



*Triangular Cases: The Application of Bilateral Tax Treaties in Multilateral Situations*

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## **Triangular Cases:**

### ***The application of bilateral income tax treaties in multilateral situations***

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## Triangular Cases:

### *The application of bilateral income tax treaties in multilateral situations*

#### Research Summary

##### 1. Introduction

Bilateral income tax treaties do not always operate effectively in situations where more than two countries are involved. These situations are known as "triangular cases" and they typically arise where a person who is resident in two states for tax purposes (a dual resident), or a person who is resident in one state and has a permanent establishment ("PE") in another, has dealings with a resident of a third state. There are two primary reasons for income tax treaties' inability to resolve the unintended consequences that can arise in triangular cases. The first is that bilateral income tax treaties generally do not take into account the results arising under other income tax treaties, such as an allocation of residence or the distribution of taxing rights. The second is that while the PE concept is generally considered simply a threshold for determining whether source based taxation can be imposed, it is, in many ways, a hybrid between a source concept and a residence concept.

There are four basic categories of triangular cases discussed in this thesis. They are (i) PE triangular cases, (ii) dual resident triangular cases, (iii) reverse PE triangular cases and (iv) reverse dual resident triangular cases. These will each be discussed in turn below.

##### 2. PE triangular cases

###### 2.1. Introduction and background

PE triangular cases arise where a person who is resident in one state (the "residence state" or "State R") earns income from sources in a second state (the "source state" or "State S") and that income is attributable to a PE of the recipient in a third state (the "PE state" or "State PE"). These situations are also known as "typical" triangular cases, particularly when they involve dividends or interest.<sup>1</sup> A PE triangular case is illustrated in the following diagram (in which "HO" denotes the head office of the entity).

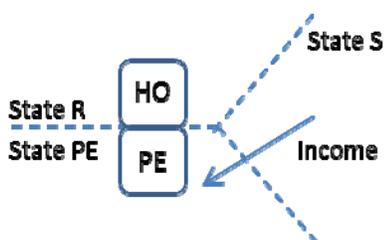


Figure 1: A PE triangular case

<sup>1</sup> See, for example: OECD, "Triangular Cases," in *Model Tax Convention: Four Related Studies* (Paris: OECD, 1992).

In a PE triangular case, tax may be imposed under the domestic laws of all three states involved. The source state would generally impose tax on a source basis, e.g., due to the residence of the payor, particularly where passive income such as dividends and interest is involved. In the PE state, it is the business activities carried on there by the person deriving the income and the link between the income and those business activities, which is likely to trigger tax. Finally, in the residence state, tax is likely to be imposed on the basis of the residence of the person deriving the income. The residence state may provide double taxation relief unilaterally under its domestic law, and in many cases will do so, but even then the relief may not be sufficient and unrelieved double taxation may arise.

In a PE triangular case, there are two applicable tax treaties:

- (i) the treaty between the residence state and the source state (the "R-S treaty"); and
- (ii) the treaty between the residence state and the PE state (the "R-PE treaty").

The source state will be bound to apply the conditions of the R-S treaty and, at least in the case of passive income, will generally be entitled to impose tax under the terms of the treaty. Where interest income is involved, for example, the source state would apply the conditions of the interest article (Article 10) and, given the income is paid by a resident of that state, would be entitled to impose tax at a limited rate (e.g., 10%) based on the gross amount of the income. The PE state, on the other hand, will be required to apply the conditions of the R-PE treaty. Under the business profits article of this treaty (Article 7) the PE state will generally be entitled to impose tax on the profit attributable to the PE, including any income which may be considered to be sourced in a third state. The PE state does not have any direct obligation to provide relief for the tax imposed in the source state, but may have a relief obligation under the PE non-discrimination article of its treaty with the residence state (the R-PE treaty); the existence and scope of this obligation is subject to debate,<sup>2</sup> as will be discussed below. Finally, the residence state must apply the conditions of both the R-S treaty and the R-PE treaty. In general, the residence state will be entitled to impose tax on the income but will have an obligation to provide relief under both the treaty with the source state and under the treaty with the PE state (under the relief article: Article 23A or Article 23B). Depending on the circumstances, this relief may or may not be sufficient to prevent unrelieved double taxation. The treaty between the PE state and the source state (the "PE-S treaty") will generally not apply because PEs are not "persons" for treaty purposes and are thus not entitled to treaty benefits.<sup>3</sup>

## ***2.2. The residence state's obligation to provide relief<sup>4</sup>***

As outlined above, the residence state in a PE triangular case may have an obligation to provide relief for tax imposed in the source state under the terms of the R-S treaty and may also have an obligation to provide relief for tax imposed in the PE state under the terms of the R-PE treaty.<sup>5</sup> This gives rise to two main issues; (i) the

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<sup>2</sup> Refer to Chapter 4 for a discussion of relief in the PE state, focussing particularly on the potential relief obligation which the PE state may have under the non-discrimination provision of its treaty with the residence state.

<sup>3</sup> This is discussed in Chapter 2 (see Section 2.3.).

<sup>4</sup> This aspect of PE triangular cases was discussed in Chapter 3.

<sup>5</sup> Refer to the analysis of PE triangular cases in Chapter 2. See also: OECD, "Triangular Cases," paras. 13 and 15.

extent to which the residence state is capable of providing sufficient relief and (ii) whether the residence state may have an obligation to grant dual relief (i.e., to both exempt the income and grant a credit).<sup>6</sup>

#### *Residence state's ability to fully relieve double taxation*

One of the main issues arising in PE triangular cases is the potential for unrelieved double taxation.<sup>7</sup> This is because source-based taxation may be imposed in both the source state and the PE state and tax may also be imposed in the residence state.<sup>8</sup> The residence state will typically have an obligation to provide relief for both the tax imposed in the source state and the tax imposed in the PE state under its respective treaties with those states, but may not be capable of providing sufficient relief.<sup>9</sup>

If the residence state uses the credit method of relief under both its treaty with the source state and its treaty with the PE state, then it will generally be capable of providing sufficient relief only in cases where the combined effective tax rate in the source state and the PE state is less than its own effective tax rate.<sup>10</sup> This may occur either where the tax rate imposed in the residence state is simply higher than the total rate of tax imposed in the other two states or where the PE state grants relief for tax imposed in the source state.<sup>11</sup> In addition, even if the overall amount of tax imposed in the PE state and the source state is higher than the applicable tax rate in the residence state, the residence state may still provide sufficient credit relief if the credit calculation rules allow excess credits to either be offset against other income or carried forward to future periods.<sup>12</sup> While this may prevent unrelieved double taxation, it arguably does not result in an equitable sharing of tax revenues between the three states involved because the residence state is reducing the tax it collects on other income. It would be more equitable for the PE state to grant relief for tax imposed in the source state and consequently, for less relief to be granted in the residence state.

If the residence state exempts the income attributable to the PE in a PE triangular case, then it is generally considered to be incapable of fully relieving double taxation unless relief is also granted in the PE state.<sup>13</sup> This is because even though the residence state does not impose any tax on the income, the income has still been taxed in two different states (i.e., the source state and the PE state) without relief being provided in either of those states. If, however, the rates of tax imposed in the two source states (i.e., the source state and the PE state) are, in aggregate, lower than the applicable tax rate in the residence state then, if the residence state

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<sup>6</sup> See, inter alia: OECD, "Triangular Cases"; Van Raad, K. "The 1992 OECD Model Treaty: Triangular Cases," 33 *European Taxation* 9, (1993), pp 298-301; Potgens, F.P.G., "The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case" 48 *European Taxation* 4, (2008), pp 210-5; Zhai, G., "Triangular Cases Involving Income Attributable to PEs". 53 *Tax Notes International* 12 (2009), pp 1105-1123.

<sup>7</sup> See, for example: OECD, "Triangular Cases," para 40.

<sup>8</sup> Refer to the analysis of PE triangular cases in Chapter 2.

<sup>9</sup> For an analysis of situations in which the residence state will and will not be able to provide sufficient relief, refer to Chapter 3 (Section 3.2.).

<sup>10</sup> Langoth, B. "Treaty Entitlement of Permanent Establishments," bound in *Triangular Tax Cases*, edited by Sutter, F.P., and Zehetner, U. (Wein, Linde Verlag, 2004), p 24; García Prats, F.A. "Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties" 11 *Intertax* (1994), pp 473-91, note 30.

<sup>11</sup> For an example of a situation where the PE state grants relief, and analysis of the impact of relief in the PE state on the potential for unrelieved double taxation, see Chapter 3 (Section 3.2.2.2.).

<sup>12</sup> Refer to the analysis in Chapter 3 (Section 3.2.3.).

<sup>13</sup> See, for example: OECD, "Triangular Cases," para 40.

used the credit method, it would be able to credit the entire amount of the tax imposed in the two source states and thus, would generally be considered to have prevented double taxation.<sup>14</sup> Given that the outcome is the same when the residence state exempts the income, it does not seem reasonable to reach a different conclusion simply because the residence state grants relief using the exemption method instead of the credit method. It is submitted that in multilateral cases unrelieved double taxation should be considered to occur only if the overall tax burden imposed on one person in relation to a particular item of income is higher than the highest of the applicable tax rates in each of the three states that seek to impose tax on the income.<sup>15</sup> On the basis of this definition, the residence state will be able to fully relieve double taxation in PE triangular cases in circumstances where the combined effective tax rate in the two source states is lower than the applicable tax rate in the residence state. This is the case regardless of whether relief is provided by way of the exemption method or the credit method. Furthermore, if the PE state provides relief for tax imposed in the source state then that relief, combined with the relief in the residence state, would be sufficient to prevent double taxation.

#### *Potential obligation to provide dual relief*

The residence state's obligations under the R-PE treaty and the R-S treaty may also potentially require the residence state to grant dual relief. That is, if one treaty (e.g., the R-PE treaty) requires the residence state to exempt the income arising in a PE triangular case and another treaty (e.g., the R-S treaty) requires the residence state to grant relief using the credit method, then the residence state may only be able to meet its treaty obligations by both exempting the income and allowing a credit.<sup>16</sup> This would clearly be inappropriate since by exempting the income the residence state has already ensured that no double taxation is caused by its taxing claims.<sup>17</sup>

The relief article of the OECD Model limits the amount of credit relief in the residence state to the amount of tax imposed in the residence state which is attributable to the income.<sup>18</sup> To the extent that the exemption under one treaty is taken into account for the purposes of applying the other treaty, then there would be no tax attributable to the income in the residence state and thus, no credit should be available.<sup>19</sup> It has been argued, however, that for the purposes of applying this limitation only the tax imposed under the domestic law of the residence state that should be considered.<sup>20</sup> One of the primary arguments for referring only to domestic law, and ignoring the treaty exemption, is that treaties are binding on the parties and cannot be affected by treaties

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<sup>14</sup> Langoth, B. "Treaty Entitlement..." p 24; García Prats, F.A. "Triangular Cases..." pp 473-91, note 30.

<sup>15</sup> For further discussion, refer to the analysis in Chapter 3 (Section 3.2.1.).

<sup>16</sup> See, for example: Van Raad, K. "The 1992 OECD Model..."; Potgens, F.P.G., "The Netherlands Supreme Court..."; Zhai, G., "Triangular Cases..."

<sup>17</sup> Kemmeren, E. and Peeters, H. "Avoidance of Double Taxation and Its Interaction with European Triangular Arrangements" 19 *EC Tax Review* 1, (2010) pp 4-18; García Prats, F.A. "Triangular Cases..."

<sup>18</sup> OECD Model, Article 23A(2) and Article 23B(1).

<sup>19</sup> Based on the limitation in Article 23A ("Such deduction ... shall not, however, exceed that part of the income tax ... as computed before the deduction is given, which is attributable ... to the income ... which may be taxed in that other State.") and the corresponding limitation in Article 23B ("Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income as derived from that other State.")

<sup>20</sup> Van Raad, K. "2008 OECD Model: Operation and Effect of Article 4(1) in Dual Residence issues under the Updated Commentary" 63 *Bulletin for International Taxation* 5/6, (2009), pp 187-90; Zhai, G., "Triangular Cases..."; Gomes Behrndt, M.A., "Passive Income (Dividends, Interest or Royalties) Derived by a Permanent Establishment from a Third State" bound in *Triangular Tax Cases*, edited by Sutter, F.P., and Zehetner, U. (Wein, Linde Verlag, 2004).

concluded by one of the parties with third states.<sup>21</sup> However, it is not the case here that the residence state has agreed something in a treaty with a third state (i.e., the PE state) that is contrary to its obligations under the treaty with the source state. In effect, as a result of the exemption, the threshold requirement for granting a credit (i.e., that there is tax attributable to the income in the residence state) is factually not met. There also does not seem to be any support in the wording of the relief provisions of the OECD Model for limiting consideration to the domestic law of the residence state, since the relevant limitations in Articles 23A and 23B do not contain any reference to domestic law. Even if consideration should, *prima facie*, be limited to the domestic law of the residence state, the distinction between domestic law on the one hand and tax treaties on the other is not always clear from a legal perspective.<sup>22</sup> In addition, it cannot be said that by taking into account the exemption of the income under the treaty with the PE state and refusing to grant credit relief, the residence state is failing to interpret the terms of the treaty in good faith. The primary purpose of tax treaties is the avoidance of international juridical double taxation in order to facilitate international trade,<sup>23</sup> and it does not seem to be contrary to this purpose, or to the principle of good faith,<sup>24</sup> for a credit to be denied in relation to income which is already exempt in the residence state. As a result, where the residence state exempts certain income in accordance with its obligations under a tax treaty, it should no longer have an obligation to provide credit relief in relation to that income under a different tax treaty; the residence state should not be obliged to grant dual relief.<sup>25</sup>

Even if it is not accepted that an exemption under one treaty should be taken into account for determining the amount of credit relief to be granted under another treaty, there are a number of reasons why the residence state may have no obligation to grant dual relief.<sup>26</sup> Firstly, to the extent that the residence state grants unilateral relief, it may not actually impose any tax on the income under domestic law, in which case it should clearly not be obliged to grant a credit. This will depend, however, on the interaction between the unilateral relief measures and the treaty relief measures; the residence state will not be able to avoid granting a credit on the basis of unilateral relief measures if those measures are supplanted by the treaty relief.<sup>27</sup> In addition, the amount of credit relief available under a tax treaty is commonly calculated by reference to domestic law calculation rules<sup>28</sup> and thus, to the extent that the domestic law denies credit relief in relation to income that is exempt under a treaty, the residence state should generally not be obliged to grant dual relief. Unless the treaty refers directly to domestic law for its operation, however, there is some risk that this denial of relief could be viewed as an impermissible override of the terms of the treaty.<sup>29</sup> Finally, treaty relief measures set the

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<sup>21</sup> Zhai, G., "Triangular Cases..."; Gomes Behrndt, M.A., "Passive Income...", p 57.

<sup>22</sup> Sasseville, J., "A Tax Treaty Perspective: Special Issues" bound in *Tax Treaties and Domestic Law*, edited by Maisto, G., (Amsterdam, IBFD, 2006), Chapter 3, Section 3.2.

<sup>23</sup> Engelen, F. *Interpretation of Tax Treaties Under International Law*, IBFD Doctoral Series, Vol. 7. (Amsterdam; IBFD, 2004), Chapter 10, para 10.3.

<sup>24</sup> Vienna Convention on the Law of Treaties, Article 26 and Article 31.

<sup>25</sup> For a more detailed analysis, refer to Chapter 3 (Section 3.3.3.)

<sup>26</sup> For a more detailed analysis, refer to Chapter 3 (Section 3.3.4., Section 3.3.5., and Section 3.3.6.)

<sup>27</sup> For a detailed discussion of the ways in which treaty relief and domestic relief may interact, refer to Chapter 3 (Section 3.3.4.).

<sup>28</sup> Couzin, R. "Relief of Double Taxation" 56 *Bulletin for International Fiscal Documentation* 6, (2002), pp 266-268; Arnold, B.J, Sasseville, J. and Zolt, E.M. "Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century" 56 *Bulletin for International Fiscal Documentation* 6, (2002), pp 233-45.

<sup>29</sup> For a more detailed analysis, refer to Chapter 3 (Section 3.3.5.).

minimum requirements that the residence state must meet. The exemption method is generally considered to be more favourable than the credit method and therefore, if income is exempt in the residence state then regardless of whether the exemption arises from domestic law or a tax treaty, the exemption should be considered to meet the requirements of a treaty obliging that state to provide credit relief.<sup>30</sup> Thus no dual relief should be required. Nevertheless, for states that remain concerned about the risk of being obliged to grant dual relief there are certain measures which could be implemented to prevent such an obligation from arising. These are outlined in Chapter 3.<sup>31</sup>

### **2.3. The PE state and non-discrimination principles<sup>32</sup>**

To the extent that the PE state imposes tax on income arising in a PE triangular case, it should be obliged to grant relief for tax imposed in the source state, both to ensure that double taxation can be prevented and to ensure an equitable distribution of taxing revenues between the PE state and the residence state.<sup>33</sup> In some cases, relief will be provided in the PE state even in the absence of a treaty obligation. Many countries extend their domestic relief provisions to apply to income derived by non-residents through local PEs (or in situations where an equivalent domestic law threshold is satisfied), either in full or in part.<sup>34</sup> In addition, following the European Court of Justice (ECJ) decision in the *Saint-Gobain* case,<sup>35</sup> it is clear that European law requires the PE state in PE triangular cases to provide relief for source state taxation to the extent that such relief would be available to a resident of the PE state, provided that both the residence state and the PE state are within the European Union (EU).<sup>36</sup> However, where relief is not provided under domestic law or EU law, the question still arises whether the PE state may have an obligation to grant relief under the non-discrimination article (Article 24(3)) of the its treaty with the residence state.

