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Fett, E.E.

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TRIANGULAR CASES: THE APPLICATION OF BILATERAL TAX TREATIES IN MULTILATERAL SITUATIONS

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Promotor: Prof. dr. S. van Weeghel.

Copromotor: Prof. dr. F. Vanistendael.

Overige leden: Prof. dr. H.J. Ault

   Prof. dr. L. de Broe

   Prof. dr. O.C.R. Marres

   Prof. dr. P.J. Wattel

Faculteit der Rechtsgeleerdheid
Bilateral income tax treaties do not always operate effectively in situations where more than two states 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 state, has dealings with a resident of a third state. This thesis explores the issues presented by the application of bilateral tax treaties in triangular cases and discusses potential solutions to those issues.
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Chapter 1
Introduction

1.1. 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.

1.2. Background and outline of triangular cases

There are four basic categories of triangular cases that will be 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. This chapter contains a brief introduction to the issues that can arise in these situations, which will be discussed in depth in later chapters. This discussion is based on the assumption that all the relevant states have concluded treaties based on the *OECD Model Tax Convention on Income and Capital* (the "OECD Model"). Further assumptions will be set out below.

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1 All references to the OECD Model are to the 2010 OECD Model unless otherwise specified.
1.2.1. Permanent establishment ("PE") triangular cases

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. A PE triangular case is illustrated in the following diagram (in which “HO” denotes the head office of the entity).

Figure 1.1: A PE triangular case

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 unrelied double taxation may arise. This brings us to the application of tax treaties, the main focus of this thesis. In a PE triangular case, there are two applicable tax treaties:

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3 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases."
(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 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. The source state will therefore 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. Finally, the residence state must apply the conditions of both the R-S treaty and the R-PE treaty and will have an obligation to provide relief under both these treaties (under the relief article: Article 23A or Article 23B). This relief may or may not be sufficient to prevent unrelieved double taxation. Thus, depending on the category of income, the domestic law of the states involved, and the terms of the applicable tax treaties, tax may be imposed on the income in the source state, the PE state and the residence state. Conversely, PE triangular cases can also give rise to opportunities for tax avoidance, since the source state may be required to apply the terms of the R-S treaty in circumstances where the residence state exempts the income and where the PE state also does not impose any tax. The following sections give a more detailed overview of the issues that may arise in PE triangular cases, while also introducing some of the potential solutions examined in more detail throughout the remainder of this thesis.

1.2.1.1. The residence state’s obligation to provide relief

In PE triangular cases, the residence state 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 grant relief for tax imposed in the PE state under the terms of the R-PE treaty. This gives rise to two main issues. The first is the extent to which the residence state is capable of fully relieving double taxation. Where source based taxation has been imposed in both the source state and the PE state, the residence state may not be able to provide sufficient relief. As will be seen in Chapter 3, the residence state's ability to provide sufficient relief will depend on a number of factors, including the relative tax rates of the three states involved (after the application of any relevant treaty limitations), whether the PE state grants relief for tax imposed in the source state, and, if the residence state grants relief using the credit method, the way in which the credit is calculated.

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 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. This would clearly be problematic. As will be discussed in Chapter 3, however, the residence state may not have a dual relief obligation for a number of reasons. For states that remain concerned about the risk of being obliged to grant dual relief, Chapter 3 will also identify some potential solutions.

1.2.1.2. The PE state and the non-discrimination principle

To the extent that the PE state imposes tax on income arising in a PE triangular case, that state should be obliged to grant relief for tax imposed in the source state. This would serve both to ensure that double

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4 This is discussed further in Chapter 2 (see Section 2.3.).
5 See, for example: OECD Committee on Fiscal Affairs, “Triangular Cases”, para. 40. This will be discussed in detail in Chapter 3 (see Section 3.2.).
6 See, for example: Potgens, F.P.G., “The Netherlands Supreme Court… ”; Van Raad, K., “The 1992 OECD Model … “; Zhai, G., ”Triangular Cases…. “. This issue is discussed in detail in Chapter 3 (see Section 3.3.).
taxation can be prevented and to ensure that there is an equitable distribution of taxing rights between the PE state and the residence state. The PE state may grant relief unilaterally under its domestic law, but given that PEs are generally not eligible for treaty benefits, the PE state will not have any obligation to provide relief under the PE-S treaty. The PE state may, however, have an obligation to provide relief under the non-discrimination article of the treaty between the PE state and the residence state.

The PE non-discrimination article (Article 24(3)) of the R-PE treaty generally requires the PE state to tax the PE "not less favourably" than a resident enterprise of the PE state. Consequently, to the extent that relief would be available to a resident of the PE state carrying on the same activities as the PE, equivalent relief should, prima facie, be available to the PE. The scope of this relief obligation is, however, subject to much debate; it is quite clear that the PE state is required to extend domestic relief measures to PEs, but there is no general consensus regarding whether the PE state is required to grant relief equivalent to that available to residents under the PE-S treaty. Where the PE state does grant relief and does so using the credit method, issues may also arise with respect to the amount of the credit which must be granted and the appropriate limitations to apply. The PE state's potential obligation to grant relief in PE triangular cases will be discussed in detail in Chapter 4.

1.2.1.3. Limitation of the source state’s taxing rights

In accordance with the existing treaty framework, the taxation of income in the source state in a PE triangular case must satisfy the conditions of the R-S treaty. The source state is not required to apply the conditions of the PE-S treaty even though the R-PE treaty will allocate the prior (and perhaps exclusive) right to tax the income to the PE state. It has therefore been suggested by various authors that the applicable treaty conditions in the source state should be those contained in the PE-S treaty, instead of those contained in the R-S treaty. Chapter 5 will assess this position, taking into consideration role of the residence concept in tax treaties, the reasons why states enter into tax treaties and agree to reduced rates of source-based taxation, the nature of PEs and their treatment under domestic tax laws and tax treaties, and the separate entity approach for determining the profit attributable to PEs (particularly under the new ‘Authorised OECD Approach’ (“AOA”)). It will also consider the extent to which extending treaty benefits to PEs may potentially facilitate improper use of tax treaties, taking into account the ways in which states seek to combat treaty shopping under existing principles, the lack of legal effect of internal transactions, the economic basis for the attribution of income to PEs under the AOA, and the impact of way in which the income attributable to PEs is generally taxed.

PE triangular cases can also give rise to concerns regarding the improper use of treaties under the existing treaty framework. That is, a resident of State R may claim the benefits of the R-S treaty in the source state in relation to income which is exempt from taxation in the residence state as a result of it being attributable

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7 OECD Committee on Fiscal Affairs, "Triangular Cases," paras. 18 and 40. See also: García Prats, F.A., "Triangular Cases...”; Van Raad, K., "The 1992 OECD Model...". This will be discussed further in Chapter 3.
8 Refer to Chapter 4, Section 4.2.2.1.
9 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases,” paras 30-2. This will be discussed in detail in Chapter 4 (see Section 4.3.).
10 Article 24(3) provides 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."
to a PE in a third state, and which is either not taxed or is subject to only minimal tax in the PE state.\textsuperscript{13} In
this situation, the source state may consider the application of the conditions of the R-S treaty to be abusive. This will be discussed further in Chapter 8, along with ways in which this type of abuse could be prevented.

1.2.1.4. Underlying causes of the issues arising in PE triangular cases

There are three primary factors underlying all the issues arising in PE triangular cases. The first is the overlap between the implicit source rules contained in tax treaties. That is, for the purposes of the R-PE treaty the income attributable to the PE is effectively considered to have its source in the PE state as a result of the PEs activities there, whereas for the purposes of the R-S treaty, the income is effectively considered to have its source in State S. As a result, both the source state and the PE state may be entitled to impose tax on a source basis in accordance with their respective treaties with the residence state. The second factor underlying the issues arising in PE triangular cases is the hybrid nature of the PE concept. While generally considered to be a threshold for source-based taxation, the PE concept has a number of features which make it more akin to a residence concept.\textsuperscript{14} In addition, PEs are commonly in the same way as a resident enterprise.\textsuperscript{15} One consequence of this is that the PE state is entitled to impose tax on the worldwide income attributable to a PE, including income which has a close link to a third state, e.g., as a result of being paid by a resident of that state. Finally, the bilateral nature of tax treaties means that their provisions generally only contemplate bilateral situations, and are not intended to interact with the provisions of other tax treaties. This means, for example, that the application of the R-S treaty does not take into account the result of applying the R-PE treaty, i.e., the distribution of taxing rights to the PE state and limitation on the taxing rights of the residence state. These underlying causes of the issues arising in PE triangular cases will be discussed in Chapter 6.

1.2.1.5. Potential solutions

The underlying causes of the issues arising in PE triangular cases, outlined briefly above, suggest three general approaches which may potentially resolve such issues. Firstly, the PE concept could be treated more like a source concept, and the overlap in the implicit sourcing rules under tax treaties could be resolved. This would involve either treating the PE state as the only state of source in relation to the income and preventing State S from imposing tax, or treating State S as the only source state and preventing the PE state from imposing tax. This would be a relatively simple approach, however, as will be discussed in Chapter 6, it would give rise to significant tax avoidance concerns. Alternatively, the hybrid nature of the PE concept could be resolved by treating the PE concept more like a residence concept. This would involve, broadly, requiring the source state to apply the conditions of the PE-S treaty, and requiring the PE state to provide relief for tax imposed in the source state. This could be done either by making the PE equivalent to a treaty eligible person in some way, or by allowing the entity to which the PE belongs to claim the benefit of the PE-S treaty in relation to the income arising in State S and attributable to the PE. In either case, treaty benefits would essentially be extended to PEs and, for ease of expression, this thesis will generally refer to the extension of treaty benefits to PEs (and to PEs being entitled to claim treaty benefits) without making a distinction between these two approaches.\textsuperscript{16} For reasons which will be discussed throughout this thesis (but particularly in Chapters 5, 6 and 7), the extension of treaty benefits to PEs is, in my view, the best approach for dealing with PE triangular cases. Finally, PE triangular cases could be resolved by replacing the relevant bilateral tax treaties with a multilateral treaty. However, the drafters of any multilateral treaty would still have to consider how the treaty should deal with PE triangular cases and for various reasons, which will be discussed in Chapter 6,

\textsuperscript{14} This will be discussed in detail Chapter 5.
\textsuperscript{15} This will be discussed in detail Chapter 5.
\textsuperscript{16} These two approaches will be discussed in Chapter 8 (see Section 8.2.1.).
the resolution of the issues arising in PE triangular cases is not considered sufficient reason to warrant replacing the existing network of bilateral treaties with (one or more) multilateral treaties.

1.2.1.6. Extension of treaty benefits to PEs

Chapters 7, 8 and 9 will further explore the possible extension of treaty benefits to PEs. In Chapter 7, the focus will be on the general approach for requiring the PE state and the source state to apply the conditions of the PE-S treaty. It will address whether treaty benefits should be available to PEs directly under provisions included in the PE-S treaty, or whether it would be preferable for provisions included in the R-S treaty and the R-PE treaty to indirectly require the application of the terms of the PE-S treaty. It will also consider the appropriate limitations on the relief to be provided in the PE state and the appropriate method of relief. Finally, Chapter 7 will deal with the non-application of the conditions of the R-S treaty with respect to income that is attributable to a PE in a third state, both in tax avoidance situations and in situations where the source state applies the conditions of the PE-S treaty.

Chapter 8 will consider the basic structure of the provisions extending treaty benefits to PEs, and the appropriate pre-requisites, if any, for the availability of treaty benefits to PEs. It will also outline various specific provisions which could be included in tax treaties to prevent improper access to treaty benefits through PEs. Finally, Chapter 9 will consider various other issues which may arise if treaty benefits are extended to PEs, including the resolution of multilateral disputes through the mutual agreement procedure, the application of threshold requirements in tax treaties, and the extension of treaty benefits to PEs of insurance companies.

Extending treaty benefits to PEs would result in PEs being treated more like separate enterprises for treaty purposes. If this occurs, the question arises as to how far this separate entity treatment should be taken. That is, whether the PE should be treated as a separate treaty-eligible entity for the purposes of the R-PE treaty and, in addition, whether notional payments between different parts of the enterprise should be recognised for treaty purposes, thus allowing states to impose source-based taxation on such notional payments. This will also be discussed, albeit briefly, in Chapter 9.

1.2.2. Dual resident triangular cases

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.

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Residence for treaty purposes is determined in accordance with Article 4 (or its equivalent) and generally depends on residence under domestic laws. As a result, a person may be a dual resident for treaty purposes if they are considered to be a resident in two different states under their respective domestic laws. Dual residence can occur, for example, where an individual lives for part of the year in each of the two states or, in the case of a company, where the company is incorporated in one state and is managed in another, or has its management split between two states. To deal with such situations, Article 4 contains tie-breaker rules which are intended to assign the residence of a dual resident to one of its residence states for the purposes of the treaty between those two states (Article 4(2) and Article 4(3)). However, in some situations the applicable tie-breaker rule may not operate effectively and the person’s residence may not be assigned to one state for the purposes of that treaty. The situations where dual residence can arise, and the tie-breaker rules for allocating residence under tax treaties, will be discussed in Chapter 10.

Whether double taxation arises in dual-resident triangular cases depends on the category of income involved. In many cases the state to which residence is not assigned (the losing residence state) will be prevented from imposing tax on income arising in third states under the conditions of the treaty between the two residence states. However, where the income is attributable to a PE in the losing residence state, then the losing residence state may be entitled to impose tax in accordance with the terms of that treaty. In this case, the situation is effectively a PE triangular case, with the exception that the treaty between the losing residence state (the PE state) and the source state may potentially apply.

An important issue in dual resident triangular cases is the ability of the dual resident to claim benefits under treaties concluded by the losing residence state with third states. If a dual resident is entitled to claim treaty benefits under the treaties concluded by both of its residence states with the source state, then the source state will only be able to satisfy its treaty obligations by applying the treaty conditions that are more favourable to the taxpayer. 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 losing residence state in situations where that state is prevented from imposing tax under the treaty between the two residence states.

The allocation of residence under the treaty between the two residence states is generally effective only for the purposes of the treaty between those two states. Residence must be determined independently for the purposes of each treaty under Article 4 of that treaty, i.e., by reference to residence under domestic law. However, the OECD Commentary takes the position 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). The second sentence of Article 4(1) provides that a person is not a resident of a particular state if they are "liable to tax in that State in respect only of sources in that State or capital situated therein." The view expressed in the OECD Commentary is that the dual resident is taxable in the losing residence state only on income from sources in that state as a result of the restrictions imposed under the treaty between the two residence states. This approach is controversial, however, and will be discussed in

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19 2010 OECD Commentary on Article 4, para 8.2.
detail in Chapter 11, along with potential alternative approaches to denying treaty benefits to dual residents.

1.2.3. **Reverse PE triangular cases**

Reverse PE triangular cases occur where a person resident in one state (“State R”) receives income from a person resident in a second state (the “head office state” or “State HO”), and that income originates in a PE of the payor located in a third state (the “PE state” or “State PE”). This situation is illustrated in the following diagram.

*Figure 1.3: A reverse PE triangular case*

In a reverse PE triangular case, both the residence state and the PE state of the payor may seek to impose source based taxation on the payment. In general, assuming that both these states have concluded treaties with the residence state of the recipient of the income, only one of them will be entitled to impose tax as a result of the limitations imposed under those treaties. In the case of interest, however, both the PE state and the residence state of the payor are likely to be entitled to impose tax under Article 11 of their respective treaties with the residence state of the recipient of the income. Dual source-based taxation may similarly arise in relation to royalties in situations where the applicable treaties depart from the OECD Model in allowing source-based taxation of such income. To the extent that both the payor's residence state and the PE state are entitled to impose tax, the residence state of the person receiving the income would generally be required to provide relief under its treaties with each of those states. However, if tax is imposed on a source basis in two separate states, then the recipient's residence state may be unable to provide sufficient relief to prevent double taxation.

Reverse PE triangular cases will be discussed in Chapter 12.

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1.2.4. Reverse dual resident triangular cases

Reverse dual resident triangular cases occur where a dual resident pays an amount which forms part of the income of a resident of a third state (State R). This is illustrated in the following diagram.

Figure 1.4: A reverse dual resident triangular case

In a reverse dual resident triangular case, both residence states of the dual resident payor may seek to impose source-based taxation on the income under their domestic laws on the basis that it is paid by a local resident person. In relation to most categories of income, either one or both of the source states (the residence states of the payor) will be prevented from imposing tax under their respective treaties with the residence state of the recipient. However, where the applicable treaties allow source-based taxation on the basis of the residence of the payor, e.g., with respect to dividends, interest and (commonly) royalties, both source states may be entitled to impose tax under terms of the applicable treaties.

For the purposes of applying the treaty between the two residence states, the tie-breaker provisions of Article 4 of the treaty between the two residence states will generally assign the residence of the dual resident person to one state. If this is the case then it would seem reasonable for the state to which residence is not assigned (the losing residence state) to be prevented from imposing source-based taxation on the basis that the income is no longer paid by a resident of that state. However, this allocation of residence may not be effective for the purposes of the treaties concluded between the residence states of the payor and the third state where the recipient of the income is resident, in which case the dual resident payor would continue to be a resident of both its residence states for the purposes of those treaties. As a result, the source states may both be entitled to impose tax in accordance with Article 10, Article 11 or Article 12 (as applicable) of their respective treaties with the residence state of the person receiving the income. To the extent that both source states do impose tax on the income, the residence state of the person receiving the income would generally be required to provide relief under its treaties with each of those states. However, if tax is imposed on a source basis in two separate states, then the recipient's residence state may be unable to provide sufficient relief and thus, unrelieved double taxation may arise.

Reverse dual resident triangular cases will be discussed in Chapter 12.

1.2.5. Variations on the basic triangular cases

While this thesis will focus on the four basic situations outlined above, variations on these situations which can arise where more than three states are involved will also be addressed, primarily Section VI. In general, these situations give rise to the same kind of issues as situations involving just three states, although there is often an additional layer of complexity.

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1.3. Scope and assumptions

The cases and situations to be addressed in this thesis will be set out more fully in later chapters, however, in general terms, this thesis will address triangular situations involving PEs and dual residents as set out above. For the sake of simplicity, it is generally assumed that all the states involved agree on the characterisation of the situation. Thus, in PE triangular cases, it will be assumed that the recipient of the income is resident in the "residence state" for both domestic law and treaty purposes, and is not resident in any other state. It will also be assumed that a PE exists in the PE state for the purposes of the treaty between the PE state and the residence state. It will further be assumed that the "source state" considers the income to be locally sourced under its domestic law, and that the amount in question is attributable to the PE. Thus, the rules for the attribution of income to PEs will not be addressed in detail. It will further be assumed that all three states would seek to impose tax under their respective domestic laws in the absence of any treaty restrictions.

Similarly, in dual-resident triangular cases, it will be assumed that the dual-resident is resident in two states and is not resident in any other state. It will also be assumed that the payor of the income is resident in a third state and not in any other state, and that their residence state considers the income to be locally sourced under its domestic law. It will further be assumed that all three states would seek to impose tax under their respective domestic laws in the absence of any treaty restrictions.

In relation to reverse triangular cases, it will be assumed that the person receiving the income is resident in one state (their residence state) and not in any other state, and does not have a PE outside that state. In reverse PE triangular cases, it will be assumed that the person paying the income is resident in one state (generally referred to as the “head office” state) and has a PE in a second state from which the payment originates. In reverse dual-resident triangular cases, it will be assumed that the person paying the amount in question is resident in two states under their respective domestic laws. It will further be assumed that all three states would seek to impose tax under their respective domestic laws in the absence of any treaty restrictions.

This study will generally refer to companies. This is primarily for ease of expression and is not to suggest that triangular cases involving individuals cannot arise. It is expected, however, that such cases would be less common and that the analysis of the issues in cases involving companies could also apply to cases involving individuals. Any considerations relevant specifically to individuals will be discussed where appropriate.

This study will not address hybrid entity triangular cases. Hybrid entity triangular cases can arise when a particular entity is treated as fiscally transparent in one state but is treated as a corporate taxpaying entity in another. Hybrid entity triangular cases present fundamentally different issues to those which arise in other types of triangular cases. In the cases discussed in this study, issues arise because a single person (either a recipient or payor of income) has a connection to multiple states or, to phrase it another way, because an item of income has a connection to multiple states. This is not the case with respect to hybrid entity triangular cases, where issues arise because different states seek to impose tax on different taxpayers with respect to the same income. The primary issue in hybrid entity triangular cases is the lack of uniform treatment of the entity involved, which is quite separate from the issues being addressed in this study. In addition, the issues associated with applying tax treaties in the context of hybrid entities are not fundamentally different where three states are involved instead of two. The main issue is determining who should be entitled to claim treaty benefits, and the analysis of this issue should not change in any fundamental way depending on whether two or more states are involved (although it is of course more important to determine the appropriate person to claim treaty benefits where the two potential claimants are located in different states).

Transfer pricing considerations will also not be addressed. The transfer pricing issues that arise in situations involving more than two states are, in general, not fundamentally different from those arising where only two states are involved.

22 For a discussion of hybrid entities (dealing primarily with bilateral cases but also touching on multilateral cases), see: Barenfeld, J., "Taxation of Cross-Border Partnerships" IBFD Doctoral Series Vol. 9 (Amsterdam: IBFD 2005).
The focus of this thesis is on general international and treaty law with respect to taxation. The impact of European (EU) law will not be addressed except to the extent that principles developed in EU law (e.g., with respect to non-discrimination) may be relevant to the interpretation of tax treaties.

Except where otherwise stated, it is assumed that there are bilateral income tax treaties in place between all the relevant states and that those treaties follow the 2010 OECD Model. All references to treaty articles are to the relevant article of the OECD Model unless indicated otherwise.

This thesis will only deal with the following categories of income: business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12), income from immovable property (Article 6), income from shipping, inland waterways transport and air transport (Article 8), capital gains (Article 13) and other income (Article 21). It does not discuss income from employment (Article 15), directors’ fees (Article 16), artistes and sportsmen (Article 17, although Article 17 is discussed briefly in relation to business income in Chapter 2), pensions (Article 18), government service (Article 19) or students (Article 20), which are outside the scope of this study.

