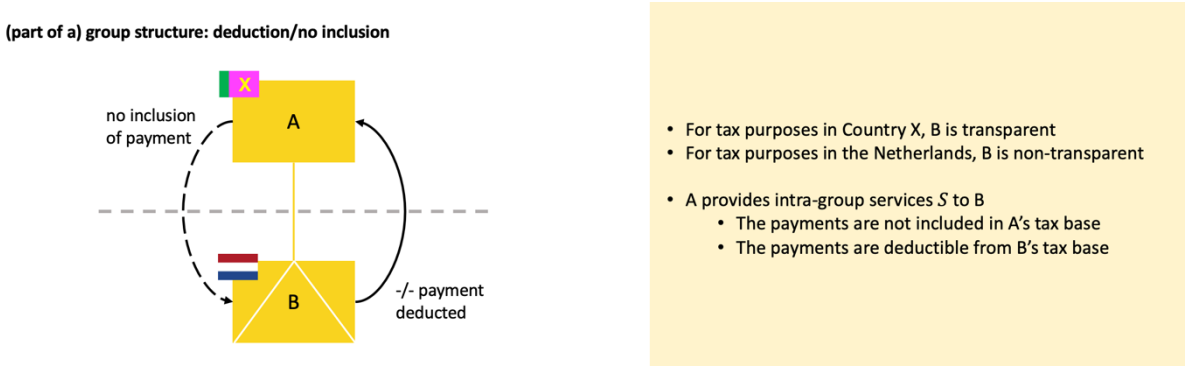

Figure 5.3.1

5.3.2 Entity A in Country X

A makes equity investments in other group entities, such as its participation in B.[320] A can be considered a vendor entity: it buys services on an external market and resells these to B to benefit from the hybrid mismatch. Furthermore, B's profits are not taxable in Country X, so there is no dual inclusion income.[321]

It can be assumed that A does generate income within other parts of the group structure, but to isolate the hybrid mismatch, this other income is not included in the model.[322] Because A resells the services to B, it incurs the costs of buying these services from an external market. The intra-group services must be priced at arm's length, so the costs are equal to the revenue A receives from B. Hence, A does not generate economic profits with respect to the hybrid mismatch.

The hybrid mismatch serves to obtain tax benefits. From a tax perspective, A does not incur costs for providing the services to B, since the intra-group transaction is not recognized in Country X. Due to B's

[316] C.J.D. Warren, 'Een hybride mismatch maar dan anders', *WFR* 2020/24, section 4.2.
[317] Art. 8:69 Awb. See also C.J.D. Warren, op. cit., section 3.1.
[318] C.J.D. Warren, op. cit., section 4.3.
[319] Even though this implies that no additional costs would be incurred at the level of the MNE, the exclusion of concealment costs is an important limitation of this model that is left for future research.
[320] It is assumed that intra-group financing only relies on equity.
[321] This can occur, e.g., if Country X has a territorial tax system.
[322] The existence of other income would make the corporate structure plausible (i.e., A would be loss-making).

transparency, the payment for the intra-group service is not included in A's tax base, so that no tax payments are generated in Country X with respect to the intra-group services.[323]

Summarizing, without application of the hybrid mismatch rules, A's profits are expressed as:[324]

$$\pi_A = 0$$

5.3.3 Entity B in the Netherlands

B uses the intra-group services as a production factor in producing its own services for an external market through a production function $x_B = F(K_B, S)$.[325] The production factors are equity capital K_B and intra-group service input S. There are diminishing marginal returns to both capital and service inputs.[326] Furthermore, capital and services are complements in production.[327]

It is assumed that the marginal cost of the service is $q > 0$. Therefore, q is the marginal arm's length cost of the intra-group services A provides.[328] In principle, the payment for the intra-group services is tax-deductible for B. Hence, the D/NI mismatch results in a tax benefit for the MNE, since the costs generate tax savings in the Netherlands without creating tax payments in Country X.[329] Additionally, B is required to pay the capital market rate r on the equity K_B through which it is financed, these capital costs are non-tax-deductible.

Summarizing, without application of the hybrid mismatch rules, the profits of entity B are expressed as:[330]

$$\pi_B = (1 - t_{NL})[F(S, K_B) - qS] - rK_B$$

5.3.4 Optimal behavior without hybrid mismatch rules

The risk neutral MNE maximizes the following global profit equation:

$$\max_{K_B, S} \Pi = \pi_A + \pi_B = 0 + (1 - t_{NL})[F(S, K_B) - qS] - rK_B$$

5.3.4.1 Optimal intra-group services without hybrid mismatch rules

To maximize profits, the MNE equates the marginal after-tax benefits of production to the marginal after-tax costs of the intra-group services. Deriving first-order conditions for optimal intra-group services S under a hybrid mismatch $\frac{\partial \Pi}{\partial S} = 0$ gives $(1 - t_{NL})[F_S^B - q] = 0$. An additional unit of services

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[323] For simplicity, only part of the MNE group is considered, so it is assumed that A does not provide services to external markets.

[324] The Mathematical Appendix shows how to calculate total profits, which is essentially economic profits minus the tax rate multiplied with taxable profit: $\pi_A = \pi_A^e - t_X \pi_A^t = 0 - t_X 0 = 0$. See *infra*, A3.1.1 of the Mathematical Appendix.

[325] E.g., the intra-group service might be IP-related or management-related. The external service produced by B could be of a different nature, e.g., consultancy services.

[326] This implies $F_K^B, F_S^B > 0$ and $F_{KK}^B, F_{SS}^B < 0$, which implies that production increases with each additional unit of a production factor, but the increase becomes smaller with each additional unit of a production factor.

[327] This implies $F_{KS}^B > 0$, which means that each production factor becomes more productive with each additional unit of the other production factor.

[328] The model abstracts from any transfer pricing consequences and assumes that A should resell to B for the external cost of the services that A buys from the market. The reason is that the incentives from the hybrid mismatch are isolated in the model. Including transfer pricing in the model would allow for additional mechanisms to shift profits.

[329] This hybrid mismatch is targeted by the hybrid mismatch rules, discussed in *infra*, section 5.3.5.

[330] *Infra*, A3.1.1 of the Mathematical Appendix.

input yields $(1 - t_{NL})F_S^B$ in income and costs $(1 - t_{NL})q$. Hence, the D/NI mismatch in principle does not distort production efficiency, because the private and social marginal costs and benefits of the intra-group services in production are equal in the MNEs optimal production decision.[331] However, the CIT indirectly affects production decisions through investment distortions.[332] Only with respect to the hybrid mismatch, the CIT in the Netherlands is non-distortive.[333]

5.3.4.2 Optimal capital investment without hybrid mismatch rules

To optimize its investment decision, the MNE equates the marginal costs of investment to the marginal benefits of investment. Deriving first-order conditions for optimal investment K_B in a hybrid mismatch situation $\frac{\partial \Pi}{\partial K_B} = 0$ gives $(1 - t_{NL})F_K^B - r = 0$.

In line with standard results, due to the non-tax-deductibility of capital costs, the CIT is distortive.[334] The CIT drives a wedge between the private and social marginal returns on investment. Hence, the CIT makes it less attractive for the MNE to invest in the Netherlands, but this is not directly related to the hybrid mismatch.[335]

5.3.5 Neutralization

The Netherlands will apply the primary hybrid mismatch rule for D/NI situations.[336] Neutralizing the hybrid mismatch implies that the payment is neither tax-deductible for B, nor included in A's tax base. However, the payment for the intra-group services remains deductible from B's economic profits.[337] This is summarized in the following profit equations:

$$\pi_A^N = 0$$
$$\pi_B^N = (1 - t_{NL})F(S, K_B) - qS - rK_B$$

The risk neutral MNE then maximizes the following global profit equation:[338]

$$\max_{K_B, S} \Pi^N = \pi_A^N + \pi_B^N = 0 + (1 - t_{NL})F(K_B, S) - qS - rK_B$$

5.3.5.1 Optimal intra-group services with neutralization

To maximize profits, the MNE equates the marginal after-tax benefits of production to the marginal after-tax costs of production. Deriving first-order conditions for optimal intra-group services S through

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[331] The private marginal benefits are $(1 - t_{NL})F_S^B$, whereas the social marginal benefits are F_S^B. However, due to the tax-deductibility of the service costs, the private marginal costs are $(1 - t_{NL})q$. This results in optimal decisions as the private marginal benefits of production equal the social marginal benefits of production, as the CIT is non-distortive in production decisions.

[332] The CIT is indirectly distortive due to the implicit tax on capital investment because of the non-deductibility of capital costs, but this is not the direct result of the hybrid mismatch.

[333] Furthermore, no taxes are paid in Country X.

[334] The private marginal benefit of investment $(1 - t_i)F_K^i$ is reduced below the social marginal benefits of investment F_K^i. This implies that an additional unit of capital investment yields $(1 - t_{NL})F_K^B$ in private benefits, whereas the social marginal benefits are F_K^B. Both private and social marginal costs of investment are r.

[335] The investment distortion indirectly distorts production decisions due to the complementarity in production of capital and services, so that production is also distorted below economic efficiency. Again, this is unrelated to the hybrid mismatch.

[336] Art. 12aa(1)e DCITA 1969.

[337] The intra-group services are still related to economic costs; hence they should be included in the profit equation.

[338] *Infra*, A3.1.2 of the Mathematical Appendix.

setting $\frac{\partial \Pi}{\partial S} = 0$ gives $(1 - t_{NL})F_S^B - q = 0$. Each additional unit of production yields $(1 - t_{NL})F_S^B$ in after-tax revenue and costs q because of the deduction limitation.

Since the payments for the services are no longer tax-deductible due to the hybrid mismatch rules, the CIT distortion is worsened. Therefore, the neutralization leads to a reduction in the extent to which the MNE engages in the hybrid mismatch, since the use of intra-group services is unambiguously decreased as a result of the deduction limitation.

Intuitively, due to the increased tax burden, it becomes less attractive to produce in the Netherlands. This does not necessarily imply that the use of intra-group services is decreased to zero. If the marginal after-tax benefits of production outweigh the pre-tax costs of the services, the MNE does not refrain from buying intra-group services. Hence, a neutralizing hybrid mismatch rule does unambiguously lower production, but does not necessarily incentivize the MNE to seize its activities in the Netherlands altogether.[339]

5.3.5.2 Optimal capital investment with neutralization

In its optimal investment decision, the MNE equates the marginal costs of investment to the marginal benefits of investment. Deriving first-order conditions for optimal investment K_B through $\frac{\partial \Pi}{\partial K_B} = 0$ gives standard results $(1 - t_{NL})F_K^B - r = 0$. Each additional unit of capital investment yields private marginal benefits of $(1 - t_{NL})F_K^B$ and costs r, which makes the Dutch CIT distortive.[340]

The optimal condition for investment decisions remains unchanged compared to the situation without hybrid mismatch rules. However, since the optimal use of intra-group services is decreased because of the neutralization, the complementarity of services and capital in production implies that the level of optimal investment in the Netherlands decreases. Capital becomes less productive because of the decrease of intra-group services. Therefore, the hybrid mismatch rules make it less attractive to invest in the Netherlands.

5.3.6 Double taxation

A limited interpretation of the dual inclusion exception can lead to economic double taxation caused by the hybrid mismatch rules.[341] In that case, the payment is non-tax-deductible for B but de facto included in A's tax base, which generates tax payments both in the Netherlands and in Country X.[342] This changes the profit equations:

$$\pi_A^{DT} = -t_X qS$$
$$\pi_B^{DT} = (1 - t_{NL})F(K_B, S) - qS - rK_B$$

The risk neutral MNE maximizes the following profit equation:[343]

$$\max_{K_B, S} \Pi^{DT} = \pi_A^{DT} + \pi_B^{DT} = -t_X qS + (1 - t_{NL})F(S, K_B) - qS - rK_B$$

[339] See the discussion on the tax revenue trade-off between in *infra*, section 5.5.3.
[340] See *infra*, section 5.3.4.2.
[341] See *infra*, chapter 4 for a discussion of the circumstances where this might occur.
[342] The intra-group services remain excluded from A's economic profits, since they do not constitute economic production costs.
[343] *Infra*, A3.1.3 of the Mathematical Appendix.

5.3.6.1 Optimal intra-group services with double taxation

To maximize profits, the MNE equates the marginal benefits of production to the marginal costs of production. Deriving first-order conditions for optimal intra-group services S under the double taxation that results from the hybrid mismatch rules $\frac{\partial \Pi}{\partial S} = 0$ gives $(1 - t_{NL})F_S^B - (1 + t_X)q = 0$. Each additional unit of production yields $(1 - t_{NL})F_S^B$ in after-tax revenue and costs $(1 + t_X)q$, which is the marginal cost of the intra-group services plus the additional tax payment in Country X.

The non-tax-deductibility of the intra-group payments implies that the Dutch CIT is distortive. Additionally, the double taxation means that the intra-group payments also generate tax payments in Country X. Therefore, compared to neutralization, double taxation further distorts production efficiency as the use of intra-group services is decreased. The increased tax burden makes it less attractive to produce in the Netherlands. Only if the marginal productivity of intra-group services outweighs the costs plus additional tax payments, the MNE keeps producing in the Netherlands.[344]

5.3.6.2 Optimal capital investment with double taxation

For its investment decision, the MNE equates the marginal costs of investment in entity B to the marginal after-tax benefits of investment. Deriving first-order conditions for optimal investment K_B under the double taxation that results from the hybrid mismatch rules $\frac{\partial \Pi}{\partial K_B} = 0$ gives standard results $(1 - t_{NL})F_K^B - r = 0$.

In addition to the CIT distortion, there are indirect investment effects from the double taxation that results from the application of the hybrid mismatch rules due to the complementarity of capital and intra-group services in production. The investment effects are worsened compared to a situation of neutralization, since production is decreased further. Hence, double taxation further discourages investment in the Netherlands.

5.3.7 Evaluating the hybrid mismatch rules in D/NI situations

Intuitively, application of the hybrid mismatch rules implies that the increased tax burden makes production more expensive. The neutralization of the hybrid mismatch under the primary rule implies that the tax rate in the Netherlands affects the optimal amount of intra-group services used in production. The deduction limitation increases the effective tax rate in the Netherlands, which implies that the MNE's optimal use of intra-group services in B decreases.[345] In case of double taxation, the tax rates in both the Netherlands and in Country X lead to a decreased use of intra-group services in production.

The decline in the optimal use of intra-group services also implies that capital becomes less productive. Since capital and services are complementary in production, optimal capital investment declines. Hence, the hybrid mismatch rules make it less attractive to invest in the Netherlands and carry out economic activities there. The investment and production effects of hybrid mismatch rules that create double taxation are relatively more severe compared to hybrid mismatch rules that lead to neutralization.[346]

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[344] As long as the marginal after-tax benefits of production $(1 - t_{NL})F_S^B$ outweigh the marginal production costs plus the tax $(1 + t_X)q$, the MNE will not refrain from producing in the Netherlands.

[345] *Infra*, section A3.1.4 of the Mathematical Appendix presents comparative statics for interdependent first-order conditions to derive the effects of the hybrid mismatch rules on the use of intra-group services and investment.

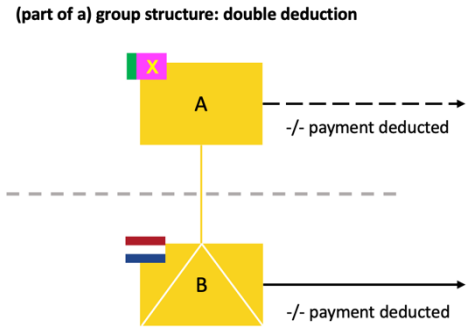
[346] This result follows from the first-order conditions for optimal use of external services under neutralization and double taxation. Comparing $(1 - t_X)g$ for neutralization to g for double taxation, the result $(1 - t_X)g < g$ holds if $t_X > 0\%$. Due to diminishing marginal returns in production, this implies that production is decreased relatively more under double taxation than under neutralization.

The hybrid mismatch rules do not necessarily imply that the MNE seizes investment and production activities in the Netherlands altogether. Both with neutralization and double taxation, if there are sufficiently high positive marginal after-tax benefits of production and sufficiently low production costs, the use of intra-group services is not decreased to zero. However, in both cases, optimal investment and the use of intra-group services unambiguously declines compared to a situation without application of the hybrid mismatch rules.

5.4 Double deduction situation

5.4.1 Introduction

Figure 5.4.1 illustrates a DD situation, where payments for external services Z are deducted twice due to B's transparency.[347]



- For tax purposes in Country X, B is transparent
- For tax purposes in the Netherlands, B is non-transparent

- B buys services Z from an external market
  - The payments are deductible from A's tax base
  - The payments are deductible from B's tax base

Figure 5.4.1

5.4.2 Entity A in Country X

The tax-deductibility of the external services generates a tax benefit in Country X.[348] In the DD situation, A de facto cannot use the external services to increase its production as those services are not actually performed to B. Instead, the costs are deducted from A's tax base in Country X because of B's transparency. Since the payment for the external services does not constitute an economic cost, it is not deducted from A's economic profits, as the MNE only economically incurs the costs once at the level of B.[349]

Summarizing, the after-tax profits of entity A are expressed as:

$$\pi_A = t_X g Z$$

5.4.3 Entity B in the Netherlands

B uses equity K_B and the external services Z as production factors in producing its own services for an external market through production function $x_B = F(K_B, Z)$. There are diminishing marginal returns to both equity capital and external services.[350] Additionally, capital and services are complementary in production.[351] The marginal unit cost of the service is $g > 0$. In principle, the payments for the external services are tax-deductible for B.[352] Furthermore, B is required to pay the capital market rate r on the equity K_B through which it is financed.

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[347] E.g., the services could be IT-related.
[348] B's transparency generates a tax benefit resulting from the double deduction of the services costs $t_X g Z$.
[349] Economically incurring costs requires an external outflow for the MNE.
[350] I.e., $F_K^B, F_Z^B > 0$ and $F_{KK}^B, F_{ZZ}^B < 0$.
[351] I.e., $F_{KZ}^B > 0$.
[352] This hybrid mismatch is targeted by the hybrid mismatch rules, see *infra*, section 5.4.5.

Summarizing, without application of the hybrid mismatch rules, the profits of entity B are expressed as:

$$\pi_B = (1 - t_{NL})[F(Z, K_B) - gZ] - rK_B$$

5.4.4 Optimal behavior without hybrid mismatch rules

The risk neutral MNE maximizes the following global profit equation:[353]

$$\max_{K_B, S} \Pi = \pi_A + \pi_B = t_X gZ + (1 - t_{NL})[F(Z, K_B) - gZ] - rK_B$$

5.4.4.1 Optimal external services without hybrid mismatch rules

To maximize its after-tax profits, the MNE equates marginal productivity in the Netherlands to the marginal costs of the external services. Deriving first-order conditions for optimal use of external services Z under a hybrid mismatch $\frac{\partial \Pi}{\partial Z} = 0$ gives $(1 - t_{NL})F_Z^B - (1 - t_{NL} - t_X)g = 0$. Hence, each additional unit of production yields after-tax revenue of $(1 - t_{NL})F_Z^B$ and costs $(1 - t_{NL} - t_X)g$ because the marginal costs are reduced through the double tax-deductibility.

The MNE benefits from the tax-deductibility of the external service costs both in Country X and in the Netherlands. Hence, compared to a situation without the hybrid mismatch, the MNE increases the use of external services in B's production. This means that the MNE overinvests in the service production factor beyond an economically efficient level, as the marginal product of the external services is driven below the marginal social cost.[354]

Intuitively, due to the double tax-deductibility, the external services become cheaper from an after-tax perspective, which makes it more attractive to produce in the Netherlands. All else equal, this implies that the hybrid mismatch results in distorted production decisions, increasing production above an economically efficient level.[355]

5.4.4.2 Optimal capital investment without hybrid mismatch rules

To optimize investment in the Netherlands, the MNE equates the marginal costs of investment to the marginal after-tax benefits of investment. Deriving first-order conditions for optimal investment K_B under a hybrid mismatch $\frac{\partial \Pi}{\partial K_B} = 0$ gives standard results $(1 - t_{NL})F_K^B - r = 0$.

The CIT drives a wedge between the private marginal benefits and the social marginal benefits. Therefore, the MNE will invest less than socially optimal, so investment in the Netherlands is distorted.[356] However, this is not the direct result of the hybrid mismatch. Instead, the hybrid mismatch leads to overinvestment in the service production factor, which implies that capital also becomes more productive. Hence, compared to a situation without a hybrid mismatch, the hybrid mismatch itself increases optimal investment in the Netherlands, which is then distorted downwards by the CIT distortion.[357]

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[353] *Infra*, A3.2.1 of the Mathematical Appendix.

[354] The marginal after-tax product is $(1 - t_{NL})F_Z^B$, hence it would be economically efficient to equate this to the marginal after-tax cost of the external services $(1 - t_{NL})g$ in the Netherlands. Here, the MNE equates to $(1 - t_{NL} - t_X)g < (1 - t_{NL})g$.

[355] This is contrasted with the D/NI mismatch, which did not result in a production distortion.

[356] The social marginal benefits of investment are F_K^B, but due to the CIT distortion, the private marginal benefits of investment are $(1 - t_{NL})F_K^B$.

[357] It depends on the production function and the tax rate whether this increased investment from the hybrid mismatch offsets the decrease in investment from the CIT distortion. Such analysis is beyond the scope of this research.