To determine whether the PE state contravenes Article 24(3) of the R-PE treaty by not granting relief, it is necessary to compare the tax burden imposed on the PE to the tax burden which would be imposed on a resident enterprise carrying on the same activities.<sup>37</sup> It is widely accepted that in PE triangular cases, the PE state is obliged to extend any unilateral relief measures which are available to resident enterprises to the PE in order to satisfy the requirements of Article 24(3) of the R-PE treaty.<sup>38</sup> If such relief is not extended to PEs, then

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<sup>30</sup> Vann, R. "International Aspects of Income Tax" bound in *Tax Law Design and Drafting*, Vol. 2, edited by Thuronyi, V. (Washington: International Monetary Fund, 1998), p 759; Shelton, N., *Interpretation and Application of Tax Treaties*, (London; Lexis Nexis UK, 2004), at p. 51.

<sup>31</sup> Refer to Section 3.3.8.

<sup>32</sup> This aspect of PE triangular cases is discussed in Chapter 4.

<sup>33</sup> For further discussion and an example showing the impact of relief in the PE state, refer to Chapter 3 (Section 3.2.2.2.) and Chapter 4 (Section 4.2.1.).

<sup>34</sup> OECD, "Triangular Cases," para 30. For further discussion and examples see Chapter 4 (Section 4.2.2.1.).

<sup>35</sup> Case C-307/97, *Compagnie Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, [1999] ECR I-6161.

<sup>36</sup> For further discussion, refer to Chapter 4 (Section 4.2.2.2. and 4.3.6.).

<sup>37</sup> Article 24(3) provides (in part) that: "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities."

<sup>38</sup> OECD Commentary on Article 24, para 67; Van Raad, K. *Nondiscrimination in International Tax Law*. Vol. 6, Series on International Taxation, (Deventer, Kluwer, 1986), p. 151; Van Raad, K. "The 1992 OECD Model..."; Avery Jones, J.F. and Bobbett, C. "Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London" 53 *Bulletin for International Fiscal Documentation* 1, (1999), pp 16-20; Avery Jones, J.F., et al., "The Non-discrimination Article in Tax Treaties," 31 *European Taxation* 10, (1991), pp 310-47;

they would generally be subject to a higher tax burden in the PE state than a resident enterprise carrying on the same activities, and the PE state would contravene Article 24(3).

The extension of the relief available to resident enterprises under the PE-S treaty is more controversial.<sup>39</sup> Where the resident enterprise to which the PE is being compared would be entitled to relief under the PE-S treaty then, unless equivalent relief is granted to the PE, the tax burden imposed on the PE would, all other things being equal, be greater than that which would be imposed on the resident enterprise.<sup>40</sup> This will depend, however, on the comparison entity being entitled to relief under the treaty between the PE state and the source state.<sup>41</sup> Determining whether it would be entitled to such relief requires establishing the characteristics of the comparison entity and then hypothetically applying the PE-S treaty. In order for the comparison entity to be eligible for relief under the PE-S treaty, it must fulfil three basic conditions; (i) it must be a resident of the PE state for the purposes of the PE-S treaty, (ii) it must be considered to derive income to which the PE-S treaty would apply (i.e., from sources in State S), and (iii) it must be eligible for relief under the relief provision of the PE-S treaty.<sup>42</sup> The comparison entity's eligibility for treaty relief may also raise difficult issues where the PE is established by a partnership or where the PE-S treaty contains an LOB provision.<sup>43</sup> In principle, however, there is no basis for limiting consideration to domestic law and the PE state should therefore be obliged to extend treaty relief to PEs in accordance with the non-discrimination article of the R-PE treaty to the extent that the comparison entity would be entitled to such relief.

One of the primary arguments against extending treaty relief to PEs under the non-discrimination principle is based on the principle of the relative (or bilateral) effect of treaties, according to which treaty benefits may not be extended to residents of third states. In the context of treaty relief for PEs it is argued that the PE should not be entitled to relief because, for the purposes of the PE-S treaty, the PE is not a resident of either contracting state and thus does not satisfy the requirements of Article 1.<sup>44</sup> However, the fact that the PE is not entitled to the benefits of the PE-S treaty under Article 1 should not prevent the PE state from granting relief equivalent to that which would be available to a resident taxpayer under the PE-S treaty. Another common (and related)

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Gusmeroli, M. "Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1" 45 *European Taxation* 1, (2005), pp 2-13; Zhai, G. "Triangular Cases..."; Friedhelm, J., "Discriminatory Tax Treatment of German Permanent Establishments – The Rebirth of an Old Problem" 31 *Tax Management International Journal* 13, (2002), pp 613-617.

<sup>39</sup> OECD Commentary on Article 24, para 67; Van Raad, K., *Nondiscrimination...*, p. 151; Van Raad, K. "The 1992 OECD Model..."; Avery Jones, J.F. and Bobbett, C. "Triangular Treaty Problems..."; Avery Jones, J.F., et al., "The Non-discrimination Article..."; Friedhelm, J., "Discriminatory Tax Treatment..."; Gusmeroli, M. "Triangular Cases... Part 1"; Zhai, G. "Triangular Cases..."

<sup>40</sup> Avery Jones, J.F., et al., "The Non-discrimination Article..."; Van Raad, K., "Issues in the Application of Tax Treaty Non-Discrimination Clauses" 42 *Bulletin for International Fiscal Documentation* 8/9, (1988), pp 347-51; Friedhelm, J., "Discriminatory Tax Treatment..."; García Prats, F.A. "Triangular Cases..."

<sup>41</sup> For further discussion and analysis, refer to Chapter 4 (Section 4.3.3.2.).

<sup>42</sup> For further discussion and analysis, refer to Chapter 4 (Section 4.3.3.2.).

<sup>43</sup> For further discussion and analysis, refer to Chapter 4 (Section 4.3.4.).

<sup>44</sup> The 1977 OECD Commentary on Article 24, paras. 52 and 54, stated that treaty relief should not be available on the basis of Article 1 and the relative effect of treaties, however these comments were removed in the 1992 Commentary. The relative effect of treaties has been identified as a primary argument against granting treaty relief to PEs by various authors, including: Avery Jones, J.F., et al., "The Non-discrimination Article..." at p 337 (referring to paragraphs 52 and 54 of the 1977 OECD Commentary); García Prats, F.A. "Triangular Cases..."; Martín Jiménez, A.J., et al., "Triangular Cases, Tax Treaties and EC Law: The Saint-Gobain Decision of the ECJ" 55 *Bulletin for International Fiscal Documentation* 6, (2001), pp 241-53; Friedhelm, J., "Discriminatory Tax Treatment..." (referring to several German authors); Zhai, G. "Triangular Cases..."

argument against extending treaty relief to PEs is that if such relief were provided, it would upset the balance and reciprocity of the treaty between the PE state and the source state.<sup>45</sup> The reciprocity argument was soundly rejected in the *Saint-Gobain* case, which dealt with the taxation of a PE in a PE triangular case under EU law.<sup>46</sup> The ECJ noted that the obligation imposed on the PE state by EU law did not affect in any way the obligations arising from the treaties with the source states and likened the double taxation relief to be provided under non-discrimination principles to a unilateral extension of relief in the PE state.<sup>47</sup> The balance and reciprocity argument is also complicated by the fact that the state which is on one occasion the "source state" may on other occasions be the "PE state." Thus, the overall impact on the tax revenues collected by the two states (the balance of the treaty) is difficult to assess and will depend on the relative levels of investment, the prevalence of triangular structures in each state, and the domestic tax laws of each state.<sup>48</sup> For these reasons, the PE state should generally have an obligation to extend the relief available to resident enterprises under the PE-S treaty to PEs in accordance with Article 24(3) of the R-S treaty. However, given the uncertainty surrounding the scope of the obligation to grant relief under non-discrimination principles, and the importance of relief in the PE state, it would be preferable for the PE state to have an explicit obligation to provide relief for tax imposed in the source state in PE triangular cases.

#### *Amount of credit relief*

The OECD Commentary suggests that where the PE state extends treaty relief to PEs using the credit method, the amount of the credit should be the lesser of (i) the amount of tax actually imposed in the source state and (ii) the amount of tax that could have been imposed in the source state if the treaty between the source state and the PE state had applied<sup>49</sup> (the credit is of course also limited to the amount of tax attributable to the income in the PE state). The logic behind these two limitations is not entirely consistent, however, in terms of what is being compared to determine whether the taxation on the PE is less favourable than that which would be imposed on a resident enterprise carrying on the same activities. The first limitation effectively compares the PE to a resident enterprise that paid the same amount of tax in the source state as was actually paid by the PE,<sup>50</sup> while the second limitation compares the PE to a resident enterprise of the PE state that earned the same income as the PE from the same sources and paid the same amount of tax in the source state that a resident of State PE would pay (taking into account the conditions of the PE-S treaty).<sup>51</sup> This means that applying both limitations effectively requires a differing comparison depending upon the rate of tax imposed in the source state relative to the amount of tax that could have been imposed if the PE-S treaty applied. Nevertheless, applying either of the suggested limitations to the exclusion of the other is problematic. If the first limitation is not applied, then the PE state may be required to allow relief in excess of the amount of tax actually imposed in the source state. If the second limitation is not applied then the PE state may collect less tax than it would be

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<sup>45</sup> For example, this was presented as an argument against requiring the PE state to grant relief in the *Saint-Gobain* case (ECJ, 21 September 1999, *Compagnie de Saint-Gobain v. Finanzant Aachen-Innenstadt*, C-307/97, paras 59-60).

<sup>46</sup> ECJ, 21 September 1999, *Compagnie de Saint-Gobain v. Finanzant Aachen-Innenstadt*, C-307/97.

<sup>47</sup> ECJ, 21 September 1999, *Compagnie de Saint-Gobain v. Finanzant Aachen-Innenstadt*, C-307/97, para 59.

<sup>48</sup> For further discussion and analysis refer to Chapter 4 (Section 4.3.3.3.)

<sup>49</sup> OECD Commentary on Article 24, para 70.

<sup>50</sup> For further discussion of this limitation refer to Chapter 4 (Section 4.3.5.1.).

<sup>51</sup> For further discussion of this limitation refer to Chapter 4 (Section 4.3.5.2.).

able to collect if the income were earned by a resident enterprise of the PE state. Clearly neither of these outcomes would be acceptable to the PE state, although on balance, most states would probably be more averse to granting a credit where no tax has been imposed, given the opportunities this would present for tax avoidance. Since it is not appropriate to apply either one of these two limitations in isolation, and given the inconsistency inherent in applying both under the current wording of Article 24(3), it would be highly desirable for tax treaties to include specific wording establishing the applicable limitations.

#### **2.4. Applicable treaty conditions in the source state<sup>52</sup>**

In accordance with the existing treaty framework, the taxation of income in the source state in a PE triangular case must apply the conditions of the R-S treaty in relation to the income attributable to the PE and not the conditions of the PE-S treaty. In such cases, the source state is generally considered to be applying the wrong treaty conditions, since the R-PE treaty will allocate the prior (and perhaps exclusive) right to tax the income to the PE state.<sup>53</sup> Underlying this view is the idea that, although the PE concept is ostensibly just a threshold for determining whether source based taxation can be imposed, it effectively represents a quasi-residence basis of taxation.<sup>54</sup> The application of the R-S treaty also gives rise to treaty shopping concerns, since reductions in source-based taxation may be claimed in situations where the residence state is prevented from taxing the income (under the R-PE treaty) and where there is little or no economic link to the residence state.<sup>55</sup> This section will give an overview of the analysis conducted in Chapter 5, where it is concluded that in PE triangular cases it would indeed be preferable for the source state to apply the conditions of the PE-S treaty, instead of the conditions of the R-S treaty, in relation to the income attributable to the PE.

#### *Why states agree to restrictions on their taxing rights under tax treaties<sup>56</sup>*

To determine whether it would be appropriate for the source state to apply the conditions of the PE-S treaty in relation to income attributable to a PE, it is important to understand why states enter into tax treaties and thus agree to restrictions on their taxing rights in the first place. To the extent that the reasons apply equally in the case of income earned by PEs, this provides support for the application of the PE-S treaty conditions in the source state in PE triangular cases.

The primary purpose of tax treaties is to eliminate double taxation, which they do through limiting the amount of tax that can be imposed in the source state and by requiring the residence state to grant double taxation relief.<sup>57</sup> Clearly a requirement for the PE state to grant relief under the PE-S treaty would promote the

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<sup>52</sup> This aspect of PE triangular cases is discussed in Chapter 5.

<sup>53</sup> See, inter alia: García Prats, F.A. "Triangular Cases..."; Avery Jones, J.F. and Bobbett, C. "Triangular Treaty Problems..."; Avery Jones, J.F., "The David R. Tillinghast Lecture: Are Tax Treaties Necessary?" 53 *Tax Law Review* 1, (1999), pp 1-38; Martín Jiménez, A.J., et al., "Triangular Cases..."; Arnold, B.J. and Sasseville, J., "Source Rules for Taxing Business Profits Under Tax Treaties" bound in *The Taxation of Business Profits Under Tax Treaties* (Toronto, Canadian Tax Foundation, 2003) at p 118; Langoth, B. "Treaty Entitlement..."; Zhai, G., "Triangular Cases..."; Yong, S. "Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place" 64 *Bulletin for International Taxation* 3, (2010), pp 152-64.

<sup>54</sup> For further discussion and analysis refer to Chapter 5 (Section 5.2.3.).

<sup>55</sup> OECD, "Triangular Cases," para 21. See also: Van Weeghel, S. *The Improper Use of Tax Treaties*, (London; Kluwer Law International, 1998), at pp 124-126.

<sup>56</sup> This is discussed in more detail in Chapter 5 (Section 5.2.2.).

<sup>57</sup> See, for example: 2010 OECD Model Convention, Introduction, paras 1-3.

elimination of double taxation, but in certain circumstances the elimination of double taxation would also require the application of the conditions of the PE-S treaty in the source state. This could occur, for example, where the relief in the PE state is limited to the tax that the source state could impose if it applied the conditions of the PE-S treaty (and the residence state is unable to provide sufficient relief).

In addition, limiting source-based taxation under tax treaties serves to allocate taxing jurisdiction between the two contracting states. If the PE-S treaty doesn't apply to income derived by PEs in PE triangular cases, then in such cases, that treaty has no influence over the allocation of taxing jurisdiction between the PE state and the source state. Instead, it is the R-S treaty and the R-PE treaty which will determine how much tax each state collects; the R-S treaty by determining the extent to which the source state can impose tax on the income, and the R-PE treaty by requiring the PE state to grant relief for tax imposed in the source state under the non-discrimination article (Article 24(3)). Clearly, the split of tax revenues between the PE state and the source state should be a matter for negotiation between those two states and should not depend on separate negotiations between those states and the residence state. This strongly supports the application of the conditions of the PE-S treaty in the source state.

Finally, tax treaties are based on the principle of reciprocity; each state agrees to restrict its taxing rights under a treaty in exchange for the other state agreeing to do the same.<sup>58</sup> The reciprocity principle does not provide an argument either for or against applying the conditions of the PE-S treaty in the source state to income derived by the PE, provided the terms of whichever treaty effects the application of the PE-S treaty to income derived by PEs imposes a corresponding obligation on both contracting states.

#### *The role of the residence concept in tax treaties*<sup>59</sup>

Given that the extension of treaty benefits to PEs would further many of the aims of tax treaties, it is important to consider why the benefits of tax treaties are limited to persons who are resident in one or both of the contracting states.<sup>60</sup> The arguments for doing so are generally discussed in the context of treaty shopping most commonly rest on the reciprocal nature of tax treaties, the potential for income to escape taxation, and the diminished incentive for states to negotiate new treaties.<sup>61</sup> This suggests that, in the context of treaty entitlement, the residence concept primarily aims to achieve two things; <sup>62</sup> (i) it attempts to define those taxpayers who may be subject to double taxation (i.e., on both a residence and source basis) and (ii) it attempts to identify those persons who have a sufficient personal or economic connection to a particular state to benefit

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<sup>58</sup> IBFD International Tax Glossary, 5th Ed., (IBFD, Amsterdam, 2005), p 329.

<sup>59</sup> This is discussed in more detail in Chapter 5 (Section 5.2.3.).

<sup>60</sup> Article 1 provides that "This Convention shall apply to persons who are residents of one or both of the contracting states." For a discussion the role of Article 1, and a discussion of certain exceptions to this general rule, see: Hattingh, P.J., "The Role and Function of Article 1 of the OECD Model," 57 *Bulletin for International Fiscal Documentation* 11, (2003), pp. 546-553.

<sup>61</sup> See, inter alia: OECD, "Double Tax Conventions and the Use of Conduit Companies" in *International Tax Avoidance and Evasion*. (Paris: OECD, 1987), p. 90; United Nations Organization, "Contributions to International Co-operation in Tax Matters: Treaty Shopping, Thin Capitalization, Co-operation between Tax Authorities, Resolving International Tax Disputes," (New York: United Nations, 1988), UN Doc. ST/ESA/203; Van Weeghel, S., *The Improper Use...* at pp. 117-118; Avi-Yonah, R.S., & Panayi, C., "Rethinking Treaty Shopping: Lessons for the European Union," bound in *Tax Treaties: Building Bridges between Law and Economics*, (Amsterdam: IBFD, 2010), pp. 21-50.

<sup>62</sup> There is, however, disagreement with respect to the underlying policy behind the residence requirement and, in particular, the liable to tax requirement. For an overview, see: Wheeler, J.C., "The missing keystone of income tax treaties," 3 *World Tax Journal* 2 (2011), pp. 247-367 at pp. 253-255.

from that state's treaty network (even though they may not suffer any double taxation as a result).<sup>63</sup> However, in many cases, one or both of these features will also be present in the case of a PE (with respect to the income that is attributable to it).