Any departures from these assumptions will be noted where relevant.

1.4. Conclusion

Triangular cases clearly present a number of difficult and interesting issues. Despite the work that has been done on triangular cases over the years, there is still, as yet, no satisfactory and generally accepted solution to the issues they present. To date, there has been no comprehensive and detailed analysis of all the issues that can arise in triangular cases or of the range of potential solutions. The impact which recent developments such as the new Authorised OECD Approach to the attribution of profits to PEs may have in PE triangular cases also not been considered in depth. The intention of this thesis is therefore to present a comprehensive analysis of the issues arising in PE triangular cases, taking into account recent developments in international tax law and with respect to tax treaties, with the ultimate aim of identifying a comprehensive solution to the issues that such cases present.
Chapter 2

PE triangular cases and specific categories of income

2.1. Introduction

Treaty articles vary in the extent to which they allow source-based taxation. As a result, the distribution of taxing rights under an income tax treaty depends upon which article of the treaty applies, which itself depends on the category of income involved. It follows that the outcome in triangular cases also depends upon the nature of the income involved, as this will determine the extent of source-based taxation allowed under the applicable treaties. This chapter presents a more in-depth analysis of the result of applying tax treaties in PE triangular cases and, in particular, outlines the results of applying the tax treaties where different types of income are involved. PE triangular cases are typically only discussed in relation to passive income (i.e., dividends, interest and royalties), however, as will be seen below, this chapter takes a broader approach. As described in Chapter 1, typical PE triangular cases occur where a person who is resident in one state (the "residence state" or "State R") and which has a PE in a second state (the "PE state" or "State PE"), earns income from sources in a third state (the "source state" or "State S") which is attributable to the PE. 23

The analysis in this chapter is structured around the categories of income identified in the OECD Model, namely business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12), income from immovable property (Article 6), income from shipping, inland waterways transport and air transport (Article 8), capital gains (Article 13) and other income (Article 21). It does not discuss income from employment (Article 15), directors' fees (Article 16), artistes and sportsmen (Article 17, although Article 17 is discussed briefly in relation to business income), pensions (Article 18), government service (Article 19) or students (Article 20), which are outside the scope of this study.

2.2. Tax treatment in the absence of income tax treaties

In the absence of any applicable treaty limitations, all three states involved in a PE triangular case may seek to impose tax on the income in accordance with the provisions of their respective domestic laws. This is a result of the application of the residence and source principles and, unless sufficient relief is provided, can lead to unrelieved double or even triple taxation.

In a PE triangular case, the recipient of the income is a resident of State R under its domestic tax law and therefore State R could be expected to impose tax on the basis of residence. This may not be the case if, for example, the residence state has a territorial system of taxation or if the income is covered by an exemption under domestic law. If the residence state does impose tax on the income, it may provide unilateral relief for foreign taxes in order to prevent double taxation. For the purposes of the analysis below, it will be assumed, however, that the residence state does seek to impose tax on the income and does not grant any unilateral double taxation relief.

In a typical PE triangular case, the income is considered to be sourced in State S. Source rules vary widely between states, but are generally based on the income having some kind of economic connection to the state concerned. 24 For the purposes of the analysis below, it will be assumed that State S seeks to impose

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tax on the income under its domestic laws. It is also assumed that the person receiving the income does
not have a PE in the source state. This is considered a reasonable assumption, since it is relatively easy for
a person to earn income (including business income) from a particular state without triggering a PE there.
This is particularly true in the modern world, where the advent of various technologies has reduced the
need for a physical presence for conducting business activities. Cases where the recipient of the income
does have a PE in the source state are generally called "sub-PE triangular cases" and are discussed
briefly below (see Section 2.5.1.).

In addition to both the residence and source states imposing tax, the PE state may also seek to impose tax
on the income. In some countries, domestic sourcing rules are based upon the existence of a PE and
income attributable to a local PE is considered to have a local source and is thus taxable under domestic
law. This is not always the case, but even where the domestic sourcing rules are not based on the
existence of a PE, the level of activity required to give rise to a PE is likely to trigger the domestic source
rules and thus, taxation under domestic law. It can therefore be assumed that the PE state will seek to
impose tax on the income attributable to the PE in the absence of any applicable treaty limitation. Where
the income is taxed in the PE state, unilateral relief may be available for tax imposed in the source state,
however this will not always be the case. For the purposes of the analysis below it will be assumed that
the PE state does not grant any unilateral relief.

Thus, the analysis of PE triangular cases below is conducted on the basis that all three states involved
seek to impose tax under their respective domestic laws and do not provide any unilateral double taxation
relief. This approach highlights the multitude of issues that can arise in PE triangular cases. Nevertheless,
it should be kept in mind that some of the issues raised below may not arise in certain situations where,
for example, the applicable domestic law does not impose tax on certain items of income (either in the
source state, the PE state or residence state) or where one or more of the states grant unilateral double
taxation relief.

It should also be noted that the actual flows of income (e.g., the locations of bank accounts) are not
relevant for the analysis set out below. The multiple taxing claims in PE triangular cases arise due to the
fact income is derived by a person who is taxed on a worldwide basis in their residence state and is
considered to be locally sourced income in both the PE state and the source state. Taxation based on
residence and source typically does not depend on the income physically moving between the various
states.

2.3. Applicable tax treaties

Assuming there are treaties in place between all three of the states involved, and assuming that those
treaties all follow the OECD Model, the applicable treaties in a PE triangular case are:

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

(ii) the treaty between residence state and the PE state (the "R-PE treaty").

The treaty between the PE state and the source state (the "PE-S treaty") does not apply. Tax treaties
generally apply to "persons who are residents of one or both of the Contracting States." A PE, being
only part of an enterprise, does not fulfill these criteria and is therefore generally not eligible for treaty
benefits. The term "person" is defined in Article 3(1) of the OECD Model to include "...an individual, a

25 See, for example: Zhai, G., "Triangular Cases..."; Yong, S., "Triangular Treaty Cases...."
23.
27 This is discussed further in Chapter 4 (Section 4.2.2.1.) See also: Burns, L., et al., “Availability of Foreign Tax
Credits (or Deductions) to Host Country Branch Taxpayer and Host Country Company Taxpayer,” 23 Tax
28 See, for example, OECD, "Triangular Cases", paras. 13 and 15.
30 For an exception, refer to the France-Italy treaty, under which benefits are available to PEs in some circumstances
(this will be discussed in Chapter 7 (Section 7.2.3.)).
company\textsuperscript{31} and any other body of persons." The OECD Commentary to Article 3 emphasises that this definition is not exhaustive, and that it should be interpreted "in a very wide sense."\textsuperscript{32} However, a PE is clearly not an individual or a company and, unlike a partnership or other unincorporated association, cannot be considered a body of persons.\textsuperscript{33} For treaty purposes, the relevant person receiving the income attributable to the PE is the individual or company (or potentially the partnership) to which the PE belongs and, in a typical PE triangular case, this person will not be resident in the PE state for treaty purposes.\textsuperscript{34} Thus, the treaty between the PE state and the source state will not apply.

2.4. Passive income

By far the most commonly discussed PE triangular cases are those involving passive income. Where passive income is involved, the applicable treaties would generally allow all three states to impose tax on the income (as will be seen below) and it is in these cases that the issues arising in PE triangular cases are most clearly evident.

2.4.1. Dividends

In a typical PE triangular case involving dividends, a resident of State S pays dividends to a resident of State R, and those dividends are attributable to a PE of the recipient which is located in a third state (State PE). This is illustrated in the following diagram.

Figure 2.1.: PE triangular case involving dividends

The dividends article of the OECD Model (Article 10) provides that:

“1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
   b) 15 per cent of the gross amount of the dividends in all other cases.”

Thus, Article 10 applies to dividends which are paid by a resident of one contracting state to a resident of the other, and allows the residence state of the payor to impose tax on the dividends. The rate of tax that

\textsuperscript{31} The term "company" is defined in Article 3(1) to mean "...any body corporate or entity that is treated as a body corporate for tax purposes."
\textsuperscript{32} 2010 OECD Commentary to Article 3, para. 2.
\textsuperscript{33} Vogel, K., et al., \textit{Klaus Vogel on Double Taxation Conventions...}, at p. 88 (m.no. 17). For an alternate view, see: Langoth, B., "Treaty Entitlement..." at p. 30-32.
\textsuperscript{34} For situations where a company is resident in two states (e.g., in both the "residence state" and the "PE state"), refer to the discussion of dual-resident triangular cases in Chapters 10 and 11.
can be imposed is limited to either 5% or 15% of the gross amount of the dividends, depending on the circumstances. The applicable rate (or rates) is a common point of negotiation in concluded treaties.

**The source state**

In a PE triangular case, the source state is obliged to apply the conditions of the R-S treaty. For the purposes of this treaty, dividends are paid by a resident of one contracting state (i.e., State S) to a resident of the other (i.e., State R) and therefore, Article 10 would apply. Under Article 10, the source state would be entitled to impose a limited rate of tax on the gross amount of the dividends.35

**The PE state**

The PE state is obliged to apply the conditions of the R-PE treaty. For the purposes of this treaty, the dividends are not paid by a resident of one contracting state to a resident of the other and therefore, Article 10 will not apply. If the dividends are considered to be business profits for the purposes of the R-PE treaty then Article 7 will apply.36 However, Article 7 will also apply, albeit indirectly, if the income is not considered business profits. This is because if the income is not business profits then, prima facie, the “other income” article (Article 21) will apply on the basis that the income is not dealt with in any other article of the treaty. Where income falling under Article 21 is attributable to a PE, Article 21(2) generally provides that Article 7 will apply to that income instead of Article 21.37 Thus, Article 7 will apply regardless of whether the dividends are considered business profits. Under Article 7 of the R-PE treaty, the PE state will be entitled to impose tax on the profit attributable to the PE, including any dividends which are paid by a resident of a third state.38

The R-PE treaty may also potentially require the PE state to grant relief for tax imposed in the source state. Under the non-discrimination article of the R-PE treaty, the PE state has an obligation to ensure that the taxation imposed on the PE is not less favourable than the taxation that would be imposed on an enterprise resident in the PE state and carrying on the same activities as the PE (Article 24(3)).39 This obligation is generally considered to extend to granting any unilateral relief for source state taxes that would be available to an enterprise resident in State PE and may also include granting relief that would be

35 See, for example: OECD "Triangular Cases," para. 11.
36 This would generally depend on whether the dividends are considered to be business profits under the domestic law of the PE state. Article 3(2) of the OECD Model provides that "[a]s regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State...." The term "business profits" is not defined in the treaty and thus takes its meaning from the domestic law of the state applying the treaty. In this case, the state applying the treaty is the PE state, which is determining how much tax it may impose on the income. If there is a conflict of qualification (i.e., the residence state does not consider the income to be business profits) then for the purposes of determining whether relief is required under Article 23A or 23B, the residence state is bound by the classification in the source state (in this case, State PE) (See: OECD Commentary on Articles 23A and 23B, Section E, paras. 32.1-32.7).
37 Article 21(2) of the OECD Model reads as follows: "The provisions of paragraph 1 [of Article 21] shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."
38 See, for example, OECD "Triangular Cases," para. 15.
39 Article 24(3) of the OECD Model reads: "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. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents."
available to a resident of State PE under the PE-S treaty. The PE state's obligations under the non-discrimination article of the R-PE treaty will be discussed in Chapter 4.

The residence state

The residence state must apply the conditions of both the R-S treaty and the R-PE treaty. Neither of these treaties will prevent the residence state from imposing tax, but both will oblige the residence state to provide relief. The OECD Model contains two alternative articles dealing with the elimination of double taxation, Article 23A and Article 23B. Article 23A generally provides for the exemption method, however it provides for the credit method of relief in relation to income which falls within the distributive rules of Article 10 (dividends) or Article 11 (interest). Article 23B provides for the credit method of relief regardless of the type of income involved.

For the purposes of the R-S treaty, the dividends fall under the distributive rule of Article 10 and therefore, regardless of the general method of relief provided in the R-S treaty, the residence state will be obliged to provide credit relief for tax imposed in the source state. In accordance with Article 23A/B, the amount of the credit will be limited to the amount of tax imposed in the source state (after applying the terms of the treaty) and also to the amount of tax imposed in the residence state in relation to the dividends.

The residence state will also be obliged to provide relief under the R-PE treaty, either by exempting the income (Article 23A) or by providing a credit (Article 23B) depending on the terms of the treaty. If the exemption method (Article 23A) generally applies under the R-PE treaty then the residence state must exempt the income rather than providing a credit, even though the income is a dividend, because the income falls under Article 7 of the treaty and not under Article 10.

Given that the residence state is obliged to provide relief under both the R-S treaty and the R-PE treaty, the residence state may not be capable of providing sufficient relief to ensure that there is no unrelieved double taxation. It is also possible that the residence state may be obliged to provide a credit under the R-S treaty whilst also exempting the income under the R-PE treaty. Taxation in the residence state and the residence state's obligations to provide relief will be discussed in detail in Chapter 3.

Overall result

The overall result of the application of the R-S and R-PE treaties in a PE triangular case involving dividends is that tax can be imposed in the source state (albeit at a limited rate), in the PE state and in the residence state. The residence state has an obligation to provide relief for the tax imposed in both the source state and the PE state under its treaties with those states, although may not be able to provide sufficient relief. In addition, the PE state may have an obligation to provide relief for tax imposed in the source state.

In PE triangular cases, the application of the R-PE treaty means that taxing rights are transferred from the residence state to the PE state. If the residence state uses the exemption method, then the PE state will have exclusive taxing rights under the R-PE treaty. Similarly, if the residence state uses the credit method, then the PE state has at least prior taxing rights, and depending on the relative rates of tax involved, the residence state may impose no tax on the income after the allowance of relief. This raises the question of whether it is appropriate for the source state to continue to apply the conditions of the R-S treaty and whether it would be more appropriate for the source state to apply the conditions of the PE-S treaty. This would have an impact where, for example, the maximum rates of dividend withholding tax

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41 See, for example, OECD "Triangular Cases," para. 40.

42 See, for example: Potgens, F.P.G., "The Netherlands Supreme Court…"; Van Raad, K., "The 1992 OECD Model…"; Zhai, G., "Triangular Cases…" This issue is discussed in detail in Chapter 3 (see Section 3.3).

43 See, for example: Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems..."
allowed under Article 10 differ between the two treaties. The application of the R-S treaty also raises concerns about the potential for avoidance. That is, a person may claim the benefit of the R-S treaty to reduce the applicable rate of source-based taxation in circumstances where the residence state is prevented from imposing tax under the R-PE treaty and little or no tax is imposed in the PE state. Issues related to the appropriate treaty conditions to apply in the source state will be discussed in detail in Chapter 5.

2.4.2. Interest

In a PE triangular case involving interest income, interest which arises in State S is paid to a resident of State R, and is attributable to a PE of the recipient which is located in a third state (State PE). A typical PE triangular case involving interest income is illustrated in the following diagram.

Figure 2.2: PE triangular cases involving interest income

The interest article of the OECD Model (Article 11) provides as follows:

“1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. ...”

Thus, Article 11 applies to interest which arises in one contracting state and is paid to a resident of the other, and allows the state where the interest arises to impose tax. The rate of tax that can be imposed is limited to 10% of the gross amount of the interest. This rate is a common point of negotiation in concluded treaties.

Whether interest “arises” in a particular state is determined under Article 11(5) which provides that:

“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 in a Contracting State 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.”

Thus, interest will arise in the source state if it is either paid by a resident of that state or (broadly) if it originates from a PE of the payor located in that state. For the purposes of the discussion below it is assumed that the interest arises in the source state and that the payor is not resident in the PE state and does not have a PE there.

The source state

The source state must apply the conditions of the R-S treaty. For the purposes of the R-S treaty, the interest arises in State S and is paid to a resident of State R and therefore, Article 11 will apply. Under
Article 11, the source state may impose a tax, but the tax is limited to a certain percentage of the gross amount of the interest.44

The PE state

The PE state is obliged to apply the conditions of the R-PE treaty. For the purposes of the R-PE treaty, Article 11 does not apply because the interest does not "arise" in the PE state for the purposes of Article 11 (given that the payor is not resident in the PE state and does not have a PE there). Instead, the income will fall under Article 7, either directly because the income is considered to be business profits under the domestic laws of the PE state, or indirectly as a result of the application of Article 21(2). Given that the interest is attributable to a PE of the recipient which is located in the PE state, the PE state will be entitled to impose tax on the interest on the basis of the profit attributable to the PE in accordance with Article 7 of the R-PE treaty.45

Under the non-discrimination article (Article 24(3)) of the R-PE treaty, the PE state may have an obligation to grant relief for tax imposed in the source state (either by granting a credit or by exempting the income). The PE state's obligations under the non-discrimination article of the R-PE treaty will be discussed in Chapter 4.

The residence state

The residence state will be obliged to apply both the R-S treaty and the R-PE treaty. Under the R-S treaty, the residence state will be obliged to provide relief for tax imposed in the source state. Given that the income falls under Article 11, the residence state must provide relief using the credit method regardless of the general method of relief provided by the treaty. Under the R-PE treaty, the residence state will be obliged to either exempt the income attributable to the PE or to provide a credit for the tax imposed in the PE state, depending on the terms of the treaty. Where tax has been imposed in both the source state and the PE state, the residence state may not be able to provide sufficient relief to prevent unrelieved double taxation. In addition, the residence state may potentially be obliged to both exempt the income and grant a credit as a result of being subject to multiple treaty obligations. The residence state’s obligations to provide relief will be discussed in detail in Chapter 3.

Overall outcome

In a PE triangular case involving interest income, tax may be imposed in the source state, the PE state and the residence state. The residence state will have an obligation to provide relief for tax imposed in both the source state and the PE state, but may not be able to provide sufficient relief to prevent unrelieved double taxation. The PE state may also have an obligation to provide relief under the non-discrimination article of the R-PE treaty.

As is the case with respect to dividends, the transfer of primary (or exclusive) taxing rights to the PE state under the R-PE treaty raises the question of whether it is appropriate for the source state to continue to apply the conditions of the R-S treaty and whether it would be more appropriate for the source state to apply the conditions of the PE-S treaty.46 This would have an impact where, for example, the maximum rates of interest withholding tax allowed under Article 11 differ between the two treaties. The application of the R-S treaty also raises concerns about the potential for avoidance. That is, a person may claim the benefit of the R-S treaty to reduce the applicable rate of source-based taxation in circumstances where the residence state is prevented from imposing tax under the R-PE treaty and little or no tax is imposed in the PE state. Issues related to the appropriate treaty conditions to apply in the source state will be discussed in detail in Chapter 5.

44 See, for example: OECD "Triangular Cases," para. 11.
45 See, for example, OECD "Triangular Cases," para. 15.
46 See, for example: Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems...."
2.4.3. Royalties

In a typical PE triangular case involving royalty income, royalties arising in State S are paid to a resident of State R, and those royalties are attributable to a PE of the recipient which is located in a third state, State PE. A typical PE triangular case involving royalty income is illustrated in the following diagram.

Figure 2.3.: PE triangular case involving royalties

Article 12 provides that:

"Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."

Thus, under the OECD Model, Article 12 prevents taxation of royalties in the state where they arise, assigning exclusive taxing rights to the residence state. In many concluded treaties, however, Article 12 does allow source based taxation of royalties, generally limited by reference to a certain percentage of the gross amount of the income (as is the case for dividends and interest).47 This is also the case in the UN Model treaty.48 If Article 12 allows source based taxation in the same way as Article 10 and Article 11, then the outcome in a PE triangular case would be the same as that outlined above for dividends and interest, i.e., tax could be imposed in the source state, the residence state and the PE State. For the purposes of the discussion below, however, it is assumed that the relevant treaties all follow the OECD Model and thus do not allow any source-based taxation of royalties.

The source state

The source state is obliged to apply the conditions of the R-S treaty. In this situation royalties arising in State S are paid to a resident of State R. Therefore, for the purposes of the R-S treaty, Article 12 would apply and State S would be prevented from imposing any tax.

The PE state

The PE state is obliged to apply the conditions of the R-PE treaty. It is assumed that the royalties arise in State S and not in State PE and therefore, for the purposes of the R-PE treaty, the royalties do not arise in one of the contracting states and Article 12 would not apply. Instead, Article 7 will apply, either directly because the income is considered to be business profits for the purposes of applying the treaty, or indirectly as a result of the application of Article 21(2). Under Article 7, the PE state will be entitled to impose tax on the royalties on the basis of the profit attributable to the PE, despite the fact that they are considered to arise in a third state. Where the source state is prevented from imposing tax under the R-S treaty, as is the case here, the PE state would generally have no obligation to provide relief under Article 24(3) of the R-PE treaty. This will be discussed further in Chapter 4.

47 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Taxation Conventions…, at p. 773, (m.no. 9).
The residence state

The residence state must apply the conditions of both the R-S treaty and the R-PE treaty and under both these treaties, may impose tax on the income. Under the R-S treaty the source state is prevented from imposing tax and the residence state will therefore have no obligation to provide relief. The residence state will, however, have an obligation to provide relief under the R-PE treaty, using either the exemption method or the credit method depending on the terms of the treaty.

Overall result

In a PE triangular case involving royalties, tax can be imposed in the PE state and in the residence state, and the residence state will have an obligation to provide relief (either exemption or credit). To the extent that the R-S treaty follows the OECD Model, the source state will be prevented from imposing any tax on the income. In this situation, there would be no unrelieved double taxation. However, the R-PE treaty still allocates primary taxing rights to the PE state and thus, it remains questionable whether it is appropriate for the source state to be applying the conditions of the R-S treaty and not the conditions of the PE-S treaty. The conditions of these two treaties may differ with respect to whether the source state is entitled to impose tax on royalties or with respect to the maximum applicable rate. The application of the R-S treaty also raises concerns about the potential for avoidance. Issues related to the appropriate treaty conditions to apply in the source state will be discussed in detail in Chapter 5.