5.4.5 Neutralization

Since Country X is an investor jurisdiction that does not apply the primary hybrid mismatch rule for DD situations, the Netherlands will apply the secondary rule by denying the deduction of the payment from B's tax base.[358] Neutralizing the hybrid mismatch implies that the payment is no longer tax-deductible for producer B in the Netherlands, but remains tax-deductible for investor A in Country X. The payment for the services does remain deductible from B's before-tax profit. This gives the following profit equations:

$$\pi_A^N = t_X g Z$$
$$\pi_B^N = (1 - t_{NL})F(K_B, Z) - gZ - rK_B$$

The risk neutral MNE then maximizes the following global profit equation:[359]

$$\max_{K_B, Z} \Pi^N = \pi_A^N + \pi_B^N = t_X g Z + (1 - t_{NL})F(Z, K_B) - gZ - rK_B$$

5.4.5.1 Optimal external services with neutralization

To maximize profits, the MNE equates the marginal after-tax benefits of the hybrid mismatch to the marginal after-tax costs. Deriving first-order conditions for the optimal use of external services Z through setting $\frac{\partial \Pi}{\partial Z} = 0$ gives $(1 - t_{NL})F_Z^B - (1 - t_X)g = 0$. Every additional unit of external services in production yields after-tax revenue of $(1 - t_{NL})F_Z^B$ and costs $(1 - t_X)g$.

The MNE still benefits from the tax-deductibility of the external services costs in Country X, which decreases the private marginal costs of the services. Hence, if the marginal after-tax benefits of production are sufficiently high, the MNE will still use the external services in production, but unambiguously decreases the number of services compared to a situation in which the hybrid mismatch rules do not apply.

Furthermore, in this DD situation, neutralization of the hybrid mismatch through the secondary rule does not necessarily restore production efficiency in the Netherlands. If there is a tax rate differential between Country X and the Netherlands, there will be a CIT distortion. Only when the tax rates would be equal, i.e., $t_{NL} = t_X$, the MNE would equate the social marginal benefits F_Z^B with the social marginal costs of production g, which would result in production efficiency.[360]

5.4.5.2 Optimal capital investment with neutralization

The MNE equates the marginal costs of investment to the marginal after-tax benefits of investment. Deriving first-order conditions for optimal investment K_B through setting $\frac{\partial \Pi}{\partial K_B} = 0$ gives standard results $(1 - t_{NL})F_K^B - r = 0$. This result appears unchanged compared to the hybrid mismatch rules not being in place.[361] However, there is an indirect investment effect from the complementarity of capital and external services in production. As the optimal use of external services is reduced through the application of the hybrid mismatch rules, capital becomes less productive due to this production

[358] The economic effects on investment and production are comparable to a situation where the primary rule would be applied.

[359] *Infra*, A3.2.2 of the Mathematical Appendix.

[360] The reason behind the CIT distortion is that the secondary rule applies. See also *infra*, section 5.5.2, where neutralization under the primary rule would result in production efficiency. Here, production efficiency would require applying the primary hybrid mismatch rules for DD situations, or the tax rates in the Netherlands and Country X being equal.

[361] The private marginal benefits of investment in the Netherlands are decreased below the social marginal benefits through the CIT $(1 - t_{NL})F_K^B$, whereas the costs r are non-tax-deductible.

complementarity. Hence, because of the increased overall tax burden, the hybrid mismatch rules lead to a decrease in investment in the Netherlands.[362]

5.4.6 Double taxation

A limited interpretation of the DI-exception can result in economic double taxation.[363] In a DD situation, this implies that the payment is non-tax-deductible for both A and B. This double taxation changes the profit equations:[364]

$$\pi_{DT}^{A} = 0$$
$$\pi_{DT}^{B} = (1 - t_{NL})F(K_B, Z) - gZ - rK_B$$

Hence, the risk neutral MNE maximizes the following profit equation:

$$\max_{K_B, S} \Pi_{DT} = \pi_{DT}^{A} + \pi_{DT}^{B} = 0 + (1 - t_{NL})F(K_B, Z) - gZ - rK_B$$

5.4.6.1 Optimal external services with double taxation

The MNE equates the marginal after-tax benefits of production to the pre-tax cost of the external services. Deriving first-order conditions for the optimal use of external services Z under the double taxation that results from the hybrid mismatch rules $\frac{\partial \Pi}{\partial Z} = 0$ results in $(1 - t_{NL})F_Z^B - g = 0$. Every additional unit of services yields after-tax revenue of $(1 - t_{NL})F_Z^B$ and costs g.

Under double taxation, only the Dutch tax rate influences the amount of external services that are used in production.[365] In contrast, Country X's tax rate no longer affects the amount of external services, since the payment is no longer tax-deductible in Country X. The fact that the payment is non-tax-deductible essentially results in a regular CIT distortion in the Netherlands. Therefore, in case of double taxation, the MNE unambiguously decreases its use of external services, because the MNE's private marginal benefits of production are driven below the social marginal benefits of production.

For sufficiently low tax rates and sufficiently high marginal after-tax benefits of production in B, the MNE would still buy external services.[366] Hence, the MNE will not necessarily refrain from producing in the Netherlands altogether. However, the MNE will always decrease production compared to situations without hybrid mismatch rules or situations where the hybrid mismatch is neutralized.[367]

5.4.6.2 Optimal capital investment with double taxation

To optimize investment in the Netherlands, the MNE equates the marginal costs to the marginal benefits of investments in B. Deriving first-order conditions for optimal investment K_B under the double taxation that results from the hybrid mismatch rules $\frac{\partial \Pi}{\partial K_B} = 0$ gives standard results $(1 - t_{NL})F_K^B - r = 0$.

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[362] Whether this decreased investment restores efficiency in investment decisions is beyond the scope of this research.

[363] See *infra*, chapter 4 for a discussion of the circumstances under which this might happen.

[364] *Infra*, A3.2.3 of the Mathematical Appendix.

[365] In section A3.2.4 of the Mathematical Appendix, comparative statics for interdependent first-order conditions are presented to derive the effects of the hybrid mismatch rules on the use of services and investment.

[366] If the MNE faces a production option that satisfies the first-order condition, it will retain economic activities in the Netherlands.

[367] As noted in *infra*, section 5.4.4, the hybrid mismatch already results in production distortions.

The optimal investment decision appears unchanged compared to a neutralization or DD situation. However, there are indirect investment effects due to the complementarity of capital and external services in production. As the optimal use of external services is decreased as a result of the economic double taxation from the hybrid mismatch rules, optimal investment in the Netherlands is distorted below an economically efficient level as well.

5.4.7 Evaluating the hybrid mismatch rules in DD situations

Intuitively, application of the hybrid mismatch rules implies that producing in the Netherlands becomes more expensive as a result of the increased tax burden. If the effective tax rate increases – which is what de facto happens through the deduction limitation in the hybrid mismatch rule – the optimal use of external services in B declines.[368] Furthermore, the neutralization of the DD situation under the secondary rule implies that the tax rates of both the Netherlands and Country X affect the optimal amount of external services used in production.[369]

Due to production complementary, the decreased use of external services implies that capital becomes less productive. Therefore, capital investment declines. Intuitively, if less services are used in the production, the MNE will also want to invest less in the Netherlands, because the investment capital will be less productive.[370] Hence, the hybrid mismatch rules make it less attractive to undertake economic activities in the Netherlands. Furthermore, the investment and production effects of double taxation are relatively more severe compared to neutralization.[371]

The hybrid mismatch rules do not imply that the MNE seizes its activities in the Netherlands altogether. Both with neutralization and with double taxation, as long as there are sufficiently high marginal after-tax benefits of production and the external services have sufficiently low costs, the use of external services is not decreased to zero. Therefore, the MNE does not necessarily entirely refrain from production as a result of the hybrid mismatch rules. However, the use of external services declines compared to a situation without hybrid mismatch rules. In that case, investment will decline as well. These effects are more pronounced under double taxation than under neutralization.

5.5 Tax revenue considerations

5.5.1 Introduction

The hybrid mismatch rules do not only create production incentives for taxpayers, but also generate tax revenue incentives for governments. First, this is a result of the effects on taxpayers' investment and production decisions. Second, this is a result of a trade-off between decreased tax abuse and decreased economic activity. Third, the hybrid mismatch rules affect the inter-jurisdictional distribution of tax revenue through the ranking of primary and secondary rules.

5.5.2 Production effects

As a result of the hybrid mismatch rules, the tax burden increases, which increases the effective costs of production factors. It was shown that this may result in decreased production. It should be determined whether this negatively affects economic efficiency, or that the hybrid mismatch rules restore economic efficiency that was distorted by the hybrid mismatch in the first place.

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[368] See section A3.2.4 of the Mathematical Appendix.

[369] In case the primary rule would apply, the tax rate in Country X would not affect optimal external service decisions in the Netherlands. See *infra*, section 5.5.2.2.

[370] This implies that it may be profitable to invest where the MNE can earn higher returns on investment.

[371] This result follows from the first-order conditions for optimal use of external services under neutralization and double taxation. Comparing $(1 - t_X)g$ for neutralization to g for double taxation, the result $(1 - t_X)g < g$ holds if $t_X > 0\%$.

5.5.2.1 Deduction/no inclusion situations

Economic double taxation always leads to production and investment distortions, irrespective of whether the primary or secondary rule is applied.

In a D/NI situation, without hybrid mismatch rules, the tax-deductibility of the payment for the productive affiliate implies that production efficiency remains undistorted, because the payment for the intra-group services is not taxed at the level of the investor.[372] If the hybrid mismatch is neutralized through the primary rule, this results in a deduction limitation, which distorts production efficiency in the production jurisdiction.[373] Double taxation aggravates these production distortions, because this implies that both the Netherlands and Country X effectively tax the intra-group payments that result in a hybrid mismatch, resulting in higher private marginal costs of production.[374] Hence, the hybrid mismatch rules imply that investment becomes relatively less profitable and that economic activity is discouraged.

In contrast to the primary rule, application of the secondary rule in a D/NI situation would result in tax-deductibility of the intra-group services payment in the productive entity, with the income being included in the tax base of the entity that is deemed to receive the income. However, such secondary neutralization of the hybrid mismatch would not result in restored production efficiency either, since the MNE must now trade off the tax rate differential in both jurisdictions.[375]

5.5.2.2 Double deduction situations

In a DD situation, without hybrid mismatch rules, the double tax-deductibility from the hybrid mismatch results in a distortion of production efficiency in the production jurisdiction, as too many external services are used in production.[376] Through neutralizing the hybrid mismatch and only allowing tax-deductibility of the payment once, production efficiency can in principle be restored.[377]

The secondary rule for DD situations implies that the external services costs are tax-deductible at the level of the investor entity, which leads to production distortions.[378] In contrast, if the primary rule would be applied, the payment would be tax-deductible at the level of the productive entity only, with the deduction being denied at the level of the investor entity. Hence, application of a neutralizing primary hybrid mismatch rule would result in production efficiency in the productive jurisdiction.[379]

If the hybrid mismatch rules result in economic double taxation, there is a standard CIT distortion, which leads to distorted production decisions as the double taxation effectively implies that the payment for the external services is non-tax-deductible in both jurisdictions.[380]

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[372] *Infra*, section 5.3.4.
[373] *Infra*, section 5.3.5.
[374] *Infra*, section 5.3.6.
[375] This can be seen from the following. The first-order condition for the intra-group services under neutralization through the secondary rule becomes $(1 - t_{NL})F_S^B + (t_{NL} - t_X)q = 0$. Hence, the tax rate differential between Country X and the Netherlands $t_{NL} - t_X$ can still distort production incentives. This provides incentives for abusive transfer pricing. See S.B. Nielsen, P. Raimondos-Møller and G. Schjelderup, 'Taxes and decision rights in multinationals', *Journal of Public Economic Theory* (10) 2008, nr. 2, section 2.1.
[376] *Infra*, section 5.4.4.
[377] The next paragraph discusses the difference between the application of the primary rule which restores economic efficiency and the secondary rule through which economic efficiency remains distorted.
[378] There are no production distortions if $t_{NL} = t_X$.
[379] *Infra*, section 5.4.5. The first-order condition for the external services under neutralization becomes $(1 - t_{NL})[F_Z^B - g] = 0$. In that case, there would be no CIT distortion.
[380] *Infra*, section 5.4.6.

5.5.3 Tax revenue considerations

When designing hybrid mismatch rules, legislators might want to trade off increased tax revenues from a reduction in hybrid mismatch arrangements against production distortions that result in decreased economic activity:

- Because the hybrid mismatch rules theoretically always affect investment and production decisions, this can be viewed as an inherent consequence of anti-abuse measures. Such distortions may impact a jurisdiction's overall tax revenue, since a reduction in economic activity may result in a smaller tax base as less profits are generated within that jurisdiction.
- In contrast, the hybrid mismatch rules could also increase tax revenue if taxpayers engage less in double non-taxation through hybrid mismatches. In that case, the deduction limitation or income inclusion in the hybrid mismatch rules effectively increases the tax base and tax revenue.

The Dutch legislator has stated that the above trade-off implies that there are no expected tax revenue effects from the hybrid mismatch rules for the Netherlands.[381] The legislator expects that taxpayers will ensure that payments will be included in the tax base of another jurisdiction to avoid application of the hybrid mismatch rules in the Netherlands.[382] Furthermore, it is noted that some taxpayers might choose to accept the application of the hybrid mismatch rules, which would generate some tax revenue.[383] However, it is also acknowledged that other taxpayers will cease economic activity in the Netherlands, thereby reducing the tax base and tax revenue.[384] Hence, overall, the legislator expects that budgetary consequences of the hybrid mismatch rules are zero.[385]

5.5.4 Distribution of tax revenue

The neutralization and double taxation that result from the hybrid mismatch rules decrease the extent to which the MNE engages in the hybrid mismatch.[386] It could be argued that through these economic incentives, the hybrid mismatch rules are in line with their goal of reducing double non-taxation.[387] However, the primary rule and the secondary rule differ with respect to which jurisdiction's tax base is increased, because the jurisdiction that applies the hybrid mismatch rule gets to increase their tax base through a deduction limitation or income inclusion rule.[388] This creates tax revenue effects.[389]

These tax revenue effects are not specifically addressed in the hybrid mismatch rules. Instead, the OECD states that the hybrid mismatch rules are meant to push taxpayers towards less complicated and more transparent corporate structures.[390] The hybrid mismatch rules are therefore meant to be prohibitive and should incentivize MNEs to no longer engage in hybrid mismatches. However, as shown

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[381] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 34.
[382] *Ibid.*
[383] *Ibid.*
[384] Future research should explicitly analyze the hybrid mismatch rules' effects on tax revenue and derive formal conditions under which tax revenue decreases. It could be that the Dutch legislator underestimates the investment effects, implying that the Netherlands loses tax revenue through the hybrid mismatch rules.
[385] Specific measures in the DCITA 1969 are not published in the Dutch Annual Financial Report, so it is impossible to verify whether these budgetary predictions have materialized.
[386] The MNE decreases the amount of intra-group or external services it uses in production as a result of the hybrid mismatch rules.
[387] OECD BEPS Action 2 Final Report, p. 13, states that "[Hybrid mismatches] are widespread and result in a substantial erosion of the taxable bases of the countries concerned."
[388] For further discussion, see *infra*, section 4.2.1.
[389] The tax revenue aspects of hybrid mismatch rules might incentivize countries to implement hybrid mismatch rules and thereby curb tax competition. A full analysis of these policy incentives is out of scope of this research. See N. Johannesen, 'Tax avoidance with cross-border hybrid instruments', *Journal of Public Economics* (112) 2014, p. 40-52.
[390] OECD BEPS Action 2 Final Report, par. 278.

in this chapter, the hybrid mismatch rules do not always incentivize taxpayers to refrain from engaging in hybrid mismatches altogether. Only when the hybrid mismatch rules would truly eliminate all hybrid mismatches, taxes would be paid where profits are created.[391]

If taxpayers continue to engage in hybrid mismatches, the tax revenue effects from the hybrid mismatch rules can lead to a redistribution of tax revenue between jurisdictions.

- In the D/NI situation, the payment is no longer tax-deductible in the production jurisdiction. From an economic point of view, it could be argued that the payment should be included as income in the investor's tax base, instead of denying the deduction in the production jurisdiction.[392] In the D/NI situation, the primary hybrid mismatch rule thus results in a redistribution of tax revenue from the deemed recipient jurisdiction where the payment should have been included in the tax base towards the production jurisdiction where the payment becomes non-tax-deductible.[393]
- Tax revenue redistribution effects also occur for the secondary rule in DD situations, where the payment is again no longer tax-deductible in the production jurisdiction. However, it could be argued that the tax base of the investor jurisdiction is primarily being eroded. The secondary rule therefore results in a redistribution of tax revenue from the investor jurisdiction where the payment remains tax-deductible towards the jurisdiction where the payment is no longer tax-deductible but where production takes place.[394] In contrast, the primary DD rule would result in the deductibility of the payment where production takes place, which would be more in line with the base erosion argument.[395]

5.5 Sub-conclusion

This chapter analyzed the tax incentives from the hybrid mismatch rules for production and investment through a model of profit maximization for an MNE with two affiliates in different jurisdictions. The MNE can benefit from international differences in qualifications of associated entities to maximize profits and minimize tax payments, as the tax-deductibility of production costs allows the MNE to engage in hybrid mismatches in the form of D/NI or DD situations.

In a D/NI situation, the MNE benefits from the tax-deductibility of payments for intra-group services. These intra-group services lead to tax-deductible payments at the level of the hybrid entity, without inclusion of these payments in the tax base of another jurisdiction.

- Without application of the hybrid mismatch rules, the corporate income tax is non-distortive with respect to the use of intra-group services.

[391] This is one of the goals of the OECD BEPS Project, see OECD BEPS Action 2 Final Report, p. 5, where the OECD states: "Once the [BEPS] measures become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created."
[392] See the rationale behind the primary and secondary rule in *infra*, section 2.4.5.
[393] This redistribution should be compared to a situation without a hybrid mismatch, i.e., where the income would be included in the tax base in Country X and the payment would be tax-deductible in the Netherlands. As a result of the hybrid mismatch, Country X does not levy any tax, whereas the Netherlands applies a deduction limitation rule, which leads to implicit taxation in the Netherlands. Therefore, in that sense, there is no redistribution since there was double non-taxation in the first place.
[394] Again, this redistribution should be compared to a situation without a hybrid mismatch. The redistribution comes from the economic argument that the payment should not be deductible in Country X, since that is not the jurisdiction where production takes place. Instead, production-wise, the payment should be deductible in the Netherlands and non-deductible in Country X. Because the Netherlands now implicitly levies a tax due to the deduction limitation and Country X still does not levy any taxes, there is a redistribution in tax revenue from Country X to the Netherlands, because from an economic point of view, the Netherlands should be the jurisdiction where the payment is deductible.
[395] *Infra*, section 5.5.2.2.

- Under neutralization through the hybrid mismatch rules, the payment for the intra-group services is no longer tax-deductible, which means that production efficiency is distorted, and the use of intra-group services is decreased.
- Double taxation resulting from the hybrid mismatch rules aggravates these production distortions.
- Both with neutralization and double taxation, the decrease in the optimal amount of intra-group services indirectly decreases optimal investment for the MNE, with the negative effects being larger in situations with double taxation.

In a DD situation, the MNE benefits from the tax-deductibility of payments for external services, where payments are tax-deductible both at the level of the hybrid entity and at the level of the investor entity.

- Without application of the hybrid mismatch rules, the double tax-deductibility of the payments means that the hybrid mismatch incentivizes the MNE to produce more than economically efficient.
- Under neutralization through the hybrid mismatch rules, the payment for the intra-group services is only tax-deductible once, which means that under specific circumstances, the corporate income tax should not be distortive and production efficiency can be restored.
- With double taxation, the corporate income tax is distortive since the external services costs are no longer tax-deductible in either jurisdiction.
- The decrease in the optimal amount of services indirectly leads to negative investment effects for the MNE, with the negative investment effects being larger under double taxation than under neutralization.

In addition to production and investment incentives for taxpayers, the hybrid mismatch rules generate tax revenue incentives for legislators.

- First, this is a result of the production and investment effects for taxpayers. The decrease in economic activity reduces taxable profit and thereby decreases tax revenue. This decrease in tax revenue should be traded off against higher tax revenue from a decrease in hybrid mismatches.
- Second, depending on the circumstances, the primary and secondary rule generate production distortions from the inter-jurisdictional distribution of tax-deductibility of payments.
- Third, the hybrid mismatch rules affect the inter-jurisdictional distribution of tax revenue as a result of the ranking mechanisms in the hybrid mismatch rules, which assign the right to effectively levy taxes to neutralize the hybrid mismatch.

Chapter 6 Elimination of economic double taxation

6.1 Introduction

This chapter is concerned with the following sub-question: **how can economic double taxation resulting from the ATAD hybrid mismatch rules be effectively relieved?** First, the importance of preventing economic double taxation resulting from the hybrid mismatch rules is discussed (section 6.2). Subsequently, the role of double tax conventions and primary and secondary EU law in the relief of economic double taxation is analyzed (section 6.3). In the context of the ATAD, the interpretation of EU directives is discussed (section 6.4) to assess whether a broader interpretation of dual inclusion income would be warranted (section 6.5), or whether the interpretation of the scope of the hybrid mismatch rules themselves could provide relief of economic double taxation from the hybrid mismatch rules (section 6.6). Based on the analysis of the ATAD, possible unilateral measures to relieve economic double taxation resulting are proposed (section 6.7). The chapter is summarized in a sub-conclusion (section 6.8).

6.2 Hybrid mismatches and neutralization

Neutralization of D/NI and DD outcomes is essential to eliminate the tax benefits that arise from hybrid mismatches.[396] This neutralization approach is also the fundamental reason why the ATAD hybrid mismatch rules may generate economic double taxation.[397] Namely, if international differences in the tax characterization of entities and instruments remain unaddressed, hybrid mismatches persist and potentially result in economic double taxation when applying the hybrid mismatch rules.[398]

It is important to achieve and retain support for the anti-BEPS objectives.[399] Therefore, anti-abuse legislation should be effective and efficient.[400] Insofar the hybrid mismatch rules go beyond their intended objective of neutralizing a hybrid mismatch, the resulting economic double taxation can negatively impact economic efficiency.[401] Furthermore, economic double taxation may negatively affect taxpayer morale if the hybrid mismatch rules are perceived as disproportionate.[402] Therefore, it should be analyzed whether there is scope to prevent economic double taxation resulting from the hybrid mismatch rules. This would ensure that the objective of neutralizing hybrid mismatches to prevent double non-taxation is effectively achieved, with minimal loss of economic efficiency.