Furthermore, applying the residence article of treaties is not always straight-forward, particularly in respect to the “liable to tax” requirement; in many cases there is no clear-cut distinction between entities subject to worldwide taxation on the one hand and entities which are taxed solely on a source basis on the other.<sup>64</sup> Difficulties in determining treaty residence also arise, for example, in relation to partnerships and hybrid entities,<sup>65</sup> collective investment vehicles,<sup>66</sup> sovereign wealth funds,<sup>67</sup> persons taxed on a remittance basis<sup>68</sup> and dual residents.<sup>69</sup> Thus, the residence concept does not always provide a solid basis upon which to determine eligibility for treaty benefits.

Domestic law residence rules are generally relatively easy for a company to satisfy.<sup>70</sup> In a treaty context, however, this means that corporate residence is often open to manipulation.<sup>71</sup> A company can be a resident of a particular state with little or no activity or economic presence in that state<sup>72</sup> and furthermore, a company can often change its place of residence with little or no change in its economic activities. This limits the usefulness of the residence concept as the sole basis for determining whether treaty benefits should be available, at least to the extent that the underlying policy rationale is to identify those persons who have a sufficient connection to a particular state to warrant the availability of treaty benefits.

In an international context, corporate taxation can also effectively operate as a kind of source-based taxation. In economic theory, taxation is always ultimately borne by natural persons since legal persons do not have any

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<sup>63</sup> Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation on Income and Capital: With Particular Reference to German Treaty Practice*, 3rd ed., (London: Kluwer Law International, 1997) at p. 229 (m.no. 24a).

<sup>64</sup> For examples, see Section 5.2.3.3.

<sup>65</sup> See, for instance: OECD, “The Application of the OECD Model Convention to Partnerships: Issues in International Taxation No. 6” (Paris: OECD, 1999); Barenfeld, J., *Taxation of Cross-Border Partnerships*, Doctoral Series, Vol. 9, (Amsterdam: IBFD, 2005); Couzin, R., *Corporate Residence...* at pp. 115-123 (Section 3.1.1.4.); Avery Jones, J.F., et al., “Characterization of Other States’ Partnerships for Income Tax,” 56 *Bulletin for International Fiscal Documentation* 7, (2002), pp. 288-320.

<sup>66</sup> OECD, “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles,” (Paris: OECD, 2010); Couzin, R., *Corporate Residence and International Taxation*, (Amsterdam: IBFD Publications, 2002) at pp. 123-126 (Section 3.1.1.5.).

<sup>67</sup> OECD Commentary on Article 1, paras. 6.35-6.39; OECD, “Discussion Draft on the Application of Tax Treaties to State-Owned Entities, Including Sovereign Wealth Funds,” (Paris: OECD, 2010); Couzin, R., *Corporate Residence...* at pp. 111-112 (Section 3.1.1.2.).

<sup>68</sup> OECD Commentary on Article 1, para. 26.1.

<sup>69</sup> With respect to dual residents, the main difficulty is in determining whether a dual resident will be considered resident in the “losing” residence state (i.e., the state to which residence is not assigned under the treaty between the two residence states) for the purposes of treaties between that state and third states. This will be discussed in detail in Chapter 10 and, in particular, in Chapter 11. Difficulties can also arise with respect to the application of the residence tie-breaker provisions in Article 4 (paragraphs 2 and 3).

<sup>70</sup> Vann, R., “‘Liable to Tax’ and Company Residence under Tax Treaties” bound in Maisto, G. (Ed.), *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2006), pp. 197-271 at p. 251 (Section 7.4.2.).

<sup>71</sup> Arnold, B.J., Sasseville, J., & Zolt, M., “Summary of the Proceedings ...” at p. 240.

<sup>72</sup> Duff, D.G., “Responses to Treaty Shopping: A Comparative Evaluation” bound in: *Tax Treaties: Building Bridges Between Law and Economics*. (Amsterdam: IBFD, 2010), pp. 75-102 at p. 76.

capacity to consume.<sup>73</sup> On this basis, corporate taxation can be viewed as a prepayment of tax on behalf of the ultimate (individual) shareholders, at least in situations where the company and the shareholders are resident in the same state.<sup>74</sup> In an international context, however, taxation on the basis of corporate residence may result in tax effectively being imposed on foreign income that is ultimately attributable to non-resident individual shareholders.<sup>75</sup> Thus, corporate residence effectively operates at least partly as a sourcing rule.<sup>76</sup> One implication of this is that corporate residence concepts and the PE concept have more in common than may appear at first sight.<sup>77</sup> Not only is a PE similar to a resident enterprise in many ways (as will be discussed below), but in an international context, corporate residence has a similar role to that of the PE concept with respect to the imposition of source-based taxation.

#### *Similarity between PE taxation and residence-based taxation*<sup>78</sup>

Further support for the application of the PE-S treaty conditions in the source state can be found in the similarity between PE taxation and residence-based taxation. Where non-residents derive income through a PE (or in situations where an equivalent domestic law threshold is satisfied), that income is commonly taxed under domestic laws in the same way as the income of resident taxpayers, i.e., on a net basis.<sup>79</sup> This can be contrasted with the way in which taxation is generally imposed on non-residents deriving passive income, such as dividends and interest in the absence of a PE; such income is commonly taxed on a gross basis by way of withholding tax.<sup>80</sup> Thus, under the domestic laws of many states, the taxation of business income attributable to a local PE (or derived in circumstances where an equivalent criteria is met) may be considered a hybrid between pure source-based taxation on one hand and full residence-based taxation on the other.

This distinction is also reflected in tax treaties. Where a treaty based on the OECD Model applies, the PE definition operates to distinguish between those situations where the source state is either (i) prevented from

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<sup>73</sup> Musgrave, R.A., & Musgrave, P.B., "Public Finance in Theory and Practice," 5<sup>th</sup> ed. (Hamburg, McGraw-Hill Book Co, 1989) at p. 237; Bird, R., "Why Tax Corporations?" 56 *Bulletin for International Fiscal Documentation* 5, (2002) pp. 194-203.

<sup>74</sup> Schön, W., "Attribution of Profits to PEs and the OECD 2006 Report," 46 *Tax Notes International* 10, (2007), pp. 1059-1072 at p. 69; Schön, W., "Persons and Territories: On the International Allocation of Taxing Rights" *British Tax Review* 6, (2010), pp. 554-562 at p. 558; Bird, R., "Why Tax Corporations?" 56 *Bulletin for International Fiscal Documentation* 5, (2002) pp. 194-203.

<sup>75</sup> Schön, W., "International Tax Coordination..." at p. 69; Fantozzi, A., Et al., "Round Table: The Issues, Conclusions and Summing Up" bound in *Residence of Companies under Tax Treaties and EC Law*, (Amsterdam: IBFD, 2006), pp. 889-933, at pp. 915-923, (Chapter 24, Section 24.4.2.). This section of Chapter 24 (Section 24.4.), written by Nikolakakis, A., is titled "The Unbearable Lightness of Being Incorporated."

<sup>76</sup> Schön, W., "International Tax Coordination..."; Schön, W., "Persons and Territories..." at p. 558; Vann, R., "'Liable to Tax'..." at pp. 199-200 and p. 202 (Section 7.2.1.); Green, R.A., "The Future of Source-Based Taxation of the Income of Multinational Enterprises." 79 *Cornell Law Review* (1993), pp. 18-86 at p. 27; Auerbach, A., Devereux, M.P., & Simpson, H., "Taxing Corporate Income" bound in *The Institute for Fiscal Studies, Reforming the Tax System for the 21<sup>st</sup> Century: The Mirrlees Review*, (Oxford University Press, 2008) at p. 34.

<sup>77</sup> In this respect, Vann writes: "Taxation of subsidiaries ... on a residence only basis is in policy terms a source tax on that portion of a group's income. (Or conversely, the taxation of PEs has much in common with residence taxation of subsidiaries and may be thought of as quasi-residence taxation)." See: Vann, R., "'Liable to Tax'..." at pp. 199-200 (Section 7.2.1.).

<sup>78</sup> This is discussed in more detail in Chapter 5 (Section 5.2.4.).

<sup>79</sup> Couzin, R., *Corporate Residence...* at p. 4-5. This type of taxation may also apply to income and gains derived from real property. See also: Phillips, J.S., & Collins, M.H., "General Report," bound in *The Assessment and Collection of Tax from Non-residents*, IFA Cahiers de Droit Fiscal International, Vol. LXXa, (Deventer: Kluwer, 1985) at p 28.

<sup>80</sup> Phillips, J.S., & Collins, M.H., "General Report" at p 26. Income which would otherwise be subject to withholding tax may be taxed on a net basis if it is derived in the context of a business which is operated through a PE (or satisfies an equivalent domestic law threshold).

imposing tax on business profits and limited to imposing tax at specified maximum rates on dividends, interest and often royalties (on a gross basis), or (ii) is allowed to impose tax on the (net) profit attributable to the PE in the same way as it would impose tax on the income of a resident taxpayer. Furthermore, once a PE exists, the PE state may impose tax on the income attributable to the PE without regard to the implicit source rules contained in the treaty. In the absence of a PE, the non-residence state is generally limited to imposing tax on income which is considered to have its source in that state in accordance with those implicit source rules, based on, e.g., the effective location of the payor. Once a PE exists, however, the PE state may impose tax on the income attributable to the PE without regard to the implicit source rules contained in the treaty and thus may impose tax on the worldwide profit attributable to the PE. Even if a particular item of income has a stronger economic connection to a third state, the PE state is effectively allowed to impose tax on the income due to the "personal" connection which part of the entity has to the PE state by virtue of having a fixed place of business there.<sup>81</sup>

The source rule for interest also indicates that PEs may be considered to be similar to resident enterprises for treaty purposes. Article 11 of the OECD Model provides that interest arises in a particular state if it is paid by a resident of that state.<sup>82</sup> However, if the debt claim giving rise to the interest payment is effectively connected with a PE of the payor in one of the contracting states, and the interest is borne by the PE, then the interest is instead deemed to arise in the PE state.<sup>83</sup> Thus, for the purposes of determining the source of income, the "payment" of interest by a PE is treated as being equivalent to the payment of interest by a resident person.<sup>84</sup> Finally, the OECD Model also likens the taxation of a PE to that of a resident taxpayer in the PE non-discrimination article (Article 24(3)), which requires the PE state to impose tax on the PE "not less favourably" than on a resident enterprise. There is no equivalent rule for income earned by a non-resident in the absence of a PE.

#### *Importance of different legal nature of a PE and a subsidiary*

The classic image of a PE is simply a branch established by a company resident in another state, while a corporate taxpayer is usually a separate legal entity. The question to be addressed, then, is whether this essential difference in the legal nature of a PE and a resident enterprise warrants different treatment with respect to treaty eligibility. In general, there is a trend towards treating PEs and subsidiaries in the same way on the basis that the economic substance of the two different forms of business is effectively the same.<sup>85</sup> The essential difference is in the allocation of risk, given that the owner of a subsidiary entity will generally have limited liability. The impact of this may be limited, however, since the value of the parent company's shares will depend on the value of the assets of the subsidiary and, in addition, there are often cross guarantees within a

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<sup>81</sup> Martín Jiménez, A.J., García Prats, F.J., and Calderón Carrero, J.M., "Triangular Cases... "

<sup>82</sup> 2010 OECD Model, Article 11(5).

<sup>83</sup> 2010 OECD Model, Article 11(5). Similar rules often exist with respect to royalties in tax treaties that allow for source-based taxation of such income. See: Vann, R., "Reflections on Business Profits and the Arm's-Length Principle" bound in *The Taxation of Business Profits Under Tax Treaties*, (Toronto: Canadian Tax Foundation, 2003) at p 144.

<sup>84</sup> Vann, R., "Reflections on Business..." at p 144. It should be noted, however, that this does not apply if the interest is borne by a resident of a third state (i.e., in a reverse PE triangular case); this will be discussed in Chapter 9.

<sup>85</sup> Schön, W., "International Tax Coordination..." at p. 106.

multinational group. Nevertheless, the lack of separate legal personality can have real economic consequences, at least in some cases.

Perhaps more importantly, the classic distinction between a PE and a subsidiary is not always so clear cut in reality, since it is not always the case that the tax characterization of the situation follows the legal characterization. A PE may effectively arise, for example, as a result of activities conducted by what may be considered a separate entity from a legal perspective that is treated as a transparent entity for tax purposes.<sup>86</sup> That is, in some cases, an entity which would generally be considered to be a corporate entity from a legal perspective, or which has significant corporate features, may be taxed on a flow-through basis in the state where it is located.<sup>87</sup> Conversely, there are also situations where certain entities which would not generally be considered to be companies from a legal perspective, e.g., partnerships, are treated as separate taxable entities and subject to corporate taxation in their own right.<sup>88</sup> Such entities are in principal entitled to treaty benefits, notwithstanding the fact that they may not be considered to be separate entities from a purely legal perspective. Finally, the determination of whether a particular entity is taxable in its own right or is treated as fiscally transparent under domestic laws may not be consistent between different states, since different states base their classification on different factors and draw the line between taxable and fiscally transparent entities differently.<sup>89</sup> What is considered a PE under the domestic law of one state may be considered a separate taxable entity under the laws of another state and vice versa. It therefore makes little sense to deny treaty benefits to PEs simply on the assumption that they have no separate legal capacity and on the assumption that there is a significant difference between the legal nature of a PE and a subsidiary.

#### *Separate enterprise approach for attributing profit to PEs<sup>90</sup>*

The profit attributable to a PE must be determined as though the PE were a "separate and independent enterprise engaged in the same or similar activities under the same or similar conditions..."<sup>91</sup> Beginning in the late 1990's, the OECD conducted a review the way in which profit is attributed to PEs for treaty purposes, which culminated in the rewriting of the commentary on Article 7 in 2008 and the adoption of a new Article 7 in 2010,

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<sup>86</sup> Schön writes: "In this context it should be taken into account that there is again a continuum of choices between extremities, including partnerships, S corporations, LLCs or LLPs, which may be treated as 'transparent', resulting in characterization of their activity as a permanent establishment notwithstanding their undisputed recognition as legal entities under civil and corporate law." See: Schön, W., "International Tax Coordination..." at p. 96.

<sup>87</sup> In an international context, this often leads to issues associated with "hybrid entities," entities which are subject to corporate tax in one state but taxed on a flow-through basis in another. For discussion of hybrid entities, see, inter alia: Barenfeld, J., *Taxation of Cross-Border Partnerships...*; OECD, "The Application of the OECD Model Convention to Partnerships..."

<sup>88</sup> Schön, W., "International Tax Coordination..." at p. 107, who writes: "...domestic tax law itself has lost its acumen when drawing the line between taxable and transparent entities. While some countries have a tradition to offer partnerships the option or even require them to be taxed as corporations, recent developments, particularly in the United States, have brought about the reverse effect, granting S corporations and limited liability companies the option to be treated in a transparent manner, thus applying the 'pass through' approach to fully incorporated entities." Schön also notes that some countries have even considered taxing sole proprietorships on a corporate basis (at pp. 107-108).

<sup>89</sup> This gives rise to so-called hybrid entities, entities which are treated as separate taxable entities in one state but as fiscally transparent in another. Such entities raise a number of very difficult issues with respect to the application of tax treaties as discussed, for example, in the OECD's Partnership Report (OECD, "The Application of the OECD Model Convention to Partnerships..."). See also: Barenfeld, J., *Taxation of Cross-Border Partnerships*; Avery Jones, J.F., et al., "Characterization of Other..."

<sup>90</sup> This is discussed in more detail in Chapter 5 (Section 5.2.4.).

<sup>91</sup> 2010 OECD Model, Article 7(2).

both incorporating a new "Authorised OECD Approach" (AOA) for the attribution of profits to PEs. The application of the AOA involves, firstly, a "functional and factual analysis," which is performed in order to hypothesise the PE as a distinct and separate enterprise and to "identify the economically significant activities and responsibilities undertaken by the PE,"<sup>92</sup> an analysis similar to that which must be performed to apply the arm's length principle to transactions between associated enterprises (i.e., under Article 9).<sup>93</sup> The outcome of this analysis will be an allocation of assets, risks and capital to the PE.<sup>94</sup> The second step in the AOA is to apply the OECD's Transfer Pricing Guidelines (by analogy) to determine the appropriate remuneration for any dealings between the PE and other parts of the enterprise.<sup>95</sup> Under the AOA, PEs are treated much more similarly to independent enterprises than they were previously, at least for profit attribution purposes, and the AOA can thus be said to increase the independence of PEs.<sup>96</sup> This is reflected in the fact that, under the AOA, a PE may assume risks, may have economic ownership of assets, and must be allocated sufficient capital to support its operations (i.e., functions performed, assets economically owned and risks assumed).<sup>97</sup> Thus, in a major step towards hypothesising the PE as a separate entity, a PE is now considered to have notional legal capacity for profit attribution purposes.

One of the limits which has historically been placed on the separate entity approach relates to the treatment of dealings between the PE and other parts of the enterprise.<sup>98</sup> With the adoption of the AOA, this limit has essentially been removed and replaced with a framework for assessing whether a particular dealing meets the criteria for recognition. Under the AOA, an internal dealing may be recognised if a "real and identifiable event has occurred."<sup>99</sup> As a result, it is now possible for internal dealings such as payments of royalties or service fees to be recognised for the purposes of determining the profit attributable to the PE. Another key development is that the AOA explicitly requires the application of the OECD's Transfer Pricing Guidelines, both in the functional and factual analysis (step 1) and in relation to pricing dealings between PEs and other parts of the enterprise or other related parties (step 2).<sup>100</sup> The explicit application of the Transfer Pricing Guidelines to PEs emphasises the AOA's transactional approach to determining the profit attributable to PEs (as opposed to an "allocation" approach),<sup>101</sup> which also brings the treatment of a PE conceptually closer to that of a separate enterprise.<sup>102</sup> The increase in the independence of PEs under the AOA clearly lends support to the idea that PEs should be treated as separate entities for the purposes of treaty entitlement, as well as for the purposes of determining the profit

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<sup>92</sup> OECD, "2010 Report on the Attribution of Profits to Permanent Establishments" (Paris: OECD, 2010), Part 1, Section B-2, para 10.