2.5. Business Profits

This section deals with situations where the income involved in a PE triangular case is considered to be business profits under the domestic laws of the source state. This should be distinguished from situations where the income is only considered business profits in the PE state and/or the residence state, since this may also occur with respect to other categories of income, e.g., interest or royalties derived in the context of a business. A typical PE triangular case involving business profits is illustrated in the following diagram.

![Figure 3.4.: PE triangular case involving business profits](image)

Article 7 of the OECD Model applies to business profits and provides that:

"1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State."^{49}

Thus, under Article 7, business profits derived by a resident of one contracting state can only be taxed in the other state (the source state) to the extent that they are attributable to a PE in that state.

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^{49} Article 7, paragraph 1, 2010 OECD Model Tax Convention. Prior to the 2010 update to the OECD Model, Article 7(1) read: “The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.” (changed wording indicated in italics)
The Source state

The source state must apply the conditions of the R-S treaty. For the purposes of the R-S treaty, Article 7 will apply and, since the recipient of the income does not have a PE in State S, State S will be prevented from imposing any tax on the income.

The PE state

The PE state must apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 7 will apply and the PE state will be entitled to impose tax on the basis of the profits attributable to the PE. Given that the source state is prevented from imposing tax under the R-S treaty, the PE state will generally not have any obligation to provide relief under the non-discrimination article of the R-PE treaty. This will be discussed further in Chapter 4.

The residence state

The residence state must apply the conditions of both the R-S treaty and the R-PE treaty. Neither of these treaties will prevent the residence state from imposing tax on the income. Under the R-S treaty, the source state is prevented from imposing any tax on the income and therefore, the residence state will not have any obligation to provide relief. The residence state will however have an obligation to provide relief under the R-PE treaty, with the method of relief depending on the terms of the treaty.

Overall result

The overall result in a PE triangular case involving business profits (after the application of the relevant treaties) is that taxation can be imposed in the PE state and in the residence state, with relief being provided in the residence state. The source state is prevented from imposing tax and there is thus no unrelieved double taxation. As will be seen below, however, this will not be the case if the business income is derived through a ”sub-PE” in the source state (see Section 2.5.1.).

As is the case in PE triangular cases involving passive income, the transfer of primary taxing rights to the PE state under the R-PE treaty in relation to business profits raises the question of whether it is appropriate for the source state to be applying the R-S treaty and not the PE-S treaty. In most cases, the application of these two treaties would give the same result in PE triangular cases involving business profits, since the vast majority of concluded treaties follow the OECD Model and base the allocation of taxing rights in relation to business profits on the existence of a PE.50 This stands in contrast to the treaty articles dealing with passive income which commonly differ with respect to the rate of tax that the source state can impose. Nevertheless, if the PE definitions do differ between the two treaties,51 this may give rise to circumstances in which the source state could impose tax if it applied the R-S treaty but not if it applied the PE-S treaty or vice versa. Thus, it is still important to consider which treaty conditions the source state should be required to apply. The application of the R-S treaty also continues to raise concerns about the potential for avoidance, i.e., in situations where the residence state is prevented from imposing tax under the terms of the R-PE treaty. Issues related to the appropriate treaty conditions to apply in the source state will be discussed in detail in Chapter 5.

51 A common example is the period of time over which a building site or construction project must exist before it gives rise to a PE for treaty purposes. In treaties that follow the UN Model Treaty, this period is reduced to 6 months, and some treaties between developed and developing countries specify an even shorter period, or no minimum period at all (see: Skaar, A.A., Permanent Establishment. Erosion of a Tax Treaty Principle, (Deventer: Boston, Kluwer Law and Taxation Publishers, 1991) at p. 344.)
2.5.1. Sub-PE triangular cases

A sub-PE triangular case is similar to a typical PE triangular case, with the exception that in this case the recipient of the income has a PE in the source state which is a sub-PE of the PE in the PE state. That is, the income attributable to the sub-PE in the source state (or sub-PE State, “State SPE”) is also attributable to the PE in the PE State. This is illustrated in the following diagram.

![Diagram](https://via.placeholder.com/150)

**Figure 2.5.: Sub-PE triangular case**

Sub-PE triangular cases are likely to be extremely rare, since they will only occur where income attributable to one PE is also properly attributed to another PE (i.e., the sub-PE) which somehow operates as an extension of the first PE. This could occur, for example, where a company resident in one state operates a regional headquarters through a PE in another state (the PE state) and also operates local offices in third states (through PEs) which fall under the responsibility of the regional headquarters (and are thus “sub-PEs”). In many cases a better analysis may be that the "sub-PE" is in fact just a separate PE of the enterprise as a whole and its income should not also be attributable to the PE in the "PE State." That is, there may be a PE in both states but they should each be attributed their appropriate share of the income and there should be no income that is attributable to both PEs. Sub-PE triangular cases should also be distinguished from cases where two source states disagree with respect to the attribution of certain income, and both consider it to be attributable to a local PE under their respective treaties with the residence state; such cases can better be resolved by determining which PE the income is more properly attributable to. Nevertheless, if a sub-PE triangular case does occur the applicable treaties will be:

(i) the treaty between the residence state and the sub-PE state (the R-SPE treaty); and
(ii) the treaty between the residence state and the PE state (the R-PE treaty).

These are the same treaties that apply in other PE triangular cases (with the R-SPE treaty being equivalent to the R-S treaty). The PE-SPE treaty will not apply because the recipient of the income is not resident in either of the contracting states and the existence of the PE does not give rise to eligibility for treaty benefits (as discussed above).

**State SPE**

State SPE must apply the conditions of the R-SPE treaty. For the purposes of this treaty, Article 7 would apply and the sub-PE state would be entitled to impose tax on the profits attributable to the sub-PE. This stands in contrast to situations where there is no (sub-) PE in the source state (discussed above), in which case the source state is prevented from imposing tax.

**The PE State**

The PE state is obliged to apply the conditions of the R-PE treaty. For the purposes of the R-PE treaty, Article 7 will apply and the PE state will be entitled to impose tax on the profit attributable to the PE. The PE state may also have an obligation to provide relief for tax imposed in the sub-PE state under the PE non-discrimination article of the R-PE treaty (Article 24(3)). This obligation will be discussed in Chapter 4.
The residence state

The residence state must apply the conditions of both the R-SPE treaty and the R-PE treaty. The residence state may impose tax but will have an obligation to provide relief under both these treaties, either by granting a credit or by exempting the income. The residence state may not, however, be able to provide sufficient relief to prevent unrelieved double taxation. The residence state may also potentially be required to grant dual relief, i.e., to grant a credit under on treaty while simultaneously exempting the income under the other applicable treaty. Issues associated with the residence state’s relief obligations will be discussed in Chapter 3.

Overall result

The overall result in a sub-PE triangular case is that tax may be imposed in the sub-PE state, the PE state and the residence state. The residence state has an obligation to provide relief for tax imposed in both the sub-PE state and the PE state, however may not be able to provide sufficient relief to prevent unrelieved double taxation.

The existence of a sub-PE can also alter the source state’s taxing rights under the R-S (R-SPE) treaty in cases involving categories of income other than business profits, i.e., in situations where the income is attributable to a sub-PE in the source state. This occurs in relation dividends,52 interest,53 royalties,54 capital gains from the alienation of movable property forming part of the business property of a PE,55 and other income.56 For dividends and interest, and potentially also royalties, the existence of a sub-PE to which the income is attributable means that the source state (sub-PE state) may impose tax on the basis of the profit attributable to the PE, rather than being limited by reference to a certain percentage of the gross amount of the income. Depending on the rate specified in the treaty, the expenses attributable to the income, and the rate imposed on the profit attributable to the PE under domestic law, the existence of the sub-PE may result in the source state (the sub-PE state) imposing either more or less tax on the income. For other categories of income, such as capital gains from movable property attributable to the PE and other income, the existence of the sub-PE means that the source state is entitled to impose tax on income which it would otherwise be prevented from taxing. Where there is additional taxation in the source state as the result of the existence of the sub-PE, this both increases the likelihood of double taxation occurring and also increases the likely quantum of any unrelieved double taxation that does occur. In relation to other categories of income (such as income from immovable property and income from shipping and air transport57) the existence of a PE (or sub-PE) has no impact on the distribution of taxing rights and thus, the outcome in a sub-PE triangular case is the same as in a typical PE triangular case. Sub-PE cases will not be discussed extensively in this thesis, partly because they are simply a sub-set of other PE triangular cases, however they will be addressed further in Chapter 9 (Section 9.2.5).

52 The sub-PE state is entitled to impose tax on the profit attributable to the sub-PE under Article 7 of the R-SPE treaty; Article 7 applies as a result of Article 10(4).
53 The sub-PE state is entitled to impose tax on the profit attributable to the sub-PE under Article 7 of the R-SPE treaty; Article 7 applies as a result of Article 11(4).
54 The sub-PE state is entitled to impose tax on the profit attributable to the sub-PE under Article 7 of the R-SPE treaty; Article 7 applies as a result of Article 12(3).
55 The sub-PE state is entitled to impose tax under Article 13(2) of the R-SPE treaty.
56 The sub-PE state is entitled to impose tax on the profit attributable to the sub-PE under Article 7 of the R-SPE treaty; Article 7 applies as a result of Article 21(2).
57 In relation to income from immovable property located in the sub-PE state, Article 6 of the R-SPE treaty applies and the sub-PE state may impose tax. In relation to income from shipping, inland waterways transport and air transport, Article 8 of the R-SPE treaty applies and the source state is likely to be prevented from imposing tax (since exclusive taxing rights are allocated to the state where the place of effective management is located). For both these categories of income, the existence of a PE (or sub-PE) has no impact on the sub-PE state’s taxing rights under the R-SPE treaty. In relation to the other types of capital gains to which Article 13 applies, the existence of the sub-PE similarly has no impact on the distribution of taxing rights under the R-SPE treaty.
2.5.2. Business income arising from activities of artistes and sportsmen (Article 17)

Although income arising from the personal activities of a sportsman or entertainer is beyond the scope of this thesis, Article 17 can in some cases, apply to business income derived by an enterprise. Article 17(2) provides as follows:

"Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7 and 15 [dealing with independent personal services], be taxed in the Contracting state in which the activities of the entertainer or sportsman are exercised."

Thus, for example, a company resident in State R may derive business income from managing performers who undertake their activities in the source state and that income may be attributable to a PE in a third state (the PE state). This is illustrated in the following diagram.

Figure 2.6.: PE triangular case involving business profits dealt with under Article 17

In this case, Article 17(2) of the R-S treaty would apply, and the source state would be entitled to impose tax on the income even though the person deriving the income does not have a PE in that state. For the purposes of the R-PE treaty, Article 7 would apply and the PE state would be entitled to impose tax on the income. The residence state would also be entitled to impose tax, but would be obliged to provide relief for tax imposed in both the source state and the PE state; the issues associated with the residence state’s relief obligations will be discussed in Chapter 3. The PE state may also have a relief obligation under the non-discrimination article of the R-PE treaty, as will be discussed in Chapter 4.

2.6. Income from immovable property

In a PE triangular case involving income from immovable property, a person resident in State R derives income from immovable property located in State S, and that income is attributable to a PE in State PE. This may occur, for example, in a situation where the income is rental income and the PE conducts property management activities in the PE state.58 A PE triangular case involving income from immovable property is illustrated in the following diagram.

Figure 2.7.: PE triangular case involving income from immovable property

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58 Refer to Chapter 5 (particularly Section 5.2.5.) for discussion of the attribution of profits to PEs.
Article 6, dealing with income from immovable property, provides that:

"Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other state."

Thus, Article 6 allows the state where the property is located to impose tax on the income without limitation. Article 6(2) contains the following definition of immovable property:

"The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property."

The source state

The source state must apply the conditions of the R-S treaty. For the purposes of the R-S treaty, Article 6 applies and the source state to impose tax on the income. The residence state may also impose tax on the income, but will be obliged to provide relief, either by granting a credit or by exempting the income.

The PE state

The PE state must apply the conditions of the R-PE treaty. Under the R-PE treaty, Article 6 does not apply because the income is not derived from "...immovable property... situated in the other Contracting State...", i.e., the PE state. The question then arises as to which article of the R-PE treaty should apply in this situation. The two possibilities are Article 7 and Article 21, and the outcome in this triangular situation will depend upon which of these articles applies. If Article 7 applies, the PE state will be entitled to impose tax on the income and tax may be imposed in the source state, the PE state and the residence state, with relief being provided in the residence state and potentially also in the PE state (under the non-discrimination article of the R-PE treaty). The application of Article 7 of the R-PE treaty may lead to unrelieved double taxation. On the other hand, if the distributive rule of Article 21 applies then the PE state will be prevented from imposing tax. In this case, tax can only be imposed in the source state and the residence state and the residence state will be obliged to provide relief; there will be no unrelieved double taxation.

Paragraph 1 of the OECD commentary on Article 6 states that Article 21(1) will apply to income from immovable property situated in a third state (i.e., for the purposes of the R-PE treaty), however, it does not explain the basis upon which this conclusion is reached. Various authors have questioned the interpretation reflected in the OECD commentary, while others have put forward arguments in support of it. The following sections analyses, firstly, a situation where the income is considered business profits under the domestic law of the PE state and, secondly, a situation where the income is not considered business profits under the domestic law of the PE state.

59 OECD Commentary on Article 6, para. 1.
2.6.1. Income considered "business profits" under domestic law

This section considers whether Article 7 of the R-PE treaty can apply to income derived from immovable property situated in a third state where that income is considered to be business profits under the domestic laws of the PE state. Income from immovable property is often treated as business profits under domestic law62 and, prima facie, if income is considered to be business profits and is not considered to be "dealt with" in another article of the treaty (for the purposes of Article 7(4)63), then the distributive rule contained in Article 7 will apply. This is contrary to the position taken in the OECD Commentary (i.e., that Article 21(1) applies), which requires that Article 7 does not apply.64 The main argument in support of the non-application of Article 7 in this situation is that business profits and income from immovable property are mutually exclusive categories of income, and therefore, that income from immovable property situated in a third state cannot be business profits for treaty purposes. An alternative argument, advanced by Rust,65 is that such income should be considered to be "dealt with" in Article 6 (even though Article 6 does not apply) and, as a result, Article 7 should not apply. These two alternative arguments will be discussed in turn below. If Article 7 does not apply then Article 21 will apply and the issue then arises as to whether Article 21(2) can operate to shift the income back to Article 7; this will be discussed in Section 2.6.2.

2.6.1.1. Whether the income will be business profits for treaty purposes

The term "business profits" is not defined in tax treaties that follow the OECD Model and therefore takes its meaning from the domestic law of the state applying the treaty.66 In this case, the PE state is applying the R-PE treaty to determine whether it may impose tax on the income and therefore, if the income is considered to be business profits under the domestic laws of the PE state it, will also, prima facie, be considered to be business profits for the purposes of the R-PE treaty. The question, then, is whether there is anything which may limit this definition or exclude income derived from immovable property situated in a third state from the meaning of business profits for treaty purposes.

Scandone and Pappalardo67 argue that the definition of immovable property in Article 6 is part of the "context" of the definition of business profits and therefore the meaning of business profits should exclude items of income which fall within the definition of income from immovable property. If this argument is accepted, then it follows that Article 7 should not apply to income from immovable property arising in a PE triangular case and that instead, Article 21 should apply. One issue with Scandone and Pappalardo's argument is that the definition of immovable property in Article 6(2) generally does not apply when the property is situated in a third state (as it is for the purposes of the R-PE treaty in a PE triangular case).68 Article 6(2) provides that "[a]the term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated." If the property is not located in either of the Contracting States (i.e., State R and State PE) then this definition cannot apply.69 As a result, the income is not "Income derived... from immovable property..." for the purposes of the treaty and it is difficult to see how the concept of income from immovable property could limit the definition of business profits in such a case. Secondly, even though the definition of immovable property may be part of the context of the definition of business profits, it does not follow

62 Arnold, B.J., "At Sixes and Sevens...".
63 This reference is to the 2010 OECD Model; the corresponding paragraph in the 2008 OECD Model was contained in Article 7(7).
64 OECD Commentary on Article 6, para. 1.
65 Rust, A., "Situs Principle...".
66 The term "business profits" is not defined in the treaty and thus takes its meaning from the domestic law of the state applying the treaty (Article 3(2)). In this case, the state applying the treaty is the PE state, which is determining how much tax it may impose on the income. If there is a conflict of qualification (i.e., the residence state does not consider the income to be business profits) then for the purposes of determining whether relief is required under Article 23A or 23B, the residence state is bound by the classification in the source state (in this case, State PE) (See: OECD Commentary on Articles 23A and 23B, Section E, paras 32.1-32.7).
67 Scandone, F.S., & Pappalardo., B.E., "The Interaction Between...".
68 With the exception of, e.g., livestock and equipment used in agriculture or forestry, which is always considered to be immovable property under Article 6(2).
69 OECD Commentary on Article 6, para. 1.
that it limits that definition. There is no indication in the treaty that the definitions of income from immovable property and business profits cannot overlap.\(^70\) Rather, the existence of Article 6(4), providing that income from immovable property includes the income of an enterprise, and Article 7(4), providing that Article 7 does not apply to income that is dealt with in another treaty article, both seem to imply that there can be an overlap between the definition of business profits and the definitions of other types of income, including income from immovable property. In addition, the OECD commentary on Article 6 states that the fact that the source state has the priority taxing right over the residence state, including in situations where the income is only indirectly derived from immovable property, "... does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise."\(^71\)

A similar argument to that of Scandone and Pappalardo was presented by Papotti and Saccardo,\(^72\) albeit on a different basis. These authors, referring to case law in Luxembourg and France, argued that as a result of Article 6(4), which provides that the provisions of Article 6 "... shall also apply to the income from immovable property of an enterprise", Article 7 never applies to income from immovable property including immovable property located in a third state. This argument was rejected by Arnold,\(^73\) who stated that:

"I do not find this argument persuasive. It requires reading into Art. 7 a rule that excludes any income from immovable property that constitutes business profits under domestic law. There is nothing in the Commentary to indicate that such an interpretation is appropriate. In fact, Para. 32 of the Commentary on Art. 7 states clearly that the term "business profits" has a very broad meaning. Accordingly, the more natural and less strained interpretation is that income from immovable property that constitutes business profits is covered by both Arts. 6 and 7 and that Art. 7(7) [now Article 7(4)] is necessary to resolve the overlap in favour of Art. 6. Admittedly, this interpretation makes Art. 6(4) unnecessary."

An additional problem in relation to Papotti and Saccardo's argument is that the definition of immovable property generally would not apply for the purposes of the R-PE treaty in the present situation where the property is situated in a third state. As a result, there is in fact no overlap between Article 6 and Article 7; Article 6 simply does not apply, and Article 6(4) is not relevant.

Based on the analysis above, income from immovable property situated in a third state may be considered to be business profits for the purposes of Article 7 of the treaty between the residence state and the PE state. The question then is whether the income excluded from Article 7 as a result of Article 7(4); that is, whether it is "dealt with" in another article of the treaty.

2.6.1.2. Whether the income is "dealt with" in another article of the treaty

Article 7(4) provides that:

"Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

In effect, this excludes the operation of the distributive rules of Article 7 where another article of the treaty applies. The usual meaning given to the term "dealt with" in Article 7(4) is that the income in question is subject to the distributive rules of another article of the treaty.\(^74\) The distributive rules of Article 6 of the R-PE treaty do not apply where the property is situated in a third state. Therefore, in accordance with the normal interpretation of Article 7(4), the income arising from immovable property situated in a third state would not be dealt with in Article 6 and thus, Article 7(4) would not apply.

\(^{70}\) Arnold, B.J., "At Sixes and Sevens....".
\(^{71}\) OECD Commentary on Article 6, para. 4.
\(^{72}\) Papotti, R., & Saccardo, N., "Interaction of Articles...."
\(^{73}\) Arnold, B.J., "At Sixes and Sevens....".
\(^{74}\) Rust, A., "Situs Principle...."
Rust has proposed an alternative interpretation of Article 7(4) which would exclude from Article 7 any income arising from immovable property situated in a third state. Rust suggests that the term "items of income... dealt with separately" in Article 7(4) should be interpreted as "type of income dealt with separately." He argues that this would result in Article 7 no longer being applicable to income from immovable property located in a third state and that, consequently, the distributive rule of Article 21(1) would become applicable. The main problem with Rust's proposed approach is that it would result in the term "dealt with" having distinctly different meanings in Article 7 and in Article 21. This is difficult to accept because in both these articles, the term "dealt with" appears in a similar context and serves a similar purpose. On the other hand, if the proposed meaning of "dealt with" also applied for the purposes of Article 21, then income from immovable property located in third states, and potentially also other types of income derived from sources in a third states, would not be covered by the treaty at all. Rust maintains, therefore, that for the purposes of Article 21, "dealt with" should continue to have its traditional meaning, with the result that the income must be subject to the distributive rules of another treaty article for Article 21 to be excluded. Rust recognises the conflict this creates (i.e., the same term having two different meanings within one treaty), but argues that more weight should be given to "arguments of consistency"; that is, ensuring that income from immovable property situated in a third state is covered by Article 21 rather than Article 7, and is thus not taxed in the PE state. It seems, however, that the better approach for achieving this outcome would be to make changes to Article 7(4) of the OECD Model, as Rust proposes in his article.

An additional issue with Rust's argument is that it requires that the income is considered to be a "type of income dealt with separately" in Article 6, even though the property which gives rise to the income does not fall within the definition of immovable property in Article 6(2). It also ignores the potential application of Article 21(2), which, if it applied, would shift the income back to Article 7. This is discussed in the following section.

In summary, where income arising from immovable property located in a third state is considered to be business profits for the purposes of the R-PE treaty, Article 7 should apply. The income should not be considered to be "dealt with" in another article of the treaty, and should not be excluded from the scope of Article 7 of the R-PE treaty simply because it is considered to be income from immovable property for the purposes of the R-S treaty. As a result of the application of Article 7 of the R-PE treaty, the PE state would be entitled to impose tax on the income on the basis of the profit attributable to the PE.