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[396] *Infra*, section 2.2.

[397] See also *infra*, section 2.3 for a discussion of the mechanisms in the hybrid mismatch rules.

[398] Parada and others hold the opinion that the neutralization of hybrid mismatches cannot be justified, because instead, the qualification differences should be addressed directly. See L. Parada, 'Hybrid Entity Mismatches: Exploring Three Alternatives for Coordination', *Intertax* (47) 2019, nr. 1, footnote 50.

[399] At this point, 141 countries have joined the OECD Inclusive Framework, which is a political commitment to support the anti-BEPS objectives. With respect to taxpayers and their advisors, there is an increasing number of multinational firms that has publicly stated that they are committing to less aggressive tax planning. For an ethical background on the responsibility of both government and taxpayers, see H. Gribnau, 'The integrity of the tax system after BEPS: A shared responsibility', *Erasmus Law Review* 2017, nr. 1, p. 12-28.

[400] Effectiveness means the extent to which the legislative objectives are achieved. Efficiency requires avoidance of underkill or overkill. See *Kamerstukken II* 1990/91, 22008, nr. 2 (hereinafter: Notice of Legislative Vision), p. 25.

[401] *Infra*, chapter 5.

[402] Proportionality requires a reasonable balance between legislation's benefits and burdens. See Notice of Legislative Vision, p. 27. For an economic and legal interpretation of tax morale, see E.F. Luttmer and M. Singhal, 'Tax morale', *Journal of economic perspectives* (28) 2014, nr. 4, p. 149-168. Tax morale in the context of anti-BEPS measures would require that anti-abuse measures motivate taxpayers to refrain from tax abuse. In my view, proportional anti-abuse measures should prevent a polarization between taxpayers on the one hand and tax authorities on the other hand.

6.3 The role of supranational law in relieving economic double taxation

6.3.1 The role of double tax conventions

Economic double taxation resulting from hybrid mismatches is not specifically addressed by the OECD MTC.[403] Instead, the OECD MTC focuses on juridical double taxation by determining access to treaty benefits and allocating taxing rights between jurisdictions.[404] Furthermore, the OECD Commentary does not address the fact that hybrid mismatch rules may generate economic double taxation, even though such economic double taxation can be perceived as being contrary to the objective of double tax conventions, which is to limit impediments to cross-border activities.[405]

6.3.2 The role of primary and secondary EU law

The EU fundamental freedoms do not prohibit nor require that economic double taxation is alleviated by Member States.[406] The ATAD hybrid mismatch rules are part of secondary EU law, which implies that the economic double taxation that might result from their application is in principle not contrary to primary EU law, insofar a Member State has implemented its hybrid mismatch rules in accordance with the ATAD. Aside from the ATAD, other EU Directives in principle do not contain provisions that require the relief of economic double taxation resulting from the hybrid mismatch rules.[407] These directives only play a role insofar they result in the neutralization of the hybrid mismatch.[408]

6.3.3 Conclusion on the role of supranational law

Because neither double tax conventions nor primary or secondary EU law require the relief of economic double taxation that results from the application of the hybrid mismatch rules, it should be assessed whether the ATAD can be interpreted in a way that would allow such relief.

6.4 Interpreting the ATAD

6.4.1 Interpreting directives: wording, purpose, context, and origin

The ATAD is binding with respect to its intended objectives. This implies that Member States are free to choose their implementation methods.[409] Because the hybrid mismatch rules in section 2.2a of the DCITA 1969 are based on the ATAD, the Dutch hybrid mismatch rules should be interpreted in accordance with the ATAD.[410]

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[403] The double tax convention Australia-New Zealand does contain such provision, see art. 1(2) and 23(3) Australia-New Zealand Income Tax Treaty 2009. See also M. Brabazon, *Application of Tax Treaties to Fiscally Transparent Entities – IBFD Global Tax Treaty Commentaries*, Amsterdam: IBFD 2021, section 4.7.

[404] *Infra,* section 3.4.1. See also A.J.A. Stevens, 'Hybride entiteiten en belastingverdragen', *MBB* 2010/04-01, section 3.3, where it is shown that the solutions for hybrid entities in the OECD Partnership Report cannot prevent economic double taxation under certain circumstances.

[405] *Infra*, section 3.4.

[406] *Infra*, section 3.5.1.

[407] Other directives include the PSD, IRD, TDRD, and other provisions in the ATAD, see *infra*, section 3.5.3.

[408] ATAD2, preamble, recital 30 states that the hybrid mismatch rules should not be applied insofar another EU Directive leads to neutralization of the hybrid mismatch. For a discussion, see J. Versluis, op. cit., section 2. This requirement has been implemented in the Netherlands, see *infra*, section 4.4.5, 4.4.6 and 4.5.5.

[409] Art. 288 TFEU. Furthermore, a directive only has direct legal effect if the provision in the directive is unconditional, sufficiently clear, and accurately formulated, if the provision in the directive has not been implemented or has been implemented incorrectly or incompletely, or if the implementation deadline has passed. See J.W. van de Gronden, J. Krommendijk, A. Looijestijn-Clearie, S.J. Tans and H.C.F.J.A. de Waele, *Kern van het Europees recht*, Den Haag: Boom juridisch 2021, p. 81.

[410] Art. 4(3) TEU. All tax legislation should comply with the legality principle, which requires that legislation complies with the Dutch Constitution and international and EU law. See Notice of Legislative Vision, p. 24-25.

The interpretation of a directive is based on linguistic,[411] teleological, systematic, and historical methods, which requires considering the directive's **wording**, **purpose**,[412] the **context** of the directive and EU law generally, and the **origin** of a provision.[413] From CJEU case law, it is a priori unclear which interpretation criterion should prevail, but the purpose, context, and origin of the provision cannot prevail over the wording in the directive.[414]

6.4.1.1 Wording

Linguistic interpretation implies that the interpretation of a directive's provisions cannot be contrary to the wording of the provision.[415] An economic interpretation is allowed insofar this is in accordance with the text.[416]

6.4.1.2 Purpose and context

In principle, the function of a directive's preamble is to justify the exercise of the EU's legislative competences.[417] Therefore, the ATAD's preamble is part of the Member States' assignment to implement the hybrid mismatch rules in national law and formulates the purpose and context of the hybrid mismatch rules.[418]

The CJEU has established that a preamble has no binding legal force.[419] Hence, the recitals in the preamble are interpretative tools in the EU legal order, which implies that the recitals can only be relied on as a means to resolve ambiguities in the wording of the provisions of a directive.[420] Because recitals do not have binding legal force, they cannot justify derogating from the provisions in the ATAD, nor lead to an interpretation of the provisions in the ATAD that is contrary to the text.[421]

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[411] This is often referred to as grammatical interpretation. However, the term grammatical is imprecise because linguistics requires grammatical and lexical phenomena. See J. Reugebrink, 'The grammatical interpretation of a tax law (I)', *WFR* 1959/769. See also M. van Gijlswijk and L. van Heijningen, 'De (ir)relevantie van de wetsgeschiedenis bij de uitleg van implementatiebepalingen', *NLF-W* 2022/18, section 2.

[412] CJEU 10 April 1984, C-14/83, ECLI:EU:C:1984:153 (*Von Colson*), par. 26.

[413] CJEU 10 December 2018, C-621/18, ECLI:EU:C:2018:999 (*Wightman*), par. 47. The interpretation of EU law is similar to Dutch tax law interpretation, see J.J.A.M. Korving and W.R. Kooiman, op. cit., section 3.2.

[414] CJEU 19 September 2019, C-527/18, ECLI:EU:C:2019:762 (*Gesamtverband Autoteile-Handel*), par. 34. The CJEU implicitly confirms this notion through weighing the wording of the provision in light of the preamble.

[415] H. Vermeulen, '33.6.1 Grammaticale interpretatie', in: L.J.A. Pieterse & R. van Scharrenburg (red.), *Springende punten. Liber Amicorum mr. P.J. van Amersfoort* (Van Amersfoort-bundel), Deventer: Wolters Kluwer 2017.

[416] J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.3.

[417] This is confirmed in European Commission Legal Service, *Joint Practical Guide of the European Parliament, the Council and the Commission for persons involved in the drafting of European Union legislation*, Publications Office 2016 (hereinafter: EC Joint Practical Guide), par. 10. This Guide is a non-binding document for the European institutions. See also M. den Heijer and T. van Os van den Abeelen, 'Doel, gebruik en betekenis van de considerans in richtlijnen van de Europese Unie, *Ars Aequi* 2020/1149, p. 1150.

[418] Art. 296 TFEU.

[419] E.g., CJEU 19 November 1998, C-162/97, ECLI:EU:C:1998:554 (*Nilsson and others*), par. 54; CJEU 9 February 1995, C-412/93, ECLI:EU:C:1995:26 (*Edouard Leclerc-Siplec*), par. 47; CJEU 25 November 1998, C-308/97, ECLI:EU:C:1998:566 (*Manfredi*), par. 30; and CJEU 24 November 2005, C-136/04, ECLI:EU:C:2005:716 (*Deutsches Milch-Kontor*), par. 32. From the recent Conclusion of AG Bobek on 2 April 2020, C-724/18 and C-727/18, ECLI:EU:C:2020:251 (*Cali Apartments*), par. 47, it becomes clear that this interpretation of the role of recitals is still relevant.

[420] E.g., CJEU 26 June 2001, C-173/99, ECLI:EU:C:2001:356 (*BECTU*), par. 37-39. This did not concern a tax directive, but that should not be of material difference based on CJEU 7 February 2018, C-643/16, ECLI:EU:C:2018:67 (*American Express*), par. 51.

[421] See also J.J.A.M. Korving and W.R. Kooiman, op. cit., section 3.4.

6.4.1.3 Origin

According to the ATAD2's preamble, Member States should use the applicable explanations and examples in the OECD BEPS Action 2 Final Report insofar these are consistent with the ATAD and general EU law.[422] This implies that the OECD BEPS Action 2 Final Report is part of the origin of the hybrid mismatch rules and can provide relevant information for interpreting the rules.[423]

6.4.2 Interpreting the ATAD

Based on the wording, purpose, context, and origin of the ATAD, it should be assessed whether the hybrid mismatch rules can be interpreted in a manner that would allow for the prevention or relief of economic double taxation. This could be either through a broader interpretation of the DI-exception[424] or through a broader interpretation of the hybrid mismatch rules themselves.[425]

6.5 Application of the dual inclusion exception

6.5.1 The dual inclusion exception

The DI-exception is essential in ensuring that the hybrid mismatch rules do not result in economic double taxation.[426] Hence, it should be assessed whether the DI-exception can be interpreted such that third country involvement, transfer pricing mismatches, timing differences, and deduction limitations can result in dual inclusion income with respect to the **wording**, **purpose**, **context**, and **origin** of the DI-exception.[427]

6.5.2 Third country involvement

Third country involvement specifically refers to a country that is not directly involved in the hybrid mismatch that is targeted by the hybrid mismatch rules, which may result in economic double taxation.[428]

With respect to **wording**, dual inclusion income should be interpreted in a narrow manner. In a legal interpretation, the DI-exception cannot be applied in case of third country involvement, since the DI-exception only applies to income that is included in the tax base of the jurisdictions that are involved in the hybrid mismatch.[429] An economic interpretation could imply that the income must be de facto included in the tax base.[430] However, even with an economic interpretation, the DI-exception cannot be applied when a third country is involved. Namely, the income must be included in the tax base of both jurisdictions involved in the hybrid mismatch. Therefore, the DI-exception cannot be applied in

[422] ATAD2, preamble, recital 28.

[423] It could be argued that, because the OECD plays a large role in developing international tax principles, the connection between the ATAD and the OECD BEPS Reports would ensure global mismatches in the application of hybrid mismatch rules become less likely. See J.J.A.M. Korving, 'The influence of the OECD in the creation of binding legislation on Exchange of information within the EU: why is the EU always re-inventing the wheel?', *REALaw.blog.*

[424] *Infra*, section 6.5.

[425] *Infra*, section 6.6.

[426] See *infra*, section 4.4, ATAD2, preamble, recital 21, and art. 2(9) and 9b ATAD.

[427] This approach is inspired by J.J.A.M. Korving and W.R. Kooiman, op. cit.

[428] Again, it should be noted that third country in *infra*, section 4.5.2 does not refer to a non-Member State but refers specifically to a country that is not directly involved in the hybrid mismatch with respect to which the hybrid mismatch rules are applied.

[429] Art. 2(9)g ATAD and art. 12ac(1)d DCITA 1969.

[430] With the term *de facto*, it is meant that income is economically or substantively included in the tax base, which implies that such income is subject to tax. In their article, J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.3, state that an economic interpretation would still imply that third country income is de facto included at the level of the investor, so that there is dual inclusion income.

case the income is included in the tax base of a third country, regardless of whether this occurs legally or economically.

With respect to its **purpose**, the DI-exception is aimed at reversing the application of the hybrid mismatch rules insofar the taxpayer's income is subject to economic double taxation.[431] It would not seem reasonable to distinguish between income that is included in the tax base of both jurisdictions that are involved in the hybrid mismatch, and income that is economically subject to double taxation in a different jurisdiction than both jurisdictions that are directly involved in the hybrid mismatch.[432]

With respect to the **context**, according to the preamble, the ATAD hybrid mismatch rules should only apply to the extent a taxpayer is involved in a hybrid mismatch and insofar income is not taxed twice.[433] However, the preamble itself does not have binding legal force.[434]

With respect to the **origin**, the OECD BEPS Action 2 Final Report states that the identification of dual inclusion income primarily depends on the legal treatment of the income under the laws of the jurisdictions that are involved in the hybrid mismatch.[435] This statement can be interpreted so as to deny an economic approach in determining dual inclusion income. However, the statement can also be interpreted as being aimed at broadening the interpretation of dual inclusion income, in the sense that the OECD would not require an actual inclusion of income. In that case, the qualification of income as taxable would be sufficient, regardless of whether the income is de facto taxed.[436]

Summarizing, the purpose, context, and origin of the DI-exception would allow a broader interpretation of dual inclusion income. However, the respect to wording, the application of the DI-exception is limited to dual inclusion income that occurs between jurisdictions that are not directly involved in the hybrid mismatch.[437] Hence, third country involvement cannot fall within the scope of the DI-exception.

6.5.3 Transfer pricing mismatches and timing differences

Transfer pricing mismatches imply that income is not de facto included in the tax base of both jurisdictions that are directly involved in the hybrid mismatch and can lead to economic double taxation when the hybrid mismatch rules apply.[438] With respect to timing differences, the hybrid mismatch rules can lead to economic double taxation if income is de facto included in the tax base of both jurisdictions before the hybrid mismatch rules are applied.[439]

With respect to **wording**, an economic interpretation would allow applying the DI-exception in case of transfer pricing mismatches and timing differences. Because these situations are not explicitly

[431] *Infra*, section 4.2.2.2.
[432] J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.3.
[433] ATAD2, preamble, recital 29.
[434] The context of the DI-exception cannot justify a broader definition of dual inclusion income because this is contrary to the linguistic definition of dual inclusion income in the ATAD, which requires that income is included in the tax base of both jurisdictions. See *infra*, section 4.4.1.
[435] OECD BEPS Action 2 Final Report, par. 125 and 197. The ATAD2 requires that the Report is used as a source of interpretation insofar this is consistent with EU law.
[436] *Infra*, section 4.4.2.
[437] OECD BEPS Action 2 Final Report, par. 125 and 197. Hence, the OECD also requires a comparison of the treatment of the income under the laws of the jurisdictions that are involved in the hybrid mismatch.
[438] *Infra*, section 4.5.3.
[439] *Infra*, section 4.5.4.

excluded from the application of the DI-exception, it could be argued that such economic interpretation would be warranted: [440]

- A transfer pricing mismatch can de facto lead to income being included in the tax base of two different taxpayers, resulting in economic double taxation.[441]
- With respect to timing differences, the wording of the definition of dual inclusion income would in principle allow inclusion of income in a prior period, at least in D/NI situations. With respect to DD situations, the ATAD requires that income is included in a current or subsequent period.[442]

It should be noted that it remains imperative that the income is included in the tax base of both jurisdictions that are involved in the hybrid mismatch.[443]

With respect to the **purpose**, it would seem reasonable to include transfer pricing mismatches and timing differences in the DI-exception insofar these result in economic double taxation, as there is de facto double-taxed income in these situations. Furthermore, through the origin requirement, the fundamental purpose of the hybrid mismatch rules is to not target non-hybrid mismatches.[444] Hence, it could be argued that transfer pricing mismatches and timing differences should in principle be included in the scope of the DI-exception.

With respect to the **context**, according to the preamble, the ATAD hybrid mismatch rules should only apply to the extent a taxpayer benefits from a hybrid mismatch.[445] Following this pro rata approach, it would seem justified to not apply the hybrid mismatch rules if a transfer pricing adjustment or timing difference leads to the inclusion of income in jurisdiction that is involved in the hybrid mismatch.[446]

With respect to the **origin**, in the OECD's interpretation, transfer pricing mismatches and timing differences could in principle fall within the scope of dual inclusion income.[447]

- It is important to recognize that in case of transfer pricing mismatches, the mismatch must arise from a difference in the valuation of an item of income. Hence, if the stream of income is not recognized in the first place, there cannot be dual inclusion income, unless it is argued that the non-recognition qualifies as a difference in valuation of the item of income.[448] Since the OECD's approach primarily assesses the legal treatment of the income in the jurisdictions that are involved in the hybrid mismatch, taking into account income that is not recognized

[440] The mechanisms behind the double taxation resulting from transfer pricing mismatches and timing differences are similar; hence a similar analysis applies here.
[441] J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.3.
[442] Art. 9(1) ATAD.
[443] In the example in *infra*, section 4.5.3, this requirement is satisfied, since the non-deductibility of the arm's length payment implies the income is de facto included in Country X's tax base. Since the arm's length payment is also included in the tax base in the Netherlands, an economic interpretation of the hybrid mismatch rules would allow recognizing dual inclusion income.
[444] *Infra*, section 2.3.1.
[445] ATAD2, preamble, recital 29 states (modifications by author): "The hybrid mismatch rules […] only apply to the extent that the situation involving a taxpayer gives rise to a mismatch outcome. No mismatch outcome should arise when an arrangement is subject to adjustment [under the hybrid mismatch rules]."
[446] J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.3.
[447] In OECD BEPS Action 2 Final Report, par. 197, the OECD adds that "An amount should still be treated as dual inclusion income even if there are differences between jurisdictions in the way they value that item or in the accounting period in which that item is recognised for tax purposes."
[448] In the example in *infra*, section 4.5.3, the payment is not recognized by Country X due to B's transparency. Hence, there is no transfer pricing mismatch as a result of a difference in valuation, but rather a transfer pricing mismatch as a result of the hybrid qualification of B.

does not seem justified.[449] Hence, it could be argued that the legal non-recognition of a stream of income as a result of an entity's tax transparency does not qualify as a difference in valuation of the item of income, so that the DI-exception should not apply.
- This issue does not arise with timing differences, as these involve income that is included in the tax base as such, and the OECD allows a carry-back approach insofar this is consistent with domestic laws.[450]

Summarizing, the wording, purpose, context, and origin of the DI-exception would in principle allow a broader interpretation of dual inclusion income in case of certain transfer pricing mismatches and timing differences. However, the DI-exception would remain limited to dual inclusion income that occurs between jurisdictions that are directly involved in the hybrid mismatch.

6.5.4 Deduction limitations

In some instances, deduction limitations concur with the hybrid mismatch rules, which results in economic double taxation.[451]

With respect to **wording**, a linguistic interpretation does not include deduction limitation rules in the definition of the DI-exception, but also does not explicitly exclude deduction limitations. Furthermore, an economic interpretation allows concluding that deduction limitations de facto lead to the inclusion of income.[452]

With respect to the **purpose**, the DI-exception should assess the effective tax benefit that arises from the hybrid mismatch, and both *general* and *specific* deduction limitations can economically eliminate such benefits. Applying the DI-exception would be in line with its objective, which is that the hybrid mismatch rules should not apply in case there is no tax benefit from the hybrid mismatch.[453]

With respect to the **context** of the DI-exception, according to the ATAD's preamble, the hybrid mismatch rules should not apply if the provisions of another directive neutralize the mismatch.[454]
- In principle, Dutch deduction limitation rules cannot concur with the hybrid mismatch rules.[455]
- Foreign deduction limitation rules are not always taken into account when applying the Dutch hybrid mismatch rules.[456] In case of foreign deduction limitations, it could be argued that the ATAD's preamble only requires relief in case the deduction limitation is based on the ATAD's *general* deduction limitation rule.

With respect to the **origin**:
- The OECD states that *specific* deduction limitation rules should not lead to concurrence with the hybrid mismatch rules, except in case of the hybrid financial instrument rule.[457]

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[449] OECD BEPS Action 2 Final Report, par. 125 and 197. ATAD2 requires that the OECD BEPS Action 2 Final Report is used as a source of interpretation insofar this is consistent with EU law.
[450] *Infra*, section 4.4.4.
[451] *Infra*, section 4.5.5.
[452] *Infra*, section 4.4.6. For the DI-exception, it is not required that there is a direct link between payment and dual inclusion income, see *infra*, section 4.4.2. It would not be practical to allow general deduction limitations as dual inclusion income. Therefore, it would be important that the burden of proof lies with the taxpayer.
[453] *Kamerstukken II* 2018/19, 35241, nr. 3, p. 11.
[454] ATAD2, preamble, recital 30.
[455] *Infra*, section 4.5.5.1.
[456] See J. Versluis, op. cit., section 4.5.
[457] *Infra*, section 4.4.6 and *infra*, section 4.5.5. See also OECD BEPS Action 2 Final Report, par. 122, 190, 223, and 284. Only in case of hybrid financial instruments, specific anti-abuse and re-characterization rules should not be considered when assessing whether the hybrid mismatch rules should apply, see par. 289-290.