<sup>93</sup> OECD, "2010 Report...", Part 1, Section B-3, para 15.

<sup>94</sup> OECD, "2010 Report...", Part 1, Section D-2, para 59.

<sup>95</sup> OECD, "2010 Report...", Part 1, Section B-2, para 10.

<sup>96</sup> Baker, P. & Collier, R., "General Report" bound in *The Attribution of Profits to Permanent Establishments*, IFA Cahiers de Droit Fiscal International, Vol. 91b, (Amersfoort: Sdu Fiscale & Financiële Uitgevers, 2006), p 37.

<sup>97</sup> OECD, "2010 Report ...," Part I, Section D-2(iv), para 107.

<sup>98</sup> See, for example, the 2005 OECD Commentary on Article 7, paras 17.1-21.

<sup>99</sup> OECD, "2010 Report...", Part I, Section B-3(v), para 35.

<sup>100</sup> Fris, P., Llinares, E., and Gonnet, S., "PEs and Transfer Pricing: The Playing Field in International Taxation Redefined," 9 *Tax planning international transfer pricing* 12, (2008), pp 4-9; Van Wanrooij, J.S.A., "Comments on the Proposed Article 7 of the OECD Model Convention," 37 *Intertax* 5, (2009), pp 298-306.

<sup>101</sup> Vann, R., "Reflections on Business...", at pp 157-167.

<sup>102</sup> Baker, P. & Collier, R., "General Report," at p 37.

attributable to the PE.<sup>103</sup> Allowing PEs to claim treaty benefits would be a logical extension of the separate enterprise approach and would represent the next step in the ongoing process of personalisation of PEs. The main objection to allowing PEs to claim treaty benefits is the potential for treaty shopping, however, as will be discussed below, any additional risk of treaty shopping is likely to be counteracted by the economic basis for determining the profit attributable to a PE.

#### *Whether source state should apply the conditions of the R-S treaty*<sup>104</sup>

If the taxation in the source state is made subject to the conditions contained in PE-S treaty, then the question arises as to whether the R-S treaty should continue to apply. If the R-S treaty does continue to apply then the source state will be obliged to satisfy the relevant conditions of both the R-S treaty and the PE-S treaty. This would have no impact to the extent that both the R-S treaty and the PE-S treaty follow the OECD Model, however, if the relevant conditions differ between the two treaties the source state could only fulfil its treaty obligations by applying the conditions which are most favourable to the person deriving the income. The source state is unlikely to be satisfied with this outcome and thus, from the source state's perspective, it would generally be desirable to exclude the application of the R-S treaty if the PE-S treaty is to be applied. Excluding the R-S treaty also addresses treaty shopping concerns. However, if the operation of the R-S treaty is completely excluded in relation to the income attributable to the PE, then the residence state will have no obligation to provide relief for tax imposed in the source state. If the income attributable to the PE is exempt in the residence state (either under domestic law or under the PE-S treaty) then this will of course not be a problem, but if the residence state uses the credit method of relief in the R-PE treaty and does not provide relief for tax imposed in the source state under domestic law, then unrelieved double taxation may occur. If the residence state uses the credit method to provide relief for tax imposed in the PE state then the residence state then it should therefore continue to have an obligation to provide relief (either exemption or credit) for tax imposed in the source state.

#### **2.5. Underlying issues and potential solutions**<sup>105</sup>

In order to identify potential solutions to the problems arising in PE triangular cases, it is helpful to examine their underlying causes. This section will therefore discuss those causes along with the potential solutions which they suggest.

#### *Overlap between treaty source rules*<sup>106</sup>

One of the reasons why problems arise in PE triangular cases is that there is an overlap between the source rules contained in the R-S treaty and those contained in the R-PE treaty.<sup>107</sup> For the purposes of the R-S treaty, the income is generally considered to be sourced in State S and, depending on the type of income involved, State S

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<sup>103</sup> Baker, P. & Collier, R., "General Report," at p 37.

<sup>104</sup> This is discussed in more detail in Chapter 5 (Section 5.3.).

<sup>105</sup> This section provides a summary of the discussion in Chapter 6.

<sup>106</sup> This is discussed in more detail in Chapter 6 (Section 6.2.1. and Section 6.4.).

<sup>107</sup> Vogel, K., "'State of Residence' may as well be 'State of Source' – There is no Contradiction," 59 *Bulletin for International Fiscal Documentation* 10, (2005), pp 420-423.

may be entitled to impose tax. For the purposes of the R-PE treaty, on the other hand, the income which is attributable to the PE is effectively considered to be sourced in the PE state. The PE concept is not generally considered to be a sourcing rule; rather, it establishes a minimum threshold below which no tax can be imposed on locally sourced business profits.<sup>108</sup> However, in allowing source based taxation, the existence of a PE effectively means that the income attributable to the PE is considered to be sourced in the PE state for treaty purposes. This overlap in the source rules can give rise to problems in PE triangular cases because both the PE state and the source state may be entitled to impose tax on the income on a source basis.

If the PE concept is viewed purely as a source concept, then the appropriate response to the problems arising in PE triangular cases, at least from a theoretical perspective, would be to resolve the overlap between the implicit sourcing rules contained in the R-S treaty and those contained in the R-PE treaty.<sup>109</sup> This would involve preventing either the source state or the PE state from imposing tax in PE triangular cases and would result in the situation effectively becoming bilateral. As a result, there would be no need for the PE state to provide any relief and no need to alter the applicable treaty conditions in the source state. One of the main advantages of this approach is its relative simplicity. It does not require provisions to be included in multiple treaties, meaning that there is less potential for mismatch between the terms of different treaties and that there is no need to be concerned about an incomplete implementation, i.e., where one of the relevant treaties does not include the required provisions.

Preventing the PE state from imposing tax in PE triangular cases would effectively redefine the source rules contained in the R-PE treaty such that income which has a strong economic connection to a third state would not be considered to be sourced in the PE state for the purposes of that treaty, thus resolving the overlap in favour of the source state.<sup>110</sup> This may involve the income being excluded from the income attributable to the PE. If this approach were implemented, however, it would undermine the residence-supporting role of the PE concept in tax treaties<sup>111</sup> and would give rise to significant tax avoidance concerns. The tax avoidance concern here primarily relates to companies which are currently resident in the PE state or are contemplating establishing residence in the PE state. If tax treaties incorporated a provision eliminating taxation of third country income attributable to PEs (i.e., by excluding such income from the profit attributable to PEs), then such companies would have a strong incentive to shift their residence to states with lower tax rates or, if possible, to states which unilaterally exempt the income attributable to foreign PEs. In this way, a company could lower the rate of residence-based taxation imposed on income derived from sources in third states (potentially to zero) while continuing to conduct its activities in what is now the PE state without triggering any tax liability in that state in relation to such income.<sup>112</sup>

Alternatively, the source state could be prevented from taxing income which is attributable to a PE in a third state.<sup>113</sup> This would effectively resolve the overlap in the sourcing rules in favour of the PE state. However, if

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<sup>108</sup> Arnold, B.J., "Threshold Requirements for Taxing Business Profits Under Tax Treaties," *57 Bulletin for International Fiscal Documentation* 10, (2003), at 473.

<sup>109</sup> This is discussed in more detail in Chapter 6 (Section 6.4.).

<sup>110</sup> Preventing taxation in the PE state is discussed in Chapter 6, Section 6.4.1.

<sup>111</sup> As outlined by: Vann, R., "Reflections on Business Profits..." at p 147.

<sup>112</sup> For an example of how this approach may lead to opportunities for tax avoidance, refer to Chapter 6 (Section 6.4.1.2.).

<sup>113</sup> This is discussed in Chapter 6, Section 6.4.2.

source states were prevented from imposing tax on income derived in PE triangular cases, then all source-based taxation could be avoided simply by operating through a PE in a third state (i.e., outside the residence state and the source state). These tax avoidance concerns could be mitigated by including a proviso that the source state may tax the income in accordance with the ordinary distributive rules of the R-S treaty if the income is not taxed in the PE state (i.e., a subject-to-tax clause), or is subject to a lower rate of tax than the source state considers to be sufficient (e.g., 60% of the residence state tax rate). However, there may still be a significant advantage in deriving income through a PE to avoid source based taxation and consequently, potential opportunities for tax avoidance.

Another objection to dealing with PE triangular cases by resolving the overlap in the source rules is that the income has a legitimate economic connection to both the source state and the PE state and thus, both the PE state and the source state arguably have a valid taxing claim in relation to the income. It follows that neither state should be required to completely surrender its taxing rights and in practice, are states are unlikely to be willing to do so. For this reason, and due to the significant tax avoidance concerns which arise, this approach is not a viable solution for dealing with PE triangular cases.

#### *Bilateral nature of tax treaties*<sup>114</sup>

The bilateral nature of tax treaties is frequently identified as the main cause of the issues arising in PE triangular cases.<sup>115</sup> However, the issue is not so much that tax treaties themselves are bilateral, but rather, that their provisions generally only contemplate bilateral situations and are not intended to interact with the provisions of other treaties. This lack of interaction between tax treaties has an impact in PE triangular cases in a number of ways. Most clearly, the allocation of primary (or exclusive) taxing rights to the PE state under the R-PE treaty is not recognised for the purposes of the application of the PE-S treaty, i.e., the PE state is not required to grant relief under the PE-S treaty and the source state is not required to apply its conditions in relation to income attributable to the PE. Alternatively, if the PE is viewed as a purely source-based concept, then lack of interaction between the R-S treaty and the R-PE treaty results in an overlap in the treaty source rules (as discussed above). The sourcing of income in a particular state under a bilateral tax treaty has no impact on where the income is considered to be sourced for the purposes of other bilateral treaties, and there is no mechanism to resolve any overlap.

The issues arising as a result of the lack of interaction between bilateral treaties suggests that PE triangular cases could be dealt with by concluding multilateral treaties.<sup>116</sup> However, as discussed in Chapter 6, the conclusion of a multilateral treaty would not automatically resolve PE triangular cases and thus, the contracting states would still need to agree on how the treaty should apply in such cases. In general, the possible approaches under multilateral treaties mirror the options available for resolving the issues arising in PE triangular cases under bilateral tax treaties.<sup>117</sup> For example, all three states could be allowed to impose tax with the PE state and

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<sup>114</sup> This is discussed in more detail in Chapter 6 (Section 6.2.3. and Section 6.5.).

<sup>115</sup> See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases," para 1.

<sup>116</sup> Multilateral treaties are discussed in Chapter 6, Section 6.5.

<sup>117</sup> For an overview of the possible approaches, refer to Chapter 6, Section 6.5.2. For an analysis of the provisions of existing multilateral treaties, refer to Chapter 6, Section 6.5.1.

residence state being obliged to grant relief, or either the PE state or the source state could be prevented from imposing tax on the income.

A multilateral treaty has a number of advantages for dealing with PE triangular cases.<sup>118</sup> Perhaps most importantly, the same conditions would generally apply in the source state regardless of whether the income is derived by a resident of the PE state or of the residence state and thus, a major complication and issue which usually arises in triangular cases is simply not relevant in a multilateral treaty context (i.e., the applicable treaty conditions in the source state). The application of the same treaty conditions with respect to both the residence state and the PE state also limits concerns regarding the potential for treaty shopping. The primary issue which must be dealt with in PE triangular cases in a multilateral treaty context is therefore the prevention of unrelieved double taxation, which is likely to be relatively easy to resolve.

Despite the advantages of multilateral treaties for dealing with triangular cases, the practical difficulties involved in concluding and maintaining such treaties make this solution problematic. The primary obstacle to concluding multilateral treaties is likely to be the difficulty involved in getting multiple states to agree to the terms of the treaty.<sup>119</sup> It would also be more difficult to renegotiate and amend a multilateral treaty, given that any changes would likely require the unanimous agreement of all the contracting states.<sup>120</sup> A multilateral treaty will also be less flexible in dealing with the particular circumstances of the countries involved and the differences between their tax systems.<sup>121</sup> Perhaps most importantly, the standardisation of distributive rules under a multilateral treaty (in particular the withholding tax rates for passive income) could substantially alter the global distribution of taxing rights, which would be unwarranted if the intention is simply to deal with PE triangular cases. Multilateral treaties could resolve the issues arising in PE triangular cases, but the difficulty inherent in concluding and updating multilateral treaties and the impact on the distribution of taxing rights means that unless there are other strong motivating factors, this solution is unlikely to be implemented in practice.

#### *Hybrid nature of the PE concept*<sup>122</sup>

As discussed above, the PE concept is generally considered to be a threshold for determining the minimum presence required in order for a state to impose source-based taxation on business profits, and effectively operates as a sourcing rule for treaty purposes. There are, however, a number of reasons (as discussed in Chapter 5) for considering the PE concept as something of a quasi-residence concept or at least a "residence-supporting" concept. This gives rise to problems in PE triangular cases where the income which is attributable to the PE and which the PE state is entitled to tax under the R-PE treaty includes income which is sourced in a third state. Like a resident of the PE state, the PE is taxed on its worldwide income but, unlike a resident, the PE has no corresponding entitlement to treaty benefits. As a result, the PE state has no direct obligation to grant relief for tax imposed in the source state (although an obligation may arise under non-discrimination principles) and the source state has no obligation to apply the conditions of the PE-S treaty. Thus, issues can arise in PE

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<sup>118</sup> For a more detailed discussion, see Chapter 6, Section 6.5.3.

<sup>119</sup> Arnold, B.J., Sasseville, J., and Zolt, M. "Summary of the Proceedings..."; Schön, W., "International Tax Coordination..."

<sup>120</sup> Schön, W., "International Tax Coordination..."; McIntyre, M.J., "Options for Greater International Coordination and Cooperation in the Tax Treaty Area," 56 *Bulletin for International Fiscal Documentation* 6, pp 250-253.

<sup>121</sup> McIntyre, M.J., "Options for Greater..."

<sup>122</sup> This is discussed in more detail in Chapter 6 (Section 6.2.2.).

triangular cases because PEs are treated partially, but only partially, in the same way residents of the PE state for treaty purposes.

This could be dealt with by treating the PE concept as a pure source concept and resolving the overlap in the sourcing rules by preventing either the PE state or the source state from imposing tax. However, as discussed above, this is not a viable solution since both the PE state and the source state arguably have a legitimate claim to impose tax and because it gives rise to significant tax avoidance concerns. The better approach would be to treat the PE concept more like a residence concept, and thus extend treaty benefits to PEs.

## **2.6. Application of the treaty between the PE state and the source state<sup>123</sup>**

The issues arising in PE triangular cases could be comprehensively dealt with by allowing the person deriving the income to claim the benefit of the PE-S treaty in relation to the income attributable to the PE. If implemented, this would generally resolve the issues arising in PE triangular cases as follows:

1. The source state would apply the conditions of its treaty with the PE state (the PE-S treaty) instead of the conditions of the R-S treaty in relation to the income attributable to the PE. The source state is therefore applying the more appropriate treaty conditions;
2. The PE state would be required to provide relief for tax imposed in the source state, using the method specified under the PE-S treaty (either exemption or credit). The provision of relief in the PE state would generally ensure, in conjunction with relief in the residence state, that there would be no unrelieved double taxation in PE triangular cases; and
3. The residence state would provide relief for tax imposed in the PE state and/or the source state to the extent that such relief is required to prevent unrelieved double taxation. This may take the form of either exemption or credit relief, depending on the terms of the applicable treaties and the category of income involved.

Applying the PE-S treaty to the income attributable to the PE, and thus effectively allowing the PE to claim treaty benefits, would represent a dramatic departure from the existing treaty principles. However, given the hybrid nature of the PE concept and the extent of the similarities between the taxation of PEs and the taxation of resident enterprises, the implications of this approach would perhaps be less drastic than they may appear at first glance. Applying the PE-S treaty in PE triangular cases would certainly represent less of a departure from the existing international tax framework than a solution based on the conclusion of multilateral treaties and would also have less of an impact on the distribution of taxing rights than a solution which prevents either the PE state or the source state from imposing tax in PE triangular cases.<sup>124</sup>

It is recognised, however, that states may not be willing to implement such a fundamental change in the personal scope of tax treaties, particularly in light of the perceived risk for tax avoidance and, in particular, the

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<sup>123</sup> This section provides an overview of the discussion in Chapters 7 and 8 and certain parts of Chapter 5 (namely, Section 5.2.5. regarding the potential for treaty shopping through PEs).

<sup>124</sup> Refer to Chapter 6 for a detailed discussion of these potential solutions for PE triangular cases.

potential for treaty shopping through PEs (which is discussed further below).<sup>125</sup> In this case, it would still be possible to resolve perhaps the most pressing issues by including provisions in tax treaties which (i) explicitly require the PE state to grant relief for tax imposed in the source state and (ii) exclude the operation of tax treaties in relation to income attributable to a PE in a third state in circumstances where the contracting states consider the application of the treaty to be improper (i.e., the R-S treaty). This would both ensure that there is no unrelieved double taxation and prevent abuse of the treaty between the residence state and the source state. However, the source state would continue to apply the less appropriate treaty conditions to the income attributable to the PE.

#### *Approaches to extending treaty benefits to PEs*<sup>126</sup>

There are two primary ways of extending treaty benefits to PEs, which are distinguished by the way in which the conditions PE-S treaty are made to apply. These two approaches are as follows:

1. The direct approach: The source state is required to apply the conditions of the PE-S treaty in relation to income attributable to the PE and the PE state is required to grant relief (either exemption or credit) for tax imposed in the source state by provisions included directly in the PE-S treaty.
2. The indirect approach: The source state is required to apply the conditions of the PE-S treaty indirectly by provisions included in the R-S treaty. The PE state is required to provide relief for tax imposed in the source state (either exemption or credit) under specific provisions included in the R-PE treaty.