2.6.2. Income not considered business profits

If the income arising from the immovable property is not considered to be business profits for the purposes of the R-PE treaty then, prima facie, Article 7 will not apply. Instead, given that none of the other articles of the treaty apply, the income will fall under Article 21. Article 21(1) provides that:

"Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State."

If the distributive rule of Article 21(1) applies, it will prevent the PE state from imposing any tax on the income. Article 21(1) will not apply, however, if Article 21(2) applies; Article 21(2) generally excludes the application of the distributive rule of Article 21(1) where the income arises in connection with a PE in the "other contracting state" (in this case, the PE state), and provides that Article 7 will apply instead. However, Article 21(2) excludes income from immovable property. Article 21(2) provides that:

"The provisions of paragraph 1 [which provides that the income shall be taxable only in the residence state] shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is

\[75\text{Rust, A., "Situs Principle...."}
\[76\text{Rust proposes that changes be made to Article 7(4) (then Article 7(7)) of the OECD Model, "eliminating any remaining doubt." To have effect, these changes would of course have to be reflected in the treaty that is being applied.}
paid is effectively connected with such permanent establishment. In such case, the provisions of Article 7 shall apply.” [Emphasis added.]

The most important aspect of this paragraph for the present case is that the exclusion for income from immovable property only applies to income from immovable property as defined in Article 6(2). As mentioned earlier, this definition generally does not apply if the property in question is situated in a third state. Thus, for the purposes of the R-PE treaty, the exclusion from Article 21(2) will generally not apply in relation to income from immovable property situated in a third state. This means that where income from immovable property located in a third state is attributable to a PE in one of the contracting states, Article 21(2) will operate to shift the income to Article 7. This would not be the case if the property in question falls within one of the categories of property which is always considered immovable property under Article 6(2), without reference to the domestic laws of the Contracting States, such as livestock and equipment used in agriculture and forestry. For income derived from this type of property, Article 21(2) of the R-PE treaty will not apply and the income will continue to be dealt with under the distributive rule of Article 21(1). Article 21(1) will prevent the PE state from imposing any tax on the income. However, this would only be the case if the income is not considered to be business income. If the income is considered to be business income then, based on the analysis above, it should fall under the distributive rule of Article 7 directly (i.e., without any need to apply Article 21(2)).

2.6.3. Overview

If income from immovable property situated in a third state is considered to be business income under the domestic law of the PE state, then it should also be considered to be business income for the purposes of the R-PE treaty. In addition, the income should not be considered to be "dealt with separately" in Article 6 and thus, Article 7(4) should not apply to prevent Article 7 from applying. As a result, where the income is considered to be business profits for the purposes of the R-PE treaty, the distributive rule of Article 7 should apply; this would allow the PE state to impose tax on the income.

If the income is not considered to be business profits or, alternatively, is considered to be business profits but is also considered to be "dealt with" in Article 6, such that Article 7 would not apply directly, the distributive rule of Article 7 should still ultimately apply. This occurs under Article 21(2), and is partly a result of the fact that the definition of immovable property in Article 6 is worded to apply bilaterally, such that income from immovable property situated in a third state is not considered to be income from immovable property for the purposes of the treaty. In this situation, the application of Article 7 would again allow the PE state to impose tax on the income.

The only situation in which the distributive rule of Article 21(1) should apply for the purposes of the R-PE treaty in a PE triangular case is if (i) the income is not considered to be business income and (ii) the property from which the income arises falls within one of the categories of property which is always considered to be immovable property under Article 6(2), without reference to the domestic laws of the Contracting States, such as livestock and equipment used in agriculture and forestry. In this case, Article 21 will apply and Article 21(2) will not operate to shift the income to Article 7. However, such cases are likely to be uncommon since such income would typically be business income.

2.6.4. Policy considerations

Much of the commentary to date, including the OECD Commentary, considers the appropriate result in this case to be that the income is covered by Article 21(1) with the result that no tax is imposed in the PE state. It is true that this prevents triple taxation and the potential for unrelieved double taxation. That is,

77 The exception in Article 21(2) for income from immovable property would apply, however, in a bilateral case where income from immovable property situated in the residence state was attributable to a PE in the other state. In this case, Article 21 would continue to apply and the PE state would be prevented from imposing any tax on the income.
78 OECD Commentary on Article 6, para. 1. See also the articles discussed above.
the income would only be taxed in the source state and the residence state with relief being provided in the residence state (either by way of exemption or credit). However, if Article 7 applies and, as a result, the PE state is also entitled to impose tax on the income, then unrelieved double taxation could still be prevented provided that sufficient relief is granted in the PE state and the residence state (as will be discussed in Chapter 3).

In addition, if it is accepted that the PE state should have a right to impose tax on other types of income arising in third states, then it is not clear why an exception should be made for income from immovable property. One argument against allowing the PE state to impose tax in this case is the primacy of the situs principle; that is, the location of immovable property in the source state gives that state the primary taxing claim in relation to the income.79 However, in a bilateral case, the situs principle is not considered to be infringed by the residence state having residual taxing rights in relation to the income, as indicated by the fact that Article 6 does not prevent the residence state from imposing tax. Similarly, provided the PE state grants relief for tax imposed in the source state, taxation in the PE state should not be seen as infringing upon the source state's primary taxing right. The amount of tax that the source state can impose is not affected by whether the PE state also imposes tax on the income.

In summary, provided sufficient relief is granted in the PE state for source state taxation, then it seems appropriate that the income falls under Article 7 of the R-PE treaty and that the PE state should be allowed to impose tax. Such treatment would be in line with the treatment of other categories of income attributable to the PE. As demonstrated above, Article 7 of the R-PE treaty should generally apply to income from immovable property situated in a third state and, as a result, the PE state will generally be entitled to impose tax. Thus, no amendment to the OECD Model would be required to achieve this outcome in most cases. The only exception is in the case of property which meets the definition of immovable property and is not considered to be business profits under the domestic law of the PE state. For such income to fall under Article 7, Article 21(2) would have to be amended so that the exclusion for immovable property only applies if the property is situated in the residence state (which is the intention of the exclusion).

Finally, the transfer of primary taxing rights to the PE state under the R-PE treaty again raises the question of whether it is appropriate for the source state to be applying the conditions of the R-S treaty and not the conditions of the PE-S treaty. In most cases involving immovable property, the application of the PE-S treaty instead of the R-S treaty would have no impact on the tax that could be imposed in the source state. This is because the definition of immovable property operates by reference to domestic law and once Article 6 applies, there is no limitation on the source state's ability to impose tax. Nevertheless, the application of the R-S does raise concerns about the potential for avoidance, at least in cases where there is no PE-S treaty that may otherwise apply. Issues related to the appropriate treaty conditions to apply in the source state will be discussed in detail in Chapter 5.

2.7. Income from shipping, inland waterways transport and air transport

A PE triangular case involving income from shipping, inland waterways transport and air transport occurs where a person resident in State R derives such income from sources in State S, and that income is attributable to a PE in State PE. This situation is illustrated in the diagram below. In this diagram, "PoEM" refers to the state where the place of effective management of the enterprise is located.

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79 Rust, A., "Situs Principle...."
International transport income is covered by Article 8, which provides that:

“1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

Thus, Article 8 allocates sole taxing rights to the state where the place of effective management of the person deriving the income is located. For the purposes of Article 8, the term "enterprise" refers to the enterprise as a whole and not only to the part of the enterprise carrying on the transport business. This means that in a PE triangular case, the place of effective management of the enterprise will not be located in the PE state, even if the shipping or air transport business is carried on exclusively by the PE. In a PE triangular case, the place of effective management would generally be located in the residence state and this is assumed to be the case for the purposes of the discussion below.

The OECD Commentary on Article 8 notes that some states "prefer to confer exclusive taxing rights on the residence state" and provides alternative wording for states that wish to do so. Evidently, a number of states have followed this approach. This would generally not give a different result, however, than if the distributive rule were based on the place of effective management, since the place of effective management and the residence state would typically coincide.

Application of the R-S treaty and the R-PE treaty

In a PE triangular case involving income from shipping, inland waterways transport or air transport, Article 8 would apply for the purposes of the R-S treaty and State S will be prevented from imposing any tax on the income. Similarly, for the purposes of the R-PE treaty, Article 8 will apply and State PE will be prevented from imposing any tax. Under both these treaties, exclusive taxing rights will be allocated to the state where the place of effective management is located, i.e., the residence state. Given that neither the source state nor the PE state are able to impose tax, there will be no double taxation and the residence state will have no obligation to provide relief. The PE state will also have no obligation to provide relief under the non-discrimination article of the R-PE treaty. Finally, in this situation there would be no transfer of taxing rights from the residence state to the PE state under the R-PE treaty and thus, it is clearly appropriate for the source state to continue to apply the conditions of the R-S treaty. There is also no question of avoidance, since there is no restriction on the residence state’s ability to impose tax.

81 Refer to Chapter 9 for further discussion of the residence rules under tax treaties, including the residence tie-breaker provisions for companies which are based on the “place of effective management.”
82 2010 OECD Commentary on Article 8, para. 2.
83 Based on a survey of treaties between OECD member states and between OECD member and non-member states, Maisto identifies that around 47% of treaties follow the wording in the OECD Model (allocating exclusive taxing rights to the state where the place of effective management is located) and around 44-48% of treaties base the allocation of taxing rights on residence. Thus, 85-90% of treaties base the allocation of taxing rights on either the place of effective management or on residence. The only country which does not primarily use one of these rules is Greece, which uses a "place of registration" criterion for shipping income. See: Maisto, G., "Shipping, Inland Waterways…,” at pp. 37-38.
2.8. Capital gains

The outcome in a PE triangular case involving capital gains depends on the type of gain involved. The analysis below is organised around the categories of gains identified in Article 13. In each case, it is assumed that the company resident in State R derives a capital gain in relation to the alienation of property situated in a third state (State S), and that the capital gain is attributable to the PE in State PE.

2.8.1. Capital gains from the alienation of immovable property

In the situation discussed in this section, a person resident in State R derives a capital gain from the alienation of immovable property situated in State S, and that capital gain is attributable to a PE located in State PE. This situation is illustrated in the following diagram.

Figure 2.9.: PE triangular case involving capital gains from the alienation of immovable property

Article 13(1) provides that:

"Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other state."

Thus, Article 13(1) allows the state where immovable property is situated to impose tax on any gains from its alienation.

The source state

The source state will be obliged to apply the conditions of the R-S treaty. For the purposes of the R-S treaty, Article 13(1) will apply and the source state will be entitled to impose tax on the gain.

The PE state

The PE state must apply the conditions of the R-PE treaty. For the purposes of the R-PE treaty, Article 13(1) will not apply because the gain does not arise from property situated in the other contracting state (i.e., the PE state). Given that Article 13(1) does not apply, the question then arises as to which other paragraph of Article 13 should apply. Article 13(2) applies to movable property forming part of the business property of a PE and in this case, the property does form part of the business property of a PE. However, while the property is not "immovable property" within the definition contained in Article 6, it is arguably not "movable property" either and thus does not fall under Article 13(2). Given that the gain

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84 This is the case even if the property does fall within the definition of immovable property in Article 6(2), which will generally not be the case given that the property is situated in a third state. The exception is certain property, such as livestock and equipment used in agriculture and forestry, which is always considered to be immovable property under the second sentence of Article 6(2), without reference to the domestic laws of the Contracting States. Refer to Section 2.6., above.

85 Paragraph 24 of the OECD Commentary on Article 13 states that "The term "movable property" means all property other than immovable property which is dealt with in paragraph 1." However, there is no definition of "movable property" in the OECD Model and it will thus take its meaning from the domestic law of the state applying the treaty (in accordance with Article 3(2). If the domestic law of that state includes the particular type of
is not covered by any of the other paragraphs of Article 13, it will fall under the distributive rule of Article 13(5). Article 13(5) provides that:

“Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.”

Thus, gains falling under Article 13(5) can only be taxed in the residence state. Under Article 13(5) of the R-PE treaty, the PE state will be prevented from imposing any tax on the income. The PE state will therefore have no obligation to provide relief under the non-discrimination article of the R-PE treaty (Article 24(3)).

The residence state

The residence state is obliged to apply the conditions of both the R-S treaty and the R-PE treaty. Under the R-S treaty, the residence state may impose tax but will be obliged to provide relief for tax imposed in the source state, either by granting a credit or by exempting the income. The residence state will have no relief obligation under the R-PE treaty because that treaty does not allow the PE state to impose any tax on the gain.

Overall result

The overall result in this situation is that tax may be imposed in the source state (the state where the property is located) and in the residence state, with the residence state obliged to provide relief for tax imposed in the source state. There will be no unrelieved double taxation. There will also be no question of the appropriate treaty conditions to be applied by the source state, since there is not transfer of taxing rights to the PE state under the R-PE treaty, and no scope for avoidance.

The outcome in this case is different to the outcome of a case involving income (as opposed to capital gains) from immovable property, where the application of Article 7 of the R-PE treaty means that the PE state may be entitled to impose tax on the basis of the profit attributable to the PE (as discussed above in Section 2.6.). This is not intended; the OECD commentary indicates that the outcome of the application of Article 13 to capital gains is intended to give the same result as applying the treaty article applicable to income from a corresponding source. This argument of consistency is perhaps one reason why it should be Article 21 (and not Article 7) that applies under the R-PE treaty to income from immovable property situated in a third state, in which case the PE state would be prevented from imposing any tax on the income. Alternatively, it may be preferable for Article 13(1) to be modified, such that capital gains arising in relation to immovable property situated in a third state may be taxed in the PE state. This will be discussed further in Chapter 9 (see Section 9.2.4.).

2.8.2. Capital gains from the alienation of movable property of a PE

In the situation discussed in this section, a person resident in State R derives a capital gain from the alienation of movable property which forms part of the business property of a PE located in State PE, but which is also considered to be sourced in State S under the domestic law of that state. This could occur, for example, if the property were located in that state or if the contracts for the sale were negotiated and concluded in that state. This situation is illustrated in the following diagram.
Article 13(2) provides that:

"Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other contracting state."

In short, Article 13(2) allows gains from the alienation of movable property of a PE to be taxed in the PE state.

**The source state**

The source state is obliged to apply the conditions of the R-S treaty. For the purposes of this treaty, Article 13(2) would not apply because the gain does not relate to property of a PE located in the source state. Assuming in this case that the gain does not fall under paragraphs 1, 3 or 4 of Article 13, Article 13(5) would apply and, as a result, the source state would be prevented from imposing any tax on the gain.

**The PE state**

The PE state is obliged to apply the conditions of the R-PE treaty. For the purposes of this treaty, capital gains from the alienation of movable property forming part of the business property of the PE would fall under the distributive rule of Article 13(2) and the PE state would be entitled to impose tax. Given that the source state is prevented from imposing tax on the income, the PE state should not be obliged to provide any relief under the non-discrimination article of the R-PE treaty (Article 24(3)).

**The residence state**

The residence state must apply the conditions of both the R-S treaty and the R-PE treaty. The residence state may impose tax on the income, and is not prevented from doing so by either treaty, but will be obliged to provide relief under the R-PE treaty. This may take the form of either exemption or credit relief, depending on the terms of the treaty. The residence state will have no relief obligation under the R-S treaty since the source state is not entitled to impose any tax under the terms of the treaty.

**Overall result**

The overall result in this situation is that tax can be imposed in both the PE state and the residence state (but not in the source state), and the residence state must provide relief for tax imposed in the PE state. There is no unrelieved double taxation.

Although the source state is prevented from imposing tax under the R-S treaty, the transfer of primary taxing rights to the PE state under the R-PE treaty nevertheless raises the question of whether it is appropriate for the source state to be applying the conditions of the R-S treaty and not the PE-S treaty.
The application of the R-S treaty also raises concerns about the potential for avoidance. Issues related to the appropriate treaty conditions to apply in the source state will be discussed in detail in Chapter 5.

2.8.3. Capital gains from the alienation of ships or aircraft operated in international traffic

In the situation discussed in this section, a person resident in State R derives a capital gain from the alienation of certain assets which are used in international transport, and the capital gain is attributable to a PE in State PE. The gain is also considered to be locally sourced under the domestic law of State S, e.g., because the property is located in that state or because the sale occurs there. This situation is illustrated in the following diagram.

Figure 2.11.: PE triangular case involving capital gains from the alienation of ships or aircraft in international traffic and associated assets

![Diagram]

Article 13(3) provides that:

"Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated."

As discussed above in relation to Article 8, the phrase "place of effective management of the enterprise" refers to the place of effective management of the enterprise as a whole. As a result, in a PE triangular case, the place of effective management for the purposes of Article 13(3) will typically be located in the residence state (State R), and this is assumed to be the case for the purposes of the discussion below.

For the purposes of both the R-S treaty and the R-PE treaty, Article 13(3) will apply to any gains derived from the alienation of property mentioned in Article 13(3). As a result both the source state and the PE state will be prevented from imposing any tax under their respective treaties with the residence state. There will be no limitation on the residence state's right to impose tax and the residence state will not be required to provide relief. Given that tax can only be imposed in the residence state, there will be no double taxation in this case and the PE state will have no obligation to provide relief under the non-discrimination article of the R-PE treaty. There is also no transfer of taxing rights from the residence state to the PE state under the R-PE treaty in this case and it is therefore clearly appropriate for the source state to apply the conditions of the R-S treaty. There is also no question of avoidance, since there is no restriction on the residence state's ability to impose tax.

2.8.4. Capital gains from the alienation of shares in a real estate company (and similar cases)

The discussion in this section deals with a situation where a person who is resident in State R derives a capital gain from the alienation of shares which derive their value from immovable property located in State S. The capital gain is attributable to a PE of the person deriving the gain, which is located in State PE. This situation is illustrated in the following diagram.

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88 Maisto, G., "Shipping, Inland Waterways…."

54
Article 13(4) provides that:

"Gains derived by a resident of one Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State."

The OECD Model does not contain any other specific provision dealing with shares, but some concluded treaties also allow source based taxation of capital gains arising from:

1. The alienation of shares in a company having more than 50% of its assets located in the source state (i.e., not limited to immovable property);89 and/or
2. The alienation of shares in a company resident in a contracting state where the person disposing of those shares has a "substantial participation" (i.e., a shareholding of more than a certain specified percentage) in the company whose shares are being alienated.90

In general, these provisions allow the source state (i.e., the state where the underlying property is located) to impose tax on the gains in the same way as Article 13(4) allows gains arising from shares in a real estate company to be taxed. The discussion below will also apply, therefore, in relation to the other types of shares outlined above where the relevant treaties contain such provisions (although reference will only be made to Article 13(4)). In the case of Article 13(4) and other articles referring to the place where the underlying property is located, the state where the shares are registered or where the company owning the underlying property is resident is not relevant because it does not alter the distribution of taxing rights.

The Source state

The source state must apply the conditions of the R-S treaty. For the purposes of that treaty, the gain is derived by a resident of one contracting state (State R) arises from the sale of shares in a company deriving their value from immovable property located in the other contracting state (State S). Article 13(4) will therefore apply and the source state will be entitled to impose tax on the gain.

The PE state

The PE state must apply the conditions of the R-PE treaty. For the purposes of that treaty Article 13(4) will not apply because the underlying property is not situated in the PE state. The question then arises as to which paragraph of Article 13 should apply to the gain. From the perspective of the PE state, which is the state applying the treaty in this case, the gain relates to the alienation of shares forming part of the business property of the PE. Shares are generally considered movable property91 and thus, the applicable

90 See, for example the reservations of France, Chile, Sweden and Korea in the OECD Commentary to Article 13 of the OECD Model.
91 The OECD Commentary on Article 13(4) notes that “The term ‘movable property’ means all property other than immovable property which is dealt with in paragraph 1.” (at para. 24).
article of the R-PE treaty will be Article 13(2). The PE state is entitled to impose tax on the gain.

This stands in contrast to the result of applying the R-PE treaty in a PE triangular case involving capital gains from the alienation of immovable property located in a third state and held directly by the PE, rather than through an intermediate company. As discussed above, the applicable article of the R-PE treaty in that case would be Article 13(5) and the PE state would be prevented from imposing tax on the gain. However, the taxation of the gain in the PE state is consistent with the outcome in relation to income from immovable property, discussed above, where Article 7 applies and the income can be taxed in the PE state. This supports the argument for applying Article 7 instead of Article 21 in that case.

The residence state

The residence state must apply the conditions of both the R-S treaty and the R-PE treaty. Under both the treaties, the residence state may impose tax on the gain but will have an obligation to provide relief for tax imposed in the other contracting state, using either the credit or exemption method depending on the terms of the treaty.

Overall result

The overall result in this case is that the gain can be taxed in the source state, the PE state and the residence state. The residence state has an obligation to provide relief under both the R-S treaty and the R-PE treaty, but may not be able to fully relieve double taxation. This will be discussed in Chapter 3. The PE state may also have an obligation to provide relief for tax imposed in the source state under the non-discrimination article of the R-PE treaty. This will be discussed in Chapter 4.

Finally, the transfer of primary taxing rights to the PE state under the R-PE treaty raises the question of whether it is appropriate for the source state to be applying the conditions of the R-S treaty and not the PE-S treaty. The application of the R-S treaty in the source state may also raise concerns about the potential for avoidance. Issues related to the appropriate treaty conditions to apply in the source state will be discussed in detail in Chapter 5.

2.8.5. Capital gains from the alienation of other property

In the situation described in this section, a resident of State R derives a capital gain from the alienation of property not covered under paragraphs 1 through 4 of Article 13. The capital gain is considered to be sourced in State S under the domestic laws of that state, and is attributable to a PE of the person deriving the gain situated in State PE. This situation is illustrated in the following diagram.

Figure 2.13.: PE triangular case involving capital gains from the alienation of other property

Article 13(5) provides that:

"Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable in the Contracting State of which the alienator is a resident."