- With respect to *general* deduction limitation rules, the OECD states that domestic law should coordinate the *general* deduction limitation and the hybrid mismatch rules to achieve an outcome that is proportionate on an after-tax basis.[458]

Hence, it could be argued that the OECD allows an economic approach in assessing whether deduction limitations lead to dual inclusion income.

Summarizing, the wording, purpose, context, and origin of the DI-exception would in principle allow a broader interpretation of dual inclusion income in case of deduction limitations, with some exceptions, and only insofar the deduction limitation applies in a jurisdiction that is involved in the hybrid mismatch.

6.5.5 Unilateral approach to the dual inclusion exception

To prevent economic double taxation, determining whether income is included in the tax base for the DI-exception would require an economic approach. As examples of how such an economic approach could provide relief, the UK and Ireland provide a broader interpretation of dual inclusion income, and the Dutch Hybrid Mismatch Decree also contains a policy of approval.[459]

6.5.5.1 Inclusion/no deduction situations

Broadening the scope of the DI-exception could imply allowing the application of the DI-exception in case of inclusion/no deduction (hereinafter: I/ND) situations. An I/ND mismatch implies that a payment is non-tax-deductible for the payer, whereas the payment is included in the tax base of the recipient. An I/ND mismatch can be direct, e.g., in case of a payment made directly by a foreign parent entity to a domestic hybrid entity.[460] The mismatch can also be indirect, e.g., in case of a payment from a foreign parent entity to a hybrid group entity in another jurisdiction, where that hybrid group entity makes a payment to a domestic hybrid entity.[461] I/ND mismatches are not addressed by the hybrid mismatch rules, as they result in tax disadvantages instead of tax benefits.[462]

6.5.5.2 Dual inclusion income in the UK

The UK legislator amended the definition of dual inclusion income to include payments that result in I/ND situations.[463] According to the UK legislator, this extension of the DI-exception is unobjectionable since an I/ND mismatch results in a hybrid tax disadvantage, so it would be fair to allow a double deduction as an offset.[464] Based on the amendment, an amount that is not deductible from the tax base under the law of any jurisdiction, but which is included in the tax base of the hybrid payer qualifies as deemed dual inclusion income.[465]

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[458] OECD BEPS Action 2 Final Report, par. 292. See *infra*, section 4.5.5.

[459] Dutch Member of Parliament Idsinga (VVD) has filed a Motion to amend the definition of dual inclusion income in the DCITA 1969, based Irelands' approach. See *Kamerstukken II* 2021/22, 35931, nr. 6.

[460] Compare the example in *infra*, section 4.5.3. If A would make a payment to B, the payment would be non-deductible for A because of B's transparency. However, since B is treated as non-transparent in its residence jurisdiction, the payment will be included in B's tax base.

[461] Compare the example in *infra*, section 4.5.2, where C makes a payment to B. If A would first make a payment to C which is non-deductible, there would be an indirect I/ND mismatch for B.

[462] The UK legislator recognizes that the hybrid mismatch rules effectively address the gross hybrid benefit, rather than the net benefit. See also HM Revenue & Customs, *Hybrid and other Mismatches - Summary of Responses*, 12 November 2020, par. 2.4.

[463] An I/ND situation would occur in case of the example in *infra*, section 4.5.3.

[464] HM Revenue & Customs, op. cit., par. 2.11 and TIOPA 2010, Part 6A, Chapter 5, section 259EC, subsection 6-7.

[465] HMRC International Manual, INTM557075 and INTM553100.

To qualify as dual inclusion income under the I/ND approach, three tests need to be satisfied.[466]

1. The income must be ordinary income of the hybrid entity, which requires that the hybrid entity is characterized as non-transparent in its residence jurisdiction.[467]
2. The payment must be non-tax-deductible from the tax base of another taxpayer in a relevant taxable period.[468]
3. The non-tax-deductibility of the payment must be caused by the hybrid transparency of the entity, which requires that the tax-deductibility only arises because an investor jurisdiction classifies the entity as transparent.[469]

The UK's approach to dual inclusion income is not applied in situations where third countries are involved or in case of indirect intra-group payments, because tracing funds through different jurisdictions would be too complex.[470] In contrast, deduction limitation rules, transfer pricing mismatches, and timing differences could be in scope for the DI-exception insofar these result in I/ND mismatches.[471]

It can be inferred from the amendment that the UK legislator holds the opinion that this interpretation of dual inclusion income is in line with the OECD BEPS Action 2 Final Report.[472] Because the UK does not acknowledge third country involvement, it could be argued that the UK definition of dual inclusion income is in accordance with the ATAD. However, this also means that the UK approach does not resolve all instances of economic double taxation, as only economic double taxation that occurs between the jurisdictions that are involved in the hybrid mismatch limitation can be considered.

6.5.5.3 Ireland's approach to dual inclusion income

Ireland has implemented an extended definition of dual inclusion income that specifically focuses on a worldwide system of taxation, in which all resident taxpayers are subject to tax based on worldwide income. This can result in I/ND situations, as the worldwide system of taxation implies that income from transparent entities is taxable in Ireland, whereas intra-group transactions from transparent entities are not recognized in Ireland and hence do not result in tax-deductible payments.[473] Therefore, the Irish definition of dual inclusion income is meant to ensure that the hybrid mismatch rules only

[466] See TIOPA 2010, Part 6A, Chapter 5, section 259EC, subsection 7.
[467] This implies, e.g., that reverse hybrid entities cannot fall within the scope of the I/ND exception.
[468] In the UK, the relevant taxable period lies within 12 months from the end of the fiscal year or, if longer, within a period within which it is just and reasonable for the company to recognize a deduction of the payment. See TIOPA 2010, Part 6A, Chapter 5, section 259EC, subsection 8.
[469] The test will not be satisfied if, e.g., the payment would be non-tax-deductible in the investor jurisdiction, even if the entity were not a hybrid entity.
[470] HM Revenue & Customs, op. cit., par. 2.16-2.17. There are two exceptions: the mitigating measure is still available if the payment to the UK entity is made by another entity in the parent jurisdiction which qualifies as transparent there and the mitigating measure is available on a consolidated bases for UK relief groups, see par. 2.20.
[471] See TIOPA 2010, Part 6A, Chapter 5, section 259EC, subsection 7(a).
[472] Despite the UK having left the EU, the ATAD hybrid mismatch rules must not be weakened below the OECD's minimum standards. See J.J.A.M. Korving and J.C. van der Have, 'Brexit en directe belastingen: There's still a way to escape that Brexit day? Vrij naar: Milqman (feat. Anna & Mimmi), 'Regrets Won't Do on Brexit Day'.' *MBB* 2021/40, section 3.4. The UK's alignment with the OECD BEPS Action 2 Final Report does not necessarily imply that the amendment is also in line with the ATAD hybrid mismatch rules. Recital 28 of the ATAD2 requires that the OECD BEPS Action 2 Final Report is used as a source of interpretation only insofar this is consistent with EU law.
[473] The Irish legislator provides examples in the Tax and Duty Manual, *Guidance on the anti-hybrid rules*, Part. 35C-00-01, Updated March 2021 (hereinafter: Tax and Duty Manual 2021), sections 5.1-5.2. For the implementation of the DI-exception, see Finance Act 2019, Act 45 of 2019, part 35c, section 835ab.

neutralize de facto economic hybrid mismatches without targeting juridical hybrid mismatches that do not result in tax benefits.[474]

Ireland recognizes an extensive pro rata approach in the DI-exception by allowing disregarded payments to qualify as dual inclusion income:[475]

- If third countries are involved in a hybrid mismatch with an Irish taxpayer, where a disregarded payment does not result in a de facto tax benefit because the profits of the hybrid entity are included in two or more tax bases, the disregarded payment is treated as dual inclusion income.[476] Translating the Irish approach to the third country mismatch in Figure 4.5.2, there is a disregarded interest payment of 100 between B and A. Because this disregarded payment results in partial economic double taxation of 90, the amount of 90 would remain tax-deductible for B if B would be situated in Ireland.
- The Irish approach can also be applied to transfer pricing mismatches as in Figure 4.5.3.[477] The payment of 110 from A to B is a disregarded payment, as it is not recognized as a deduction in Country X. Because this disregarded payment results in de facto economic double taxation, according to the pro rata approach an amount of 10 would remain tax-deductible for B.

To qualify for the relief, taxpayers must apply a principle-based test where the taxpayer is obliged to assess the substance of a transaction to ascertain whether a hybrid mismatch arises.[478] Hence, the taxpayer must illustrate that the transaction has not resulted in double non-taxation.[479]

Ireland has not faced an infraction procedure from the EC, so it may be assumed that the Irish approach to third country involvement is in line with the ATAD. However, the Irish approach only focuses on disregarded payments and thereby does not provide clarity on the treatment of timing differences and deduction limitations.

6.5.5.4 Dutch policy approval for dual inclusion income

The Dutch Hybrid Mismatch Decree also contains an approval for partnership structures that allows a broader interpretation of dual inclusion income, illustrated in Figure 6.5.5.4.[480]

[474] Ireland's objective for the DI-exception is that when the hybrid mismatch rules apply, the substance of a transaction is accurately reflected, and technical mismatches do not arise where they should not. See Tax and Duty Manual 2021, section 5.3.

[475] The pro rata approach is based on the wording in art. 9 ATAD. The implementation in art. 12aa DCITA 1969 is in line with the ATAD. See also ATAD2, preamble, recital 29.

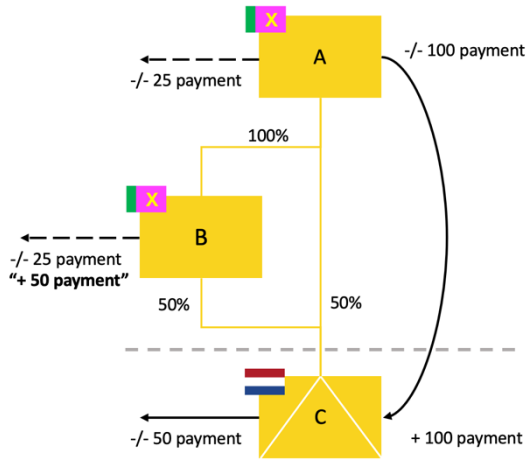
[476] Tax and Duty Manual 2021, section 5.2.2.

[477] *Ibid*, section 5.2.1.

[478] A hybrid mismatch is required to be attributable to differences in the legal characterization of a financial instrument or entity and must be meant to exploit double non-taxation.

[479] Tax and Duty Manual 2021, section 5.3.

[480] See example 6.2 in Besluit van 1 oktober 2021, nr. 2021-20014, BWBR0045683 (*Besluit Hybridemismatches*). According to the Ministry, because of this partnership approval, it is unnecessary to implement a general possibility to adduce evidence of economic double taxation. See ATAD2 Wob-request, p. 23.



- For tax purposes in Country X, C is transparent
  - A and B both hold a participation of 50% in C
- For tax purposes in the Netherlands, C is non-transparent
- A makes a payment of 100 to C
  - The payment is not deductible from A's tax base
  - The payment is included in C's tax base
  - The payment is 50% included in B's tax base
- C makes an external payment of 50
  - The payment is deductible from C's tax base
  - The payment is 50% deductible from A's tax base
  - The payment is 50% deductible from B's tax base

Figure 6.5.5.4

C is a hybrid entity, so that an I/ND outcome arises between A and C. Therefore, the legislator has stated that insofar the payment from A to B is visible between C's participants, this qualifies as dual inclusion income. Hence, if B recognizes 50 of the payment, this constitutes dual inclusion income.

6.5.6 Conclusion on a broader interpretation of dual inclusion income

With respect to the wording, purpose, context, and origin of the DI-exception, dual inclusion income can have a broader interpretation as long as the dual inclusion of income occurs between the two jurisdictions that are involved in the hybrid mismatch.[481] In specific circumstances, an economic interpretation of the definition of dual inclusion income appears to allow applying the DI-exception with respect to transfer pricing mismatches, timing differences, and deduction limitations. However, it remains imperative that the income is included in both jurisdictions involved in the hybrid mismatch, because the interpretation of the DI-exception cannot be contrary to the wording in the ATAD.

In its unilateral implementation of the DI-exception, the UK does implicitly address transfer pricing mismatches, timing differences, and deduction limitations, but does not address third country involvement. In contrast, Ireland does address third country involvement and transfer pricing mismatches, but only focuses on disregarded payments and therefore does not address timing differences or deduction limitations. The Dutch policy approval for partnership structures does not focus on timing differences, deduction limitations, or third country involvement, and the legislator has stated that the ATAD does not provide for a general relief of double taxation.[482]

Based on the analysis, none of the existing approaches to the DI-exception sufficiently relieves economic double taxation in all circumstances. Moreover, a broader interpretation of the DI-exception could result in legal uncertainty as regards its accordance with the ATAD's definition of dual inclusion income.[483] Hence, despite the DI-exception being the most salient mechanism to relieve economic double taxation from the ATAD hybrid mismatch rules, it is insufficient to prevent economic double taxation in all circumstances. Therefore, it should be assessed whether the interpretation of the ATAD's objective would allow relieving economic double taxation resulting from the hybrid mismatch

[481] It is unclear which interpretation criterion prevails, but any interpretation of the ATAD must be in accordance with its wording, see i*nfra*, section 6.4.4.1.
[482] *Kamerstukken I* 2019/20, 35241, nr. C, p. 16.
[483] Fundamentally, legislation should be in line with general principles of law, such as the principle of legal certainty. See Notice of Legislative Vision, p. 15. In the ATAD2 Wob-request, the legislator states that a broader interpretation of the DI-exception carries the political risk of being contrary to the ATAD. See *infra*, section 6.7.2.

rules, by acknowledging an economic approach to assessing whether a hybrid mismatch should be addressed.

6.6 Application of the hybrid mismatch rules

6.6.1 The legislator's view on relief

The Dutch state secretary of Finance acknowledged that the ATAD can lead to double taxation due to a limited interpretation of the definition of dual inclusion income, but that there is no possibility to derogate from the provisions in the ATAD.[484] Because the ATAD does not offer an opportunity for rebuttal, the state secretary argued that economic double taxation cannot be avoided in case of de facto dual inclusion income.[485]

The purpose of the hybrid mismatch rules is to only address hybrid mismatches that carry a risk of avoiding taxation and should therefore be neutralized.[486] The origin requirement serves to limit the scope of the hybrid mismatch rules by only targeting hybrid mismatches. At the same time, the origin requirement is ineffective to achieve this objective. This is because the requirement precludes considering relevant circumstances that might lead to economic double taxation, as the concurrence of the hybrid mismatch rules with third country involvement, transfer pricing mismatches, timing differences, or deduction limitation rules implies that the hybrid mismatch itself persists and should therefore be neutralized according to the origin requirement. Hence, the origin requirement is mechanical in the sense that it does not allow considering all facts and circumstances in assessing whether a hybrid mismatch results in a tax benefit.

Regarding economic double taxation resulting from the hybrid mismatch rules, the Dutch legislator stated that only the transaction that results in the hybrid mismatch is assessed, not other transactions within the taxpayer's group structure. According to the legislator, considering other group transactions besides the transaction that generates a hybrid mismatch outcome would not be in line with the ATAD, because the hybrid mismatch itself persists and should therefore be neutralized.[487] Hence, a tax benefit from a hybrid mismatch cannot be offset by a tax disadvantage elsewhere in the group.[488]

The legislator's view indicates that the application of the hybrid mismatch rules should not be based on an economic analysis of the tax benefit arising from the hybrid mismatch, but rather on a mechanical assessment of whether a specific transaction results in a DD or D/NI outcome.[489] In the legislator's view, not just any tax disadvantage can offset the tax benefit from the hybrid mismatch. However, a disadvantage that can be linked directly with the hybrid mismatch effectively results in offsetting the hybrid tax benefit. In my view, it would therefore be in accordance with the ATAD to not target any hybrid mismatches that do not result in de facto double non-taxation, despite the ATAD not explicitly offering a mechanism to relieve economic double taxation that results from application of the hybrid mismatch rules.

6.6.2 Not applying the hybrid mismatch rules in case of economic double taxation?

Even though the legislator has indicated that relieving economic double taxation would not be allowed, these statements can only be used in interpreting the ATAD's hybrid mismatch rules insofar this is in

[484] The state secretary of Finance emphasizes that a solution must be provided for at the EU level. See *Kamerstukken I* 2019/20, 35241, nr. C, p. 16. Despite this, there is a specific approval in the hybrid mismatch decree, see *infra*, section 6.5.5.4.
[485] *Kamerstukken I* 2019/20, 35241, nr. C, p. 16 and *Kamerstukken I* 2019/20, 35241, nr. E, p. 13.
[486] *Infra*, section 6.6.5.
[487] *Kamerstukken II* 2019/20, 35241, nr. 7, p. 37.
[488] *Ibid.*
[489] See also *infra*, section 4.2.2.1.

accordance with the ATAD.[490] Therefore, it should still be assessed whether the hybrid mismatch rules can be interpreted in a manner that would allow relieving economic double taxation. A broader interpretation of the hybrid mismatch rules would imply that the hybrid mismatch rules do not apply to the extent that income relating to the hybrid mismatch is subject to economic double taxation.[491] In this respect, the wording, purpose, context, and origin of the hybrid mismatch rules, the preamble to the ATAD1 and ATAD2, and the guidance in the OECD BEPS Action 2 Final Report may provide scope for (unilaterally) relieving economic double taxation.

6.6.3 The wording of the hybrid mismatch rules

With respect to the **wording** of the hybrid mismatch rules, it is uncertain whether the hybrid mismatch rules should not be applied in case their application leads to economic double taxation, since the ATAD's provisions do not provide guidance on the scope of the hybrid mismatch rules.[492]

6.6.4 The purpose of the hybrid mismatch rules

With respect to the **purpose**, applying the hybrid mismatch rules in case of economic double taxation would not be in accordance with the purpose of the hybrid mismatch rules as laid down in the preamble, which is to neutralize hybrid mismatches.[493] Economic double taxation can be interpreted as the lack of a risk of tax evasion through the hybrid mismatch.[494] In case the rules create or aggravate economic double taxation, this would be contrary to their objective, as the hybrid mismatch rules would then move beyond neutralizing the hybrid mismatch.[495]

6.6.5 The context of the hybrid mismatch rules

With respect to the **context** of the hybrid mismatch rules, the preamble seems to implicitly address economic double taxation. The ATAD2's preamble states that the coordination of hybrid mismatch rules serves to remove inefficiencies and distortions in the interaction of distinct national measures.[496] However, this statement does not explicitly focus on economic double taxation and serves to justify the harmonization of hybrid mismatch rules.

It does follow from the ATAD2's preamble that, to ensure proportionality, only hybrid mismatches with a substantial risk of avoiding taxation should be addressed.[497] If the application of the hybrid mismatch rules would be assessed through an economic approach – where it is decisive whether a hybrid mismatch de facto results in a tax benefit – it could be argued that the hybrid mismatch rules should not result in economic double taxation. Despite the DI-exception in principle not being applicable in case of third country involvement, transfer pricing mismatches, timing differences, and deduction limitation rules, it could be argued that the hybrid mismatch rules should not be applied in such cases in the first place as a result of the absence of a tax benefit.

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[490] M. van Gijlswijk and L. van Heijningen, op. cit., section 3.2 and 3.3.

[491] If the hybrid mismatch rules would not apply, the narrow definition of dual inclusion income would also not pose any problems.

[492] J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.2.

[493] The neutralization mechanism follows from ATAD1, preamble, recital 13 and ATAD2, preamble, recital 5 and 12. See also *infra*, section 2.3.1. The mechanical approach of the hybrid mismatch rules detracts from this, as there is no possibility to prove that there is no tax abuse.

[494] If the hybrid mismatch does not result in a tax benefit, it can be argued that the mismatch does not constitute tax abuse in light of OECD BEPS Action 2 Final Report, Executive summary, p. 11. This would be different if the hybrid mismatch rules would be aimed at targeting tax evasion in specific jurisdictions. However, due to their mechanical nature, where no attention is paid to which jurisdiction loses tax revenue, a neutralization through economic double taxation can be deemed to remove the tax benefit resulting from the hybrid mismatch. See *infra*, section 2.3.1 and 4.2.1-4.2.2.

[495] This is in line with the opinion of J.J.A.M. Korving and W.R. Kooiman, op. cit., section 4.2.

[496] ATAD2, preamble, recital 27.

[497] ATAD2, preamble, recital 12.