It may also be possible to extend treaty benefits to PEs unilaterally under domestic law, under the mutual agreement article of the PE-S treaty, or under provisions included in all three treaties; these alternative options were discussed in detail in Chapter 7.<sup>127</sup> However, applying the PE-S treaty directly under its own terms is clearly preferable to the other alternatives. It results in the PE being treated, as closely as possible, in the same way as a resident enterprise of the PE state and ensures neutral treatment of PEs located in a particular state (i.e., the PE state) and deriving income from another state (i.e., State S), regardless of the residence state of the entity as a whole. It also ensures that the split of tax revenue between the PE state and the source state in relation to income from cross-border activities is a product of the provisions of the treaty negotiated between those two states. Furthermore, in contrast to the indirect approach, the direct approach avoids the potential for unbalanced applications of the PE-S treaty due to a partial implementation, i.e., where the PE-S treaty is applied in only one of the contracting states.

#### ***Proposed treaty provisions***

The treaty provision extending treaty entitlement to PEs could be worded as follows:

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<sup>125</sup> The OECD's 1992 report on PE triangular cases finds that "The majority of states are strongly opposed to such a solution (i.e., extending treaty benefits to PEs), above all because such states fear it might encourage 'treaty shopping'..." (OECD Committee on Fiscal Affairs, "Triangular Cases," para 39).

<sup>126</sup> For further discussion of the possible approaches to extending treaty benefits to PEs, refer to Chapter 7 (Section 7.3.).

<sup>127</sup> Refer to Section 7.3.

- "(1) For the purposes of this Convention, notwithstanding the provisions of Article 1 (Persons Covered),
- (a) where a person, who is not a resident of either of the Contracting States, has a permanent establishment in one of the Contracting States for the purposes of a convention between Contracting State where the permanent establishment is located and a third state, then this Convention shall apply to any income included in the profit attributable to the permanent establishment (for the purposes of the convention between the Contracting State where the permanent establishment is located and the state where the person is resident) as though that income were income of a resident of the Contracting State in which the permanent establishment is located. However, this Convention shall not apply to income which the Contracting State where the permanent establishment is located is prevented from taxing under the convention between that State and the person's residence state or between that State and a third state.
  - (b) where a person who is not a resident of either of the Contracting states, carries on business in State A through a [permanent establishment] (as defined under the laws of State A) and that person is not considered a resident of a third state for the purposes of a convention between State A and that third state, then this Convention shall apply to any income included in the profit attributable to the [permanent establishment] (under the domestic law of State A) as though that income were income of a resident of State A. However, the Convention shall not apply under this paragraph to income which State A is prevented from taxing under a convention with a third state.
  - (c) where a person who is not a resident of either of the Contracting states, carries on business in State B through a [permanent establishment] (as defined under the laws of State B) and that person is not considered a resident of a third state for the purposes of a convention between State B and that third state, then this Convention shall apply to any income included in the profit attributable to the [permanent establishment] (under the domestic law of State B) as though that income were income of a resident of State B. However, the Convention shall not apply under this paragraph to income which State B is prevented from taxing under a convention with a third state.
- (2) This Article shall apply to capital gains and to profits in the same way as it applies to income.
- (3) Any income, capital gains or profits to which this Convention applies as a result of paragraph 1 shall be considered to be paid to, derived by and beneficially owned by a person who is a resident of the Contracting State where the permanent establishment, [equivalent term in State A] or [equivalent term in State B] is located for the purposes of the application of this Convention under paragraph 1.

Paragraph 1(a) of this provision applies where the enterprise to whom the PE belongs is resident in a state which has concluded a treaty with the PE state. Paragraphs 1(b) and 1(c), on the other hand, apply in cases where the enterprise is not resident in a state which has a treaty with the PE state, in keeping with the view that the residence state of the enterprise is not relevant to the extension of treaty benefits to the PE.<sup>128</sup> However, where these paragraphs apply, treaty benefits should be available on the basis of the PE threshold of domestic law (or an equivalent domestic threshold) being satisfied. The wording of these provisions would therefore have to be adapted to refer specifically to the domestic laws of each of the contracting states. Alternatively, the contracting states could exclude these paragraphs and apply the PE-S treaty only in situations where there is a treaty in place between the residence state and the PE state.

Paragraph 2 of this proposed provision ensures that it applies to business profits and capital gains in the same way as it applies to other types of income. Paragraph 3 is included to ensure that the various articles of the OECD Model will apply regardless of the varying terms used to establish their application,<sup>129</sup> and to ensure that the treaty is applied as though the income were beneficially owned by a resident of the PE state (as discussed below). The following sections highlight other key aspects of the operation of this provision.

#### *Person claiming the benefit of the provision*

It is sometimes suggested that treaty benefits should be extended to PEs by expanding the definitions of "person" and/or "resident" (in Articles 3 and 4, respectively) in such a way that PEs would become treaty-eligible resident persons.<sup>130</sup> This approach implies that it is the PE itself which claims the benefits of the treaty, rather than the entity to which it belongs. Allowing the PE to claim treaty benefits on its own account would be fully consistent with treating the PE as a separate entity and would generally result in the treaty being applied to PEs in the same way as it applies to persons resident in the PE state. However, treating the PE as a person for treaty purposes and allowing it to claim treaty benefits directly is likely to result in a mismatch between the "person" claiming treaty benefits and the person upon whom tax is imposed under the domestic laws of the states involved. These problems could be avoided relatively easily by structuring the provision in such a way that it is the entity to which the PE belongs who claims treaty benefits under the PE-S treaty in relation to the income attributable to the PE and the provision outlined above is worded in this way.<sup>131</sup> One consequence of this approach is that the person claiming treaty benefits is not resident in either of the contracting states, and therefore does not fall within the personal scope of the treaty. The provision outlined above is therefore worded to operate as an exception to Article 1 ("...notwithstanding the provisions of Article 1...").<sup>132</sup>

#### *Income must be attributable to a PE for the purposes of the R-PE treaty*

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<sup>128</sup> This is discussed in detail in Chapter 8 (see Section 8.3.1.1.). The main reason for considering the residence of the person to be irrelevant is that, after the provision of relief under the applicable tax treaties, the residence state is likely to either exempt the income or impose only a small amount of residual taxation. The fact that no tax is imposed in the residence state should therefore have no impact on the availability of treaty benefits to the PE and, as a result, there seems to be no reason to limit treaty benefits to PEs which belong to a person resident in a state that has a treaty with the PE state.

<sup>129</sup> Refer to Chapter 8 (Section 8.2.5.) for a brief overview of the various terms used the OECD Model.

<sup>130</sup> See, for example: Yong, S., "Triangular Treaty Cases..."; Langoth, B. "Treaty Entitlement..."

<sup>131</sup> For further discussion, see Chapter 8 (Section 8.2.1.).

<sup>132</sup> For further discussion, see Chapter 8 (Section 8.2.2.).

If specific provisions are included in the PE-S treaty to extend treaty benefits to PEs, they should only apply in circumstances where there is a PE in the PE state for the purposes of the R-PE treaty, and the income is attributable to that PE.<sup>133</sup> However, if no specific reference is made to the R-PE treaty then the applicable PE definition will be that contained in the PE-S treaty. The first paragraph (paragraph 1(a)) of the proposed provision therefore refers specifically to the R-PE treaty, and ensures that it applies only in situations where the income is attributable to a PE in the PE state for the purposes of the R-PE treaty. This ensures that no mismatches occur with respect to the existence of a PE between the application of the R-PE treaty and the application of the PE-S treaty.

*No treaty benefits if PE state prevented from imposing tax*

The proposed provision outlined above also includes wording to the effect that treaty benefits will not be available to the PE in relation to income which the PE state is prevented from taxing under its treaty with the residence state. This may potentially occur, for example, in relation to income from shipping and air transport (under Article 8), where the distribution of taxing rights does not depend on the existence of a PE. Clearly the conditions of the treaty between the PE state and the source state should not apply in these circumstances, even if the income is attributable to a PE in the PE state.

*Residence and beneficial ownership<sup>134</sup>*

Before an entity is eligible for reductions in source-based taxation under a tax treaty, it must generally be resident in one of the contracting states<sup>135</sup> and, in relation to dividends, interest and royalties, it must be the beneficial owner of the income.<sup>136</sup> However, these requirements should arguably not apply in the case of a PE claiming treaty benefits. In a PE triangular case, it is likely that the income attributable to the PE will either not be taxed at all in the residence state (e.g., if the residence state exempts the income) or will be only minimally taxed (e.g., if the residence state grants credit relief). This is the case regardless of whether the residence state is a high or low taxing country or is, indeed, a tax haven. The state in which the entity to which the PE belongs is resident should therefore not have any influence on whether treaty benefits are available to the PE.<sup>137</sup> For this reason, the entity as a whole should not be required to satisfy any residence requirement in order for the PE to be entitled to treaty benefits. It follows that the entity to which the PE belongs should also not be required to be the beneficial owner of the income, since the residence of the beneficial owner is not relevant for determining whether treaty benefits should be available to the PE.<sup>138</sup>

A PE should also not be required to satisfy any additional "residence-type" criteria (i.e., at the level of the PE) in order for the PE-S treaty to apply. Arguably, a resident enterprise is effectively created in the PE state as a result of the PE being located there,<sup>139</sup> and thus, the existence of a PE and the attribution of income to that PE should

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<sup>133</sup> For further discussion refer to Chapter 8 (Section 8.2.3.).

<sup>134</sup> This section gives an overview of the discussion in Chapter 8, Section 8.3.

<sup>135</sup> In accordance with the residence definition contained in the treaty (in the OECD Model, Article 4).

<sup>136</sup> See: OECD Model, Article 10 (2), Article 11(2) and Article 12(1).

<sup>137</sup> Refer to the discussion in Chapter 8, Section 8.3.1.1.

<sup>138</sup> Refer to the discussion in Chapter 8, Section 8.3.2.1.

<sup>139</sup> This was discussed in Chapter 5, see Section 5.2.4.

be sufficient. Furthermore, the direct application of a beneficial ownership concept to PEs is not feasible because PEs are generally not separate legal entities. Rather than trying to adapt the beneficial ownership concept to apply to PEs, the best approach would simply be to rely on the existing concepts which are used for determining the profit attributable to the PE. These concepts are well developed and result in an allocation of income to the PE on an economic basis, linked to the activities carried out by the PE. Assets giving rise to passive income, for example, will only be economically owned by a PE if active decision making with regard to whether to make the investment, and the ongoing management of the investment, is undertaken by personnel working in the PE.<sup>140</sup> This is clearly a much higher standard than is required in order for income to be earned (and beneficially owned) by a subsidiary company. Consequently, where income is attributable to the PE for treaty purposes, this connection to the activities of the PE should be sufficient to entitle the PE to claim reductions in source based taxation on dividends, interest and royalties under the PE-S treaty without the need for any additional beneficial ownership-type requirement to be satisfied. The proposed provision outlined above therefore deems the income attributable to the PE to be beneficially owned by a resident of the PE state for the purposes of applying the treaty.

#### *Certification procedure*<sup>141</sup>

Claims for treaty benefits must typically be supported by an endorsement from the residence state of the person claiming treaty benefits, usually in the form of a residence certificate.<sup>142</sup> Where a PE is claiming treaty benefits, the PE state should clearly be involved in this process,<sup>143</sup> since the PE state is effectively functioning as the residence state with respect to that claim for treaty benefits. The residence state should also be involved, however, as this would facilitate the application of the R-S treaty, particularly in cases where that treaty incorporates provisions dealing with PE triangular cases, although the residence states involvement would not be essential since, as discussed above, the availability of the PE-S treaty would not depend on the residence of the person as a whole. The development of a certification procedure for treaty claims in relation to the income attributable to PEs would not require specific provisions to be included in the treaty, but a standard procedure should be developed. Under this procedure, the PE state would certify that the person involved has a PE in that state for the purposes of the R-PE treaty and that the income is attributable to that PE. The residence state on the other hand, if it is involved, would certify that the person involved is resident in that state and that the income in question is attributable to a PE in the PE state. These certifications would generally have to be based on representations from the person involved, but would at least ensure that the taxpayer is making consistent representations in all three states.

#### ***Potential for improper access to treaties through PEs***<sup>144</sup>

One of the main concerns with extending treaty benefits to PEs is the potential for tax avoidance and, in particular, the potential for treaty shopping through PEs. States face significant challenges in combating treaty

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<sup>140</sup> OECD, "2010 Report...", Part I, Section B-3(i), note 4. and Part I, Section D-2(iii)(a), para 72.

<sup>141</sup> This section gives an overview of the discussion in Chapter 8, Section 8.3.3.

<sup>142</sup> Russo, R., "Administrative Aspects of the Application of Tax Treaties," 63 *Bulletin for International Taxation* 10, (2009), pp. 482-488.

<sup>143</sup> OECD, "Triangular Cases," at paras 51 and 52.

<sup>144</sup> This was discussed in Chapter 5 (see Section 5.2.6.)

shopping under existing principles<sup>145</sup> and for this reason, they may be understandably reluctant to open up a further avenue for claiming treaty benefits. Nevertheless, concerns about treaty shopping through PEs may be offset by the fact that the income of a PE is determined through a process of allocation, requiring a determination of the amount of income that is properly attributable to the PE on an economic basis.<sup>146</sup> As a result, states may actually find it easier to challenge what they consider to be improper claims for treaty benefits when those claims involve PEs than when they involve legal entities. In general, a much greater level of activity would generally be required in the PE state in order for the income to be properly attributable to the PE than that which would be required for a legal entity to be the beneficial owner of income. Where this standard has been met, and it has been agreed that the income is economically the income of the PE and arises from the PEs activities, it seems difficult to accept that the source state may refuse to apply the conditions of the PE-S treaty. In addition, the risk of treaty shopping could be further reduced by including specific provisions in tax treaties to prevent PEs from claiming treaty benefits in situations where such a claim would be considered improper.

*Specific provisions aimed at preventing improper access to treaties through PEs*

The OECD Commentary on Article 1 suggests various provisions that could be included in tax treaties to combat treaty shopping,<sup>147</sup> a number of which could be adapted to deal with improper claims for treaty benefits through PEs. Set out below is an overview of these provisions, which are discussed in greater depth in Chapter 8. Suggested wording for the provisions is given at the end of this chapter.

*Subject-to-tax provisions:*<sup>148</sup> A provision could be included in the PE-S treaty to the effect that any exemptions or reductions available to a PE under the treaty will only apply if the income in question is taxable in the PE state under the ordinary rules of that state's tax law. Preferably, however, the provision could operate by reference to the tax that would be imposed on a resident enterprise deriving the same income.

*Anti-base erosion provisions (the "channel approach"):*<sup>149</sup> A base erosion test for PEs could provide that a PE will only be entitled to treaty benefits if, for example, less than 50% of the income attributable to the PE is paid or accrued to persons who are not resident in either of the contracting states in the form of payments that are deductible, including notional payments to other parts of the enterprise to which the PE belongs, but excluding arm's length payments in the ordinary course of business for services or tangible property.

*Denial of benefits where there is a tax avoidance motive:*<sup>150</sup> A specific provision may deny reductions in source-based taxation in relation to dividends, interest, royalties and other income which would otherwise be available to the PE if "it was the main purpose or one of the main purposes of any person concerned with," for example, any actions which cause the income to be attributable to a PE in one of the Contracting States, in order to obtain a reduction in source-based taxation under the treaty. The exact wording of this type provision would have to

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<sup>145</sup> Refer to the discussion of the ways in which states currently combat treaty shopping in Chapter 5 (Section 5.2.6.1.).

<sup>146</sup> Refer to the discussion in Chapter 5 (Section 5.2.6.2.)

<sup>147</sup> OECD Model on Article 1, paras. 13-26. These provisions are discussed in Chapter 8 (Section 8.4.).

<sup>148</sup> Refer to the discussion in Chapter 8, Section 8.4.2.

<sup>149</sup> Refer to the discussion in Chapter 8 (Section 8.4.3.). See also the suggested provisions in the OECD Commentary on Article 1, para 17 and para 20 (clause 2(e)).

<sup>150</sup> Refer to the discussion in Chapter 8 (Section 8.4.4.).

be determined by the contracting states, who may wish to give further consideration to the types of activities or actions which would be taken into account when applying the provision.

*Safe harbour provisions:*<sup>151</sup> Where the PE-S treaty contains specific anti-abuse provisions, such as those outlined above, it should also include safe harbour provisions to allow PEs to claim treaty benefits in situations where such claims would be considered legitimate but which nonetheless trigger a denial of treaty benefits under a specific anti-abuse provision included in the treaty.

### ***Excluding the operation of the R-S treaty***<sup>152</sup>

One of the primary concerns that arises in relation to PE triangular cases under the existing treaty framework is the potential for improper claims for treaty benefits. That is, the source state may be required to reduce the amount of tax it imposes on income as a result of the application of the R-S treaty in situations where the income is exempt in the residence state by virtue of being attributable to a PE located in a third state, and where the PE state imposed no (or minimal) tax on the income.<sup>153</sup>

Various existing treaties contain provisions which are intended to counteract claims for treaty benefits in relation to income attributable to a PE in a third state in certain circumstances that are considered to be abusive.<sup>154</sup> These provisions generally exclude the normal reductions in source based taxation under the treaty where income is attributable to a PE located in a third state, and commonly contain exceptions for situations which are not considered to be abusive. The inclusion of a specific provision in tax treaties to exclude treaty benefits in relation to income which is attributable to a PE in a third state has a number of advantages. It allows the states involved to specify the situations which they consider to give rise to improper claims for treaty benefits, and to prevent claims for treaty benefits in such cases. In comparison to an approach which is based, for example, on the application of domestic anti-avoidance measures, the inclusion of a specific provision in the treaty means that there is no need for the tax authority of the source state to identify the situation and challenge the claim for treaty benefits, which may or may not be successful. In addition, where treaty benefits are denied under a specific provision of the tax treaty, there is no question of whether or not the source state has failed to meet its treaty obligations by denying benefits.<sup>155</sup> Specific provisions also give taxpayers greater certainty as to the way in which the treaty will apply in their particular circumstances.