A PE triangular case involving gains falling under the distributive rule is unlikely to occur because for the purposes of the R-PE treaty, Article 13(2) would usually apply in cases where no other specific paragraph of Article 13 applied. Therefore, Article 13(5) would generally not apply except in the specific instances set out above in relation to other types of capital gains. Nevertheless, if Article 13(5) did apply under both the R-S treaty and the R-PE treaty, both State S and State PE would be prevented from imposing any tax on the gain. The gain could only be taxed in the residence state and there would be no need for double taxation relief. There would also be no issue regarding the applicable treaty conditions in the source state, since there would be no transfer of taxing rights to the PE state under the R-PE treaty, and no tax avoidance concern.

2.9. Other income

In a PE triangular case involving other income, a person resident in State R derives income from sources in State S which does not fall under any other articles of the R-S treaty, and that income is attributable to a PE in State PE. In a PE triangular case involving other income is illustrated in the following diagram.

Figure 2.14.: PE triangular case involving other income

Article 21 applies to income not dealt with elsewhere in the treaty and provides that:

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."

Thus, Article 21 provides that “other income” can be taxed only in the residence state. However, if the income is attributable to a PE in the other contracting state, then Article 7 will generally apply instead of Article 21 as a result of the application of Article 21(2).93

In a PE triangular case involving other income, Article 21 of the R-S treaty would allocate exclusive taxing rights to the residence state. The source state cannot impose any tax on the income. Under the R-PE treaty Article 21 would prima facie apply, however, because the income is attributable to a PE in the PE state, Article 7 would apply as a result of the application of Article 21(2). Under Article 7, the PE state is entitled to impose tax on the income on the basis of the profits attributable to the PE. The residence state would be obliged to provide relief for the tax imposed in the PE state, using either the exemption or credit method depending on the terms of the treaty. Thus, the overall result in this case is that tax can be imposed in the PE state and in the residence state, with the residence state providing relief for the tax imposed in the PE state. There is no unrelieved double taxation, however there has been a transfer of

93 As discussed above, Article 21(2) does not apply if the income is income from immovable property.
taxing rights to the PE state under the R-PE treaty and therefore, issues arise in relation to the appropriate treaty conditions to apply in the source state. Such issues will be discussed in Chapter 5.

2.10. Conclusions

Unrelieved double taxation can generally only arise in PE triangular cases in situations where both the source state and the PE state are entitled to impose tax under their respective treaties with the residence state. This can occur in cases involving dividends, interest, income from immovable property and certain types of capital gains. It can also occur in cases involving royalties if the treaty between the residence state and the source state departs from the OECD Model and allows taxation to be imposed in the source state.

The extent to which there is unrelieved double taxation will depend partly on the residence state’s ability to provide relief for tax imposed in both the source state and the PE state. This may in turn depend on whether the PE state provides relief for tax imposed in the source state under the non-discrimination article of the R-PE treaty. The residence state’s obligations to provide relief will be discussed in Chapter 3, while Chapter 4 will go on to discuss the PE state’s potential obligations to grant relief for tax imposed in the source state.

In virtually all the PE triangular cases outlined above, with the primary exception of those involving income dealt with under Article 8 and certain types of capital gains, the application of the R-PE treaty results in a transfer of taxing rights to the PE state. This could be either exclusive taxing rights, in situations where the residence state uses the exemption method of relief, or primary taxing rights where the residence state uses the credit method. In either case, this raises the issue of whether the source state is applying the appropriate treaty conditions. This is amplified by the potential for tax avoidance, wherein a person may claim the benefit of the R-S treaty in circumstances where the residence state is effectively prevented from imposing any tax on the income. Issues related to the appropriate treaty conditions to apply in the source state will be addressed in detail in Chapter 5.
Chapter 3
Double taxation relief in the residence state

3.1. Introduction

Countries that tax their residents on worldwide income generally provide relief for foreign tax to prevent double taxation, either unilaterally or in accordance with treaty obligations. In PE triangular cases it is possible for source-based taxation to be imposed on an item of income in both the source state and the PE state.94 As a result, the residence state is faced with the prospect of granting relief in relation to income that has been taxed on a source basis in more than one state.95 This gives rise to two main issues; the first is whether and in what circumstances the residence state will be able to provide sufficient relief to fully prevent double taxation (discussed in Section 3.2)96 and the second is whether the residence state may be required to grant relief in excess of the tax it imposes on the income, i.e., double relief (discussed in Section 3.3). Specifically, if the treaty between the residence state and the PE state (the R-PE treaty) requires the residence state to exempt the income and the treaty between the residence state and the source state (the R-S treaty) requires the residence state to grant credit relief (or vice versa), then the question arises as to whether the residence state may have to grant both an exemption and a credit in relation to the same income in order to meet its treaty obligations.97

Where all the relevant treaties follow the OECD Model, dual source-based taxation can occur in PE triangular cases in relation to dividends, interest, income from immovable property, and certain types of capital gains.98 However, to the extent that the R-S treaty differs from the OECD Model and allows source based taxation in a situation where the OECD Model would not, dual source-based taxation can also arise in relation to other categories of income. A good example is royalties, where it is relatively common for treaties to depart from the OECD Model and allow the source state to impose a limited rate of tax on the gross amount of the income. For an analysis of the situations where dual-source based taxation may occur in PE triangular cases, please refer to Chapter 2.

3.1.1. Methods of relieving double taxation

The two most common methods of granting double taxation relief are the credit method, whereby the tax imposed in the residence state is reduced by the amount of foreign tax paid, and the exemption method, whereby the residence state exempts the foreign source income.99 There are competing theories regarding

94 This Chapter deals only with typical PE triangular cases. The implications of dual-source based taxation in reverse triangular cases will be discussed in Chapter 11.
96 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases", para 40.
97 See, for example: Van Raad, K., "The 1992 OECD Model...”; Potgens, F.P.G., "The Netherlands Supreme Court...”; Zhai, G., "Triangular Cases...”.
98 Refer to the analysis in Chapter 2, for further detail.
99 Relief may also be provided by allowing the foreign tax as a deduction from income (the deduction method), but this method can result in a high overall tax burden on foreign income and is not widely accepted. Where it is used, the deduction method is often a fallback which is available if, for example, no credit is allowed under the foreign tax credit provisions. (See: Vann, R., "International Aspects...” at p. 757.) Given that it is not generally used in tax
which of these methods is the most appropriate, based on the concepts of capital import neutrality (supporting the exemption method) and capital export neutrality (supporting the credit method).100 In practice, many states use a combination of methods in their domestic law, with the applicable method often depending on the circumstances and the type of income involved.101 Both methods of relief are also used in income tax treaties, as reflected in the two alternative relief provisions in the OECD Model. The first of these, Article 23A, provides for exemption relief in most cases but provides for the credit method in relation to income falling under the distributive rules of Article 10 (dividends) and Article 11 (interest).102 Article 23B requires the residence state to provide relief using the credit method regardless of the type of income involved.

The OECD Model deals only with the prevention of juridical double taxation, which occurs "... where the same income or capital is taxable in the hands of the same person by more than one state."103 It does not deal with the elimination of economic double taxation, where two different persons are taxable in relation to what is effectively the same income.104 Likewise, the discussion in this chapter does not consider economic double taxation, which is beyond the scope of this study.

3.2. Residence state’s ability to fully relieve double taxation

Where taxation is imposed in both the source state and the PE state, both the R-S treaty and the PE-S treaty will generally oblige the residence state to grant relief from double taxation, however, the residence state may not be able to provide sufficient relief to prevent double taxation. This section will discuss the ability of the residence state to fully relieve double taxation in PE triangular cases.

3.2.1. Assessing the extent of unrelieved double taxation in multilateral situations

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.105 Even though the residence state does not impose any tax on the income, the income has still treaties and is not commonly used in domestic law, the deduction method will not be discussed further in this chapter.

100 Capital import neutrality supports the use of the exemption method on the basis that it ensures that investors face the same tax rate in a foreign investment country as locally resident entities, and can thus compete with those local enterprises on a neutral basis. Capital export neutrality supports the use of the credit method on the basis that a resident entity will not be subject to a lower tax rate merely by investing abroad rather than in the home state; unless the foreign tax rate is higher than the tax rate in the residence state, the credit method is neutral with respect to the decision to invest at home or abroad. (IBFD International Tax Glossary, 5th ed., (IBFD, Amsterdam: 2005), at pp. 57-8; Rohatgi, R., Basic International Taxation, at p. 278; Arnold, B.J., & McIntyre, M.J., International Tax Primer, at p. 36.)


102 Article 23A, para 2 provides: " Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 [dividends] and 11 [interest], may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. 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 derived from that other State." To the extent that the treaty allows source-based taxation of royalties, the credit method usually also applies to royalty income.

103 OECD Commentary on Articles 23A and 23B, paras 1 and 2.

104 OECD Commentary on Articles 23A and 23B, paras 1 and 2.

105 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases," para 40.
been taxed in two different states (i.e., the source state and the PE state) without relief being provided in either of those states. This conclusion is questionable, however, in a situation where 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. This is because if the residence state had applied the credit method in this situation, then it would have been 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.\textsuperscript{106} Given that the outcome is the same when the residence state exempts the income (and in fact, less tax may even be imposed overall), 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. The contrary argument is that if it were merely a bilateral situation involving, say, the source state and the PE state without the residence state being involved, then there would clearly be unrelieved double taxation in the absence of relief in the PE state (i.e., tax imposed in the source state and the PE state with no relief). The question then, is how the successful relief of juridical double taxation should be determined in multilateral situations.\textsuperscript{107}

In a bilateral situation it is quite clear that exempting certain income or granting a credit in the residence state will relieve double taxation. However, it is not quite so straightforward in multilateral cases because one must consider not only whether relief has been provided, but also how much relief has been provided. 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.\textsuperscript{108} Applying this definition in a bilateral case, double taxation will be relieved regardless of whether the residence state uses the exemption method or the credit method;\textsuperscript{109} if the residence state uses the exemption method, the income will be subject to a tax burden equal to the applicable tax rate in the source state and if the residence state uses the credit method, the income would be subject to a tax burden equal to the higher of the two applicable rates. So, for example, in a situation where the source state imposes tax at a rate of 20\% and the residence state imposes tax at a rate of 30\%, if the residence state uses the exemption method then the overall tax burden will be 20\% and if the residence state uses the credit method, the overall tax burden will be 30\%. In both cases, the overall tax burden is less than (or equal to) the highest of the two applicable rates. This definition can be applied similarly in multilateral cases. Assume, for example, that in a PE triangular situation the applicable tax rates are 20\% in the source state, 30\% in the PE state and 25\% in the residence state.\textsuperscript{110} In this case, applying the suggested

\textsuperscript{107} According to the OECD Commentary, juridical double taxation occurs "... where the same income or capital is taxable in the hands of the same person by more than one state." (OECD Commentary on Articles 23A and 23B, paras 1 and 2.) While this provides a clear definition of juridical double taxation, it does not address how relief of such double taxation should be assessed, particularly in situations involving more than two states.
\textsuperscript{108} The main difficulty with applying this definition arises from the effect of reductions in the rate of source based taxation under tax treaties, i.e., with respect to passive income. For the purposes of the following discussion, this definition will be applied on the basis that double taxation is only relieved if the total amount of tax imposed is equal to (or less than) the highest of the three applicable rates, \textit{as determined after the application of tax treaties}. However, where passive income is involved and a treaty limits the rate of tax the source state may impose, that reduction in source-based tax also serves to limit double taxation. Thus, in certain situations, the available relief may be considered to be sufficient if the pre-treaty tax rates are used to apply the definition, but not if after-treaty tax rates are used. This will generally only occur if the pre-treaty rate in the source state is greater than the applicable tax rates in the PE state and the residence state, and thus becomes the reference rate. In most cases, however, it will not make any difference to the analysis.
\textsuperscript{109} Note that according to the suggested definition, the deduction method would not generally be capable of preventing unrelieved double taxation. Given that the deduction method is not widely accepted (Vann, R., "International Aspects…", at p. 757), this is not considered fatal to applying such a definition.
\textsuperscript{110} Assuming the income in question is the only income earned by the company and the company has no deductible expenses.
definition, there would only be unrelieved double taxation to the extent that the overall tax burden imposed on the income exceeds 30% (i.e., the highest of the three applicable tax rates).\textsuperscript{111}

On the basis of the definition suggested above, the residence state in a triangular case will be in a position to grant full relief for dual-source based taxation provided the combined effective tax rate in the source state and the PE state is lower than the applicable tax rate in the residence state. As will be seen below, this is the case regardless of whether the residence state provides relief using the exemption method or the credit method and therefore gives a fairer comparison between exemption states and credit states with respect to their ability, as the residence state, to fully relieve double taxation.

### 3.2.2. Factors relevant to both the credit and exemption methods

This section discusses factors which are relevant to the residence state's ability to fully relieve double taxation in PE triangular cases regardless of the method of relief which it applies. Based on the analysis in the second part of this chapter (Section 3.3.), it is assumed that the residence state will not provide dual relief (i.e., it will not both exempt the income and provide credit relief). Thus, the residence state may either simply exempt the income arising in the triangular case or may provide credit relief in relation to the tax imposed in both the PE state and the source state.

It should be noted that any references to tax rates or to the overall tax burden refer to the effective rate of tax on the net income (after deductible expenses); this is not necessarily the same as the statutory tax rate which may be imposed on the gross amount of the income. In many situations involving passive income, such as dividends and interest, source-based taxation may be imposed by way of a final withholding tax on the gross amount of the income and the limits on source state taxation of such income in tax treaties are also generally based on the rate of tax that can be imposed on gross income. When expenses are taken into account, this can result in a very high effective tax rate and it is this effective tax rate that is relevant for determining whether there is any unrelieved double taxation. In addition, if one of the states (e.g., the residence state) imposes tax using a progressive rate scale, a reference to the tax rate should also be read as a reference to the effective tax rate on the net amount of the income, i.e., the average rate that applies to that income. It is also possible that the tax imposed in the source state will exceed the amount of net income in the residence state; in this case the residence state is clearly unable to prevent unrelieved double taxation (regardless of whether it is a bilateral or triangular situation). This type of unrelieved double taxation could only be prevented by sufficiently reducing (or perhaps eliminating) the tax imposed in the source state. Further discussion of this issue is beyond the scope of this thesis.

#### 3.2.2.1. Relative tax rates

One of the most important factors in determining whether the residence state can provide sufficient relief is the relative tax rates in the three states involved (i.e., the effective tax rates imposed on net income). If the rate of tax imposed in the residence state is higher than the combined tax burden in the source state and the PE state, then the residence state would generally be able to fully relieve double taxation. However, if the rate of tax imposed in the residence state is lower than the combined tax burden in the source state and the PE state, then the residence state would generally not be able to provide sufficient relief. This is illustrated in the following example.

**Example:**

Assume that a company resident in State R earns interest income of $100 in a PE triangular case. The interest is the company's only income and the company has no expenses. Both State S and State PE impose tax on the income at a rate of 10%. State R imposes tax on the income at a rate of either (i) 30% or (ii) 15%. It is assumed that the PE state does not grant any relief for tax imposed in the source state. It

\textsuperscript{111} Note that in this example, double taxation can only be prevented if the PE state grants relief. The residence state is not in a position to fully relieve double taxation. If, however, the rate in the source state was 5%, the rate in the PE state was 25%, then the residence state (with its tax rate of 25%) would be able to fully relieve double taxation.
is also assumed that the residence state applies a gross-up for the tax imposed in the source state and PE state when calculating the company's tax liability. This situation is illustrated in the following diagram.

**Figure 3.1.: PE triangular case example demonstrating the impact of relative tax rates in the three states involved**

![Diagram](image)

**Table 1: Example showing the impact of the relative tax rates in the states involved**

<table>
<thead>
<tr>
<th></th>
<th>Residence state uses credit method</th>
<th>Residence state uses exemption method</th>
</tr>
</thead>
<tbody>
<tr>
<td>State R tax rate</td>
<td>(i) 30%</td>
<td>(i) 30%</td>
</tr>
<tr>
<td>Income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Tax in State S (10%)</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Tax in State PE (10%)</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Tax in State R</td>
<td>30</td>
<td>15</td>
</tr>
<tr>
<td>Credit in State R ($10 + $10, but limited to tax imposed in State R)</td>
<td>(20)</td>
<td>(15)</td>
</tr>
<tr>
<td>Tax in State R after relief</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>Overall tax burden</td>
<td>30 (30%)</td>
<td>20 (20%)</td>
</tr>
<tr>
<td>Highest applicable tax rate</td>
<td>30%</td>
<td>15%</td>
</tr>
<tr>
<td>Unrelieved double taxation</td>
<td>-</td>
<td>5</td>
</tr>
</tbody>
</table>

As can be seen in the table above, where the rate of tax imposed in the residence state is higher than the combined tax burden in the source state and the PE state, the residence state is able to fully relieve double taxation, regardless of whether it uses the exemption or the credit method of relief. By contrast, where the combined rate of tax imposed in the PE state and the source state is higher than the applicable rate in the residence state, the relief in the residence state is not sufficient to fully relieve double taxation. Thus, the ability of the residence state to fully relieve double taxation in PE triangular cases depends upon the relative tax rates in the three states involved.

### 3.2.2.2. Relief in the PE state

To the extent that the PE state grants relief for tax imposed in the source state, that relief combined with the relief provided in the residence state will be sufficient to prevent unrelieved double taxation in PE triangular cases. If the PE state grants relief using the exemption method, it will impose no tax on the income and as a result, the relief in the residence state will only need to compensate for the tax imposed in the source state and the overall tax burden would never exceed the highest of the rates imposed in those two states. If the PE state grants relief using the credit method, then the amount of tax imposed in the PE state will be reduced by the amount of tax imposed in the source state (potentially to nil). In this
case, the residence state (if it uses the credit method) would generally only credit for the lower amount of tax which is actually paid in the PE state, i.e., after the application of the credit for tax imposed in the source state. However, the result of the relief provided in the PE state is that unrelieved double taxation can always be prevented, as follows:

1. **The highest of the three tax rates is that imposed in the source state:** In this situation, neither the PE state nor the residence state will impose any tax on the income. This is the case regardless of whether they use the credit or exemption method of relief, since if they use the credit method then the credit will fully offset the tax that would otherwise be imposed. The overall tax burden will equal the rate of tax imposed in the source state and there will be no unrelieved double taxation. This is the case even though the residence state, if it uses the credit method of relief, will not be able to credit all the tax imposed in the source state.

2. **The highest of the three tax rates is that imposed in the PE state and the PE state uses the credit method:** If the PE state uses the credit method of relief, then it will impose a certain amount of tax after the allowance of the credit for source state taxation. However, the residence state will impose no tax on the income, regardless of whether it uses the credit or exemption method of relief. This follows from the fact that the tax imposed in the source state and the PE state must necessarily exceed the tax that would otherwise be imposed in the residence state and thus, there would be no residual tax imposed after the allowance of the credit. Therefore, regardless of the method of relief used in the residence state, the overall tax burden will be equal to the applicable tax rate in the PE state and there will be no unrelieved double taxation.

3. **The highest of the three tax rates is that imposed in the PE state and the PE state uses the exemption method:** If the PE state exempts the income, then the overall tax burden imposed on the income will be equal to the lesser of the applicable tax rate in the residence state and the applicable rate in the source state (depending on whether the residence state uses the credit or exemption method of relief). In either case, the overall tax burden will be less than the applicable tax rate in the PE state (i.e., the highest of the three applicable rates) and there will be no unrelieved double taxation.

4. **The highest of the three tax rates is that imposed in the residence state, and the residence state uses the exemption method:** In this situation, the relief in the PE state means that the total amount of tax imposed in the PE state and the source state will be equal to the higher of the PE state tax rate and the source state tax rate (depending on whether the PE state uses the exemption or the credit method). The total amount of tax imposed in these two states will therefore be less than the applicable tax rate in the residence state. Because the residence state uses the exemption method, it will not impose any further tax on the income and the overall tax burden will be lower than the highest of the three applicable tax rates (i.e., that applicable in the residence state). Thus, there will be no unrelieved double taxation.

5. **The highest of the three tax rates is that imposed in the residence state, and the residence state uses the credit method of relief:** Again, in this situation, the relief in the PE state means that the total amount of tax imposed in the PE state and the source state will be equal to the higher of the PE state tax rate and the source state tax rate. The tax imposed in these two states will therefore be less than the applicable tax rate in the residence state. The residence state will provide a credit for tax imposed in the source state and the PE state, and will impose some residual tax on the income. In this case, the overall tax burden will be equal to the applicable tax rate in the residence state and there will be no unrelieved double taxation.

Thus, provided the PE state grants relief for tax imposed in the source state, then regardless of the methods of relief used in the residence state and the PE state, the overall tax burden imposed on the income will never exceed the highest of the three applicable tax rates and there will be no unrelieved double taxation.

In certain cases, the relief in the PE state will have no impact on the residence state’s ability to fully relieve double taxation. That is, if the sum of the rates of tax imposed in the source state and the PE state

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is less than the applicable tax rate in the residence state, and the residence state uses the credit method of relief, then the relief in the PE state has no impact on the overall tax burden imposed on the income.\textsuperscript{113} The additional credit in the PE state merely reduces the credit available in the residence state, resulting in less tax being payable in the PE state but more (residual) tax being payable in the residence state. However, in this case, the credit in the PE state would arguably lead to a more equitable distribution of taxing revenues between the PE state and the residence state because the obligation to provide relief is shared by the residence state and the PE state, rather than falling solely on the residence state. The provision of relief in the PE state is therefore important both to ensure that there is no unrelieved double taxation, and to ensure an equitable distribution of tax revenue between the PE state and the residence state. The PE state's potential obligation to grant relief is discussed in the following chapter (Chapter 4).

3.2.3. Additional factors relevant where the residence state uses the credit method

If both the R-S treaty and the R-PE treaty provide for the credit method of relief, then the residence state will be obliged to credit the tax imposed in both the source state and the PE state. This section discusses additional factors which are relevant to the residence state's ability to prevent unrelieved double taxation where it uses the credit method.