The ATAD2's preamble additionally states that the hybrid mismatch rules should only be applied when a deduction is set off against non-dual inclusion income.[498] The hybrid mismatch rules do not focus on a legal coordination of the international disparities in tax characterization of entities and instruments.[499] Instead, the hybrid mismatch rules require assessing whether a D/NI or DD mismatch results in a tax benefit.[500] This justifies an economic approach to whether the rules should be applied.[501] Indeed, the pro rata rule provides scope to not apply the hybrid mismatch rules or offer a general relief mechanism in case there is no de facto tax benefit arising from the hybrid mismatch.[502]

In contrast to the ATAD2, the preamble of the ATAD1 explicitly pays attention to relieving double taxation.[503] Recital 5 in the preamble seems to imply that there should be relief for double taxation resulting from the ATAD hybrid mismatch rules (*emphasis added)*:

"5. […] Where the application of [the ATAD] rules *gives rise to double taxation, taxpayers should receive relief through a deduction for the tax paid* in another Member State or third country, as the case may be. Thus, the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation."[504]

This recital implies that economic double taxation can negatively affect economic efficiency in the EU internal market. Despite the fact that this recital does not focus on the hybrid mismatch rules specifically, it suggests that Member States can and should relieve economic double taxation resulting from the ATAD hybrid mismatch rules.[505] Therefore, it could be argued that Member States would be allowed to implement a relief mechanism, either through deducting the foreign tax paid from the tax base, or through a foreign tax credit in the domestic tax burden.[506]

6.6.6 The origin of the hybrid mismatch rules

With respect to the **origin** in the OECD BEPS Action 2 Final Report, the hybrid mismatch rules are specifically meant to address double non-taxation.[507] The OECD therefore seems to follow an economic

[498] ATAD2, preamble, recital 20-21.
[499] The ATAD hybrid mismatch rules do not stipulate a legal approach to assessing where the mismatch originates from. See also *infra*, section 6.2.
[500] Art. 9 ATAD. The implementation in art. 12aa DCITA 1969 is in line with the ATAD. See also ATAD2, preamble, recital 29.
[501] See also the further discussion on the OECD's interpretation in *infra*, section 6.6.6.
[502] E.g., in case a transfer pricing mismatch results in economic double taxation, the origin requirement remains satisfied, as the transfer pricing mismatch results from the hybrid transparency of the entity. However, applying the hybrid mismatch rules would not be in line with the pro rata approach, which stipulates that the hybrid mismatch rules should apply insofar the taxpayer is involved in a D/NI or DD mismatch.
[503] The preamble of the ATAD1 is still relevant to the ATAD2, see EC Joint Practical Guide, par. 18.11-18.12. See also J.J.A.M. Korving and W.R. Kooiman, op. cit., section 3.2, who argue that the preamble of the ATAD1 is only relevant insofar the ATAD2 does not change the core of the provisions in the ATAD1. In my opinion, this is the case, since the ATAD2 in essence only broadens the scope of the hybrid mismatch rules that were already adopted in the ATAD1.
[504] ATAD1, preamble, recital 5.
[505] Alternatively, G.K. Fibbe, 'Hybride mismatches onder de ATAD; symptoombestrijding is geen oplossing', *WFR* 2016/186, section 6.2 mentions that because taxpayers can change their group structure. This might imply that the relief of economic double taxation would be unnecessary. However, the author then argues that taxpayers perceive alternative structuring as complex.
[506] L.R. Jacobs, P.G.H. Albert and G.K. Fibbe, op. cit., section 5.
[507] Double non-taxation occurs both under DD situations (i.e., a payment is deducted twice, hence the tax base is reduced in two jurisdictions) and under D/NI situations (i.e., a payment is deducted from the tax base, without being included in another tax base, so that two tax bases are reduced).

approach in assessing whether a hybrid mismatch should be targeted by the hybrid mismatch rules.[508] This is in line with the fact that the hybrid mismatch rules do not address mismatches in legal qualifications by harmonizing the tax treatment of entities and instruments, but rather neutralize the economic consequences from hybrid mismatches.[509] The interpretation that economic double taxation implies that there is no DD or D/NI situation because of the lack of a tax benefit would allow not applying the hybrid mismatch rules.

6.6.7 Interpreting the hybrid mismatch rules

Table 6.6.7 summarizes the findings on the application of the DI-exception and the hybrid mismatch rules. Not applying the hybrid mismatch rules would in principle be possible, based on an interpretation of the ATAD with respect to its wording, purpose, context, and origin. However, because a broader interpretation of the DI-exception might result in legal uncertainty, it would be preferable to allow an economic interpretation of the hybrid mismatch rules such that they do not result in economic double taxation, since the rules were meant as a neutralizing measure. Therefore, in the following, the possibilities for unilateral relief of economic double taxation are analyzed.

Table 6.6.7

	Third country involvement: DI-exception	**Transfer pricing mismatch / timing difference: DI-exception**	**Deduction limitation: DI-exception**	**Not applying the hybrid mismatch rules**
Wording	No broader interpretation possible	(No) broader interpretation possible [1]	Broader interpretation possible [3]	Economic interpretation possible
Purpose	Broader interpretation possible	Broader interpretation possible	Broader interpretation possible	Economic interpretation possible
Context	No broader interpretation possible	Broader interpretation possible	(No) broader interpretation possible [4]	Economic interpretation possible
Origin	No broader interpretation possible	(No) broader interpretation possible [2]	(No) broader interpretation possible [5]	Economic interpretation possible

[1] Only if the transfer pricing mismatch or timing difference occurs between both jurisdictions involved in the hybrid mismatch. With respect to timing differences, only in DD situations it is required that income is included in the tax base in a subsequent period. For other hybrid mismatches, a prior period seems allowed.
[2] In principle, transfer pricing mismatches or timing differences that result from differences in valuation constitute dual inclusion income. This does not hold if the income is not recognized.
[3] Only if the deduction limitation applies in one of the jurisdictions involved in the hybrid mismatch.
[4] Only for deduction limitation rules that are based on ATAD earnings stripping rule.
[5] Only for *specific* deduction limitation rules, not for *general* deduction limitation rules.

[508] The hybrid mismatch rules assess the outcome of an arrangement, without regard for the technique to achieve the hybrid mismatch. See OECD BEPS Action 2 Final Report, par. 137. In my view, this is also the case for dual inclusion income, see *infra*, section 6.5.2.
[509] *Infra*, section 6.2. The reverse hybrid mismatch rule does coordinate legal qualifications, but this rule is left out of scope of this research.

6.7 Unilateral measures to relieve economic double taxation?

6.7.1 Designing relief

Recital 5 of the ATAD1's preamble states that taxpayers should receive relief through a deduction or credit of foreign taxes paid.[510] This would ensure that the tax burden on the payment is equal to the effective Dutch tax rate. However, because the hybrid mismatch rules result in economic double taxation, it is difficult to assess the amount of double taxation for which relief should be granted from a domestic perspective since multiple taxpayers are involved.[511] Therefore, the remainder discusses an alternative approach to unilateral relief of economic double taxation.

6.7.2 Suggested Dutch approach to preventing economic double taxation

In a Freedom of Information Act request (hereinafter: Wob-request), stakeholders requested information from the Dutch legislator about the economic double taxation resulting from the ATAD hybrid mismatch rules.[512] In the Wob-request, the legislator holds the opinion that currently, based on the ATAD, economic double taxation cannot be relieved.[513] However, the Wob-request also contains a memorandum from the DTA, in which the possibilities for soft law policies of approval are discussed in case of transfer pricing mismatches and I/ND situations.[514]

In the memorandum, the DTA discuss that the hybrid mismatch rules are "conceptually incomplete" because there is only a DI-exception, not an exception for I/ND situations.[515] In case of DD situations with transfer pricing mismatches, the DTA suggest policy of approval that could be communicated in a Decree from the state secretary of Finance. The policy would provide that the hybrid mismatch rules do not have to be applied if the following requirements are satisfied:[516]

1. The taxpayer must make plausible[517] whether and for which amount double taxation results from the application of the hybrid mismatch rules.
2. The taxpayer must make plausible that the double taxation is caused by the application of the DD hybrid mismatch rule.[518]
3. The taxpayer must make plausible that the intra-group income is included in the tax base of the taxpayer and that this income is not legally or de facto directly or indirectly deductible from the tax base.[519]

[510] *Infra*, section 6.6.5.
[511] *Infra*, section 3.2.2. E.g., in case of a deduction limitation, it is difficult to trace the amount of tax paid, since the income is not legally included in the tax base, but the non-deductibility of a payment results in implicit taxation.
[512] Besluit op Wob-verzoek over ATAD2 en dubbele belastingheffing van 29 april 2022, 2021-0000212803 (hereinafter: ATAD2 Wob-request). The Freedom of Information Act (Wob) has been replaced by the Open Government Act (Woo). However, the ATAD2 double taxation Wob-request was filed under the old Wob.
[513] This is in line with the parliamentary history that was mentioned in *infra*, section 6.5.6 and 6.6.1.
[514] ATAD2 Wob-request, p. 11-16.
[515] The ATAD2 does not provide for the possibility of such an I/ND exception.
[516] ATAD2 Wob-request, p. 12-14.
[517] The burden of proof is lower for making something plausible than for proving a certain statement. The DTA note that it could instead be required that taxpayers prove the occurrence of economic double taxation and thereby increase the burden of proof.
[518] The memorandum only looks at the application of hybrid mismatch rules in DD situations, not in D/NI situations.
[519] A de facto I/ND situation is required. The reason seems that the EC has concluded that economic double taxation cannot be prevented in other situations, see ATAD2 Wob-request, p. 21.

4. The taxpayer must make plausible that there is a relationship between the payment that is deducted twice (the DD payment) and the intra-group income.[520]

The Ministry of Finance does not acknowledge the DTA's approach to the DI-exception. Because the Ministry does not foresee the possibility to implement a general conditional possibility to adduce evidence of economic double taxation, this legislative option is not explored in the documents provided in the Wob-request.[521] Furthermore, the Ministry has indicated that the suggested policy of approval with the conditional possibility to adduce evidence is in principle contrary to the ATAD.[522] Additionally, the Ministry mentions that the Hybrid Mismatch Decree contains an approval for partnership structures that allows for a broader interpretation of dual inclusion income.[523] However, the state secretary of Finance's approval does not relieve all instances of economic double taxation.

6.7.3 Extending policy approval to other situations of economic double taxation

Based on the analysis in this chapter, the ATAD seems to justify a general relief mechanism to relieve economic double taxation in D/NI and DD situations. Building on this interpretation of the ATAD and the DTA's suggestions for policy of approval, six recommendations for a general relief mechanism are formulated and discussed in Table 6.7.3.[524]

Table 6.7.3.

1. Proving double taxation	The taxpayer must make plausible whether and for which amount of income double taxation results from the application of the hybrid mismatch rules.

General relief could allow that the hybrid mismatch rules do not apply insofar a taxpayer provides plausible evidence that economic double taxation would result from their application. This requirement implies that the taxpayer must illustrate that the transaction has not resulted in double non-taxation.[525]

The requirement that the taxpayer must plausibly prove the amount of income is added. Alternatively, this requirement could be left out, in which case the taxpayer must plausibly prove the amount of economic double taxes paid. However, economic double taxation may complicate tracing the amount of tax that was paid in relationship to the income that is subject to economic double taxation.[526] Therefore, through adding the income requirement, the relief would imply that the hybrid mismatch rules do not apply to a D/NI or DD payment to the extent a corresponding amount of income is subject to economic double taxation.

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[520] The DTA note that the relationship requirement does not seem necessary from the ATAD's objective. Not including this requirement would mean that the approval could also be applied if the intra-group income does not have a relationship with the double deduction. This latter option would also be in line with the DI-exception, which also does not require such relationship.

[521] It is more difficult to provide relief for all situations where the hybrid mismatch rules result in economic double taxation, particularly in case of foreign dual inclusion income when there is a third country involved.

[522] According to the Ministry, even though there is a low risk of an infraction procedure by the EC, the political risk of such conditional possibility is large. See ATAD2 Wob-request, p. 20. This is also mentioned by G.K. Fibbe, op. cit., section 6.2.

[523] In the Wob-request, a Ministry official mentions that in practice, taxpayers will be able to resolve economic double taxation in most instances through the policy approval. See ATAD2 Wob-request, p. 20 and *infra*, section 6.5.5.4.

[524] Of course, this depends on the interpretation that the ATAD allows relieving economic double taxation, in line with the findings summarized in Table 6.7.1.

[525] Both D/NI and DD situations lead to double non-taxation.

[526] E.g., a deduction limitation rule does not lead to the inclusion of income but does lead to de facto economic double taxation. Due to complex tax rate structures, it may be more difficult to calculate the amount of tax that would be owed if the deduction limitation would not apply, than to prove the amount of the payment to which the deduction limitation applies.

Currently, taxpayers are required to keep documentation of and to assess the applicability of the hybrid mismatch rules in their income tax return.[527] Therefore, introducing policy of approval that includes the possibility to adduce evidence is feasible because the burden of proof remains with the taxpayer. Giving taxpayers the opportunity to adduce evidence of economic double taxation does not mean that they are obliged provide such evidence. If taxpayers consider the administrative information requirement too burdensome, the hybrid mismatch rules are applied regularly.[528] Therefore, taxpayers are not worse off than without the opportunity to adduce evidence of economic double taxation.[529]

2. Causal relationship	The taxpayer must make plausible that the double taxation is caused by the application of ~~art. 12aa(1)g VPB~~ the hybrid mismatch rules in section 2.2a of the DCITA 1969.

To ensure all situations of economic double taxation can be addressed by the relief, there are no restrictions as to which hybrid mismatch rule should have imposed the economic double taxation.

3. De facto double taxation	The taxpayer must make plausible that the ~~intra-group~~ income is included in the tax base of the taxpayer and of another group entity, and that this income is not legally or de facto directly or indirectly deductible from the tax base in any jurisdiction.

To ensure that all types of economic double taxation can be relieved, there is no requirement that the income must be intra-group income.[530] Instead, it should be required that the income is directly involved in the hybrid mismatch, which should be assessed based on all facts and circumstances.[531] This does not mean that there must be a direct relationship between the payment and the income.[532] Instead, this implies that the income must be at least included the tax base of the hybrid entity or the beneficial owner of a hybrid financial instrument, but it is irrelevant in which corresponding tax base there is dual inclusion income.[533]

This requirement allows an economic approach in assessing whether a hybrid mismatch results in a tax benefit that should be neutralized, so that economic double taxation resulting from deduction limitation rules can be addressed as well. Additionally, the income must be de facto included in

[527] Art. 12ag DCITA 1969.
[528] E.g., taxpayers need to extend their knowledge of applicable foreign tax law. See also J. Versluis, op. cit., footnote 60. There has been some critique on the documentation requirement in the hybrid mismatch rules, see for example Nederlandse Orde van Belastingadviseurs Commissie Wetsvoorstellen*, NOB-commentaar wetsvoorstel Wet implementatie tweede EU-richtlijn antibelastingontwijking (35 241),* Amsterdam 2019, par. 35; D.P.J.G. van Kappel and G.K. Fibbe, op. cit., and C.J.D. Warren, op. cit.
[529] J. Versluis, op. cit., section 4.5.
[530] Intra-group income would refer to payments made between group entities, i.e., excluding income obtained from third parties.
[531] The facts and circumstances approach also follows from the imported mismatch rule, which requires a direct link between the deduction in the Netherlands and the foreign deduction that results in a hybrid mismatch regarding all facts and circumstances. See ATAD2, preamble, recital 25 and *Kamerstukken II* 2018/19, 35241, nr. 3, p. 69-70.
[532] In line the definition of dual inclusion income, see *infra*, section 4.4.2.
[533] Of course, this only holds as long as the other requirements for relief are satisfied. Compare the Irish rule for disregarded payments in *infra*, section 6.5.5.2, which effectively resolves third country involvement, transfer pricing mismatches, but not deduction limitations and timing differences.

both the tax base of the taxpayer that is invoking the relief and in the tax base of another group entity. To prevent situations from de facto double non-taxation from arising, the income may not be legally or de facto directly or indirectly deductible from the tax base in any jurisdiction. This ensures that the relief can only be invoked in case of double taxation.

4. Intra-group income	~~The taxpayer must make plausible that there is a relationship between the payment that is deducted twice (the DD payment) and the intra-group income.~~

This requirement is deleted because it only provides relief in DD situations.

5. Adequate level of taxation	The taxpayer must make plausible that the income of the other group entity is subject to an adequate level of taxation according to Dutch standards.

The hybrid mismatch rules do not have general requirements with respect to the level of taxation, except for the inclusion of income under a CFC rule.[534] However, to ensure that the hybrid mismatch rules still satisfy their objective of targeting double non-taxation, an adequate tax requirement is warranted.[535] This requirement implies that, according to Dutch standards, the income that is subject to economic double taxation must bear a sufficient level of taxation to prevent situations from de facto double non-taxation from arising.

6. Obtaining relief only once	The taxpayer must make plausible that relief of economic double taxation is obtained only once, and that the hybrid mismatch remains neutralized insofar relief of economic double taxation is approved.

This requirement ensures that in case of third country involvement, relief of economic double taxation is not obtained in more than one country involved, as this would result in a de facto tax benefit instead of a neutralization of the hybrid mismatch.[536] The requirement is necessary since other double taxation relief could imply that the income is not deductible from the tax base but remains untaxed as a result of the application of another relief measure.

6.8 Conclusion

The mechanical approach in the hybrid mismatch rules may result in economic double taxation. Such economic double taxation negatively affects economic efficiency and is contrary to the hybrid mismatch rules' objective of neutralizing hybrid mismatches that are aimed at achieving double non-taxation.

Double tax conventions and primary and secondary EU law do not oblige the relief of economic double taxation resulting from the hybrid mismatch rules. Furthermore, it is uncertain whether the dual

[534] For the hybrid mismatch rules, CFC rules require a statutory tax rate of at least 10%. See *Kamerstukken II* 2018/19, 35241, nr. 3, p. 59 and *infra*, section 4.4.5.
[535] The minimum effective tax rate for obtaining relief should still be determined. This could be a statutory rate of 10%, just as in the CFC approach in the hybrid mismatch rules. The level of adequate taxation could also be an effective tax rate of at least 10%, so that it could be calculated according to the approach in art. 10a(3)b DCITA 1969, see *Kamerstukken II* 1995/96, 24696, nr. 3, p. 20. Furthermore, the OECD Pillar Two Model Rules rely on an effective minimum tax rate of 15%, so this could also be the required tax rate for obtaining relief.
[536] In Figure 4.5.2, if entity A would be able to obtain relief for economic double taxation, e.g., because A is situated in Ireland and the disregarded payments exception is applied, this requirement ensures that it is not possible for B to obtain additional relief of economic double taxation.

inclusion exception can be interpreted so that income of taxpayers in jurisdictions that are not directly involved in the hybrid payment is qualified as dual inclusion income.

Instead, it may be possible to interpret the scope of the hybrid mismatch rules in line with the wording, purpose, context, and origin of the ATAD to ensure that the application of the rules does not result in economic double taxation. Based on the interpretation of the ATAD and the OECD BEPS Action 2 Final Report, it seems possible to assess hybrid mismatch outcomes using an economic approach. The reason is that the hybrid mismatch rules follow a pro rata approach, which stipulates that the hybrid mismatch rules should apply insofar a difference in the tax characterization of an entity or instrument results in a deduction/no inclusion or double deduction outcome.

To relieve economic double taxation resulting from the hybrid mismatch rules, unilateral measures could be considered. Such relief must ensure that, to prevent situations from de facto double non-taxation from arising, the income may not be legally or de facto directly or indirectly deductible from the tax base in any jurisdiction, and that no relief of economic double taxation is obtained otherwise. This ascertains that the relief can only be invoked in case of de facto economic double taxation resulting from the hybrid mismatch rules. With such relief of economic double taxation, the hybrid mismatch rules achieve their objective, which is to neutralize hybrid mismatches with a substantial risk of double non-taxation.

Chapter 7 Conclusion

7.1 Economic double taxation in the hybrid mismatch rules

This research analyzed the consequences of the economic double taxation that may result from the ATAD hybrid mismatch rules in the DCITA 1969, with the main research question:

Should economic double taxation from the ATAD hybrid mismatch rules in Dutch tax law be relieved from a tax-legal and economic perspective? If so, how can relief of economic double taxation be achieved?

The research question was answered through five sub-questions, aimed at analyzing the interrelationship between the hybrid mismatch rules as an instrument to curb double non-taxation, the consequences of economic double taxation resulting from the rules, and potential methods to provide relief for the economic double taxation created by the hybrid mismatch rules.

7.1.1 The objectives and mechanisms of the hybrid mismatch rules

Taxpayers can gain tax benefits from the interaction between differences across jurisdictions in the tax characterization of financial instruments, payments, or entities. Therefore, the objective of the ATAD hybrid mismatch rules that were implemented in the DCITA 1969 is to neutralize the double non-taxation that results from such hybrid mismatches.

Instead of harmonizing the qualification of entities and instruments to address these hybrid mismatches, the ATAD uses mechanical linking rules to neutralize the tax benefits from mismatches that result in a deduction in two jurisdictions (double deduction) or a deduction of a payment in one jurisdiction without inclusion of that payment in the tax base of another jurisdiction (deduction/no inclusion). To ensure the neutralization of hybrid mismatches, the hybrid mismatch rules coordinate which jurisdiction should address the hybrid mismatch through a primary or secondary rule. This ranking of primary and secondary rules serves to balance the tax outcomes from the hybrid mismatch and achieve a single deduction, deduction plus inclusion, or non-deduction plus non-inclusion of a payment.

The hybrid mismatch rules do not require establishing that a jurisdiction has lost tax revenue through a hybrid mismatch. Instead, by operating mechanically, the hybrid mismatch rules can affect the international distribution of tax revenue, as the primary and secondary rule determine which jurisdiction is allowed to effectively levy taxes through a deduction limitation or inclusion of a payment in its tax base:

- In a deduction/no inclusion situation, the hybrid mismatch originates from the fact that the recipient jurisdiction does not include the income in its tax base. It could therefore be argued that the payer's tax base is primarily eroded, which justifies the deduction limitation as a primary rule. Hence, the primary rule denies the deduction of the payment from the tax base and thereby results in effective taxation in the payer jurisdiction. If the primary rule does not apply, the secondary rule requires including the income in the tax base of the recipient.
- In a double deduction situation, the hybrid mismatch effectively originates in the investor jurisdiction through the payer's hybrid transparency. Therefore, the primary rule results in effective taxation in the investor jurisdiction by denying the deduction of the payment from the investor's tax base. If the payer jurisdiction is the jurisdiction where real production takes place, the primary rule is efficient. Furthermore, the investor jurisdiction likely has more information on the deductibility of the payment in the payer jurisdiction. As a secondary rule, the deduction of the payment is denied in the payer jurisdiction.