If treaty benefits are extended to PEs, then in addition to dealing with treaty shopping concerns, the exclusion of the normal provisions of the PE-S treaty in relation to income attributable to a PE in a third state would serve to prevent the source state from being subject to multiple treaty restrictions with respect to the same income.<sup>156</sup>

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<sup>151</sup> Refer to the discussion in Chapter 8 (Section 8.4.6.). See also: OECD Commentary on Article 1, para 19.

<sup>152</sup> This section gives an overview of the discussion in Chapter 7, Section 7.5.

<sup>153</sup> OECD, "Triangular Cases," at para 21. See also: Van Weeghel, S., *The Improper Use...*, at pp. 124-126.

<sup>154</sup> For a detailed discussion of these provisions, refer to Chapter 7 (Section 7.5.1.1.).

<sup>155</sup> For discussion of the potential for the application of domestic anti-avoidance measures in a treaty context to contravene international law, see: Arnold, B.J., & Van Weeghel, S., "The Relationship Between Tax Treaties & Domestic Anti-abuse Measures," bound in Maisto, G. (Ed.), *Tax Treaties and Domestic Law*, (Amsterdam: IBFD, 2006), pp. 81-120 (Chapter 5).

<sup>156</sup> Refer to the discussion in Chapter 7 (Section 7.5.2.).

In order to deal with situations where there is either no PE-S treaty or the PE-S treaty does not apply, the best approach would be to combine a provision excluding the operation of the R-S treaty in cases where the PE-S treaty applies with a provision along the lines of those included in existing treaties which excludes its operation in situations where access to the treaty is considered improper. This would prevent the source state from being obliged to apply the conditions of the R-S treaty in what may be considered abusive situations, but would allow the R-S treaty to continue to apply in situations where the source state doesn't apply the conditions of the PE-S treaty and the application of the R-S treaty is not considered improper.

Thus, ideally, the R-S treaty would include provisions to the effect that its conditions do not apply in relation to income attributable to a PE in a third state if either:

1. The source state applies the conditions of the PE-S treaty in relation to that income; or
2. The source state does not apply the conditions of the PE-S treaty, but the situation is one where the application of the conditions of the R-S treaty would be considered improper.

A provision excluding the application of the R-S treaty in the above circumstances could be worded along the following lines:

"(1) Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third state for the purposes of a convention between the Contracting State of the enterprise and that third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the profits of the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and third state that is less than [60] percent of the general company tax rate applicable in the first-mentioned Contracting State. Any dividends, interest or royalties to which the provisions of this paragraph apply shall be subject to tax in the other Contracting State at a rate that shall not exceed [15] percent of the gross amount thereof. Any other income to which the provisions of this paragraph apply shall be subject to tax under the provisions of the domestic law of the other Contracting State, notwithstanding any other provision of the Convention. The provisions of this paragraph shall not apply if:

- a) In the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself; or
- b) In the case of any other income, the income derived from the other Contracting State is derived in connection with or is incidental to, the active conduct of a business carried on by the permanent establishment in the third state (other than the business of making, managing or simply holding investments for the enterprise's own account).

- (2) Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third state for the purposes of a convention between the Contracting State of the enterprise and that third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the other Contracting State applies the conditions of a convention between that State and the third state in relation to that income."

Paragraph 1 of this provision is based on the wording of the provisions of certain US treaties, with minor modifications. One of these modifications clarifies that the provision applies if, and only if, a PE exists for the purposes of the R-PE treaty. The second paragraph ensures that the R-S treaty does not apply in situations where the source state applies the conditions of its treaty with the PE state.

*Continued relief obligation in the residence state*

Where the residence state exempts the income attributable to the PE, there will be no need for any additional relief in the residence state. However, where the residence state uses the credit method in relation to the income attributable to the PE, then unrelieved double taxation may persist unless the residence state continues to grant relief in accordance with the provisions of the R-S treaty. To preserve the operation of the relief provisions of the R-S treaty in the residence state, treaties could include the following paragraph (in addition to those outlined above):

- "(3) Where the tax benefits which would otherwise be available under the other provisions of this Convention do not apply as a result of paragraph 1 or paragraph 2, the Contracting State where the person deriving the income is resident shall continue to apply [Article 23A/ Article 23B]. However, that State shall not apply [Article 23A/Article 23B] if the other Contracting State is prevented from imposing tax on the income under the terms of a convention with a third state. Where a Contracting State applies [Article 23A / Article 23B] under this paragraph, it shall be applied as though the other Contracting State has applied the other provisions of this Convention in relation to the income."

This provision requires the residence state to continue applying the relief provisions of the R-S treaty, but allows it to apply those provisions as though the source state had also applied the conditions of the treaty. This means, for example, that the residence state will not be obliged to provide relief in relation to income which the source state would have been prevented from taxing if it had applied the conditions of the R-S treaty (e.g., where it is not prevented from taxing under the PE-S treaty). It also means that, in relation to passive income, the residence state will not be obliged to provide credit relief for any tax in excess of the amount the source state could have imposed under the R-S treaty. Where the residence state grants credit relief, the amount of the credit will also naturally be limited to the amount of tax actually imposed in the source state by the existing wording of the relief provisions. Furthermore, the proposed provision does not require the residence state to apply the relief provisions of the R-S treaty if the source state is prevented from imposing tax under the terms of the PE-S treaty; this is particularly relevant where the residence state uses the credit method under the R-PE treaty and the exemption method under the R-S treaty.

It is also important to keep in mind the interaction between the relief provision of the R-S treaty and the relief provisions of the R-PE treaty. In general, if one or both of the two applicable treaties requires the residence state to provide relief using the exemption method, then the residence state must simply exempt the income. Similarly, if the two treaties provide for different methods of relief, then the residence state must generally exempt the income. The residence state will only provide credit relief, therefore, if both the applicable treaties provide for credit relief.

## **2.7. Conclusions**

In PE triangular cases, there are essentially three main issues which must be resolved; the potential for unrelieved double taxation, the potential for improper access to the treaty between the residence state and the source state, and the application of the appropriate treaty conditions in the source state. The best way to comprehensively resolve these issues would be to allow the person deriving the income to claim the benefits of the treaty between the PE state and the source state in relation to the income attributable to the PE, i.e., to extend treaty benefits to PEs. This would ensure that the source state applies the more appropriate treaty conditions and that the PE state grants relief for tax imposed in the source state, thus preventing unrelieved double taxation. Although it has been concluded that the additional risks of treaty shopping in this scenario are minimal, due primarily to the economic basis for the attribution of income to PEs, the extension of treaty benefits to PEs could be supplemented by provisions preventing PEs from claiming treaty benefits in situations where a claim would be considered improper. The application of the PE-S treaty should also be accompanied by provisions excluding the operation of the R-S treaty, both in situations where the source state applies the conditions of the treaty with the PE state, and in other situations where the application of the treaty would be considered improper.

One of the major considerations with effectively extending treaty benefits PEs is the extent to which PEs should be treated as separate enterprises for treaty purposes. A logical consequence of treating a PE as a separate enterprise for the purposes of determining the applicable treaty conditions to apply in the source state is that the PE should also be treated as a separate enterprise for other purposes of the treaty, e.g., allowing source-based taxation of notional payments by the PE. However, as discussed in Chapter 9, this can lead to absurd results and would ultimately result in an enormous level of complexity for little practical benefit, despite its theoretical consistency. This suggests that a line should still be drawn beyond which a PE is not treated as a separate enterprise for treaty purposes. Under existing tax treaties this line is drawn at the attribution of profit, with PEs being treated as separate enterprises only for profit attribution purposes. What is proposed here is simply to shift that line such that the PE is also effectively treated as a separate enterprise for determining the applicable treaty conditions to apply in relation to foreign source income attributable to the PE (i.e., the PE-S treaty), without treating PEs as separate enterprises for the purposes of the entire treaty.

## **3. Dual resident triangular cases<sup>157</sup>**

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<sup>157</sup> Dual resident triangular cases are discussed in Chapter 9, which contains an analysis of dual resident triangular cases involving different categories of income, and in Chapter 10.

Dual resident triangular cases occur where a person who is resident in two states for tax purposes (a dual resident) receives income from sources in a third state (the "source state" or "State S"). This is illustrated in the following diagram.

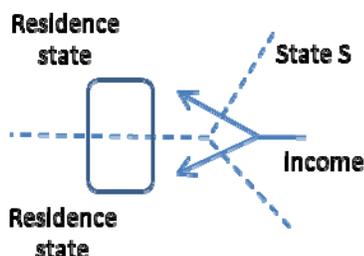


Figure 2: A dual resident triangular case

For treaty purposes, residence is determined in accordance with Article 4 (or its equivalent) by reference to residence under domestic laws and thus, a person who is resident in two states under their respective domestic laws will generally also be a dual resident for treaty purposes. To deal with such situations, Article 4 contains tie-breaker rules which are intended to assign the residence of a dual resident person to one of their residence states for the purposes of the treaty between those two states.<sup>158</sup> However, in some situations the applicable tie-breaker rule may not effectively assign residence to a particular state and the person involved may continue to be a dual-resident for the purposes of the treaty.<sup>159</sup> This is particularly likely in the case of companies given the uncertainties involved in the application of the "place of effective management" tie-breaker rule, for example, in cases where management activities are split between different states.<sup>160</sup> Where there is no effective allocation of residence for the purposes of the treaty between the two residence states, it is not clear how that treaty should be applied and unrelieved double taxation may arise both in bilateral and multilateral situations.<sup>161</sup>

Even where the tie-breaker rule of the treaty between the two residence states does effectively assign residence to one state, that assignment will generally only be effective for the purposes of that treaty.<sup>162</sup> Due to the bilateral nature of tax treaties, and as a consequence of the fact that residence for treaty purposes depends on residence under domestic laws, residence must be determined independently for each treaty.<sup>163</sup> This means that in a triangular situation a dual resident may be entitled to claim treaty benefits under the tax treaties concluded by both its residence states with the source state.<sup>164</sup> If both these treaties apply then the source

<sup>158</sup> The tie-breaker rule applicable to individuals is contained in Article 4(2). The tie-breaker rule applicable to persons other than companies is contained in Article 4(3). These tie-breaker rules are discussed in Chapter 10 (Sections 10.3.2. and 10.3.3.).

<sup>159</sup> For an analysis of how the treaty between the two residence states may apply if the tie-breaker does not effectively assign residence to one state, refer to Chapter 10 (Section 10.2.1.).

<sup>160</sup> The place of effective management tie-breaker is discussed in Chapter 10, Section 10.3.3.1.

<sup>161</sup> Refer to Chapter 10 (Section 10.2.1.).

<sup>162</sup> Refer to the discussion in Chapter 10 (Section 10.4.).

<sup>163</sup> Avery Jones, J.F., and Bobbett, C., "Triangular Treaty Problems..."; Avery Jones, J.F. "The Interaction Between Tax Treaty Provisions and Domestic Law" bound in Maisto, G. (Ed.), *Tax Treaties and Domestic Law*, (Amsterdam: IBFD, 2006), Chapter 6, Section 6.4.1.

<sup>164</sup> See, inter-alia: Avery Jones, J.F., and Bobbett, C., "Triangular Treaty Problems..."; Avery Jones, J.F. "Interaction Between Tax Treaty...", Chapter 6, Section 6.4.1.; Gusmeroli, M., "Triangular Cases... Part 1";

state will only be able to satisfy its treaty obligations by applying the treaty conditions that are more favourable to the person deriving the income.<sup>165</sup> This can give rise to significant tax avoidance concerns because the source state may continue to be bound by the conditions of its treaty with the state to which residence is not assigned (the losing residence state) in situations where that state is prevented from imposing tax under the treaty between the two residence states. On the other hand, if the losing residence state is entitled to impose tax on the income, then the non-application of the treaty between that state and the source state can result in unrelieved double taxation.

The OECD Commentary expresses the view that a dual resident will not be a resident of the losing residence state for the purposes of treaties with third states on the basis of the second sentence of Article 4(1),<sup>166</sup> however this interpretation is controversial. It is based on the view that the dual resident will not have a sufficient tax liability in the losing residence state because that state will only be able to impose tax on income which has a local source under the treaty between the two residence states. The following section will give an overview of the interpretation of the second sentence of Article 4(1).

### **13.3.1. Denial of treaty benefits under the second sentence of Article 4(1)<sup>167</sup>**

The first question which must be addressed in determining whether the second sentence of Article 4(1) excludes dual-residents from treaty eligibility is whether the treaty limitations on the tax imposed in the losing residence state should be taken into account or whether consideration should be limited to the tax imposed under the domestic law of that state.<sup>168</sup> The second sentence of Article 4(1) does not contain any reference to domestic law which seems to indicate that the impact of tax treaties could be taken into account. However, the first sentence of Article 4(1) does specifically refer to domestic law and, since the second sentence refers back to (and limits) the first sentence, the better interpretation seems to be that the second sentence consequently also refers only to domestic law.<sup>169</sup> If this is the case, then the dual resident would continue to be a resident of the losing residence state for the purposes of treaties concluded between that state and third states despite the limitations on that state's taxing rights under the treaty between the two residence states.

If, however, the treaty limitation is taken into account then the application of Article 4(1) will also depend on whether the treaty limitation prevents the person involved from being "liable to tax" on income.<sup>170</sup> The phrase "liable to tax" is also used in the first sentence of Article 4(1) for the preliminary determination of whether a person is resident in a particular state and interestingly, many countries take the view that entities that are tax exempt, such as pension funds and charities, can be resident for treaty purposes (and can be "liable to tax") on

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<sup>165</sup> See, inter-alia: Van Raad, K., "The 1992 OECD Model..."; Avery Jones, J.F., and Bobbett, C., "Triangular Treaty Problems..."; Gusmeroli, M., "Triangular Cases... Part 1."

<sup>166</sup> 2010 OECD Commentary on Article 4, para 8.2. This argument was first raised by the Dutch Under Minister of Finance when, in 1989, he refused to grant a certificate of residence to a dual-resident company incorporated in the Netherlands but having its place of effective management in Ireland. See: Betten, R., "Denial of Certificate of Residence to a Dual Resident Company," 29 *European Taxation* 11, (1989), pp 371-373.

<sup>167</sup> This section gives an overview of the discussion in Chapter 10, Section 10.4.2.

<sup>168</sup> This is discussed in detail in Chapter 10, Section 10.4.2.1.

<sup>169</sup> Van Gennep, C.J.A.M., "Dual-Resident Companies: The Second Sentence of Article 4(1) of the OECD Model Convention of 1977," 31 *European Taxation* 5, (1991), pp 141-146 at pp 143-144; Vann, R., " 'Liable to Tax' ..." at p 253.

<sup>170</sup> This is discussed in detail in Chapter 10, Section 10.4.2.2.

the basis that they are subject to the tax system of the country and are only exempt because they meet certain criteria for exemption.<sup>171</sup> A similar argument could be advanced in the case of dual residents with respect to the income which the losing residence state is prevented from taxing under the treaty between the two residence states. That is, for the purposes of the second sentence of Article 4(1), the "foreign source" income derived by the dual resident is subject to the tax system of the losing residence state, but is exempt because the person deriving the income meets certain conditions for non-taxation under the treaty between the two residence states. If this argument is accepted, the second sentence of Article 4(1) would only exclude from the definition of "resident of a contracting state" those entities whose foreign income does not fall within the tax base in the state concerned. This may be a reasonable approach and it does correspond to the general concept of source based taxation of non-residents, but it would be a very restrictive interpretation of the provision. The better interpretation seems to be that the dual-resident will not be "liable to tax" in the losing residence state on income which that state is prevented from taxing under the treaty between the two residence states (provided the treaty limitation is taken into account).

A key question in applying the second sentence of Article 4(1) in the context of dual-residents is the source of income.<sup>172</sup> The argument advanced in the OECD Commentary is that, as a result of the treaty between the two residence states, the losing residence state is only entitled to impose tax on income from sources in that state. The clearest example of a category of income which can be taxed in the losing residence state under the treaty between the two residence states but which may be considered to be sourced in a third state is passive income arising in a third state and attributable to a PE in the losing residence state.<sup>173</sup> This type of income gives rise to particular disagreements with respect to the application of the second sentence of Article 4(1), and illustrates the problems that arise in interpreting that provision. On one hand, it is argued that such income is sourced in a third state (i.e., the source state) and thus, the dual-resident is taxable in the losing residence state on income which is *not sourced in that state* and, as a result, treaty benefits cannot be denied.<sup>174</sup> On the other hand, it is argued that such income is sourced in the state where the PE is located (i.e., the losing residence state) as a result of the activities of the PE and thus, that the taxation of such income should not prevent the denial of treaty benefits under the second sentence of Article 4(1).<sup>175</sup> The main problem here is that the income does not have a single geographical source, but rather, can be considered to be sourced in both the state where it arises and in the PE state. Furthermore, the alternative viewpoints with regard to this type of income clearly demonstrate that there are two possible interpretations of the second sentence of Article 4(1), namely:

- (i) that it will apply (and thus treaty benefits will be denied) only if *none* of the income taxable in the losing residence state can be considered to have a source outside that state; and
- (ii) that it will apply (and thus treaty benefits will be denied) as long as *all* the income taxable in the losing residence state can be considered to have its source in that state.

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<sup>171</sup> OECD Commentary to Article 4, paras 8.5 and 8.6.

<sup>172</sup> This is discussed in detail in Chapter 10, Section 10.4.2.3.