3.2.3.1. Domestic credit limitations

Where the credit method is applied under domestic law, the available credit may be subject to various limitations. If the income derived in a triangular situation is the only income earned by the company, these limitations will have no impact on the amount of the credit available. They may have an impact, however, if the company also earns other (foreign) income and that income has been subjected to a lower rate of source-based taxation than the rate applicable in the residence state (i.e., low-taxed foreign income). Where this occurs, it may be possible, depending on the applicable credit limitations in the residence state, to credit all or part of the excess foreign tax imposed in the triangular situation against the tax imposed in the residence state on other foreign source income. It may even be possible to apply the excess credit against tax imposed on income from sources in the residence state if the residence state allows a "full credit" (see below), although this would be highly unusual.

The credit limitations in the residence state only become relevant where the combined rate of tax imposed in the source state and the PE state is higher than the rate of tax in the residence state, and the person involved earns income from other sources. As well as applying for the purposes of unilateral relief, these limitations are also likely to apply for the purposes of granting treaty relief because the detailed calculation of the amount of the credit available under a tax treaty is generally left to domestic law.\textsuperscript{114} In addition, where the domestic relief is more favourable than the treaty relief, it is generally accepted that the more generous domestic relief may apply.\textsuperscript{115} Depending on how the domestic limitations operate, they may result in a more generous credit being available than that which would be strictly required by the wording of the applicable tax treaty, for example, by allowing source-based taxes imposed in one state to be offset against domestic tax imposed on other foreign income.

\textsuperscript{113} So, for example, if a company earns $100 of interest income in a PE triangular case and the applicable tax rates are as follows: State S - 10%; State PE - 15%; and State R - 30% then, if the PE state grants no relief, the source state will impose $10 of tax, the PE state will impose $15 of tax and the residence state will impose $5 of tax ($30 - $25 credit), resulting in an overall tax burden of $30 (i.e., $10 + $15 + $5). Alternatively, if the PE state provides relief for tax imposed in the source state, then the source state will impose $10 of tax, the PE state will impose $5 of tax ($15 - $10 credit) and the residence state will impose $15 of tax ($30 - $15 credit), again resulting in an overall tax burden of $30 (i.e., $10 + $5 + $15).

\textsuperscript{114} Paragraph 32 of the OECD Commentary on Articles 23A and 23B states that: "The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic laws and practice applicable." See also: Couzin, R., "Relief of Double Taxation."

\textsuperscript{115} Vann, R., "International Aspects…," at p. 759.
Common credit limitations include:

1. **Full credit:** If a full credit is available, foreign taxes on foreign income can be offset not only against domestic taxes on foreign income but also against domestic taxes on domestic income. Very few countries allow a full credit.116

2. **Overall/worldwide limitation:** Typically, the amount of credit relief is limited to the domestic tax payable in relation to foreign income. This is known as an overall or worldwide limitation, and is intended to prevent foreign tax credits from being used to offset tax imposed on domestic income.

3. **Country-by-country limitation:** Some states apply a country-by-country limitation, whereby the credit for tax imposed in a particular country is limited to the domestic tax imposed on income from sources in that country; this method prevents averaging between high and low tax countries, but does not prevent the averaging of tax rates with respect to high-taxed and low-taxed categories of income from the same country.120

4. **Item-by-item limitation:** Another limitation that applies in some countries is what is known as an item-by-item limitation, or "basket" system, whereby the credit for tax imposed on a certain category of income (such as passive income) is limited to the amount of domestic tax imposed on income of that type from all foreign sources. This type of system prevents averaging of tax rates between high-taxed and low-taxed categories of income, but does not prevent averaging of tax rates between high tax and low tax countries.122

5. **Combination of limitations:** Various limitations may also be combined. For example, a particular country may apply both a country-by-country limitation and an item-by-item limitation.123

To the extent that a company deriving income in a PE triangular case has excess capacity in applying the applicable foreign tax credit limitations in the residence state, then it may be able to claim a credit in excess of the tax which the residence state imposes on the income arising in the PE triangular case. If, for example, the residence state operates an overall or worldwide limitation, then to the extent that the company earns other low-taxed foreign income, any excess credits arising in the PE triangular case may be allowed against the tax imposed in the residence state in respect of that other foreign income.

Thus, depending on how the credit limitations operate, the residence state may be able to credit all the tax imposed in both the source state and the PE state, even where the overall tax burden in those states is higher than the applicable tax rate in the residence state. The more specific the limitations, the less likely it is that the company will have excess capacity for foreign tax credits and the less likely it is that the company will be able to offset excess foreign tax credits arising in a triangular situation against other foreign income.

Even though the application of the residence state's domestic credit limitations may allow the residence state to fully relieve double taxation in certain circumstances, this arguably does not result in an equitable

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116 OECD Commentary on Articles 23A and 23B, para 16.
119 One issue which may arise in triangular cases in relation to a country-by-country limitation is which country the income should be attributed to for the purposes of the limitation (i.e., the PE state or the source state), given that the income effectively has a dual source. This is, of course, a matter for the domestic law of the residence state. One possibility is that the residence state would apply its own source rules to determine the source of the income for the purposes of the credit limitation. In this case, the tax imposed in the other source state (i.e., the state where the income is not considered to be sourced) would not be creditable unless other low-taxed income were derived from sources in that state. To the extent source-based taxation is not creditable, there will generally be unrelieved double taxation. Conversely, if the income is included in the calculation of the credit limit for both the PE state and the source state, then arguably, the calculation of the credit limit would allow too high a credit because the foreign income is being double counted for the purposes of the limitation. This may effectively allow the foreign tax credit to be offset against domestic income.
sharing of tax revenues between the states involved, particularly between the residence state and the PE state, because the residence state is effectively reducing the amount of tax it collects in relation to other income. Therefore, to ensure an equitable sharing of tax revenues, it would be desirable for the PE state to grant relief for tax imposed in the source state even if the residence state would be able to fully relieve double taxation based on the application of its domestic credit limitation provisions.

3.2.3.2. Ability to carry-forward (or back) excess credits

If the company earning income in a triangular situation is resident in a state that allows excess foreign tax credits to be carried forward to future income years or back to prior income years then it may be possible for the residence state to fully relieve double taxation in circumstances where it would not otherwise be able to do so. That is, it may be able to credit all the tax imposed in the source state and the PE state even where the combined rate of tax imposed in the source state and the PE state is higher than the rate of tax imposed in the residence state. This would occur if the company had other foreign income in the carry-forward or carry-back period that was either not subject to foreign tax or was subject to foreign tax at a rate lower than the applicable rate in the residence state (assuming the residence state applies an "overall limitation"). In this case, there would be residual domestic tax imposed on the foreign income of a later (or prior) year in the residence state against which the excess foreign tax credits arising in the triangular situation could be offset. Again, this may allow the residence state to fully relieve double taxation in a situation where the overall rate of tax imposed in the source states is higher than the rate applicable in the residence state and the PE state provides no relief. However, this would not result in an equitable distribution of tax revenues between the residence state and the PE state because the residence state would effectively be reducing the amount of tax it collects in relation to income derived from other sources.

In addition, while a carry-forward may allow the full amount of source-based taxation to be credited, the delay in applying the credit means that it is less valuable than a credit allowed in the year in which the income was derived. It may also not be possible to use excess credits in later income years; if a company has excess credits in one income year then, unless it makes changes to its foreign activities or there is a change in the applicable foreign tax rates, the company is also likely to have excess foreign tax credits in future periods. These factors would tend to limit the usefulness of the ability to carry-forward foreign tax credits.

3.2.3.3. Impact of losses

To the extent that the income arising in the triangular case can be offset by domestic losses in the residence state, the residence state will not impose any tax on the income. However, that income may

124 A residence state which uses the credit method and allows credits to be offset against the tax imposed on other income will generally collect less tax overall than if it had simply exempted the income arising in the PE triangular case.
125 Rohatgi, R., Basic International Taxation, at p. 286.
126 As mentioned above, any references to tax rates or to the overall tax burden refer to the effective rate of tax on the net income (after deductible expenses); this is not necessarily the same as the statutory tax rate which may be imposed on the gross amount of the income. In many situations involving passive income, such as dividends and interest, source-based taxation may be imposed by way of a final withholding tax on the gross amount of the income and the limits on source state taxation of such income in tax treaties are also generally based on the rate of tax that can be imposed on gross income. When expenses are taken into account, this can result in a very high effective tax rate and it is this effective tax rate that is relevant for determining whether there is any unrelieved double taxation. In addition, if one of the states (e.g., the residence state) imposes tax using a progressive rate scale, a reference to the tax rate should also be read as a reference to the effective tax rate on the net amount of the income, i.e., the average rate that applies to that income. It is also possible that the tax imposed in the source state will exceed the amount of net income in the residence state; in this case the residence state is clearly unable to prevent unrelieved double taxation (regardless of whether it is a bilateral or triangular situation). This type of unrelieved double taxation could only be prevented by sufficiently reducing (or perhaps eliminating) the tax imposed in the source state. Further discussion of this issue is beyond the scope of this thesis.
127 Creus, J., & De Jong, D., "Dividends Paid by..." at p. 169.
reduce the amount of losses which are available for carry forward to future income years. To the extent that those losses could have been used in later income years, this effectively results in the income arising in the PE triangular case increasing the tax burden in those years and may effectively result in unrelieved double taxation. This issue also arises in bilateral situations and in order for it to be resolved, the residence state must somehow take into account the inability of the recipient of the income to use the credits (e.g., by allowing unused credits to be carried forward). This issue does not arise where the residence state uses the exemption method, because the exempt income would typically not reduce the losses available for carry forward.

3.2.4. Conclusion

It cannot simply be said that the residence state is not able to provide sufficient relief to prevent double taxation in PE triangular cases. If the combined effective tax rates in the two source states are lower than the applicable tax rate in the residence state, then the residence state will be able to fully relieve double taxation regardless of whether it grants relief using the exemption method or the credit method. Similarly, 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. This is the case even if the combined tax rates in the source state and the PE state exceed the applicable tax rate in the residence state.

Where the residence state uses the credit method of relief, the residence state may also be able to fully relieve double taxation even if the overall tax burden imposed in the PE state and the source state exceeds the applicable tax rate in the residence state and the PE state does not provide relief. This will depend upon the applicable credit limitations in the residence state and on whether the person deriving the income has excess capacity for foreign tax credits after applying the foreign tax credit limitations. Where this occurs, it is a result of a set of policy decisions made by the residence state regarding the extent to which foreign tax credits arising in relation to a particular item of income may be used to offset the domestic tax imposed on other (foreign) income. 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 effectively 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. The PE state’s potential obligation to grant relief will be discussed in the following chapter (Chapter 4). First, however, the remainder of this chapter will address the issue of whether the residence state may have an obligation to grant dual relief as a result of its treaty obligations.

3.3. Potential obligation to provide dual relief

A common issue raised in relation to PE triangular cases is whether the residence state may be required to grant dual relief. That is, if the R-PE treaty requires the residence state to exempt the income attributable to the PE and the R-S treaty requires the residence state to grant credit relief (or vice versa), the question arises as to whether the residence state may have to grant both an exemption and a credit in relation to the same income in order to meet its treaty obligations. This is an issue because, from a policy perspective, the residence state should not be obliged to grant any relief in excess of the tax which it imposes on the income. By applying the exemption method, the residence state ensures that no double taxation is caused by its taxing claims and thus, no further relief measures should be required in the residence state. In addition, dual relief in the residence state may result in the income escaping taxation altogether.

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128 See, for example: Van Raad, K., "The 1992 OECD Model…", Potgens, F.P.G., "The Netherlands Supreme Court…"; Zhai, G., "Triangular Cases…"
130 For example, if relief is provided in the PE state for tax imposed in the source state, and both exemption and credit relief are provided in the residence state, the income derived in the triangular situation may effectively be tax free. So, for example, if the source state imposes tax of $10, the PE state imposes tax of $10 but provides a credit for tax imposed in the source state (resulting in no tax payable in the PE state) and the residence state exempts the
The OECD report on triangular cases indicates that most states, in the position of the residence state, would not consider themselves bound to provide a credit for tax imposed in the source state if the income of the PE is exempt under the treaty with the PE state.\textsuperscript{131} In addition, the issue of dual-relief in the residence state in a PE triangular situation was raised in two cases in the Netherlands, one in 2002\textsuperscript{132} and the other in 2007,\textsuperscript{133} and in both these cases it was decided that no credit was required. These cases (which will be discussed in Section 3.3.1.) may seem to settle the matter, but the reasoning behind these decisions (if not the reasonableness of the result) has been subject to criticism\textsuperscript{134} and this issue is generally regarded as an open one in the literature.\textsuperscript{135}

The following analysis assumes that the person involved has a tax liability in the residence state\textsuperscript{136} against which a foreign tax credit could be offset, despite the exemption of the income arising in the PE triangular case. If that person does not earn any income besides the income arising in the triangular case (which is exempt under the treaty with the PE state) then they will not pay any tax in the residence state and there would generally be no scope for the residence state to grant a credit, although it may still be possible to carry excess credits forward for use in future income years.

For the purposes of discussion it is assumed that it is the R-PE treaty which provides for exemption relief and the R-S treaty which provides for credit relief. This is the most likely situation, at least with respect to passive income, but it should be borne in mind that it could also be the case that the R-PE treaty provides for credit relief while the R-S treaty requires the residence state to exempt the income (e.g., in relation to income from immovable property). The analysis below is applicable regardless of which treaty provides for exemption relief and which treaty requires credit relief. In addition, although this section focuses on situations where one treaty provides for exemption relief and the other provides for credit relief, situations where both treaties provide for the same method of relief (either exemption or credit) are discussed briefly in Section 3.3.7., below.

### 3.3.1. Dutch case law

This section discusses two Dutch cases which have addressed the issue of whether, in a PE triangular situation, the residence state is obliged to grant credit relief under the R-S treaty in circumstances where it is simultaneously obliged to exempt the income under the R-PE treaty. These two cases are as follows:

**The 2002 case (the Japanese royalties case):**\textsuperscript{137} In this case, a Dutch resident company ("Dutch BV") earned royalties from sources in Japan, 90% of which were attributable to a PE of the Dutch BV which was located in Switzerland. This is illustrated in the following diagram.

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131 OECD Committee on Fiscal Affairs, "Triangular Cases," para 36.
132 BNB 2002/184, 8 February 2002.
134 See: Potgens, F.P.G., "The Netherlands Supreme Court…", referring also to Dutch literature. More implicitly: Van Raad, K., "2008 OECD Model…".
136 Either in the current year or in any year within an applicable carry-forward and carry-back period for foreign tax credits.
137 BNB 2002/184, 8 February 2002. This description of the facts of the case is based on: Van der Stoel, E., "Dutch Supreme Court…"; and Potgens, F.P.G., "The Netherlands Supreme Court…"
The royalties were subject to Japanese withholding tax at a rate of 10%, applied in accordance with Article 13(2) of the Japan-Netherlands treaty. As a result of the treaty between the Netherlands and Switzerland, the royalties attributable to the Swiss PE were exempt from tax in the Netherlands; this exemption was applied by way of a "tax exemption", meaning that the Dutch corporate income tax was calculated on the worldwide profits of the company, and then the tax payable was reduced by the amount of tax which was proportionately attributable to the exempt royalties. In addition to the relief available using the exemption method, the Dutch BV claimed a credit for the full amount of the Japanese withholding tax on the basis of Article 24 of the Japan-Netherlands treaty. The Dutch BV argued that a credit should be allowed for the entire amount of the withholding tax because all the royalties were included in the taxable base in the Netherlands, regardless of the fact that there was effectively no tax paid in relation to the 90% of the royalties which were attributable to the Swiss PE. The court found that no credit was available for the Japanese withholding tax to the extent the income was exempt (i.e., 90%) on the basis that no Dutch tax was actually levied on the royalties attributable to the PE (i.e., as a result of the Netherlands-Switzerland treaty) and thus, granting a credit would go against the intent of the relief article of the Japan-Netherlands treaty.

The 2007 case: A similar case was decided in the Netherlands in 2007. In this case a Dutch resident company ("Dutch BV") earned interest income from companies resident in Italy and Brazil and that income was attributable to a PE of the Dutch BV which was located in Belgium. This is illustrated in the following diagram.

The income attributable to the PE was exempt in the Netherlands under the treaty between Belgium and the Netherlands, again on the basis of a "tax exemption." The Italian source interest income was subject

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138 This effectively operates like a credit (although the reduction in tax is not by reference to the amount of tax imposed in the PE state), i.e., instead of reducing the amount of income upon which tax is imposed the "exemption" reduces the amount of tax payable on the income, which is calculated including the "exempt" income.
139 BNB 2007/230, 11 May 2007. This description of the facts of the case is based on: Vrouwenvelder, M., "No Credit For…" and; Potgens, F.P.G., "The Netherlands Supreme Court….”
140 Article 24 of the (former) 1970 Netherlands-Belgium treaty, which reads, in part, as follows (this is an unofficial translation from IBFD's tax treaty database):
"(1) With respect to residents of the Netherlands, double taxation shall be eliminated in the following manner:
to Italian withholding tax at a rate of 10% in accordance with the treaty between Italy and the Netherlands; the Italy-Netherlands treaty required the Netherlands to provide relief using the credit method. The Brazilian source interest was not subject to any withholding tax in Brazil, but the Brazil-Netherlands treaty required the Netherlands to grant a tax sparing credit of 20% to the extent that the income was included in the taxable base in the Netherlands. In this case, the Dutch BV claimed tax credits in the Netherlands in relation to the Italian withholding tax and tax sparing credits in relation to the interest sourced in Brazil, despite the fact that all the interest income in question was exempt under the Belgium-Netherlands treaty. The Dutch BV sought to distinguish this case from the 2002 case primarily on the basis of a slight difference in the wording of the applicable treaty provisions and on the basis that the most recent tax treaty should prevail over the older tax treaty (which would have had the result that the treaties containing the credit provisions would have applied first, i.e., before the treaty containing the exemption, and thus, the exemption could not have any impact on the amount of the credit available). The court did not accept these arguments and again denied the tax credit (and the tax sparing credit) on the basis that the income was not included in the taxable base in the Netherlands and that no tax was due in relation to the income.

The reasoning behind these decisions has been criticised on the basis that the court gave more weight to the purpose of the treaty relief provisions than it did to their wording. Potgens, writing in 2008, states that:

"It could be questioned whether the approach of the Supreme Court is entirely accurate from the perspective of the Vienna Convention on the Law of Treaties (hereinafter: the Vienna Convention). Art. 31 of the Vienna Convention clearly takes the wording of the treaty provision as a point of departure. Even though the outcome reached by the Supreme Court is reasonable, in that it permits the purpose of a treaty to prevail on its wording, it could be regarded as being tantamount to a teleological interpretation, which is not fully in alignment with Art. 31 of the Vienna Convention." Potgens (2008) refers to: Bender, T., & Engelen, F.A., "Hinken op Twee Gedachten in een Driehoekssituatie," WFR 2002/461.

This point was first raised in 2002 in relation to the Japanese Royalties case. The relief provisions required the Netherlands to grant a credit to the extent that the income was included in the "taxable base" in the Netherlands; due to the way in which the exemption operated in the Netherlands (i.e., a "tax exemption"), the income was in actual fact still included in the taxable base despite the treaty exemption. From a mechanical perspective, the exemption effectively operated in the same way as a credit. Various authors have noted that a literal interpretation of the wording of the taxable base requirement would seem to support the granting of the tax credits (i.e., the credit for the withholding tax and the tax sparing credit). This does not mean, however, that a proper interpretation of the wording of the credit provisions in treaties will always lead to the result that the residence state should be obliged to grant dual relief, as will be seen below.

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a) The Netherlands, when imposing tax on its residents, may include in the basis upon which the tax is levied the items of income or of capital which according to the provisions of this Convention, may be taxed in Belgium.

b) Without prejudice to the application of the provisions concerning the compensation of losses in the unilateral measures for the avoidance of double taxation, the Netherlands shall allow a deduction from the amount of tax computed in conformity with the provisions of (a). This deduction is equal to such part of the tax amount which bears the same proportion to the aforesaid tax amount as the amount of the income or the capital which is included in the basis mentioned in (a) and which may be taxed in Belgium according to Articles 6 and 7 ...[and certain other articles]... bears to the amount of total income or capital which forms the basis mentioned in (a)."


142 Potgens, F.P.G., "The Netherlands Supreme Court...


144 Kemmeren, E., & Peeters, H., "Avoidance of Double Taxation..."
3.3.2. Relief provisions of the OECD Model

Article 23A of the OECD Model, which deals with the exemption method of relief, provides that:

"1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax."

Unlike the Belgium-Netherlands and Netherlands-Switzerland treaties which were applicable in the Dutch cases (i.e., as the R-PE treaty), this provision does not operate specifically as a "tax exemption." The normal way in which an exemption works is that the income is excluded from the recipients taxable income, and is simply not included in the tax base.146 Therefore, there will generally be no tax attributable to the income in the residence state after the application of the treaty exemption.

Article 23B of the OECD Model, which deals with the credit method of relief, provides that:

"1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

a) As a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;

b) ...

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."

Article 23A, dealing with the exemption method of relief, contains a similar credit provision which applies to income dealt with under Article 10 or 11 of the treaty (i.e., dividends and interest).147

Unlike the treaties in question in the Dutch cases, Article 23 of the OECD Model does not require that the income is included in the "taxable base" in the residence state in order for a credit to be available. The relevant limitation is, rather, that the credit shall not exceed the tax imposed in the residence state which is attributable to the income that may be taxed in the source state in accordance with the treaty. Similar limitations were also contained in the treaties with the source states in the Dutch cases, but the court did not base its decision on these limitations.148 Potgens suggests that the Supreme Court may have decided not to base its decision on this limitation because this could have led to problems in other cases where the relevant treaty did not contain such a limitation.149 In his view, it would have been "more accurate" to deny the credit based on the lack of Dutch tax attributable to the income.150 The primary issue for determining whether dual relief is required under relief provisions which are based on the wording of the OECD model is therefore whether any tax imposed in the residence state is attributable to the foreign income for the purposes of the relief provision when that income is exempt under the provisions of another treaty. To the extent that income is exempt, it would generally be excluded from the tax base and thus, no tax could be attributable to it. Even if it is not excluded from the tax base, but rather operates as,

145 Paragraph 2 deals with the categories of income to which the credit method applies (i.e., interest and dividends). Paragraph 3 allows the residence state to apply exemption with progression.