7.1.2 Economic double taxation in the hybrid mismatch rules

Economic double taxation arises when two separate entities are taxed consecutively on the same object of taxation. Within the hybrid mismatch rules, there are three mechanisms to prevent economic double taxation: the ranking rule, the pro rata rule, and the dual inclusion exception. The ranking rule and the pro rata rule provide exemptions from the hybrid mismatch rules, i.e., the secondary rule only applies if the primary rule cannot be applied (ranking rule), and the hybrid mismatch rules only apply insofar there is a hybrid mismatch (pro rata rule). The dual inclusion exception provides that insofar a hybrid mismatch results in the deduction of a payment against dual inclusion income, the hybrid mismatch rules should not apply. Hence, to prevent economic double taxation, the dual inclusion exception allows the deduction of a payment despite the persistence of the hybrid mismatch.

Because of the relief mechanisms in the hybrid mismatch rules, the scope of economic double taxation resulting from the rules is relatively limited. Indeed, the dual inclusion exception is not applied to all hybrid mismatches that are addressed by the hybrid mismatch rules, because the exception is not relevant in those hybrid mismatch situations that are currently excluded from the exception. Nevertheless, the dual inclusion exception remains insufficient to relieve economic double taxation under all circumstances, specifically in case of third country involvement, transfer pricing adjustments, timing differences, and deduction limitation rules. The reason for this economic double taxation is the narrow definition of dual inclusion income, which requires the inclusion of income in the tax base under the laws of both jurisdictions that are involved in the hybrid mismatch.

7.1.3 Why economic double taxation should be relieved

Under specific circumstances, the neutralization of hybrid mismatches can restore economic efficiency. Therefore, the neutralization of hybrid mismatches can be warranted. However, removing the tax benefit from the hybrid mismatch does result in negative incentives for investment and production, implying that the hybrid mismatch rules make it less attractive to carry out economic activities in a jurisdiction that implements the rules. Such negative effects are worsened under economic double taxation from the hybrid mismatch rules. Economic double taxation always disincentivizes economic activity and may result in a loss of investment and production efficiency. As the non-tax-deductibility of production costs increases the effective tax burden, investment and production become less profitable. Therefore, economic double taxation from the hybrid mismatch rules should be relieved.

In addition to production and investment incentives for taxpayers, economic double taxation in the hybrid mismatch rules creates tax revenue incentives for governments. On the one hand, the decreased investment and production reduces taxable profits. However, in case the neutralization of hybrid mismatches results in a net tax base increase in a jurisdiction, the loss of economic activity does not necessarily constitute a loss in social welfare. When designing hybrid mismatch rules and determining whether relief of economic double taxation in the hybrid mismatch rules should be provided, legislators should consider this trade-off between the increase in tax revenue from the reduction in hybrid mismatches and the decrease in tax revenue resulting from the loss of economic efficiency.

7.1.4 A proposal for effective relief of economic double taxation

Economic double taxation is more difficult to relieve than juridical double taxation because of the lack of taxable subject identity. As bilateral double tax conventions in principle focus on relieving juridical double taxation, such conventions are inadequate to relieve economic double taxation from the hybrid mismatch rules. Furthermore, EU law and unilateral measures do relieve some instances of economic double taxation, but do not provide a general relief mechanism for economic double taxation that may result from the hybrid mismatch rules. Currently, when the hybrid mismatch rules result in economic double taxation, taxpayers do not have the possibility to adduce evidence of such double taxation and obtain relief.

It is uncertain whether the dual inclusion exception can be interpreted in a manner that would allow relieving economic double taxation from the hybrid mismatch rules, because the ATAD does not provide sufficient guidance regarding the scope of dual inclusion income. Therefore, it is preferable to use an economic interpretation for the pro rata approach in the hybrid mismatch rules. This implies that the hybrid mismatch rules in the ATAD can be interpreted in line with the wording, purpose, context, and origin of the ATAD to ensure that the application of the hybrid mismatch rules does not result in economic double taxation. Economic double taxation implies there is no de facto tax benefit from the hybrid mismatch, which makes economic double taxation contrary to the objective of neutralizing hybrid mismatches that result in double non-taxation.

Contingent on the possibility that the ATAD can be interpreted in a manner that would allow the relief of economic double taxation from the hybrid mismatch rules, it would be possible for the Dutch legislator to introduce unilateral relief. Unilateral relief of economic double taxation could be designed in a way that would allow reversing the application of the hybrid mismatch rules to the extent an amount of income that relates to a payment which is targeted by the hybrid mismatch rules is subject to economic double taxation. As an alternative, it could be required that the taxpayer plausibly proves the amount of tax that is paid in relationship to the income that is subject to economic double taxation. However, economic double taxation may make it difficult to trace the amount of tax that was paid in relationship to the economic double taxation. Therefore, reversing the application of the hybrid mismatch rules to the extent related income is subject to economic double taxation is preferred.

The relief of economic double taxation would require that the taxpayer plausibly proves that the income is not legally or de facto directly or indirectly deductible from the tax base in any jurisdiction and that no relief of economic double taxation is obtained otherwise. This ensures that the relief can only be invoked in case of de facto double taxation. Furthermore, it should be required that the amount for which relief is obtained is subject to an adequate level of taxation according to Dutch standards. Through such relief of economic double taxation, the hybrid mismatch rules effectively achieve their objective, which is to neutralize hybrid mismatches with a substantial risk of double non-taxation.

7.1.5 Conclusion

In my view, the introduction of far-reaching anti-abuse measures is justified to prevent tax abuse, despite the potential adverse consequences for taxpayers and economic efficiency. However, economic double taxation is contrary to the hybrid mismatch rules' objective of avoiding double non-taxation and goes beyond achieving the neutralization of hybrid mismatches. Based on the tax-legal and economic analysis in this research, it is concluded that economic double taxation resulting from the hybrid mismatch rules can and should be relieved. To relieve economic double taxation from the hybrid mismatch rules, this research presents recommendations for the unilateral implementation of such relief.

7.2 Considerations for the design of anti-abuse measures

Currently, the hybrid mismatch rules serve to mechanically neutralize hybrid mismatches. The consequences of this approach for the inter-jurisdictional distribution of tax revenue should be researched. To analyze this, macro-economic data can provide insight in the international consequences of the hybrid mismatch rules in terms of production and investment incentives, for example by analyzing investment and profits in jurisdictions before and after the introduction of the hybrid mismatch rules. Furthermore, national tax data can be analyzed to determine which jurisdictions lose tax revenue from hybrid mismatches and whether the hybrid mismatch rules are effective in compensating such tax revenue losses. Such analysis could improve the hybrid mismatch rules' efficiency.

Fundamentally, the OECD BEPS measures are aimed at imposing taxes on profits in jurisdictions where the economic activities generating those profits are performed, and where value is created. All anti-abuse measures should be carefully analyzed to ensure such measures effectively achieve their intended objectives with minimal loss of economic efficiency. When designing anti-abuse measures, legislators should therefore additionally consider the social welfare consequences from the trade-off between the loss of tax revenue due to a loss of economic efficiency, and the increase in tax revenue due to decreased tax abuse. It would be recommended to also include such trade-off analysis in impact assessments of future anti-BEPS measures.

In my view, providing insight into the effectiveness and efficiency of BEPS measures could increase the support for the anti-BEPS objectives, as taxpayers regain confidence in the integrity of the international tax system. By combining tax-legal and economic analysis to analyze the economic double taxation resulting from the hybrid mismatch rules, this research not only contributed to the development of the hybrid mismatch rules, but also provided an example of how other BEPS measures can be evaluated. If such analysis would be applied to more BEPS measures, legislators can perform more comprehensive impact assessments and develop a tax system that is effective and efficient in addressing international tax abuse.

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A1 Structural Appendix

An overview of the hybrid mismatches that are discussed in this research is summarized in Table A1.

Table A1

Category	Hybrid element	Type	Primary rule	Secondary rule
Hybrid financial instruments	Payments under the instrument have a different character due to differences in the tax treatment of the instrument	D/NI	Payer jurisdiction denies deduction from tax base	Recipient jurisdiction includes income in tax base
Payments made to hybrid entities	Payments are characterized differently due to differences in tax treatment of the entity	D/NI	Payer jurisdiction denies deduction from tax base	Recipient jurisdiction includes income in tax base
Allocation mismatch with PE	Differences in allocation of payments between head office and PE or between PEs	D/NI	Payer jurisdiction denies deduction from tax base	Recipient jurisdiction includes income in tax base
Disregarded PE	PE is not recognized by the jurisdiction where it is deemed to be situated by the head office[1]	D/NI	Payer jurisdiction denies deduction from tax base	Not applicable
Payments made by hybrid entities	Payments are characterized differently due to differences in tax treatment of the entity	D/NI	Payer jurisdiction denies deduction from tax base	Recipient jurisdiction includes income in tax base
Deemed payments with PE	Differences in recognition of deemed payments between head office and PE or between PEs[2]	D/NI	Payer jurisdiction denies deduction from tax base	Recipient jurisdiction includes income in tax base
Double deductions	Differences in tax treatment of payment or entity	DD	Investor jurisdiction denies deduction from tax base	Deduction is not denied if other jurisdiction applies deduction limitation

[1] The hybrid mismatch rule only applies insofar none of the jurisdictions involved applies a switch-over rule for disregarded permanent establishments as in art. 15e(9) DCITA 1969, see art. 12aa(6) DCITA 1969.
[2] A deemed payment is a fictitious transaction to allocate profits relating to permanent establishments.

A1.1 Hybrid mismatches

A1.1.1 Hybrid financial instrument (art. 12aa(1)a and art. 12ab(1) DCITA 1969)

Figure A1.1.1 shows a hybrid mismatch with a hybrid financial instrument (left panel). In this structure, both entities are considered non-transparent. The hybrid mismatch arises from a hybrid financial instrument between A and B. The Netherlands qualifies the instrument as debt. In contrast, Country X

qualifies the instrument as equity and applies a 50% exemption for dividends.[537] The payment is deductible from the Dutch tax base once the interest accrues.[538] However, the interest is not yet paid, so that the payment is not included in the tax base of Country X in the same year (T=0).[539]

In this situation, in principle, the primary rule would stipulate that the payment is non-tax-deductible in the Netherlands. However, as the payment is actually paid in the second year (T=1),[540] the payment is included in the tax base within a reasonable timeframe, so the payment remains deductible for B in the Netherlands for the amount that is included in the tax base, i.e., 50. Therefore, a payment of 50 remains non-tax-deductible (right panel).

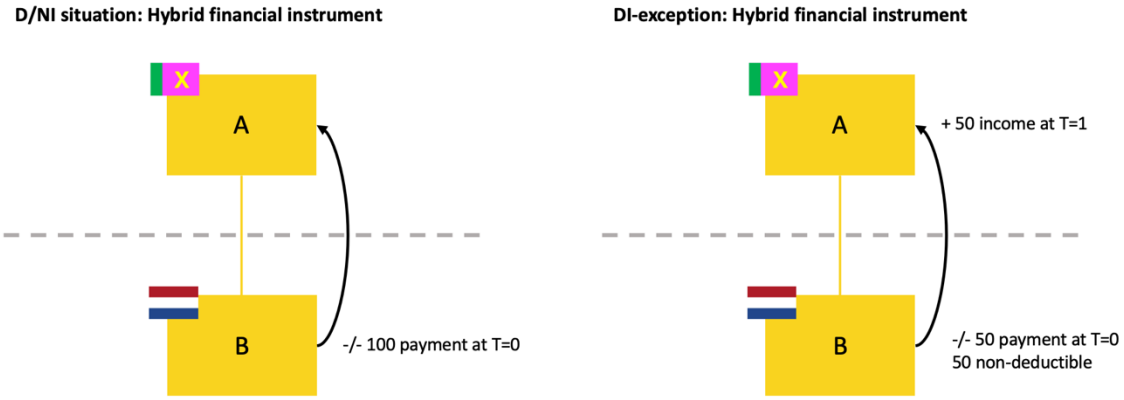

Figure A1.1.1

A1.1.2 Payments made to a hybrid entity (art. 12aa(1)b and art. 12ab(1) DCITA 1969)

Figure A1.1.2 shows a hybrid mismatch with a payment made to a hybrid entity. From A's perspective, B is non-transparent, whereas from B's and C's perspective, B is transparent. Therefore, B is a reverse hybrid entity. C makes a payment. From B's and C's perspective, the payment is made to A. However, A does not include the payment in its tax base since B is considered non-transparent from A's perspective. In this situation, the primary rule applies to C, so that the payment is non-tax-deductible as a result of the hybrid mismatch rules.

It is not possible to apply the DI-exception in this situation, since the reverse hybrid entity implies that there is never any inclusion of the income.

[537] This is given as an example in *Kamerstukken II* 2018/19, 35241, nr. 3, p. 42.
[538] In principle, for Dutch tax purposes accrual accounting applies to determine A's tax base.
[539] For example, because Country X applies cash accounting to determine B's tax base.
[540] The payment would also be deductible if there is a reasonable expectation that the payment will be included in B's tax base in a future period.

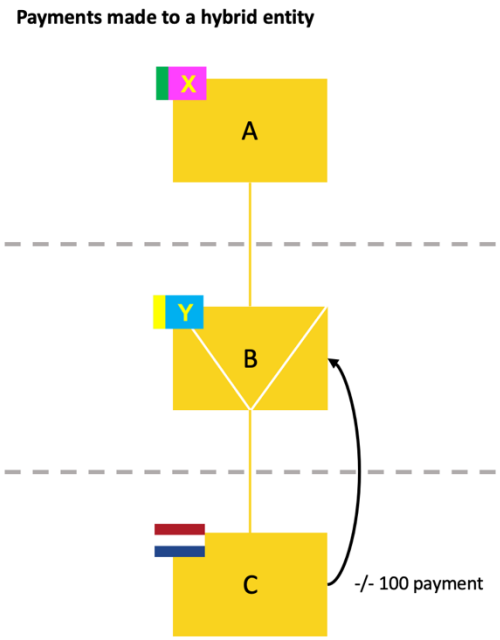

Figure A1.1.2

A1.1.3 Allocation mismatch with permanent establishment (art. 12aa(1)c and art. 12ab(1) DCITA 1969)

Figure A1.1.3 shows an allocation mismatch with a permanent establishment. None of the entities in this example is a hybrid entity. A has a permanent establishment in Country X. C makes a payment to A, which should be allocated to the PE from A's perspective. However, from the perspective of Country X, the payment accrues to A. This results in a D/NI situation. In this situation, the secondary rule applies to A, so that the payment is included in A's tax base.

It is not possible to apply the DI-exception in this situation since the payment is not included in any tax base due to the allocation mismatch.

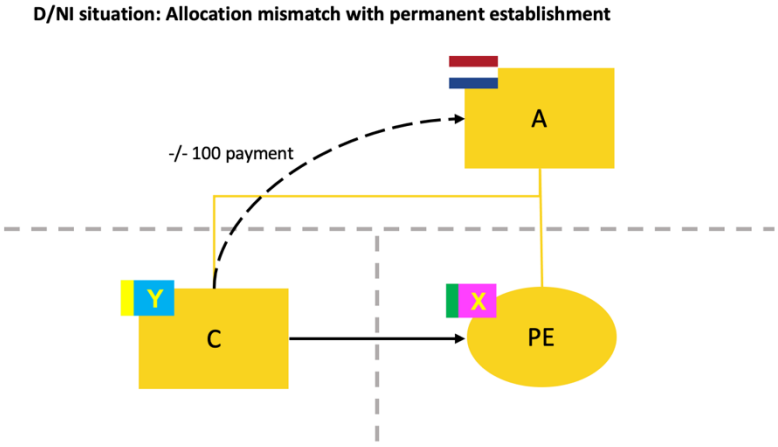

Figure A1.1.3

A1.1.4 Disregarded permanent establishment (art. 12aa(1)d DCITA 1969)

Figure A1.1.4 shows a hybrid mismatch with a disregarded permanent establishment. From the perspective of the Netherlands, A has a PE in Country X. However, from the perspective of Country X, no PE is deemed to be present. C makes a payment to A, and A allocates the payment to its deemed

PE in Country X. This results in a D/NI situation, which is targeted by the secondary rule so that the payment will be included in A's tax base.[541]

The DI-exception does not apply in this situation, as the payment is not included in any tax base since the PE is not recognized by Country X.

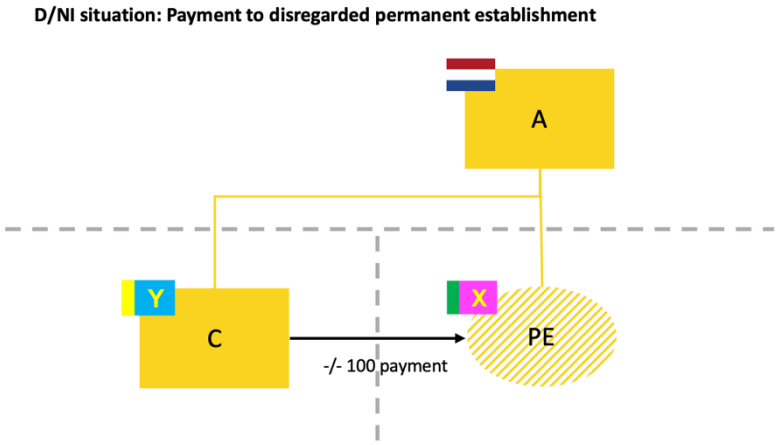

Figure A1.1.4

A1.1.5 Payments made by a hybrid entity (art. 12aa(1)e and art. 12ab(1) DCITA 1969)

Figure A1.1.5 shows a hybrid mismatch that results from a payment made by a hybrid entity. Country X characterizes B as transparent, whereas the Netherlands characterizes B as non-transparent. When B makes a payment to A, the deduction is recognized in the Netherlands, but the payment is not included in the tax base in Country X. The deduction of the payment that B makes to A results in a D/NI situation, which should in principle be neutralized by the primary hybrid mismatch rule through denying the deduction of the payment at the level of B.

In principle, payments made by such hybrid entities can be in scope of the DI-exception. B gains external revenues that are included in the tax base in the Netherlands, but due to B's transparent qualification, this income is also included in A's tax base in Country X. Hence, B's income is taxed twice because of its transparency, i.e., the income qualifies as dual inclusion income. Therefore, to prevent economic double taxation, the payment remains deductible for B.

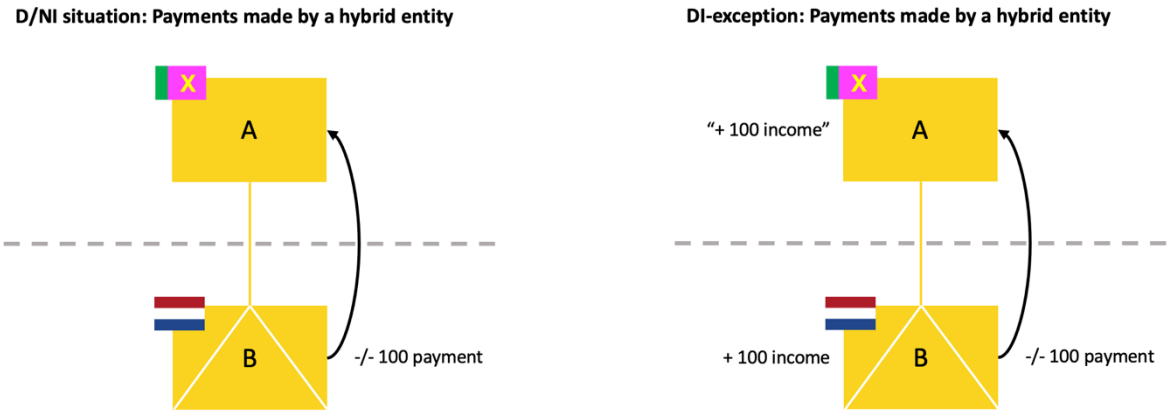

Figure A1.1.5

[541] The hybrid mismatch rule only applies insofar none of the jurisdictions involved applies a switch-over rule for disregarded permanent establishments as in art. 15e(9) DCITA 1969, see art. 12aa(6) DCITA 1969.

A1.1.6 Deemed payments with permanent establishment (art. 12aa(1)f and art. 12ab(1) DCITA 1969)

Figure A1.1.6 shows a hybrid mismatch between a PE in the Netherlands and its head office in Country X. The Netherlands recognizes a payment from the PE to A, whereas Country X does not recognize this payment.[542] Generally, this would result in a D/NI situation that would be targeted by the primary rule through denying the deduction in the Netherlands.

However, Country X also deems the PE's income to accrue to A. This implies that there is dual inclusion income. Therefore, to avoid economic double taxation, the payment remains deductible for the PE.

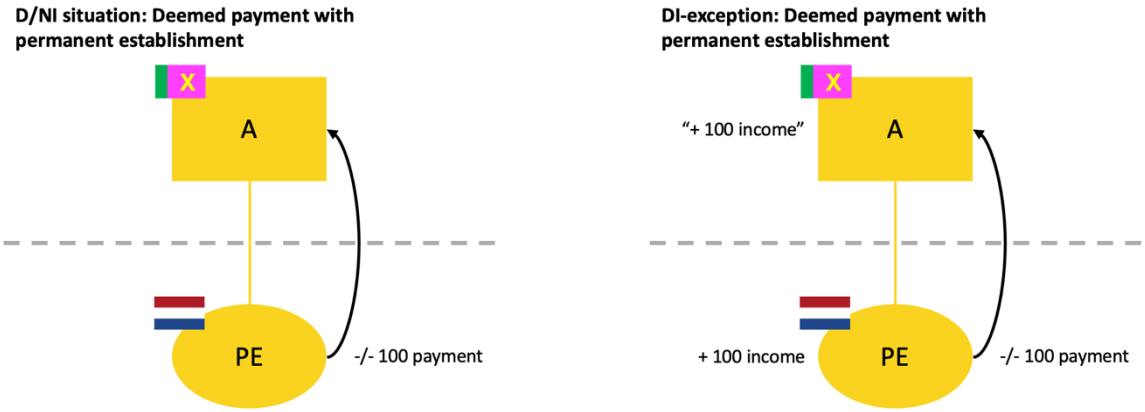

Figure A1.1.6

A1.1.7 Double deductions (art. 12aa(1)g DCITA 1969)

Figure A1.1.7 shows a DD situation. Country X characterizes B as non-transparent, whereas the Netherlands characterizes B as transparent. This results in a DD situation where the payment that B makes is deducted from the tax base twice, i.e., both in Country X and in the Netherlands. This should in principle be targeted by the primary rule through denying the deduction in the Netherlands, because the Netherlands is the investor jurisdiction.