<sup>173</sup> Van Raad, K., "Dual Residence and the 1977 OECD Model Treaty Article 4(1), Second Sentence," 30 *European Taxation* 1, (1990), pp 27-29; Van Raad, K., "2008 OECD Model..."; Sasseville, J., "A Tax Treaty Perspective...", Chapter 3, Section 3.3.

<sup>174</sup> Van Raad, K., "Dual Residence and the 1977..."; Van Raad, K., "2008 OECD Model..."

<sup>175</sup> Sasseville, J., "A Tax Treaty Perspective..."

Under the first interpretation, treaty benefits would be allowed as long as income that is sourced in a state other than the losing residence state could be identified, even if that income can also be considered to be sourced in the losing residence state. Under the second interpretation, treaty benefits would only be allowed if it were possible to identify income taxable in the losing residence state but which cannot be considered to have its source there. Clearly these two interpretations would give the second sentence of Article 4(1) a wildly differing scope but, based on the wording of the second sentence of Article 4(1), both seem to be equally correct.

Given the lack of clarity in the application of the second sentence of Article 4(1), it does not seem appropriate deny treaty benefits to an entity that would otherwise be entitled to them (even if the source state considers that such benefits should not be available) based on one of two equally defensible interpretations of the wording of that provision. In light of the difficulties with the interpretation of the second sentence of Article 4(1), it is not a satisfactory way of dealing with (potentially improper) claims for treaty benefits by dual resident persons.

### **3.2. Alternative ways of preventing dual residents from claiming dual treaty benefits<sup>176</sup>**

A better way of preventing dual residents from claiming reductions in source-based taxation under treaties between the losing residence state and third states is for states to include a provision in their domestic law to the effect that a company will not be considered to be a resident for domestic law purposes if its residence is assigned to another state under the provisions of an applicable tax treaty.<sup>177</sup> Since residence for treaty purposes depends on residence for domestic law, this will have the effect that the dual resident will no longer be resident in that state (the losing residence state) for the purposes of treaties which that state has concluded with third states. This approach would be very effective in preventing dual residents from claiming treaty benefits under treaties concluded between their losing residence state (the state implementing the provision) and third states and may also be relatively easy to implement since it does not require any renegotiation of tax treaties.

One problem with this approach is that, while this type of provision prevents the state implementing it from being used in treaty shopping structures, it does not allow that state to refuse to apply reductions in source-based taxation to companies which are dual-resident elsewhere. This limits states' incentive to develop and implement such a provision. It is also likely to have a significant impact on the application of other provisions of domestic law. In some cases this may be advantageous, since it may prevent dual residents who are resident in another state for treaty purposes from claiming certain benefits which would otherwise be available under domestic laws.<sup>178</sup> However, in other cases it may potentially give rise to problems with the interaction between different provisions<sup>179</sup> or may result in the losing residence state unilaterally giving up taxing revenue. While a provision along these lines would certainly be a good way of dealing with (improper) claims for treaty benefits

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<sup>176</sup> This section gives an overview of the discussion in Chapter 10, Section 10.4.3.

<sup>177</sup> Several authors have argued that this may be the best way to deal with the problem of dual residents claiming treaty benefits under multiple treaties. See: Avery Jones, J.F. and Bobbett, C., "Triangular Treaty Problems..."; Avery Jones, J.F. "The Interaction Between Tax Treaty...", Chapter 6, Section 6.4.1.; ; Sasseville, J., "A Tax Treaty Perspective...", Chapter 3, Section 3.4.

<sup>178</sup> Sasseville, J., "A Tax Treaty Perspective...", Chapter 3, Section 3.4.

<sup>179</sup> For example, Couzin identifies various issues that may arise in relation to the interaction between the Canadian Section 250(5) and other provisions of Canadian law (Couzin, R., *Corporate Residence...*, at pp 213-218).

by dual-residents, its impact in a domestic context would likely be far greater than its impact in a treaty context and thus, domestic considerations are likely to take precedence for any state considering whether to implement such a provision. This makes it problematic to rely on states implementing this type of provision as a solution for dual-resident triangular cases.

A better approach would be to include a specific provision in tax treaties to prevent dual resident entities from claiming treaty benefits under treaties concluded by their losing residence state with third states. The provision could deny treaty benefits by direct reference to the allocation of residence under a treaties concluded with third states. Such a provision could be worded as follows:

"Notwithstanding the other paragraphs of this Article [i.e., Article 4], a person will not be a resident of a Contracting State if that person is, under a tax treaty concluded between that State and a third State, resident in the third State and not in the first-mentioned State."

The clear advantage of including specific provisions in tax treaties to prevent claims for treaty benefits by dual-residents is that it does so clearly and directly. The main disadvantage is the extended period of time that it would take to implement such an approach, given that it will only be effective in relation to those treaties that actually include the provision. Tax treaties generally have a very long life and the substantial period of time that can elapse before a treaty is renegotiated. This makes this approach less effective as a short-term solution. Nevertheless, this is considered to be the best approach for dealing with dual resident triangular cases.

#### *Interaction with extension of treaty benefits to PEs*

Under the treaty between the two residence states, the losing residence state would generally be entitled to impose tax on income arising in third states to the extent that it is attributable to a PE in that state. This situation is effectively the same as a PE triangular case and, as in PE triangular cases, the winning residence state may not be able to provide sufficient relief to prevent double taxation unless the losing residence state provides relief for tax imposed in the source state. If the treaty between the losing residence state and the source state applies, it will require the losing residence state to grant relief for tax imposed in the source state and unrelieved double taxation will be prevented. However, if the dual resident is not considered to be resident in the losing residence state for the purposes of that treaty, then the losing residence state would generally have no direct obligation to provide relief for tax imposed in the source state and thus, unrelieved double taxation may arise. This suggests that it would be preferable for the treaty between the losing residence state and the source state to continue to apply, at least in situations where the income is attributable to a PE in the losing residence state.

The best way to resolve the conflict between the desire to deny treaty benefits to dual residents to prevent treaty shopping and the desire to prevent unrelieved double taxation would be to extend treaty benefits to PEs as proposed for dealing with PE triangular cases. If treaty benefits were extended to PEs, then dual residents could be broadly denied treaty benefits under treaties between their losing residence state and third states, but treaty benefits would continue to be available to the extent that the income arising in third states is attributable to a PE in the losing residence state. Thus, improper access to the treaty between the losing residence state and the source state could be prevented (i.e., in situations where the losing residence state is prevented from imposing tax on the income) while still ensuring that unrelieved double taxation would not arise.

#### 4. Reverse triangular cases<sup>180</sup>

Reverse triangular cases can potentially result in dual source-based taxation of passive income.<sup>181</sup> In reverse PE triangular cases, both the residence state of the payor and the PE state may be entitled to impose source-based taxation on payments of interest and royalties under their respective treaties with the residence state of the person receiving the income. Similarly, in reverse dual resident triangular cases, both residence states of the payor may be entitled to impose source-based taxation on payments of dividends, interest and royalties to residents of a third state. This dual source-based taxation is problematic because it can lead to unrelieved double taxation if the residence state of the person receiving the income does not provide sufficient relief.<sup>182</sup> This risk of unrelieved double taxation can generally only be resolved by preventing one of the source states from imposing tax on the income.

##### 4.1. Reverse PE triangular cases<sup>183</sup>

Article 11 allows interest "arising" in a contracting state (and paid to a resident of the other contracting state) to be taxed in the state where it arises.<sup>184</sup> Whether interest "arises" in a particular state is determined in accordance with Article 11(5), which provides that interest will arise in a contracting state if it is paid by a resident of that state or if it is connected with a PE of the payor located in that state. However, if the PE is located in a third state the interest will continue to arise in the residence state of the payor.<sup>185</sup> In a reverse PE triangular case, this means that the interest is considered to arise in two different states for the purposes of the two applicable treaties. As a result source-based taxation may be imposed in both the residence state of the payor and the PE state under Article 11 of their respective treaties with the residence state of the recipient.<sup>186</sup> A similar result will also arise in relation to royalties if the applicable treaties allow source based taxation, as is commonly the case, and determine where royalties arise on the basis of a provision similar to Article 11(5).<sup>187</sup> The best way to resolve such cases would be to prevent one of the two states from imposing source based taxation, preferably the residence state of the payor.

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<sup>180</sup> Reverse triangular cases are discussed in Chapter 11, which contains an analysis of reverse triangular cases involving different categories of income, and in Chapter 12.

<sup>181</sup> Refer to the analysis of reverse triangular cases involving different categories of income in Chapter 11.

<sup>182</sup> For a discussion of situations where the residence state will and will not be able to provide sufficient relief for dual source-based taxation, refer to Chapter 3 (Section 3.2., which discusses relief in the residence state in PE triangular cases). In general, the residence state's ability to provide sufficient relief will depend on the effective rates of tax imposed in the source states relative to the effective rate of tax imposed in the residence state. Note that in reverse triangular cases, the relief in the PE state (discussed in Section 3.2.2.) will not be relevant.

<sup>183</sup> This section gives an overview of the discussion in Chapter 12, Section 12.2.

<sup>184</sup> Refer to Article 11(1) and Article 11(2) of the OECD Model.

<sup>185</sup> Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Taxation Conventions...*, at p 752, m.no. 95; Avery Jones, J.F. and Bobbett, C. "Triangular Treaty Problems..."; Avery Jones, J.F., et al., "Tax Treaty Problems Relating to Source" 38 *European Taxation* 3, (1998), pp 78-93. (also published under the same title in: *British Tax Review* 3, (1998), pp 225-250).

<sup>186</sup> 2010 OECD Commentary on Article 11, paras 28-31; Avery Jones, J.F., et al., "Tax Treaty Problems..."; Avery Jones, J.F. and Bobbett, C. "Triangular Treaty Problems..."; Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Taxation Conventions...*, at p 752, m.no. 95; Lombardi, M., "Triangular Situations: A Case of Double Source Taxation of Interest and Royalties," 51 *Bulletin for International Fiscal Documentation* 4 (1997), pp 177-182; Pereira Ribeiro, R., "Dual Source Situations and the Multiple Taxation of Dividends and Interest," IV *Diritto e Pratica Tributaria Internazionale* 1 (2004), pp 151-190 at pp 183-184.

<sup>187</sup> See, for example, Article 12(5) of the UN Model Treaty (2001).

The residence state of the payor could be prevented from imposing tax by altering the wording of Article 11(5) to the effect that interest (or royalties) which are connected with a PE would be considered to arise in the PE state even if the PE is located in a third state.<sup>188</sup> As a result, the interest would not be considered to arise in the payor's residence state for the purposes of applying the treaty between that state and the recipient's residence state (the S-R treaty), and thus the distributive rule of Article 11 would not apply. Instead, article 7 or Article 21 would apply and the payor's residence state would be prevented from imposing tax (assuming the recipient does not have a PE in that state). This could be achieved by adopting the alternative wording for the second sentence of Article 11(5) suggested in the OECD Commentary, which reads as follows:

"Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has *in a State other than that of which he is a resident* a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."<sup>189</sup> [Emphasis added.]

The problem with this approach is that preventing the payor's residence state imposing tax may lead to the income escaping source-based taxation altogether (i.e., if the PE state doesn't impose tax), which could potentially create opportunities for tax avoidance.<sup>190</sup> This concern could be dealt with, however, by limiting the circumstances in which the residence state would be prevented from imposing tax, e.g., such that the residence state would only be prevented from imposing tax if tax is imposed in the PE state.<sup>191</sup> The exact wording of the provision would ultimately depend on the situations in which the contracting states would be willing to give up their source-based taxing rights in relation to interest payments connected to a PE in a third state, which would in turn depend on their level of concern regarding the potential for interest income to escape source-based taxation.

#### **4.2. Reverse dual resident triangular cases<sup>192</sup>**

In reverse dual resident triangular cases, both residence states of the payor of passive income may be entitled to impose source-based taxation on the income under their respective treaties with the residence state of the person receiving the income.<sup>193</sup> This can result in unrelieved double taxation because the residence state of the recipient may not be in a position to provide sufficient relief. To prevent such double taxation, one of the two source states should be prevented from imposing tax, preferably the state to which residence is not assigned for the purposes of the treaty between the two residence states (i.e., the losing residence state). This relies of course on the effective allocation of residence under the residence tie-breaker provisions of that treaty. If there is no such allocation, then it is not clear which state should be prevented from imposing source-based taxation

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<sup>188</sup> Avery Jones, J.F., et al., "Tax Treaty Problems..."; Avery Jones, J.F. and Bobbett, C. "Triangular Treaty Problems..."; Lombardi, M., "Triangular Situations..."; Pereira Ribeiro, R., "Dual Source Situations..."

<sup>189</sup> 2010 OECD Commentary on Article 11, para 30.

<sup>190</sup> 2010 OECD Commentary on Article 11, para 29.

<sup>191</sup> Avery Jones, J.F., et al., "Tax Treaty Problems..."

<sup>192</sup> This section gives an overview of the discussion in Chapter 12, Section 12.3.

<sup>193</sup> Refer to the analysis of reverse triangular cases involving different categories of income in Chapter 11.

and dual source-based taxation cannot effectively be prevented.<sup>194</sup> The solutions discussed below therefore only apply in situations where the residence of the dual resident payor is assigned to one state under the treaty between the two residence states.

In the case of dividends, dual source-based taxation may be prevented by Article 10(5) of the treaty between the two residence states of the company paying the dividend.<sup>195</sup> Article 10(5) prevents a particular state from imposing tax on dividends paid by a resident of the other contracting state unless they are paid to a local resident or attributable to a local PE of the person receiving the dividends. However, the application of Article 10(5) in reverse triangular cases is somewhat unclear, since the person receiving the dividends (and thus the person upon whom tax is generally being imposed) is not a resident of either of the contracting states and thus does not fall within the personal scope of the treaty under Article 1.<sup>196</sup> In addition, because of the way in which Article 10(5) is worded, it may not apply where the dual resident does not earn any income or profits from the losing residence state.<sup>197</sup> Despite these issues, there is a strong argument that Article 10(5) could be used to prevent dual source based taxation of dividends in reverse dual resident triangular situations. It's application could be clarified by removing the reference to the derivation of profits or income from the non-residence state, and by making it an express exception to Article 1.

In a more general sense, dual source based taxation will not occur if the dual resident is no longer considered a resident of the losing residence state for the purposes of treaties which that state has concluded with third states.<sup>198</sup> Thus, the solutions to dual resident triangular cases discussed above would equally resolve the issues arising in reverse dual resident triangular cases. Briefly, a denial of residence may occur as a result of the application of the second sentence of Article 4(1), which denies residence to an entity which is taxable in the potential residence state only on income from sources in that state. However, as discussed above, it is highly uncertain that a dual resident should be denied residence in the losing residence state for the purposes of treaties between that state and third states as a result of the second sentence of Article 4(1).<sup>199</sup>

As an alternative to relying on a denial of residence under the second sentence of Article 4(1), the dual resident could be more explicitly prevented from being resident in the losing residence state for the purposes of treaties concluded between that state and third states. This could be achieved by provisions included in domestic laws which prevent a dual resident from being resident for domestic purposes when the state implementing the provision is the losing residence state.<sup>200</sup> States should be encouraged to implement such provisions, however

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<sup>194</sup> Refer to the discussion in Chapter 12, Section 12.3.1.

<sup>195</sup> Avery Jones, J.F., et al., "Tax Treaty Problems..."; Smit, P.M., "Taxation of Dividends Distributed by a Dual Resident Company," 33 *European Taxation* 1 (1993) pp 36-40; Creus, J. and De Jong, D., "Dividends Paid by Dual Resident Companies," bound in Sutter, F.P., and Zehetner, U., (Eds.), *Triangular Tax Cases*, (Wein: Linde Verlag, 2004), pp 145-171; Avery Jones, J.F. and Bobbett, C. "Triangular Treaty Problems..."; Madeira, E.A. and Neves, T.C., "Exploring the Boundaries of the Application of Article 10(5) of the OECD Model," 38 *Intertax* 8/9, (2007), pp 473-483. For a detailed discussion and analysis, refer to Chapter 12 (Section 12.3.3.).

<sup>196</sup> Refer to the discussion and analysis in Chapter 12 (Section 12.3.3.2.)

<sup>197</sup> Refer to the discussion and analysis in Chapter 12 (Section 12.3.3.1.)

<sup>198</sup> Refer to the discussion in Chapter 12 (Section 12.3.2.).

<sup>199</sup> Refer also to the discussion of the second sentence of Article 4(1) in Chapter 10 (Section 10.4.2.).

<sup>200</sup> Refer to the discussion in Chapter 12 (Section 12.3.4.1.)

domestic considerations are likely to take precedence over treaty considerations in deciding whether to implement such a provision.

A better approach would be to include a specific provision in tax treaties to deny treaty benefits to dual-residents whose residence is assigned to a third state under a tax treaty between the state that would otherwise be their residence state and the third state.<sup>201</sup> Suggested wording for the provision was mentioned above in relation to dual resident triangular cases and there would be no need to alter the wording of this provision to deal with reverse dual resident triangular cases, since it is the denial of residence itself that prevents the losing residence state from imposing source-based taxation. The main disadvantage of this approach is the extended period of time that it would take to implement, since it will only be effective in relation to those treaties that actually include the provision.

## 5. General Conclusions

Although each of the triangular cases discussed in this thesis is unique, there are many common threads and many of issues which they give rise to share the same underlying causes. Perhaps the clearest of these is the failure of bilateral tax treaties to take into account the effects of other bilateral treaties, whether that be an assignment of taxing rights under the distributive rules of the treaty or an allocation of residence under a residence tie-breaker provision. Nevertheless, it would not be sufficient to introduce some general principle requiring treaties to interact; in each case it is essential to specify exactly when and how a particular treaty should take into account the results of applying other treaties.