146 See, for example: Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions, at pp. 1126-1127 (m.no. 13-20). For the purposes of the following discussion, it will always be assumed that the exemption operates as an “income exemption.” For situations where the exemption operates as a "tax exemption," refer to the discussion regarding situations where both treaties require credit relief (Section 3.3.7., below).

147 Article 23A(2) reads as follows: "Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State."

148 Potgens, F.P.G., "The Netherlands Supreme Court...." 149 Potgens, F.P.G., "The Netherlands Supreme Court...." 150 Potgens, F.P.G., "The Netherlands Supreme Court...."
e.g., a “tax exemption”, there would generally be no tax imposed in the residence state which could be attributable to income which is exempt under a treaty. The question turns, therefore, to whether the exemption under one treaty should be taken into account for the purposes of applying the credit provisions of another treaty.

Even if it is not accepted that an exemption under one treaty should be taken into account for the purposes of applying the relief provisions of another, there are a number of other situations in which the residence state may be able to avoid granting dual relief. These include situations where the income is not taxed under the domestic law of the residence state, or where the calculation of the credit relief for treaty purposes is based on credit relief provisions of domestic law which include a limitation on granting credit relief where the income is exempt under a treaty; these factors will be discussed below. An alternative argument, also discussed below, is that the exemption of the income satisfies the minimum requirements set by both treaties and thus, no further relief should be required. First, however, the following section will discuss the interaction between bilateral tax treaties and specifically, whether the exemption under one treaty should be taken into account for the purposes of applying the other applicable treaty.

3.3.3. Interaction between tax treaties

Whether the residence state has an obligation to grant dual relief may depend upon whether the exemption of the income under one treaty is taken into account for determining whether there is any tax imposed in the residence state that is attributable to the income for the purposes of the other applicable treaty. If the exemption is taken into account, then there is clearly no tax attributable to the income in the residence state and thus, no credit should be available.

It is often stated that income tax treaties are bilateral in nature and thus, can only give rise to rights and obligations in relation to the contracting states and persons who are resident in one or both of those states. While this may be true, it does not necessarily follow that the application of one treaty cannot have any effect on the application of another treaty. Van Raad gives the following example:

"Let us assume that one treaty requires, for its application to person X, that X have a particular legal characteristic, but X no longer has that characteristic because of the restrictive effect that another applicable treaty has on the application of e.g., the domestic law of X's residence state; thus, the latter treaty influences the outcome of the former treaty's application to X. Consequently, the latter treaty does affect the application of the former." 

Van Raad goes on to distinguish between this effect and the cumulative effect that two treaties may have on the taxation of a single person. Van Raad characterises question of dual relief in the residence state in a triangular situation as the cumulative effect of two treaties and states that relief must be granted under both treaties. However, this characterisation seems to ignore the effect that the application of the treaty providing for exemption relief has on the domestic law of the residence state, i.e., the treaty changes the amount of tax payable in that state by the person deriving the income. This appears more akin to the first type of effect mentioned in the quote above, because the application of one treaty has changed the facts

151 For convenience, the discussion in this section is structured in a way that assumes that the exemption is applied before the availability of the credit is considered. This is not necessarily the case, however as will be discussed below, where one treaty is taken into account for the purposes of determining the relief available under another then, regardless of whether the exemption or credit is applied first, there should be no obligation to grant relief in excess of the tax in the residence state that is attributable to the income. Thus, the discussion in this section applies equally if the credit is applied first to the extent that the tax payable in the residence state is reduced by that credit, i.e., for determining the amount of the exemption.

152 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.")

153 See, for example: Zhai, G., "Triangular Cases...."

154 Van Raad, K., "2008 OECD Model...."

155 Van Raad, K., "2008 OECD Model...."
relevant to the application of the other treaty, namely, the tax attributable to the income in the residence state.

A good example of the OECD’s acceptance of the idea that the application of one treaty can impact the application of another treaty is the position expressed in the commentary on dual-resident companies and Article 4(1).156 The OECD commentary states that a dual-resident company whose residence is assigned to one state under the treaty between the two residence states is not considered to be a resident of the losing state for the purposes of treaties with third states. This is based on the view that, as a result of the application of the treaty between the two residence states, the dual resident person is only subject to tax in the losing residence state on income from sources in that state.157 Thus, the result arising from the application of the treaty between the two residence states is said to have an impact on the application of treaties between the losing residence state and third states.158 This is not because the definition of residence or the residence tie-breaker in the treaty between the two residence states applies for the purposes of other treaties, which it does not.159 Rather, it is because the result of the application of the treaty on the tax payable in the losing residence state is taken into account in applying the definition of residence in treaties with third states. The analogy between the interpretation of Article 4(1) expressed in the OECD Commentary and the issue being discussed here is clear. Taking the same approach, the result of the exemption of the income under the R-PE treaty should be taken into account for the purposes of applying the relief provisions of the R-S treaty. As a result, no credit should be available under that treaty and the residence state should not be obliged to grant dual relief.

The alternative position is that for the purposes of determining whether there is tax attributable to the income in the residence state, and thus whether a credit is available, only the result under the domestic law of the residence state should be considered. One of the primary arguments for referring only to domestic law to determine the tax attributable to the income in the residence state is that treaties are binding on the parties and cannot be affected by treaties concluded by one of the parties with third states.160 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, because of the application of the exemption, the residence state does not impose any tax on the income and therefore 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. The residence state is not failing to meet its obligations under the treaty with the source state but rather, the obligation to grant a credit simply does not arise due to the fact that no tax is payable in the residence state. In addition, taking into account the exemption of the income under the R-PE treaty for the purposes of determining the tax attributable to the income clearly does not give rise to any right or impose any obligation on the source state.

It also cannot be said that the residence state is failing to interpret the terms of the treaty in good faith by taking into account the exemption of the income under the treaty with the PE state. The Vienna Convention requires that a treaty must be performed in good faith by the parties,161 and must be

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156 Dual residence will be discussed in detail in Chapters 9 and 10.
157 OECD Commentary on Article 4, para 8.2. This will be discussed in depth in Chapter 10.
158 Whilst this interpretation of Article 4(1) in the case of dual-resident companies has been criticised, this criticism has not focused on whether the application of one treaty can have an impact on the application of another. See, for example, Van Raad, K., "2008 OECD Model...”; Avery Jones, J.F., "The Interaction Between Tax Treaty...” at pp. 137-140 (Chapter 6, Section 6.4.1.).
159 Similarly, if a company has a PE in a particular state under the treaty between its residence state and that other state, that does not mean it will necessarily have a PE in that state for the purposes of any other income tax treaty. The definition of "permanent establishment" in the treaty between the residence state and the "PE state" does not apply for the purposes of any other treaties. This will be discussed in more detail in Chapter 8 (see Section 8.2.3.).
160 Zhai, G., "Triangular Cases...,” who states: "If we admit that every treaty in force is binding on the parties to it, we must accept that the effect of one treaty concluded by one state with another state should not be affected by that of another treaty concluded by the first state with a third state. This principle is often referred to as the bilateral effect of treaties." See also: Gomes Behrndt, M.A., "Passive Income...,“ at p. 57.
161 Vienna Convention of the Law of Treaties, Article 26. Article 26 provides that: "Every treaty in force is binding upon the parties and must be performed by them in good faith."
interpreted in good faith in light of its object and purpose. The primary purpose of tax treaties is the avoidance of international juridical double taxation in order to facilitate international trade, and it does not seem to be contrary to this purpose, or to the principle of good faith, for a credit to be denied in relation to income which is already exempt in the residence state.

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 for determining whether there is any tax attributable to the income; 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. In many countries, the "laws of that state" include the provisions of tax treaties, which effectively become part of domestic law. In some countries, such as Australia, tax treaties are given effect by an act of Parliament and once enacted, become part of the domestic law, while in other countries, treaties become part of domestic law by virtue of specific constitutional provisions. Where tax treaties do form part of the domestic law of the residence state, there seems to be even less justification for excluding the effect of the application of a treaty when determining the amount of tax attributable to a particular item of income for the purposes of applying the relief provisions of another treaty.

In summary, while tax treaties are bilateral and do not have effect for the purposes of other tax treaties, the impact which tax treaties have on the operation of domestic law cannot be ignored for the purposes of applying other tax treaties. As a result, where the residence state exempts certain income in accordance with its treaty obligations, it should no longer have an obligation to provide credit relief in relation to that income under another tax treaty; the residence state should not be obliged to grant dual relief.

Order of application of tax treaties

One of the arguments raised by the taxpayer in the Dutch case in 2007 was that the treaties in question should be applied in the order in which they were concluded, in which case the treaty providing for credit relief would have applied prior to the treaty under which the income was exempt and, so the argument runs, both the credit and the exemption should have been allowed. This argument was rejected by the court. The Advocate General in the case argued that the order of application of the treaties was irrelevant because the relief provisions of both applicable treaties limited the relief to the amount of Netherlands tax payable in relation to the income and thus, regardless of which treaty and which method of relief

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162 Vienna Convention of the Law of Treaties, Article 31. Article 31(1) provides that: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."


164 Sasseville, J., "A Tax Treaty Perspective..." at pp. 38-40 (Chapter 3, Section 3.2.). See also Vogel, who writes: "Under the theory of 'moderate dualism,' which seems to be generally accepted nowadays, international and domestic law are two spheres which exist separate of each other (save some exceptions). To exercise their intended influence on domestic law, treaties therefore have to be implemented by the domestic legislator. Thus, they receive the force of domestic law." (Vogel, K., "The Domestic Law Perspective" bound in Tax Treaties and Domestic Law, edited by Maisto, G., (Amsterdam: IBFD, 2006), pp. 3-11 at p. 3 (Chapter 1, Section 1.1.).)


166 Sasseville, J., "A Tax Treaty Perspective..." at p. 39 (Chapter 3, Section 3.2.), who gives the examples of France and the United States.


168 Potgens, F.P.G., "The Netherlands Supreme Court..."
applies first, the total relief can never exceed the amount of tax attributable to the income.\textsuperscript{169} This approach also seems to apply in the case of treaties whose relief provisions follow the wording of the OECD Model. Once it is accepted that the result of one treaty should be taken into consideration when applying other treaties, then the order of application of the treaties should not matter; in either case, no dual relief should be allowed.

3.3.4. Relief available under domestic law

To the extent that relief is available under the domestic law of the residence state, the residence state may be able to avoid granting dual relief on the basis that, after taking into account its unilateral relief measures, no tax is attributable to the income. This argument would not apply, however, if the application of a tax treaty means that the domestic relief provisions no longer operate, i.e., if the treaty relief provisions supplant those of domestic law. Therefore, the extent to which dual relief may be required could depend on the interaction between domestic relief measures and treaty relief measures.

The interaction between treaty relief and domestic relief is not always clear, and but is likely to broadly resemble one of the following approaches:

(i) The domestic law may provide that unilateral relief is not available if a treaty applies;\textsuperscript{170}

(ii) The taxpayer may apply the relief that is more favourable (i.e., treaty relief or domestic relief), to the exclusion of the other source of relief. This does not, however, solve the question of which source of relief is being applied if, for example, both the treaty and domestic law provide for an exemption;

(iii) The domestic relief may be applied first, with the treaty relief only applying to the extent that the domestic relief does not satisfy the requirements of the treaty;\textsuperscript{171}

(iv) The treaty relief may be applied first, with the domestic relief only applying to the extent that it provides for relief in excess of that available under the treaty;\textsuperscript{172} or

(v) The treaty may refer directly to the relief provisions of domestic law and require the state concerned to provide relief in accordance with those provisions.\textsuperscript{173}

\textsuperscript{169} Potgens, F.P.G., "The Netherlands Supreme Court…", referring to: Advocate General Wattel's Advisory Opinion accompanying the decision of the Supreme Court of 11 May 2007, BNB 2007/230, point 7.2.

\textsuperscript{170} Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions…}, at p. 1174 (m.no. 48).

\textsuperscript{171} For example, if the domestic law provides for the credit method and an applicable treaty provides for exemption, then the domestic credit would be available to the extent of any tax imposed in the source state and the treaty exemption would apply in relation to any residual tax payable in the residence state. See, for example, Avery Jones’s description of the interaction between treaty relief provisions and domestic law provisions in the UK prior to legislative changes in 2000: Avery Jones, J.F., “A Tale of Two Taxes…” at pp. 65-66.

\textsuperscript{172} Avery Jones suggests that the intention of legislative provisions in the UK in 2000 may have been to “alter the formal hierarchy between the two reliefs [treaty relief and unilateral relief] and encourage one to look at the treaty first.” See: Avery Jones, J.F., “A Tale of Two Taxes…,” at p. 68.

\textsuperscript{173} Couzin, R., "Relief of Double Taxation" at pp. 266-268. This is the approach taken by Australia in all its treaties. For example, Article 22 of the Australia-UK treaty (concluded in 2003) reads as follows:

"(1) Subject to the provisions of the laws of Australia from time to time in force which relate to the allowance of a credit against Australian tax of tax paid in a country outside Australia (which shall not affect the general principle of this Article:

(a) United Kingdom tax paid under the laws of the United Kingdom and in accordance with this Convention, whether directly or by deduction, in respect of income or gains derived by a person who is a resident of Australia from sources in the United Kingdom shall be allowed as a credit against Australian tax payable in respect of that income.”

This is supplemented by Article 21, which provides:

"Income or gains derived by a resident of the United Kingdom which, under any one or more of Articles 6 to 8 and 10 to 16 and 18, may be taxed in Australia shall for the purposes of the laws of Australia relating to its tax be deemed to arise from sources in Australia.”

These provisions are typical of the credit provisions contained in Australia’s treaties.
There may also be some other specific way in which the provisions of tax treaties and domestic law interact, which does not fit neatly into any of the categories identified above. In most bilateral cases, it does not matter which of these approaches applies. In a PE triangular case, however, the residence state will only be able to argue that no tax is payable under domestic law on the basis of the application of unilateral relief measures (and that, as a result, dual relief is not required) to the extent that the unilateral relief measures continue to operate.

Usually the interaction between treaty relief measures and domestic relief measures will depend on the domestic and constitutional law of the state involved. More generally, however, from a theoretical perspective there are arguments in favour of each of the various approaches. Treaties are generally considered to restrict the application of domestic law.174 As a result, the tax payable under domestic law is usually determined first, and then tax treaties are applied to determine whether they place any restriction on the operation of domestic law (e.g., by limiting the maximum rate of tax that can be imposed on dividends or interest in the source state). Where the outcome of the application of domestic law meets the minimum requirements set out by the treaty (e.g., if the rate of tax imposed under domestic law is lower than or equal to that allowed by the treaty), then the treaty should have no further effect. It is not clear why a different approach should be taken in the case of relief provisions.175 This supports the third approach outlined above, i.e., the treaty relief should only apply to the extent that the domestic relief measures do not meet the minimum relief requirements of the treaty. Expressing a different view, Vogel states that "[w]here DTCs apply, the latter’s rules – being special provisions – take precedence over unilateral domestic arrangements for eliminating double taxation."176, 177 This seems to suggest that the treaty measures should be applied before domestic relief measures, and indeed, Vogel goes on to say that where treaties do not fully eliminate double taxation, it remains possible to resort to domestic relief measures as a supplementary means of relief.178 These comments seem to support the fourth approach outlined above, i.e., that treaty relief should supplant domestic relief, with the domestic relief only applying to the extent that it is more favourable than the treaty relief. From a more practical perspective, the way in which the domestic and treaty relief provisions interact is also likely to depend on the method of relief used, as will be seen below.

3.3.4.1. Situations where there is a domestic exemption

Where income is exempt under domestic law, that exemption should generally not be supplanted by the relief measures of a tax treaty, regardless of whether the treaty specifies the credit method or the exemption method of relief.179 A good example of this exists in the *Denkavit* case of the ECJ, which involved a situation where dividends were received by a Dutch company from a company resident in France. The issue in this case related to the taxation of the dividends in France but, interestingly, the

174 With the potential exception of certain articles, such as Article 25 regarding the mutual agreement procedure. See: Shelton, N., "Interpretation and Application of Tax Treaties" (London: Lexis Nexas UK, 2004), at p. 46; Vann, R., "International Aspects…", at p. 727.


176 Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions…*, at p. 1174 (m.no. 48).

177 Vogel expands on the status of treaty provisions as special provisions elsewhere as follows: "Being restricted to cross-border taxation of residents of the two contracting states, tax treaties are equivalent to special legislation (*leges specialiae*) compared to the contracting States’ general tax law (*lex generalis*). Thus, according to the old rule "Lex specialis derogat legi generali" ("special legislation overrides general legislation"), treaties override the domestic tax law that is effective at the time of their implementation. Under a supplementary rule of "Lex posterior generalis non derogat legi priori speciali" ("later general legislation does not overrule earlier special legislation"), changes of domestic tax law normally will not affect existing treaties. This latter rule does not apply, however, if the legislator, when changing the general rule, expressly or implicitly intended to repeal the special law. General law then overrules the special (domestic) legislation. A legislation that contradicts an existing international treaty, however, is a violation of international law." (Vogel, K., "The Domestic Law…" at p. 3 (Chapter 1, section 1.1)).

178 Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions…*, at p. 1174 (m.no. 48).

179 Vann, R., "International Aspects…" at p. 759; Shelton, N., "Interpretation and Application…" at p. 51.

dividends were exempt under the domestic law of the Netherlands and, as a result, the Netherlands was not obliged to grant credit relief under the France-Netherlands treaty.\textsuperscript{181} In its judgement, the ECJ states:

"It is not in dispute that Netherlands parent companies are exempted by the Kingdom of the Netherlands from tax on foreign-sourced dividends, and accordingly on French-sourced dividends, with the result that no credit is given in respect of French withholding tax."\textsuperscript{182}

It follows that if the residence state in a PE triangular case exempts the income under domestic law then that domestic relief should generally not be excluded by treaty relief measures and the residence state should not be required to grant a credit under either of the applicable treaties. As a result, the residence state should not be required to grant dual relief.

3.3.4.2. Situations where domestic law provides for credit relief

If both domestic law and an applicable tax treaty provide for the credit method of relief, then there seems to be no question that the credit method will apply; the domestic relief is likely to be the same as that allowed under the treaty.\textsuperscript{183} This does not resolve the issue in a triangular case, however, where the residence state is required by one treaty to apply the credit method and is required by another treaty to apply the exemption method, because the domestic credit provisions may still be excluded by the exemption relief of the other treaty.

If domestic law provides for the credit method of relief, then that domestic law is likely to exclude the operation of the credit provisions in situations where an applicable treaty provides for the exemption method of relief, since exemption relief is generally considered more favourable. If this is the case in the residence state in a PE triangular case, then that state could not rely on its unilateral relief provisions to avoid granting dual relief in a PE triangular case. If, however, the domestic law does not specifically exclude the operation of the unilateral credit provisions where there is an applicable treaty exemption, the question arises as to whether those credit provisions continue to apply. Arguably the residence state has not met the requirements of the treaty by providing a credit, even if there is no residual tax payable, because the income is still included in the taxable base. In practice, however, the credit provisions may ultimately be more favourable than an exemption to the extent that excess credits can be offset against the tax payable on, e.g., other foreign income in accordance with the domestic credit limitations. This makes the situation less clear-cut and the result may therefore depend on the approach taken by the residence state to deal with overlapping treaty and domestic relief. Ultimately, the interaction between domestic relief measures and treaty relief measures will depend on the domestic and constitutional law of the state involved.

3.3.4.3. Conclusions

If the residence state unilaterally exempts the income arising in a PE triangular case, then it should not be obliged to grant credit relief under a tax treaty and therefore, should not be obliged to provide dual relief. However, where the residence state uses the credit method in its domestic law, it is less clear that the residence state will be able to rely on this argument. The residence state will not be able to avoid granting a credit on the basis of unilateral relief measures if the unilateral relief is excluded by provisions of domestic law whenever a treaty applies, or if the unilateral relief is otherwise supplanted by the treaty relief.

\textsuperscript{181} See, similarly, the Amurta judgement of the ECJ, where it appears that Portugal was not obliged to grant the credit relief provided for under the applicable tax treaty in relation to dividends due to a domestic exemption of the income. (Amurta SGPS v Inspecteur van de Belastingdienst, C-379/05, 8 November 2007, paras. 10 and 63).

\textsuperscript{182} Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l’Économie, des Finances et de l’Industrie, C-170/05, 14 December 2005, at para. 46

\textsuperscript{183} As will be discussed below (see Section 3.3.5.), the calculation of foreign tax credits available under tax treaties is commonly based on the provisions of domestic law.
3.3.5. Calculation of treaty credit relief by reference to domestic law

To the extent that the calculation of the credit relief available under the treaty is based on the domestic law of the residence state, then domestic rules aimed at eliminating overlapping relief should also apply for the purposes of determining the amount of credit available under the tax treaty. Thus, a limitation under domestic law preventing foreign tax credits from being available if the income is exempt under a tax treaty may prevent the residence state from being obliged to grant dual relief in PE triangular cases.184

There are two common approaches to providing double taxation relief using the credit method in income tax treaties; the "domestic law method" and the "OECD Model approach."185 Where the domestic law method is used, the treaty refers directly to the domestic law of the residence state and effectively obliges the residence state to apply its domestic credit provisions to income which may be taxed in the other state in accordance with the treaty.186 Treaties using the domestic law approach often include a qualification that the domestic provisions "shall not affect the general principle" of the article.187 The OECD Model approach, on the other hand, does not refer directly to the domestic law of the contracting states.188 In practice, however, this approach may not be significantly different from the domestic law approach because the OECD Model provides only a general principle and leaves the calculation of foreign tax credits up to domestic law and practice.189 Thus, in general, the domestic law relating to the computation of foreign tax credits will apply for the purposes of determining the amount of the credit available under an income tax treaty. In most cases, the domestic credit provisions could be expected to deny a credit to the extent that the income is exempt under a tax treaty190 since otherwise states may find themselves obliged to both exempt certain income and grant a credit, even in purely bilateral situations. If the domestic law provides that no credit relief is available in situations where income is exempt under a treaty, then the residence state should not be obliged to grant dual relief in situations where it is applying those credit provisions as a result of an obligation under a tax treaty.