A DD situation can involve dual inclusion income if the Netherlands includes B's income in A's tax base. Indeed, due to B's transparency from the Dutch perspective, B's income is also deemed to accrue in the Netherlands. Therefore, B's income constitutes dual inclusion income, so that the payment will remain deductible in the Netherlands.

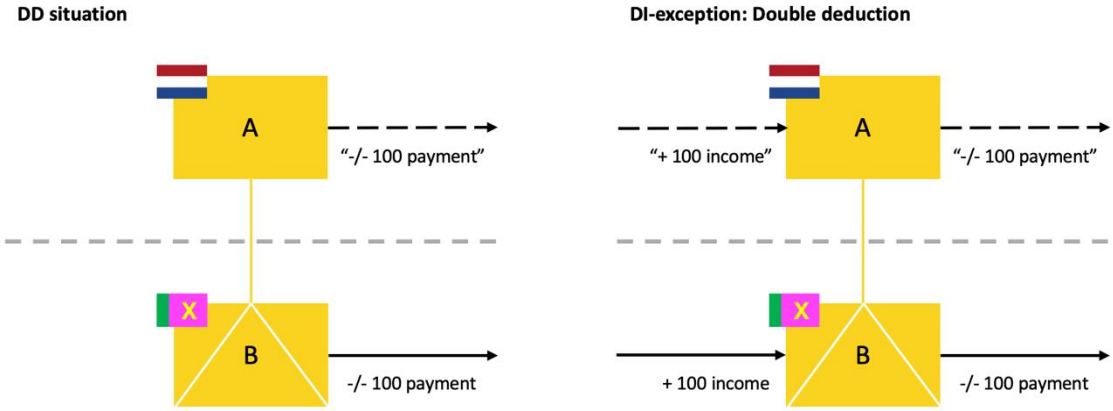

Figure A1.1.7

[542] For example, because the Netherlands does allow certain types of dealings between a head office and a PE, whereas Country X does not recognize such dealings.

A2 Double Taxation Appendix

A2.1 International tax principles in juridical double taxation

The international tax principles that constitute the foundation for the relief of juridical double taxation are described below.

A2.1.1 Residence principle

The residence principle is a subjective principle, because it allocates taxing rights with respect to the connection between a taxpayer and a jurisdiction. According to the residence principle, companies that are residents of a state are subject to domestic taxation of that state for their worldwide income. This is also referred to as full or unlimited tax liability.[543] The rationale behind the residence principle is the benefit principle; since resident taxpayers benefit from the use of infrastructure and other facilities of their residence jurisdiction, taxes should be levied over worldwide income.[544]

A taxpayer's tax residency is also of importance for its entitlement to the benefits of double tax conventions, since most jurisdictions impose full tax liability based on the residence principle, and full tax liability is a prerequisite for being considered a resident for access to treaty benefits.[545] When the residence principle coincides with another tax principle and thus results in dual residency, the corporate tiebreaker provision determines access to treaty benefits. The 2017 version of the corporate tiebreaker in the OECD MTC determines access to treaty benefits based on mutual agreement between the competent authorities of the contracting states. Hence, the corporate tiebreaker usually uses a mutual agreement procedure (hereinafter: MAP) to determine the place of effective management and other material circumstances as the relevant factors for determining treaty residence.[546] Older double tax conventions usually simply adhere to the place of effective management as a decisive criterion, without the explicit requirement of a MAP.[547]

A2.1.2 Nationality principle

The nationality principle is also a subjective principle. According to the nationality principle, corporate citizenship forms the basis of imposing taxes on worldwide income of entities that are established under national law of a jurisdiction, regardless of the entity's physical presence or place of effective management.[548] The nationality principle usually does not provide access to benefits from double tax conventions, as access is generally based on the residence principle (full tax liability).

A2.1.3 Source principle

In contrast to the residence and nationality principle, the source principle is an objective principle. Objective principles base taxing rights on the connection between a taxpayer's activities and the corresponding jurisdiction where these activities take place. Under the source principle, income that is sourced through economic activities in a jurisdiction's territory will be subject to taxation.

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[543] In Dutch tax law, pursuant to art. 4(1) of the Dutch General Act on State Taxes, the state of residence will be determined by considering all circumstances. For a discussion of the interpretation of art. 4 AWR, see S.C.W. Douma, E.J.W. Heithuis, D.S. Smit and R.C. de Smit (eds), '3.6 De woonplaats en de vestigingsplaats', in: *Algemene wet inzake rijksbelastingen*, Deventer: Wolters Kluwer 2021, p. 71-80.

[544] O.C.R. Marres, F.P.J. Snel en M.F. de Wilde (eds), '2.3. Het woonplaatsbeginsel', Kader: Nationale afbakeningen heffing, in: *NDFR Delen Internationaal.*

[545] OECD Commentary on art. 4(1) of the OECD Model Tax Convention 2017 (hereinafter: OECD MTC), par. 3.

[546] OECD Commentary on art. 4 of the OECD MTC, par. 24-24.5.

[547] See the corporate tiebreaker in art. 4(3) of the OECD MTC.

[548] For example, art. 2(5) DCITA 1969 establishes corporate tax liability for entities that are established under Dutch law.

The source principle also originates from the benefit principle, in the sense that a company that is entitled to a source of income benefits from the infrastructure and facilities of the source state.[549] Therefore, in contrast to full tax liability, there is limited tax liability with respect to source income. Source-based taxation is usually linked to the location of the economic activity that generates the income. However, source rules may differ among jurisdictions and the globalization of the economy poses specific problems with respect to determining the source of income.[550]

A2.2 Examples of juridical double taxation

Difficulty in determining the source of an item of income may generate juridical double (non-)taxation. As a simplified illustration, Company A, a resident of Country X who carries out its business activities through a permanent establishment in Country Y, has intellectual property (hereinafter: IP) that is allocated to the PE. Company B in Country Z makes a royalty payment for the use of the IP to the IP owner in Country X. Then, both Country Y (place of IP) and Country Z (place of payer) could consider themselves the source state where the royalty payment arises.[551] If both countries want to levy a source tax from Company A, this will result in juridical double taxation with respect to the royalty payment.[552]

If all countries were to exclusively apply a uniform source principle in the form of territorial taxation, there would be no double taxation, since each state would limit its taxing rights to sources of economic activity located within its jurisdiction.[553] At the other extreme, if all countries were to exclusively apply a uniform residence principle based on worldwide taxation, there would be no double taxation either, since only residents would be taxed domestically, and non-residents would not be taxed. However, most jurisdictions use elements of both systems and combine the international tax principles described above. Hence, the concurrence of different tax principles may result in juridical double taxation or juridical double non-taxation.[554]

The practical occurrence of juridical double taxation within existing tax systems can manifest in different ways, despite the straight-forward definition of juridical double taxation that consists of five elements, i.e., several jurisdictions, similar taxes, same object, same subject, and same period. Elaborating on the example above where two source countries want to impose taxes, residence Country X will also want to subject Company A for its worldwide income, including the royalty income. This generates double taxation between Countries X-Y (residence state head office – source state PE), X-Z (residence state head office – source state IP), and Y-Z (source state PE – source state IP).[555]

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[549] O.C.R. Marres, F.P.J. Snel en M.F. de Wilde (eds), '3.1. Het bronbeginsel', Kader: Nationale afbakeningen heffing, in: *NDFR Delen Internationaal.*

[550] See for a discussion on the digitalization of the economy, e.g., M.F. De Wilde, *'Sharing the Pie'; Taxing multinationals in a global market*, IBFD 2017, p. 5-21.

[551] Whether juridical double taxation arises depends on whether the national legislation of both Country Y (income tax) and Country Z (withholding tax) provides for a possibility of source taxation with respect to the IP.

[552] Company A will be dependent on the bilateral tax convention between X-Y and on the bilateral tax convention between X-Z for the relief of such juridical double taxation. However, the OECD Model Tax Convention assigns full taxing right to the residence state, which would imply that only Country X would be allowed to levy any taxes with respect to the royalty payment.

[553] O.C.R. Marres, F.P.J. Snel en M.F. de Wilde (eds), '3.1. Het bronbeginsel', Kader: Nationale afbakeningen heffing, in: *NDFR Delen Internationaal.*

[554] *Infra*, section 3.2.1.

[555] In practice, the resident of Country X can in principle invoke both tax conventions X-Y and X-Z to relieve double taxation. If these conventions are in line with art. 12 OECD MTC and the resident of state X is the beneficial owner of the royalties, neither Country Y nor Country Z will be allowed to levy source taxes, which implies that residence Country X has full taxation rights.

A2.3 Examples of economic double taxation

Four examples of economic double taxation are illustrated below.

A2.3.1 Classical system

In a classical system, a company and its shareholders are considered separate taxable entities.[556] In this type of tax system, economic double taxation arises when income is taxed both at the company level and at the shareholder level; the company is subject to corporate taxes for its income and the shareholder may be subject to source taxes with respect to the company's profits that are distributed towards the shareholder. In addition, the shareholder may be subject to income taxes with respect to the distributed profits. The economic double taxation results from the fact that there are two taxable subjects involved, i.e., the company and the shareholder, who are taxed for the same taxable object: the company's profits.

A2.3.2 Deduction limitation

Economic double taxation might also arise from the non-deductibility of a payment that is included in the tax base of a different taxpayer. This might occur when interest is non-deductible at the level of the debtor. Then, economic double taxation arises if the interest is included as income in the tax base of the creditor. Here, there are two taxable subjects, i.e., the creditor and the debtor, and the taxable object is the interest.

A2.3.3 Transfer pricing adjustment

Another case of economic double taxation concerns a difference in attribution of taxable income through transfer pricing adjustments by several jurisdictions.[557] It may be the case that the tax authorities in one jurisdiction make an upward transfer pricing adjustment to a payment to an affiliated entity, and thereby increase the taxable profits of a group entity in that jurisdiction. If the tax authorities in the other jurisdiction fail to make a corresponding upward adjustment to the deductible payment, and therefore fail to decrease the taxable profits of the group entity in that jurisdiction, economic double taxation arises. In this case, the two taxable subjects are the group entities in both jurisdictions, and the taxable object is the transfer price.

A2.3.4 Hybrid financial instrument

Hybrid mismatches do not by definition result in tax benefits but can also result in double taxation. Economic double taxation would occur when the same taxpayer is taxed successively on formally different but materially equivalent taxable objects.[558] This happens in case of international qualification mismatches of income, which implies that hybrid mismatches could in principle also result in tax disadvantages. For instance, with respect to a hybrid financial instrument, one jurisdiction qualifies the instrument as equity and therefore considers a payment related to the instrument non-deductible.[559] If the other jurisdiction qualifies the instrument as debt and includes the payment in the tax base of the recipient, this will generate economic double taxation. The taxable subjects are the payer and the recipient of the payment, and the taxable object is the payment that relates to the hybrid financial instrument.

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[556] S. Cnossen, S, 'What kind of Corporation Tax Regime?' *CESifo Working Papers* (No. 5108) 2014, p. 5-8.

[557] Transfer pricing adjustments are made to comply with the arm's length principle, which requires that transactions between affiliated entities should be made under conditions that would be agreed upon between independent parties. See art. 8b DCITA 1969.

[558] O.C.R. Marres, F.P.J. Snel and M.F. de Wilde (eds), '3. Internationale economische dubbele heffing', Kader: Internationale dubbele heffing, in: *NDFR Delen Internationaal.*

[559] In a classical system, payments on equity (such as dividends) are non-deductible from the corporate tax base.

A3 Mathematical Appendix

A3.1 Deduction/no inclusion situations

A3.1.1 No hybrid mismatch rules

Economic profits A: $\pi_A^e = qS - qS = 0$ **Intuition:** A gains income from providing services to B and incurs economic costs to provide these services

Taxable profits A: $\pi_A^t = 0$ **Intuition:** The transaction with B is invisible from the perspective of Country X

Total profits A:[560]

$$\pi_A = \pi_A^e - t_X \pi_A^t = 0 - t_X 0 = 0$$

Economic profits B: $\pi_B^e = F(S, K_B) - qS - rK_B$ **Intuition:** B gains income from producing external services and incurs intra-group costs from buying services and capital from A

Taxable profits B: $\pi_B^t = F(S, K_B) - qS$ **Intuition:** Without hybrid mismatch rules, only capital costs are non-tax-deductible

Total profits B:

$$\pi_B = \pi_B^e - t_{NL}\pi_B^t = F(S, K_B) - qS - rK_B - t_{NL}[F(S, K_B) - qS] = (1 - t_{NL})[F(S, K_B) - qS] - rK_B$$

Total profits MNE:

$$\pi_A + \pi_B = 0 + (1 - t_{NL})[F(S, K_B) - qS] - rK_B$$

A3.1.2 Neutralization

Economic profits A: $\pi_A^e = qS - qS = 0$ **Intuition:** Unchanged from A3.1.1

Taxable profits A: $\pi_A^t = 0$ **Intuition:** Unchanged from A3.1.1

Total profits A:

$$\pi_A = \pi_A^e - t_X \pi_A^t = 0 - t_X 0 = 0$$

Economic profits B: $\pi_B^e = F(S, K_B) - qS - rK_B$ **Intuition:** Unchanged from A3.1.1

Taxable profits B: $\pi_B^t = F(S, K_B)$ **Intuition:** With hybrid mismatch rules, no costs are tax-deductible

Total profits B:

$$\pi_B = \pi_B^e - t_{NL}\pi_B^t = F(S, K_B) - qS - rK_B - t_{NL}F(S, K_B) = (1 - t_{NL})F(S, K_B) - qS - rK_B$$

Total profits MNE:

$$\pi_A + \pi_B = 0 + (1 - t_{NL})F(S, K_B) - qS - rK_B$$

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[560] Total profits are always economic profits minus the tax rate multiplied by the tax base, i.e., $\pi_i^e - t_j \pi_i^t$ where $i = A, B$ and $j = X, NL$.

A3.1.3 Double taxation

Economic profits A: $\pi_A^e = qS - qS = 0$ **Intuition:** Unchanged from A3.1.2

Taxable profits A: $\pi_A^t = qS$ **Intuition:** The payment for the services is de facto included in A's tax base

Total profits A:

$$\pi_A = \pi_A^e - t_X \pi_A^t = 0 - t_X qS = -t_X qS$$

Economic profits B: $\pi_B^e = F(S, K_B) - qS - rK_B$ **Intuition:** Unchanged from A3.1.2

Taxable profits B: $\pi_B^t = F(S, K_B)$ **Intuition:** Unchanged from A3.1.2

Total profits B:

$$\pi_B = \pi_B^e - t_{NL}\pi_B^t = F(S, K_B) - qS - rK_B - t_{NL}F(S, K_B) = (1 - t_{NL})F(S, K_B) - qS - rK_B$$

Total profits MNE:

$$\pi_A + \pi_B = -t_X qS + (1 - t_{NL})F(S, K_B) - qS - rK_B$$

A3.1.4 Comparative statics

Neutralization in D/NI situations

The neutralization of the hybrid mismatch under the primary rule implies that the tax rate in the Netherlands affects the amount of external services used in production. If the tax rate in the Netherlands increases – which is what de facto happens through the deduction limitation in the neutralizing hybrid mismatch rule – the optimal use of intra-group services in B declines.

FOC for intra-group services $f(S, K_B, t_{NL}, t_X, q, r) = (1 - t_{NL})F_S^B - q \equiv 0$

Total differential $\mathrm{d}f = \frac{\partial f}{\partial S}\mathrm{d}S + \frac{\partial f}{\partial K_B}\mathrm{d}K_B + \frac{\partial f}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial f}{\partial t_X}\mathrm{d}t_X + \frac{\partial f}{\partial q}\mathrm{d}q + \frac{\partial f}{\partial r}\mathrm{d}r$

FOC for capital investment $g(S, K_B, t_{NL}, t_X, q, r) = (1 - t_{NL})F_K^B - r \equiv 0$

Total differential $\mathrm{d}g = \frac{\partial g}{\partial S}\mathrm{d}S + \frac{\partial g}{\partial K_B}\mathrm{d}K_B + \frac{\partial g}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial g}{\partial t_X}\mathrm{d}t_X + \frac{\partial g}{\partial q}\mathrm{d}q + \frac{\partial g}{\partial r}\mathrm{d}r$

Rewriting gives $\begin{pmatrix} \frac{\partial f}{\partial S} & \frac{\partial f}{\partial K_B} \\ \frac{\partial g}{\partial S} & \frac{\partial g}{\partial K_B} \end{pmatrix} \begin{pmatrix} \mathrm{d}S \\ \mathrm{d}K_B \end{pmatrix} = \begin{pmatrix} -\frac{\partial f}{\partial t_{NL}} \\ -\frac{\partial g}{\partial t_{NL}} \end{pmatrix} \mathrm{d}t_{NL} + \begin{pmatrix} -\frac{\partial f}{\partial t_X} \\ -\frac{\partial g}{\partial t_X} \end{pmatrix} \mathrm{d}t_X + \begin{pmatrix} -\frac{\partial f}{\partial q} \\ -\frac{\partial g}{\partial q} \end{pmatrix} \mathrm{d}q + \begin{pmatrix} -\frac{\partial f}{\partial r} \\ -\frac{\partial g}{\partial r} \end{pmatrix} \mathrm{d}r$

Deriving the effect of an increase in the Dutch tax rate on the optimal use of intra-group services, using Cramer's rule, because $F_S^B, F_K^B, F_{KS}^B > 0$, $F_{SS}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}S}{\mathrm{d}t_{NL}} = \frac{\begin{vmatrix} -\frac{\partial f}{\partial t_{NL}} & \frac{\partial f}{\partial K_B} \\ -\frac{\partial g}{\partial t_{NL}} & \frac{\partial g}{\partial K_B} \end{vmatrix}}{\begin{vmatrix} \frac{\partial f}{\partial S} & \frac{\partial f}{\partial K_B} \\ \frac{\partial g}{\partial S} & \frac{\partial g}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} -(-F_S^B) & (1 - t_{NL})F_{SK}^B \\ -(-F_K^B) & (1 - t_{NL})F_{KK}^B \end{vmatrix}}{\begin{vmatrix} (1 - t_{NL})F_{SS}^B & (1 - t_{NL})F_{SK}^B \\ (1 - t_{NL})F_{KS}^B & (1 - t_{NL})F_{KK}^B \end{vmatrix}} = \frac{F_S^B F_{KK}^B - F_K^B F_{SK}^B}{(1 - t_{NL})[F_{SS}^B F_{KK}^B - (F_{SK}^B)^2]} < 0$$

This result implies that the deduction limitation leads to a reduced use of intra-group services in the Netherlands, because production in the Netherlands becomes more expensive. The decline in the

optimal use of intra-group services also means that capital becomes less productive, since both capital and services are complementary factors in production, so that optimal capital investment declines. Hence, because of the increased tax burden, the hybrid mismatch rules make it less attractive to carry out economic activities in the Netherlands.

Deriving the effect of an increase in the Dutch tax rate on optimal capital investment, using Cramer's rule, because $F_K^B, F_S^B, F_{KS}^B > 0$, $F_{SS}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}K_B}{\mathrm{d}t_{NL}} = \frac{\begin{vmatrix} \frac{\partial f}{\partial S} & -\frac{\partial f}{\partial t_{NL}} \\ \frac{\partial g}{\partial S} & -\frac{\partial g}{\partial t_{NL}} \end{vmatrix}}{\begin{vmatrix} \frac{\partial f}{\partial S} & \frac{\partial f}{\partial K_B} \\ \frac{\partial g}{\partial S} & \frac{\partial g}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} (1-t_{NL})F_{SS}^B & -(-F_S^B) \\ (1-t_{NL})F_{KS}^B & -(-F_K^B) \end{vmatrix}}{\begin{vmatrix} (1-t_{NL})F_{SS}^B & (1-t_{NL})F_{SK}^B \\ (1-t_{NL})F_{KS}^B & (1-t_{NL})F_{KK}^B \end{vmatrix}} = \frac{F_K^B F_{SS}^B - F_S^B F_{KS}^B}{(1-t_{NL})[F_{SS}^B F_{KK}^B - (F_{KS}^B)^2]} < 0$$

This result implies that the deduction limitation leads to a reduction in optimal capital investment in the Netherlands, because production in the Netherlands becomes more expensive because of a higher effective tax rate. Therefore, the neutralizing hybrid mismatch rules make it less attractive to invest in the Netherlands because of the increased tax burden.

Double taxation in D/NI situations

The double taxation of the hybrid mismatch under the primary rule implies that the tax rate in the Netherlands affects the amount of external services used in production. Since the tax rate in the Netherlands increases because of the double taxation, the optimal use of intra-group services in B declines. Furthermore, the double taxation also implies that the effective tax rate in country X increases for the MNE. Using Cramer's rule, comparative statics can be derived.