Problems also arise in triangular cases due to the overlap of the implicit sourcing rules in treaties. This is certainly the main issue in reverse triangular cases, but is also relevant in PE triangular cases where both the “source state” and the PE state are effectively seeking to impose source-based taxation. Clearly it is essential to resolve the overlap in the source rules in reverse PE triangular cases, but this is not the best approach for dealing with typical PE triangular cases since it would give rise to unavoidable risks of tax avoidance. Thus, again, the solution must be specific to the situation.

Finally, issues arise due to the hybrid nature of the PE concept; a source concept that has a lot in common with residence concepts and fulfils a very residence-like role in tax treaties. The problem here is not so much the residence-like nature and role of the PE concept, which is clearly very important for the proper operation of tax treaties, but that the implications of this have not been fully dealt with. For instance, the PE state is given the ability to impose tax on the worldwide income attributable to the PE, but with no corresponding direct obligation to provide relief. It is also not recognised for the purposes of determining the applicable treaty conditions in the source state. Again, these specific issues require a targeted solution.

In PE triangular cases the proposed solution is the extension of treaty benefits to PEs, treating the PE more like a resident enterprise and requiring both the source state and the PE state to apply the conditions of their treaty in relation to the income attributable to the PE. This ensures that unrelieved double taxation is prevented and that the source state applies the appropriate treaty conditions. Coupled with complementary provisions in the treaty

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<sup>201</sup> Refer to the discussion in Chapter 12 (Section 12.3.4.2.)

between the residence state and the source state, it also ensures that that opportunities for improper use of that treaty are minimised.

In dual resident triangular cases and in reverse dual resident triangular cases, the solution is to make the allocation of residence under the treaty between the two residence states effective for the purposes of treaties which the residence states have each concluded with third states. This prevents a dual resident from claiming multiple treaty benefits with respect to the same income, and can prevent payments made by a dual resident from having a dual source. Finally, in reverse PE triangular cases, the proposed solution is to resolve the overlap in the sourcing rules for interest (and royalties) to ensure that such payments are not taxed on a source basis in more than one state.

These solutions can be achieved by including specific provisions in tax treaties, as outlined above and at the end of this summary. The starting point for implementing these solutions would be to develop a multilateral consensus, recognising the issues involved and the desirability of resolving them, and gaining acceptance of the way in which triangular situations should be dealt with. This would ideally lead to amendment of the provisions of the OECD Model with the ultimate long-term aim of having specific provisions for dealing with triangular cases included in bilateral treaties. More broadly, and in the interim, drafters of treaty provisions should recognise more explicitly that not all situations covered by a particular treaty will be bilateral, and should be more willing to specifically deal with the possible interaction between the provisions of different tax treaties in relation to a single person or item of income.

## Overview of proposed treaty provisions

### PE triangular cases – extension of treaty benefits to PEs:

The most comprehensive way of dealing with PE triangular cases would be to extend treaty benefits to PEs. This would ensure both that the PE state provides relief for tax imposed in the source state (thus preventing unrelieved double taxation) and that the source state applies the more appropriate treaty conditions, i.e., those contained in the treaty between the source state and the PE state. The following table includes an overview of suggested treaty provisions for extending treaty benefits to PEs and for supplementary provisions excluding the application of the treaty between the residence state and the source state.

Aim of the provision	Suggested text
<p><b><i>Preventing application of the R-S treaty:</i></b></p> <p>To prevent improper access to the treaty between the residence state and the source state and to prevent that treaty from applying where the source state applies the conditions of its treaty with the PE state.</p> <p>See Chapter 7 (Section 7.5.) for discussion.</p>	<p>"(1) Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third state for the purposes of a convention between the Contracting State of the enterprise and that third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the profits of the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and third state that is less than [60] percent of the general company tax rate applicable in the first-mentioned Contracting State. Any dividends, interest or royalties to which the provisions of this paragraph apply shall be subject to tax in the other Contracting State at a rate that shall not exceed [15] percent of the gross amount thereof. Any other income to which the provisions of this paragraph apply shall be subject to tax under the provisions of the domestic law of the other Contracting State, notwithstanding any other provision of the Convention. The provisions of this paragraph shall not apply if:</p> <p>a) In the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself; or</p> <p>b) In the case of any other income, the income derived from the other Contracting State is derived in connection with or is incidental to, the active conduct of a business carried on by the permanent establishment in the third state (other than the business of making, managing or simply holding investments for the enterprise's own account).</p> <p>(2) Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent</p>

	<p>establishment which that enterprise has in a third state for the purposes of a convention between the Contracting State of the enterprise and that third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the other Contracting State applies the conditions of a convention between that State and the third state in relation to that income.</p> <p>(3) This article shall apply to capital gains and profits in the same way as it applies to income.</p> <p>(4) Where the tax benefits which would otherwise be available under the other provisions of this Convention do not apply as a result of paragraph 1 or paragraph 2, the Contracting State where the person deriving the income is resident shall continue to apply [Article 23A/ Article 23B]. However, that State shall not apply [Article 23A/Article 23B] if the other Contracting State is prevented from imposing tax on the income under the terms of a convention with a third state. Where a Contracting State applies [Article 23A / Article 23B] under this paragraph, it shall be applied as though the other Contracting State has applied the other provisions of this Convention in relation to the income."</p>
<p><b><i>Ensuring the residence state continues to have a relief obligation:</i></b></p> <p>To ensure that the residence state continues to provide relief for tax imposed in the source state where necessary.</p>	<p>"(3) Where the tax benefits which would otherwise be available under the other provisions of this Convention do not apply as a result of paragraph 1 or paragraph 2, the Contracting State where the person deriving the income is resident shall continue to apply [Article 23A/ Article 23B]. However, that State shall not apply [Article 23A/Article 23B] if the other Contracting State is prevented from imposing tax on the income under the terms of a convention with a third state. Where a Contracting State applies [Article 23A / Article 23B] under this paragraph, it shall be applied as though the other Contracting State has applied the other provisions of this Convention in relation to the income."</p>
<p><b><i>Extending treaty benefits to PEs:</i></b></p> <p>To require both the source state and the PE state to apply the conditions of the PE-S treaty in relation to income arising in the source state and attributable to the PE.</p> <p>Paragraph 1(a) of this provision applies where the enterprise to whom the PE</p>	<p>"(1) For the purposes of this Convention, notwithstanding the provisions of Article 1 (Persons Covered),</p> <p>(a) where a person, who is not a resident of either of the Contracting States, has a permanent establishment in one of the Contracting States for the purposes of a convention between Contracting State where the permanent establishment is located and a third state, then this Convention shall apply to any income included in the profit attributable to the</p>

<p>belongs is resident in a state which has concluded a treaty with the PE state. Paragraphs 1(b) and 1(c), on the other hand, apply in cases where the enterprise is not resident in a state which has a treaty with the PE state, in keeping with the view that the residence state of the enterprise is not relevant to the extension of treaty benefits to the PE.</p> <p>Paragraph 2 ensures that treaty benefits are also available with respect to profits and capital gains attributable to the PE.</p> <p>Paragraph 3 ensures that the various articles of the OECD Model will apply regardless of the terms used to establish their application and that the income is considered to be beneficially owned by a resident of the PE state.</p> <p>See Chapter 8 (Section 8.2.) for discussion.</p>	<p>permanent establishment (for the purposes of the convention between the Contracting State where the permanent establishment is located and the state where the person is resident) as though that income were income of a resident of the Contracting State in which the permanent establishment is located. However, this Convention shall not apply to income which the Contracting State where the permanent establishment is located is prevented from taxing under the convention between that State and the person's residence state or between that State and a third state.</p> <p>(b) where a person who is not a resident of either of the Contracting states, carries on business in State A through a [permanent establishment] (as defined under the laws of State A) and that person is not considered a resident of a third state for the purposes of a convention between State A and that third state, then this Convention shall apply to any income included in the profit attributable to the [permanent establishment] (under the domestic law of State A) as though that income were income of a resident of State A. However, the Convention shall not apply under this paragraph to income which State A is prevented from taxing under a convention with a third state.</p> <p>(c) where a person who is not a resident of either of the Contracting states, carries on business in State B through a [permanent establishment] (as defined under the laws of State B) and that person is not considered a resident of a third state for the purposes of a convention between State B and that third state, then this Convention shall apply to any income included in the profit attributable to the [permanent establishment] (under the domestic law of State B) as though that income were income of a resident of State B. However, the Convention shall not apply under this paragraph to income which State B is prevented from taxing under a convention with a third state.</p> <p>(2) This Article shall apply to capital gains and to profits in the same way as it applies to income.</p> <p>(3) Any income, capital gains or profits to which this Convention applies as a result of paragraph 1 shall be considered to be paid to, derived by and beneficially owned by a person who is a resident of the Contracting State where the permanent establishment, [equivalent term in State A] or [equivalent term in State B] is located for the purposes of the application of this Convention under paragraph 1."</p>
<p><b>Preventing improper claims for treaty benefits by PEs:</b></p> <p>Examples of provisions which could be included in tax treaties to prevent</p>	<p><i>Subject to tax provision:</i> "Where this Conventions applies under this article to income arising in a Contracting State and included in the income</p>

<p>improper claims for treaty benefits by PEs, along with examples of safe harbour provisions to prevent the unreasonable denial of benefits.</p> <p>See Chapter 8 (Section 8.4.) for discussion.</p>	<p>attributable to a permanent establishment located in the other Contracting State, any provision of this convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State which is equivalent to the tax that would be imposed in that state if the income were derived by a resident of that State in the same circumstances as the permanent establishment."</p> <p><i>Anti-base erosion provision:</i> "Where income arising in a Contracting State is included in the income attributable to a permanent establishment located in the other Contracting State to which the Convention applies under this Article, any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of the gross income attributable to the PE is paid or accrued to persons who are not resident in either of the contracting states in the form of payments that are deductible, including notional payments to other parts of the enterprise to which the PE belongs, but excluding arm's length payments in the ordinary course of business for services or tangible property."</p> <p><i>Denial of treaty benefits where there is a tax avoidance motive:</i> "The provisions of this Convention shall not apply under this Article in relation to any item of income if it was the main purpose or one of the main purposes of any person concerned with the creation of the permanent establishment or any actions which cause that income to be included in the profit attributable to the permanent establishment to take advantage of this Article by means of that creation or attribution."</p> <p><u>Safe harbour provisions:</u></p> <p><i>General bona-fides provision:</i> "The provision of this Convention shall not apply under this Article where the person to which the permanent establishment belongs establishes that the principal purpose of the permanent establishment, the conduct of its business and, if applicable, that the acquisition or maintenance by it of property from which the income in question is derived, are motivated by sound business reasons and do not have as a primary purpose the obtaining of any benefits under this Convention."</p> <p><i>Activity provision:</i> "[Paragraphs X and Y <sup>202</sup> shall not apply where the permanent establishment is engaged in substantive business operations in the Contracting State in which it is located and the relief from taxation claimed in the other Contracting State is with respect to income that is</p>
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<sup>202</sup> The paragraphs denying treaty benefits. This provision is worded on the basis that it would be included in the article of the treaty which extends treaty benefits to PEs, and which includes the specific provisions denying treaty benefits in certain cases.

	<p>connected with such operations."</p> <p><i>Amount of tax provision:</i> "[Paragraphs X and Y]<sup>203</sup> shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of in which the permanent establishment is located."</p> <p><i>Alternative relief provision:</i> "[Paragraphs X and Y]<sup>204</sup> shall not apply if the person to which the permanent establishment belongs would be entitled to relief which from taxation (if the income were not attributable to a permanent establishment), under a treaty between a third state and the Contracting State from which relief from taxation is claimed, and that relief is not less than the relief from taxation claimed under this Convention."</p>
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### PE triangular cases – the minimalist approach:

The "minimalist approach" to resolving PE triangular cases would achieve two aims; it would prevent improper access to the treaty between the residence state and the source state and it would prevent unrelieved double taxation by requiring the PE state to provide relief for tax imposed in the source state. It does not, however, require the source state to apply the conditions of its treaty with the PE state, and does not require the PE state to grant relief under its treaty with the source state (the obligation instead arises under the treaty between the residence state and the PE state). The following table contains an overview of the provisions which could be included in bilateral tax treaties to implement the minimalist approach for dealing with PE triangular cases.

Aim of the provision	Suggested text
<p><b><i>Relief in the PE state:</i></b></p> <p>To require the PE state to provide relief for tax imposed in the source state.</p> <p>See Chapter 7 (Section 7.4) for discussion.</p>	<p>"(1) When an enterprise of a Contracting State receives income which is included in the profit attributable to a permanent establishment in the other Contracting State and that income may be taxed in a third state under an applicable tax treaty between the first-mentioned Contracting State and that third state, the state where the permanent establishment is located shall grant relief in respect of the tax paid on the income in the third state, provided such relief would be available if the income were derived by an enterprise of the Contracting State where the permanent establishment is located.</p> <p>(2) If there is a convention between the Contracting State where the permanent establishment is located and the third state, the Contracting State where the permanent establishment is located shall apply the article of that convention which provides for the elimination of double taxation as though</p>

<sup>203</sup> The paragraphs denying treaty benefits. This provision is worded on the basis that it would be included in the article of the treaty which extends treaty benefits to PEs, and which includes the specific provisions denying treaty benefits in certain cases.

<sup>204</sup> The paragraphs denying treaty benefits. This provision is worded on the basis that it would be included in the article of the treaty which extends treaty benefits to PEs, and which includes the specific provisions denying treaty benefits in certain cases.

	<p>the permanent establishment were a resident of the State where it is located for the purposes of that convention. The Contracting State where the permanent establishment is located may apply that provision as though that convention had also been applied in the third state to the income attributable to the permanent establishment as though the permanent establishment were a resident of the State where it is located and, where relevant, taking into account any limitation on the amount of tax imposed in the third state under any applicable convention between the Contracting State of the enterprise and that third state.</p> <p>(3) If the Contracting State where the permanent establishment is located grants relief other than under paragraph 2, the relief shall be granted under the same conditions, including with respect to the method of relief, that would apply if the income were derived by an enterprise of that State."</p>
<p><b><i>Preventing improper access to the R-S treaty:</i></b></p> <p>To prevent a person from claiming reductions in source-based taxation under the R-S treaty in relation to income attributable to a PE in a third state in situations which the contracting states consider to be improper.</p> <p>The suggested text is based on the wording of provisions included in many US treaties.</p> <p>See Chapter 7 (Section 7.5.1.) for discussion.</p>	<p>"(1) Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third state for the purposes of a convention between the Contracting State of the enterprise and that third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the profits of the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and third state that is less than [60] percent of the general company tax rate applicable in the first-mentioned Contracting State. Any dividends, interest or royalties to which the provisions of this paragraph apply shall be subject to tax in the other Contracting State at a rate that shall not exceed [15] percent of the gross amount thereof. Any other income to which the provisions of this paragraph apply shall be subject to tax under the provisions of the domestic law of the other Contracting State, notwithstanding any other provision of the Convention. The provisions of this paragraph shall not apply if:</p> <p>a) In the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself; or</p> <p>b) In the case of any other income, the income derived from the other Contracting State is derived in connection with or is incidental to, the active conduct of a business carried on by the permanent establishment in the third state (other than the business of making, managing or simply holding investments for the enterprise's own account).</p> <p>(2) This article shall apply to capital gains and profits in the same way as it applies to income."</p>

## Dual resident and reverse triangular cases

The following is an overview of the provisions which could be included in bilateral tax treaties to deal with dual-resident triangular cases and reverse triangular cases.

Aim of the provision	Suggested text
<p><b><i>Dual-resident triangular cases and reverse dual-resident triangular cases:</i></b></p> <p>To make the allocation of residence between the two residence states effective for the purposes of treaties between those two states and third states. This provision would be included as a separate paragraph in the residence article of the treaty (Article 4 of the OECD Model).</p> <p>See Chapter 11 (Section 11.3.2.) and Chapter 12 (Section 12.3.5.2.) for discussion.</p> <p>Note: this could also be achieved by incorporating the result of the tie-breaker into domestic law. See Chapter 11 (Section 11.3.1.) for discussion.</p>	<p>"Notwithstanding the other paragraphs of this Article, a person will not be a resident of a Contracting State if that person is, under a tax treaty concluded between that State and a third State, resident in the third State and not in the first-mentioned State."</p>
<p><b><i>Reverse dual resident triangular cases where there is no effective allocation of residence</i></b></p> <p>To limit the tax imposed in the residence states of the dual resident payor to 50% of the tax that they would otherwise be entitled to impose in situations where the tie-breaker provision of the treaty between the two residence states does not assign residence to one state.</p> <p>This provision refers to dividends (and is designed to be included in Article 10) but similar provisions should be included in the treaty to deal with interest (Article 11) and, if applicable, royalties (Article 12).</p> <p>See Chapter 11 (Section 11.3.2.) for</p>	<p>"Where dividends are paid to a resident of a Contracting State by a company which is resident in the other Contracting State and is also resident in a third State for the purposes of a convention between the last mentioned Contracting State and the third State, and is not deemed to be resident in only one of those States for the purposes of that convention, then the tax imposed in the Contracting State of which the payor is resident shall not exceed 50% of the tax that may be imposed under [paragraph 2 of Article 10]."</p>

discussion.	
<p><b>Reverse PE triangular cases:</b></p> <p>Alternative Article 11(5) (differences to the current wording are in italics) to prevent the residence state from imposing source-based taxation on income which is connected with a PE of the payor located in a third state, except where the PE state does not impose any source-based tax on the income. This provision could also outline other situations in which the interest would continue to arise in the residence state, and thus in which the residence state would continue to be entitled to impose tax.</p> <p>See Chapter 12 (Section 12.2.2.) for discussion.</p>	<p>"Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has <i>in a State</i> other than that of which he is a resident, <i>for the purposes of the treaty between the State of which he is resident and that other State</i>, a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."</p>