FOC for intra-group services $\quad f(S, K_B, t_{NL}, t_X, q, r) = (1 - t_{NL})F_S^B - (1 + t_X)q \equiv 0$

Total differential $\quad \mathrm{d}f = \frac{\partial f}{\partial S}\mathrm{d}S + \frac{\partial f}{\partial K_B}\mathrm{d}K_B + \frac{\partial f}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial f}{\partial t_X}\mathrm{d}t_X + \frac{\partial f}{\partial q}\mathrm{d}q + \frac{\partial f}{\partial r}\mathrm{d}r$

FOC for capital investment $\quad g(S, K_B, t_{NL}, t_X, q, r) = (1 - t_{NL})F_K^B - r \equiv 0$

Total differential $\quad \mathrm{d}g = \frac{\partial g}{\partial S}\mathrm{d}S + \frac{\partial g}{\partial K_B}\mathrm{d}K_B + \frac{\partial g}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial g}{\partial t_X}\mathrm{d}t_X + \frac{\partial g}{\partial q}\mathrm{d}q + \frac{\partial g}{\partial r}\mathrm{d}r$

Rewriting gives $\begin{pmatrix} \frac{\partial f}{\partial S} & \frac{\partial f}{\partial K_B} \\ \frac{\partial g}{\partial S} & \frac{\partial g}{\partial K_B} \end{pmatrix}\begin{pmatrix} \mathrm{d}S \\ \mathrm{d}K_B \end{pmatrix} = \begin{pmatrix} -\frac{\partial f}{\partial t_{NL}} \\ -\frac{\partial g}{\partial t_{NL}} \end{pmatrix}\mathrm{d}t_{NL} + \begin{pmatrix} -\frac{\partial f}{\partial t_X} \\ -\frac{\partial g}{\partial t_X} \end{pmatrix}\mathrm{d}t_X + \begin{pmatrix} -\frac{\partial f}{\partial q} \\ -\frac{\partial g}{\partial q} \end{pmatrix}\mathrm{d}q + \begin{pmatrix} -\frac{\partial f}{\partial r} \\ -\frac{\partial g}{\partial r} \end{pmatrix}\mathrm{d}r$

Deriving the effect of an increase in the Dutch tax rate on the optimal use of intra-group services, using Cramer's rule, because $F_S^B, F_K^B, F_{KS}^B > 0$, $F_{SS}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}S}{\mathrm{d}t_{NL}} = \frac{\begin{vmatrix} -\frac{\partial f}{\partial t_{NL}} & \frac{\partial f}{\partial K_B} \\ -\frac{\partial g}{\partial t_{NL}} & \frac{\partial g}{\partial K_B} \end{vmatrix}}{\begin{vmatrix} \frac{\partial f}{\partial S} & \frac{\partial f}{\partial K_B} \\ \frac{\partial g}{\partial S} & \frac{\partial g}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} -(-F_S^B) & (1-t_{NL})F_{SK}^B \\ -(-F_K^B) & (1-t_{NL})F_{KK}^B \end{vmatrix}}{\begin{vmatrix} (1-t_{NL})F_{SS}^B & (1-t_{NL})F_{SK}^B \\ (1-t_{NL})F_{KS}^B & (1-t_{NL})F_{KK}^B \end{vmatrix}} = \frac{F_S^B F_{KK}^B - F_S^B F_{KS}^B}{(1-t_{NL})[F_{SS}^B F_{KK}^B - (F_{KS}^B)^2]} < 0$$

This result implies that the double taxation leads to a reduction in the use of intra-group services in the Netherlands, because production in the Netherlands becomes more expensive. Hence, the hybrid mismatch rules make it less attractive to carry out economic activities in the Netherlands.

The decline in the optimal use of intra-group services also means that capital becomes less productive, since both capital and services are complementary production factors, so that optimal capital investment declines because of the decrease in intra-group services. Deriving the effect of an increase in the Dutch tax rate on optimal capital investment, using Cramer's rule, because $F_K^B, F_S^B, F_{KS}^B > 0$, $F_{SS}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}K_B}{\mathrm{d}t_{NL}} = \frac{\begin{vmatrix} \frac{\partial f}{\partial S} & -\frac{\partial f}{\partial t_{NL}} \\ \frac{\partial g}{\partial S} & -\frac{\partial g}{\partial t_{NL}} \end{vmatrix}}{\begin{vmatrix} \frac{\partial f}{\partial S} & \frac{\partial f}{\partial K_B} \\ \frac{\partial g}{\partial S} & \frac{\partial g}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} (1 - t_{NL})F_{SS}^B & -(-F_S^B) \\ (1 - t_{NL})F_{KS}^B & -(-F_K^B) \end{vmatrix}}{\begin{vmatrix} (1 - t_{NL})F_{SS}^B & (1 - t_{NL})F_{SK}^B \\ (1 - t_{NL})F_{KS}^B & (1 - t_{NL})F_{KK}^B \end{vmatrix}} = \frac{F_K^B F_{SS}^B - F_S^B F_{SK}^B}{(1 - t_{NL})[F_{SS}^B F_{KK}^B - (F_{KS}^B)^2]} < 0$$

This result implies that the deduction limitation leads to a reduction in optimal capital investment in the Netherlands, because production in the Netherlands becomes more expensive as a result of the increased effective tax burden. Hence, the hybrid mismatch rules make it less attractive to invest in the Netherlands.

As a result of the economic double taxation, the effective tax rate in Country X increases through application of the hybrid mismatch rules. Deriving the effect of an increase in the Country X's tax rate on the optimal use of intra-group services, using Cramer's rule, because $q, F_{KS}^B > 0$, $F_{SS}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}S}{\mathrm{d}t_X} = \frac{\begin{vmatrix} -\frac{\partial f}{\partial t_X} & \frac{\partial f}{\partial K_B} \\ -\frac{\partial g}{\partial t_X} & \frac{\partial g}{\partial K_B} \end{vmatrix}}{\begin{vmatrix} \frac{\partial f}{\partial S} & \frac{\partial f}{\partial K_B} \\ \frac{\partial g}{\partial S} & \frac{\partial g}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} -(-q) & (1 - t_{NL})F_{SK}^B \\ 0 & (1 - t_{NL})F_{KK}^B \end{vmatrix}}{\begin{vmatrix} (1 - t_{NL})F_{SS}^B & (1 - t_{NL})F_{SK}^B \\ (1 - t_{NL})F_{KS}^B & (1 - t_{NL})F_{KK}^B \end{vmatrix}} = \frac{q}{(1 - t_{NL})[F_{SS}^B F_{KK}^B - (F_{KS}^B)^2]} < 0$$

This result implies that the double taxation in the hybrid mismatch rules leads to a reduction in the use of intra-group services in the Netherlands, because production in the Netherlands becomes more expensive as a result of the additional tax payment in Country X. The decline in the optimal use of intra-group services also means that capital becomes less productive, since both capital and services are complementary factors in production, so that optimal capital investment declines. Hence, the hybrid mismatch rules make it less attractive to carry out economic activities in the Netherlands.

A3.2 Double deduction situations

A3.2.1 No hybrid mismatch rules

Economic profits A: $\pi_A^e = 0$ **Intuition:** With respect to the hybrid mismatch, A does not receive any income because it does not use the external services in its production

Taxable profits A: $\pi_A^t = -gZ$ **Intuition:** For tax purposes, A is allowed to deduct the costs for the external services

Total profits A:

$$\pi_A = \pi_A^e - t_X \pi_A^t = 0 + t_X gZ = t_X gZ$$

Economic profits B: $\pi_B^e = F(Z, K_B) - gZ - rK_B$ **Intuition:** B gains income from producing services to B and incurs capital costs and costs from buying external services

Taxable profits B: $\pi_B^t = F(Z, K_B) - gZ$ **Intuition:** Without hybrid mismatch rules, only capital costs are non-tax-deductible

Total profits B:

$$\pi_B = \pi_B^e - t_{NL}\pi_B^t = F(Z, K_B) - gZ - rK_B - t_{NL}[F(Z, K_B) - gZ]$$
$$= (1 - t_{NL})[F(Z, K_B) - gZ] - rK_B$$

Total profits MNE:

$$\pi_A + \pi_B = t_X gZ + (1 - t_{NL})[F(Z, K_B) - gZ] - rK_B$$

A3.2.2 Neutralization

Economic profits A: $\pi_A^e = 0$ **Intuition:** Unchanged from A3.2.1

Taxable profits A: $\pi_A^t = -gZ$ **Intuition:** Unchanged from A3.2.1

Total profits A:

$$\pi_A = \pi_A^e - t_X \pi_A^t = 0 + t_X gZ = t_X gZ$$

Economic profits B: $\pi_B^e = F(Z, K_B) - gZ - rK_B$ **Intuition:** Unchanged from A3.2.1

Taxable profits B: $\pi_B^t = F(Z, K_B)$ **Intuition:** With hybrid mismatch rules, no costs are tax-deductible due to the rule

Total profits B:

$$\pi_B = \pi_B^e - t_{NL}\pi_B^t = F(Z, K_B) - gZ - rK_B - t_{NL}F(Z, K_B) = (1 - t_{NL})F(Z, K_B) - gZ - rK_B$$

Total profits MNE:

$$\pi_A + \pi_B = t_X gZ + (1 - t_{NL})F(Z, K_B) - gZ - rK_B$$

A3.2.3 Double taxation

Economic profits A: $\pi_A^e = 0$ **Intuition:** Unchanged from A3.2.2

Taxable profits A: $\pi_A^t = gZ - gZ = 0$ **Intuition:** The payment for the services is de facto included in A's tax base

Total profits A:

$$\pi_A = \pi_A^e - t_X \pi_A^t = 0 - t_X 0 = 0$$

Economic profits B: $\pi_B^e = F(Z, K_B) - gZ - rK_B$ **Intuition:** Unchanged from A3.2.2

Taxable profits B: $\pi_B^t = F(Z, K_B)$ **Intuition:** Unchanged from A3.2.2

Total profits B:

$$\pi_B = \pi_B^e - t_{NL}\pi_B^t = F(Z, K_B) - gZ - rK_B - t_{NL}F(Z, K_B) = (1 - t_{NL})F(Z, K_B) - gZ - rK_B$$

Total profits MNE:

$$\pi_A + \pi_B = 0 + (1 - t_{NL})F(Z, K_B) - gZ - rK_B$$

A3.2.4 Comparative statics

Neutralization in DD situations

The neutralization of the hybrid mismatch under the secondary rule implies that the tax rate in the Netherlands affects the amount of external services used in production. If the tax rate in the Netherlands increases, the optimal use of external services in B declines.

FOC for external services $h(Z, K_B, t_{NL}, t_X, g, r) = (1 - t_{NL})F_Z^B - (1 - t_X)g \equiv 0$

Total differential $\mathrm{d}h = \frac{\partial h}{\partial Z}\mathrm{d}Z + \frac{\partial h}{\partial K_B}\mathrm{d}K_B + \frac{\partial h}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial h}{\partial t_X}\mathrm{d}t_X + \frac{\partial h}{\partial g}\mathrm{d}g + \frac{\partial h}{\partial r}\mathrm{d}r$

FOC for capital investment $k(Z, K_B, t_{NL}, t_X, g, r) = (1 - t_{NL})F_K^B - r \equiv 0$

Total differential $\mathrm{d}k = \frac{\partial k}{\partial Z}\mathrm{d}Z + \frac{\partial k}{\partial K_B}\mathrm{d}K_B + \frac{\partial k}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial k}{\partial t_X}\mathrm{d}t_X + \frac{\partial k}{\partial g}\mathrm{d}g + \frac{\partial k}{\partial r}\mathrm{d}r$

Rewriting gives $\begin{pmatrix} \frac{\partial h}{\partial Z} & \frac{\partial h}{\partial K_B} \\ \frac{\partial k}{\partial Z} & \frac{\partial k}{\partial K_B} \end{pmatrix}\begin{pmatrix} \mathrm{d}Z \\ \mathrm{d}K_B \end{pmatrix} = \begin{pmatrix} -\frac{\partial h}{\partial t_{NL}} \\ -\frac{\partial k}{\partial t_{NL}} \end{pmatrix}\mathrm{d}t_{NL} + \begin{pmatrix} -\frac{\partial h}{\partial t_X} \\ -\frac{\partial k}{\partial t_X} \end{pmatrix}\mathrm{d}t_X + \begin{pmatrix} -\frac{\partial h}{\partial q} \\ -\frac{\partial k}{\partial q} \end{pmatrix}\mathrm{d}q + \begin{pmatrix} -\frac{\partial h}{\partial r} \\ -\frac{\partial k}{\partial r} \end{pmatrix}\mathrm{d}r$

Deriving the effect of an increase in the Dutch tax rate on the optimal use of external services, using Cramer's rule, because $F_Z^B, F_K^B, F_{KZ}^B > 0$, $F_{ZZ}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}Z}{\mathrm{d}t_{NL}} = \frac{\begin{vmatrix} -\frac{\partial h}{\partial t_{NL}} & \frac{\partial h}{\partial K_B} \\ -\frac{\partial k}{\partial t_{NL}} & \frac{\partial k}{\partial K_B} \end{vmatrix}}{\begin{vmatrix} \frac{\partial h}{\partial Z} & \frac{\partial h}{\partial K_B} \\ \frac{\partial k}{\partial Z} & \frac{\partial k}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} -(-F_Z^B) & (1 - t_{NL})F_{ZK}^B \\ -(-F_K^B) & (1 - t_{NL})F_{KK}^B \end{vmatrix}}{\begin{vmatrix} (1 - t_{NL})F_{ZZ}^B & (1 - t_{NL})F_{ZK}^B \\ (1 - t_{NL})F_{KZ}^B & (1 - t_{NL})F_{KK}^B \end{vmatrix}} = \frac{F_Z^B F_{KK}^B - F_K^B F_{ZK}^B}{(1 - t_{NL})[F_{ZZ}^B F_{KK}^B - (F_{KZ}^B)^2]} < 0$$

This result implies that the deduction limitation leads to a reduction in the use of external services in the Netherlands, because production in the Netherlands becomes more expensive due to the increased tax burden. The decline in the optimal use of external services also means that capital becomes less productive, since both capital and services are complementary factors in production, so that optimal capital investment declines. Hence, the hybrid mismatch rules make it less attractive to carry out economic activities in the Netherlands.

Deriving the effect of an increase in the Dutch tax rate on optimal capital investment, using Cramer's rule, because $F_Z^B, F_K^B > 0$, $F_{ZZ}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}K}{\mathrm{d}t_{NL}} = \frac{\begin{vmatrix} \frac{\partial h}{\partial Z} & -\frac{\partial h}{\partial t_{NL}} \\ \frac{\partial k}{\partial Z} & -\frac{\partial k}{\partial t_{NL}} \end{vmatrix}}{\begin{vmatrix} \frac{\partial h}{\partial Z} & \frac{\partial h}{\partial K_B} \\ \frac{\partial k}{\partial Z} & \frac{\partial k}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} (1-t_{NL})F_{ZZ}^B & -(-F_Z^B) \\ (1-t_{NL})F_{KZ}^B & -(-F_K^B) \end{vmatrix}}{\begin{vmatrix} (1-t_{NL})F_{ZZ}^B & (1-t_{NL})F_{ZK}^B \\ (1-t_{NL})F_{KZ}^B & (1-t_{NL})F_{KK}^B \end{vmatrix}} = \frac{F_K^B F_{ZZ}^B - F_Z^B F_{KZ}^B}{(1-t_{NL})[F_{ZZ}^B F_{KK}^B - (F_{KZ}^B)^2]} < 0$$

This result implies that the deduction limitation from the hybrid mismatch rules leads to a reduction in optimal capital investment in the Netherlands, because production in the Netherlands becomes more expensive due to the increased tax burden. Hence, the hybrid mismatch rules make it less attractive to carry out economic activities in the Netherlands.

In contrast to the hybrid mismatch rules in a D/NI situation, the secondary rule was applied to the DD situation. This means that also with neutralization, the tax rate in Country X affects the optimal use of external services in the Netherlands, because the payment remains deductible in Country X. Deriving the effect of an increase in the tax rate of Country X on optimal use of external services, using Cramer's rule, because $g, F_{KZ}^B > 0$, $F_{ZZ}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}Z}{\mathrm{d}t_X} = \frac{\begin{vmatrix} -\frac{\partial h}{\partial t_X} & \frac{\partial h}{\partial K_B} \\ -\frac{\partial k}{\partial t_X} & \frac{\partial k}{\partial K_B} \end{vmatrix}}{\begin{vmatrix} \frac{\partial h}{\partial Z} & \frac{\partial h}{\partial K_B} \\ \frac{\partial k}{\partial Z} & \frac{\partial k}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} -(g) & (1-t_{NL})F_{ZK}^B \\ 0 & (1-t_{NL})F_{KK}^B \end{vmatrix}}{\begin{vmatrix} (1-t_{NL})F_{ZZ}^B & (1-t_{NL})F_{ZK}^B \\ (1-t_{NL})F_{KZ}^B & (1-t_{NL})F_{KK}^B \end{vmatrix}} = \frac{-gF_{KK}^B}{(1-t_{NL})[F_{ZZ}^B F_{KK}^B - (F_{KZ}^B)^2]} > 0$$

Double taxation in DD situations

Double taxation of the hybrid mismatch under the secondary rule implies that the tax rate in both the Netherlands and in Country X affects the amount of external services used in production. If the tax rate in the Netherlands and in Country X increases, the optimal use of external services in B declines. Using Cramer's rule, comparative statics can be derived.

FOC for external services $\quad h(Z, K_B, t_{NL}, t_X, g, r) = (1 - t_{NL})F_Z^B - g \equiv 0$

Total differential $\quad \mathrm{d}h = \frac{\partial h}{\partial Z}\mathrm{d}Z + \frac{\partial h}{\partial K_B}\mathrm{d}K_B + \frac{\partial h}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial h}{\partial t_X}\mathrm{d}t_X + \frac{\partial h}{\partial g}\mathrm{d}g + \frac{\partial h}{\partial r}\mathrm{d}r$

FOC for capital investment $\quad k(Z, K_B, t_{NL}, t_X, g, r) = (1 - t_{NL})F_K^B - r \equiv 0$

Total differential $\quad \mathrm{d}k = \frac{\partial k}{\partial Z}\mathrm{d}Z + \frac{\partial k}{\partial K_B}\mathrm{d}K_B + \frac{\partial k}{\partial t_{NL}}\mathrm{d}t_{NL} + \frac{\partial k}{\partial t_X}\mathrm{d}t_X + \frac{\partial k}{\partial g}\mathrm{d}g + \frac{\partial k}{\partial r}\mathrm{d}r$

Rewriting gives $\begin{pmatrix} \frac{\partial h}{\partial Z} & \frac{\partial h}{\partial K_B} \\ \frac{\partial k}{\partial Z} & \frac{\partial k}{\partial K_B} \end{pmatrix} \begin{pmatrix} \mathrm{d}Z \\ \mathrm{d}K_B \end{pmatrix} = \begin{pmatrix} -\frac{\partial h}{\partial t_{NL}} \\ -\frac{\partial k}{\partial t_{NL}} \end{pmatrix} \mathrm{d}t_{NL} + \begin{pmatrix} -\frac{\partial h}{\partial t_X} \\ -\frac{\partial k}{\partial t_X} \end{pmatrix} \mathrm{d}t_X + \begin{pmatrix} -\frac{\partial h}{\partial q} \\ -\frac{\partial k}{\partial q} \end{pmatrix} \mathrm{d}q + \begin{pmatrix} -\frac{\partial h}{\partial r} \\ -\frac{\partial k}{\partial r} \end{pmatrix} \mathrm{d}r$

Deriving the effect of an increase in the Dutch tax rate on the optimal use of external services, using Cramer's rule, because $F_Z^B, F_K^B, F_{ZK}^B > 0$, $F_{ZZ}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}Z}{\mathrm{d}t_{NL}} = \frac{\begin{vmatrix} -\frac{\partial h}{\partial t_{NL}} & \frac{\partial h}{\partial K_B} \\ -\frac{\partial k}{\partial t_{NL}} & \frac{\partial k}{\partial K_B} \end{vmatrix}}{\begin{vmatrix} \frac{\partial h}{\partial Z} & \frac{\partial h}{\partial K_B} \\ \frac{\partial k}{\partial Z} & \frac{\partial k}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} -(-F_Z^B) & (1 - t_{NL})F_{ZK}^B \\ -(-F_K^B) & (1 - t_{NL})F_{KK}^B \end{vmatrix}}{\begin{vmatrix} (1 - t_{NL})F_{ZZ}^B & (1 - t_{NL})F_{ZK}^B \\ (1 - t_{NL})F_{KZ}^B & (1 - t_{NL})F_{KK}^B \end{vmatrix}} = \frac{F_Z^B F_{KK}^B - F_K^B F_{ZK}^B}{(1 - t_{NL})[F_{ZZ}^B F_{KK}^B - (F_{KZ}^B)^2]} < 0$$

This result implies that the deduction limitation leads to a reduction in the use of external services in the Netherlands, because production in the Netherlands becomes more expensive. The decline in the optimal use of external services also means that capital becomes less productive, since both capital and services are complementary factors in production, so that optimal capital investment declines. Hence, the hybrid mismatch rules make it less attractive to carry out economic activities in the Netherlands.

In contrast, because the payment is no longer deductible under double taxation, the tax rate in Country X no longer affects the optimal amount of external services. Deriving the effect of an increase in the Dutch tax rate on the optimal use of external services, using Cramer's rule, because $F_K^B > 0$, $F_{ZZ}^B, F_{KK}^B < 0$ and $(1 - t_{NL}) > 0$,

$$\frac{\mathrm{d}Z}{\mathrm{d}t_X} = \frac{\begin{vmatrix} -\frac{\partial h}{\partial t_X} & \frac{\partial h}{\partial K_B} \\ -\frac{\partial k}{\partial t_X} & \frac{\partial k}{\partial K_B} \end{vmatrix}}{\begin{vmatrix} \frac{\partial h}{\partial Z} & \frac{\partial h}{\partial K_B} \\ \frac{\partial k}{\partial Z} & \frac{\partial k}{\partial K_B} \end{vmatrix}} = \frac{\begin{vmatrix} 0 & (1 - t_{NL})F_{ZK}^B \\ 0 & (1 - t_{NL})F_{KK}^B \end{vmatrix}}{\begin{vmatrix} (1 - t_{NL})F_{ZZ}^B & (1 - t_{NL})F_{ZK}^B \\ (1 - t_{NL})F_{KZ}^B & (1 - t_{NL})F_{KK}^B \end{vmatrix}} = \frac{0}{(1 - t_{NL})[F_{ZZ}^B F_{KK}^B - (F_{KZ}^B)^2]} = 0$$