One potential argument against applying a domestic limitation to deny credit relief is that the denial of credit relief is not in accordance with the requirement of the Vienna Convention that a treaty must be performed in good faith by the parties,191 and that it must be interpreted in good faith in light of its object and purpose.192 However, as previously discussed, the denial of credit relief in this situation does not seem to contravene these principles. The primary purpose of a tax treaty is to avoid international juridical double taxation, in order to facilitate international trade.193 It does not seem to be contrary to the purpose

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184 Van Raad, K., "The 1992 OECD Model….”
186 Couzin, R., "Relief of Double Taxation,” at pp. 266-268. This is the approach taken by Australia in all its treaties (see note 172, above).
187 Couzin, R., "Relief of Double Taxation.” See, for example, Article 22 of the Australia-UK treaty reproduced above (note 172).
188 OECD Model, Articles 23A and 23B. See also: Couzin, R., "Relief of Double Taxation."
189 The OECD Commentary on Articles 23A and 23B, paragraph 32, states that: "The two articles [i.e., Article 23A and Article 23B] are drafted in a general way and do not give detailed rules on how exemption or credit is to be computed, this being left to the domestic law and practice applicable." See also: Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions...., at p. 1131 (m.no. 38). The domestic rules must of course satisfy the basic requirements of the treaty provision. The following discussion assumes that the residence state does have rules for calculating foreign tax credits under its domestic law. To the extent that the residence state doesn't have rules for the calculation of foreign tax credits in its domestic law the discussion in this section will not apply except perhaps in cases where there is an equivalent principle under domestic law which the residence state can rely on. If the residence state does not have foreign tax credit calculation rules in its domestic law, it would generally need to develop at least some basic principles for the calculation of foreign tax credits under tax treaties.
190 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions...., at p. 1175 (m.no. 48).
191 Vienna Convention of the Law of Treaties, Article 26. Article 26 provides that: "Every treaty in force is binding upon the parties and must be performed by them in good faith."
192 Vienna Convention of the Law of Treaties, Article 31. Article 31(1) provides that: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.”
193 Engelen, P., "Interpretation of Tax Treaties....,” at pp. 428-429 (Chapter 10, para 10.3).
of the R-S treaty, or to the principle of good faith, for a credit to be denied where the income is already exempt in the residence state as a result of the application of the R-PE treaty.

Further, the reference to domestic law for the calculation of the amount of credit relief available under a treaty can be compared to the reference to domestic law for the meaning of terms which are not defined in the treaty under Article 3(2). Wouters and Vidal194 write:

"We submit that if a State abuses its discretion to develop a proper, domestic terminology for tax purposes, and artificially construes the terms of a tax treaty with the aim or the effect of seriously altering the equitable distribution of tax revenue, it fails to carry out the tax treaty in good faith."195

Applying this approach to the calculation of the credit available under the relief provision of a tax treaty, it follows that the residence state must develop proper domestic credit provisions and must not impose artificial limitations on the availability of credit relief with the aim or effect of seriously altering the equitable distribution of tax revenue, through the amount of credit granted. It seems highly unlikely that a provision denying a credit in cases where the income is exempt under a tax treaty would be considered to demonstrate a lack of good faith. Such provisions are widely accepted196 and would most commonly apply simply to deny unilateral credit relief in bilateral situations where the income is exempt under a tax treaty.

An alternative argument against denying dual relief on the basis of domestic calculation rules rests on Article 27 of the Vienna Convention, which provides that a state may not invoke the provisions of its internal law as justification for failure to perform a treaty. However, this should arguably not be considered to be a situation where the residence state is failing to perform its obligations under the treaty; rather, because of the exemption of the income and the operation of the domestic credit calculation principles, the obligation to grant a credit under the treaty with the source state simply does not arise. This is quite clear where the treaty refers directly to domestic law, and simply requires the residence state to apply its domestic credit provisions, but may be more questionable in cases where the relevant treaty provisions do not refer to domestic law. In such cases, the denial of a credit may potentially be viewed as a treaty override and a failure on the part of the residence state to meet its treaty obligations.

In summary, domestic law restrictions on granting unilateral credit relief in relation to income that is exempt under a tax treaty should, in many cases, also be applicable for the purposes of determining the extent to which credit relief is available under an income tax treaty. To the extent that the domestic law denies credit relief in relation to income that is exempt under a treaty, the residence state should not be obliged to grant dual relief, at least in cases where the relevant treaty refers directly to the domestic law of the residence state. It may also be possible to avoid granting dual relief as a result of such a provision in cases where the treaty does not refer to domestic law, but this is perhaps more likely to be viewed as an impermissible override of the provisions of the treaty.

3.3.6. Minimum requirement set by treaty relief measures

An alternative argument for not providing dual relief is that the exemption of the income may meet the requirements of both the treaty requiring exemption relief and the treaty requiring credit relief. As has been mentioned previously, the exemption method is generally considered to be a more generous method of relief than the credit method and thus, where the exemption method is used in domestic law, a treaty requiring relief to be provided by the credit method generally does not prevent the residence state from instead granting exemption relief.197 If this is the case, then I see no reason why a similar argument should

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195 See also Avery Jones, J.F., who writes: "If a state makes a change to the definition of a type of income in order of affect non-residents adversely it should not apply to the treaty, but if it is tidying up the edges of a definition as it affects residents and non-residents alike, it should apply to the treaty." (Avery Jones, J.F., "The Interaction Between..." at p. 133 (Chapter 6, Section 6.2.3.).)
196 See, for example: Vogel, K., Engelschak, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1175 (m.no. 48).
197 Vann, R., "International Aspects...", at p. 759; Shelton, N., "Interpretation and Application...", at p. 51. A good example of this exists in the facts of the Denkavit case of the ECJ (C-170/05, 14 December 2005), where dividends
not apply in the case of a tax treaty exemption. That is, treaty relief measures set the minimum requirements that the residence state must meet; if income is exempt, regardless of whether the exemption arises from domestic law or a tax treaty, then the exemption should also meet the requirements of a treaty obliging the residence state to provide credit relief. The fact that the residence state has an obligation to grant relief under two separate treaties does not mean that the residence state must grant relief twice, but rather that the residence state must grant sufficient relief to meet the minimum requirements set by both treaties, e.g., by exempting the income.

3.3.7. Both treaties provide for the same method of relief

If both the R-S treaty and the R-PE treaty require the residence state to exempt the income, then the interaction between these two obligations is quite clear; the residence state must simply exempt the income and the fact that the residence state’s obligation to do so arises from two different sources (i.e., two treaties) does not have any impact. There is no question, in this case, of whether the residence state has met its treaty obligations because no treaty requires it to do anything other than exempt the income. This should be the case regardless of whether the outcome of the application of one treaty is taken into account for the application of the other.

If both the R-S treaty and the R-PE treaty provide for credit relief, then the residence state will be obliged to credit the tax imposed in both those states. Where the total amount of tax imposed in the source states exceeds the tax imposed in the residence state, the residence state should not, in principle, have an obligation to grant a credit in excess of the domestic tax on the income derived in the triangular situation. The reasons for this are the same as the reasons for the residence state not to have to grant dual-relief when the income is exempt under one treaty and the other treaty provides for a credit. Firstly, as discussed above, the relief allowed under one treaty should be taken into consideration for determining the tax attributable to the income in the residence state and thus, for determining the maximum relief available under the other treaty. Where a credit has been allowed under one treaty, the maximum credit that may be available under the other treaty will be limited to the tax imposed in the residence state, as reduced by the credit available under the first treaty. Secondly, the credit provisions of treaties are generally interpreted in line with domestic credit provisions which, unless a specific policy decision has been made by the residence state, would generally not allow any credit in excess of the domestic tax imposed on the foreign income. Finally, to the extent that the entire amount of the tax attributable to the income in the residence state is offset by foreign tax credits, the relief requirements of both treaties should be satisfied. In essence, this situation is not significantly different to the situation where one treaty requires exemption relief and the other requires credit relief.

3.3.8. Overview

Where a residence state is required to exempt the income arising in a PE triangular case under one of the applicable tax treaties, that state should not be obliged to grant credit relief under the other applicable treaty. For the reasons outlined above, the exemption of the income under one treaty should be taken into account for the purposes of applying the credit provisions of the other treaty and, as a result of the

were received by a Dutch company from a company resident in France. The issue in this case related to the taxation of the dividends in France, but interestingly, the dividends were exempt under the domestic law of the Netherlands and, as a result, the Netherlands was not obliged to grant the credit relief provided for by the France-Netherlands treaty. In its judgement, the ECJ states: “It is not in dispute that Netherlands parent companies are exempted by the Kingdom of the Netherlands from tax on foreign-sourced dividends, and accordingly on French-sourced dividends, with the result that no credit is given in respect of French withholding tax.” (at para. 46). See, similarly, the Amerta judgement of the ECJ (C-379/05, 8 November 2007, paras. 10 and 63), where it appears that Portugal was not obliged to grant the credit relief provided for under the applicable tax treaty in relation to dividends due to a domestic exemption of the income.

198 Zhai, G., “Triangular Cases....”
199 Refer to Section 3.3.3., above.
200 Refer to Section 3.3.5., above.
201 Refer to Section 3.3.6., above.
application of the credit limitations in that treaty, no credit should be required. There will therefore be no dual-relief obligation in the residence state.

Even if this is not accepted, no dual relief should be required in the residence state if at least one of the following conditions is met:

1. The company has no other income, and thus no other tax is payable in the residence state against which the credit could be applied (either in the current period or in an applicable carry-forward or carry-back period for foreign tax credits);
2. No tax is payable in the residence state as a result of unilateral double taxation relief measures (either credit or exemption), provided the domestic relief is not supplanted or excluded by the operation of the treaty relief;
3. The credit relief provisions of the treaty operate by reference to the domestic law credit provisions of the residence state, and those domestic provisions include a limitation to the effect that no credit is available in relation to income which is exempt under a tax treaty; or
4. It is accepted that the exemption of the income is more favourable than the granting of a credit and thus, exemption of the income in the residence state meets the minimum requirement set by the treaty providing for credit relief.

If a particular state remains concerned about this risk of being obliged to grant dual relief in PE triangular cases, then there are several measures which could be taken to alleviate this risk. These are discussed in the following section.

### 3.3.9. Potential solutions

If a state is concerned about the risk of being obliged to grant dual relief as the residence state in PE triangular cases, the clearest and most certain solution is for that state to include a provision in the relief articles of its treaties to the effect that no credit is available to the extent that the income is exempt under the provisions of an applicable treaty. To provide complete certainty, however, such a provision would need to be incorporated into all of that state’s tax treaties and, as a result, this is probably the most difficult solution to implement, given the long life which treaties generally have and the time it would take for the entire treaty network to be renegotiated.

To the extent that a state’s treaties operate by requiring that state to apply its domestic credit rules, the issue could be avoided by incorporating a provision into domestic law providing that no credit is available to the extent that the income is exempt under a treaty. Most countries probably already have such a provision (or at least this general principle) in their domestic law to deal with bilateral cases where income is exempt under a treaty, but for those who don’t, a specific provision of this nature could potentially guard against the risk of being required to grant dual relief in PE triangular cases. This solution may provide less certainty than including a specific provision in tax treaties, but it has the advantage that it can be achieved unilaterally by enacting a relatively simple provision in domestic law. However, this approach could not be used in all situations. In particular, where the treaty in question does not refer directly to domestic law, the denial of relief under such a provision may raise questions of treaty override.

Finally, countries could mimic the result of a domestic exemption by incorporating a provision into their domestic law that unilaterally exempts income that is exempt under a tax treaty. This solution would

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202 Without such a rule, states would in principle have to apply both their domestic relief and the treaty relief in every situation. This clearly does not occur in practice.
203 This is already the case in some countries, i.e., the domestic law provides that double taxation will be eliminated through the exemption method in the case of certain types of income arising in countries with which there is a tax treaty (Sasseville, J., "A Tax Treaty Perspective...", at p. 58 (Chapter 3, section 3.1.), who gives the example of Canada (in Note 3): See, for instance, Subsection 113(1) of the Canadian Income Tax Act and the related definitions of "exempt earnings" in regulation 5907(1) and "designated treaty country" in regulation 5907(11)). This is also similar to the way some countries, such as Canada, deal with the issue of dual-resident companies which have their residence assigned to another state under an income tax treaty; Canada incorporates this allocation of residence into its domestic law and, as a result, the dual-resident person is not considered resident in Canada for the purposes
have the advantage over a provision included in the domestic credit rules that it could also be used by states whose treaty relief does not rely on the application of domestic credit provisions.

3.4. Conclusions

The residence state in a triangular case will generally be in a position to grant full relief for dual-source based taxation provided (i) the overall tax burden in the two source states is lower than the applicable tax rate in the residence state and/or (ii) the PE state grants relief for tax imposed in the source state. This is the case regardless of whether the residence state provides relief using the exemption method or the credit method. In addition to the relief provided in the residence state, it is important that the PE state grants relief for any tax imposed in the source state, both to ensure an equitable division of tax revenues in relation to the income and to ensure that unrelieved double taxation can be prevented regardless of the relative tax rates in the three states involved. The PE state’s potential obligation to grant relief is the subject of the next chapter (Chapter 4).

For the reasons outlined above, the risk that the residence state will have an obligation to grant dual relief is generally limited. For states that are concerned about this issue, there are some relatively straightforward provisions that could be incorporated into domestic law or tax treaties to give a greater level of certainty that an obligation to grant dual relief will not arise.

of treaties with third states (Section 250, Canadian Income Tax Act. Dual-residence will be discussed in more detail in Chapters 9 and 10.
Chapter 4

The PE state and the non-discrimination principle

4.1. Introduction

In PE triangular cases, income may effectively taxed on a source basis in both the source state and the PE state. One of the key issues in such cases is whether, and to what extent, the PE state is obliged to grant double taxation relief for tax imposed in the source state. Without such relief PE triangular cases can result in unrelieved double taxation, since the residence state, on its own, may not be capable of providing sufficient relief. In addition, if relief is granted only in the residence state and not in the PE state, this may result in an inequitable distribution of tax revenues between those two states.

Given that PEs are generally not entitled to treaty benefits, the PE state will not have any relief obligation under its treaty with the source state (the PE-S treaty). However, under the PE non-discrimination article (Article 24(3)) of the treaty between the residence state and the PE state (the R-PE treaty), the PE state is obliged to ensure that the taxation of the PE is "not less favourably levied" than the taxation of a resident enterprise carrying on the same activities. As a result, the PE state may have an obligation to grant relief for tax imposed in third states; the scope of this obligation will be the main focus of this chapter.

4.2. The need for relief in the PE state and potential sources of relief obligation

4.2.1. The need for relief in the PE state

In PE triangular cases, the residence state may be in a position to fully relieve double taxation even if no relief is provided in the PE state, however this will not always be the case (as discussed in Chapter 3). In addition, even if the residence state can provide sufficient relief, it may come at the expense of tax revenue which the residence state would otherwise have collected in relation to other items of income. This arguably does not result in an equitable distribution of tax revenues between the residence state and the PE state. If the PE state does provide relief, then the combination of this relief and relief provided in the residence state will generally be capable of fully preventing unrelieved double taxation. These considerations suggest that if the PE state imposes tax on income which is also taxed on a source basis in a third state, then the PE state should be obliged to provide double taxation relief.
One argument that has been made against allowing relief in the PE state is that it may lead to a situation where the income is not taxed in any of the three states (commonly referred to as “double non-taxation”).\textsuperscript{213} Non-taxation of the income may occur if, for example; (i) the source state does not seek to impose tax on the income under its domestic law, (ii) the treaty between the residence state and the PE state requires the residence state to exempt the income attributable to the PE, and (iii) the PE state grants double taxation relief using the exemption method.\textsuperscript{214} However, in this example, the income would also escape taxation if it were derived by a resident of the PE state; the relief in the PE state merely places the PE in the same position as a resident enterprise of that state. In addition, the non-taxation of the income arguably arises from the combination of the domestic law of the source state and the relief in the PE state, and not solely as a result of the relief.\textsuperscript{215} PE triangular cases do raise tax avoidance concerns (which will be discussed in detail in Chapter 7), but these concerns should not result in double taxation relief being generally unavailable to PEs in all circumstances.

Of course, the PE state should not be required to provide any relief if the source state is prevented from imposing tax under the conditions of its treaty with the residence state (the R-S treaty). In general, the relief provisions of tax treaties only require relief in relation to income which the non-residence state may tax under the terms of the treaty. In PE triangular cases, however, the source state is generally bound by the conditions of the R-S treaty and not those of the PE-S treaty. Where the PE state uses the credit method of relief, the amount of the credit will be limited to the amount of tax imposed in the source state\textsuperscript{216} and thus there will naturally be no relief in the PE state if the source state is prevented from imposing tax under the terms of the R-S treaty. Where the exemption method applies, however, there may need to be an express limitation on the circumstances in which relief is required to ensure that the PE state does not exempt income that the source state is prevented from taxing under the R-S treaty. This should be distinguished from situations where the source state may impose tax under the R-S treaty but chooses not to exercise its taxing rights; in such cases the PE state should continue to grant the exemption in the same way that the residence state would continue to grant an exemption in a bilateral case. The possible mechanisms for requiring the PE state to grant relief will be discussed in detail in Chapter 7.

Double taxation could also theoretically be prevented by the source state providing relief for tax imposed in the PE state, but to my knowledge, such a solution has never been suggested. It would also be inconsistent with the way in which the treaty articles dealing with passive income operate, in that they allow the source state to impose a certain rate of tax by reference to the gross amount of the income. By contrast, under Article 7, the income attributable to a PE is taxed on a net basis. The similarities between PE taxation and residence-based taxation (which are discussed in depth in Chapter 5) also support the provision of relief in the PE state,\textsuperscript{217} given that in cases of international double taxation it is typically the residence state which is charged with providing relief. Thus, the basis for the discussion in this chapter is that relief should be provided in the PE state for tax imposed in the source state, and not vice versa.

4.2.2. Potential sources of relief obligation

There are various sources of law which may give rise to an obligation for the PE state to grant relief in PE triangular cases; each of these sources will be discussed briefly in this section.

\textsuperscript{213} Jann, M., "How Does Community Law….”; ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, para 61 (The ECJ did not consider this argument to be relevant because there was no risk that the profits in question would not be taxed in any country (see para 62).)

\textsuperscript{214} Jann, M., "How Does Community Law….”

\textsuperscript{215} Martín Jiménez, A.J., García Prats, F.J., & Calderón Carrero, J.M., "Triangular Cases….”

\textsuperscript{216} Limitations on the amount of credit relief in the PE state are discussed in detail in Section 4.3.5., below.

4.2.2.1. Domestic law

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.218 In these countries, income which has been taxed on a source basis in a third state may give rise to a foreign tax credit or the income may be exempt, provided the domestic requirements for relief are satisfied. For example, in the United States a specific provision allows non-residents with a US "trade or business" to claim credits for foreign taxes on income which is "effectively connected" with that trade or business.219 Similarly, Australia's foreign tax credit rules apply to PEs of non-residents in the same way as they apply to residents.220 Other states, including the UK and Canada, only grant unilateral relief to PEs in certain circumstances. In the UK, for example, foreign tax credits may be available under domestic law in relation to income derived through a UK branch, but only if that income represents interest derived by a UK branch of a bank or insurance company.221 Similarly, in Canada, credit relief may be available to Canadian branches of authorised foreign banks.222 Certain other states restrict their unilateral double taxation relief measures to resident taxpayers and thus, do not grant any double taxation relief to PEs under their domestic law.223 Alternatively, the PE state may not grant any double taxation relief under domestic law, even to resident taxpayers, in which case domestic relief would clearly not be available in relation to income derived by local PEs.224

4.2.2.2. European law

Following the European Court of Justice (ECJ) decision in the Saint-Gobain case,225 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). The impact of EU law on PE triangular cases is beyond the scope of this thesis, however, it is important to note that (depending on the states involved) it may give rise to a relief obligation in the PE state. In addition, the non-discrimination principles discussed in the Saint-Gobain case may be relevant to the interpretation of the non-discrimination obligation that arises under the R-PE treaty226 (discussed below). Section 4.3.7. contains a brief

218 OECD Committee on Fiscal Affairs, "Triangular Cases," para 30.
219 Section 906, IRC. This section provides as follows: "(a) A nonresident alien individual or foreign corporation engaged in trade or business within the United States during the taxable year shall be allowed a credit under section 901 for the amount of income, war profits, and excess profits taxes paid or accrued during the taxable year... to any foreign country or possession of the United States with respect to income effectively connected with the conduct of a trade or business within the United States."
220 Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007, p. 18. Under Australia's Foreign Income Tax Offset Rules (FITO), a credit may be available "...where a foreign resident pays income tax in a foreign country on an amount that is included in their assessable income (under Australian tax law) and such tax is imposed because the income is sourced in that country. By contrast, where a foreign country imposes tax on the amount included in an entity's assessable income merely because it is a resident of that country (that is residence-based taxation), a foreign income tax offset entitlement does not arise if the tax is imposed on income from a source outside the foreign country." (Australian Taxation Office, "Guide to Foreign Income Tax Offset Rules 2009-10," available at http://www.ato.gov.au/corporate/content.asp?doc=/content/00238031.htm&page=1&H1, viewed 20 September 2010.) There is no specific section providing for this treatment; the new rules simply no longer include the requirement that the person claiming the foreign tax credit is a resident of Australia.
221 Section 794(1) and Section 794(2)(c), Income and Corporation Taxes Act 1988. See also: Avery Jones, J.F. & Bobbett, C. "Triangular Treaty Problems...".
224 Rohatgi, R., Basic International Taxation at p. 279.
226 See: Vanistendael, F., "Taxation and Non-Discrimination, A Reconsideration of Withholding Taxes in the OECD" 2 World Tax Journal 2, (2010), pp. 175-191. See also, reporting on a seminar which discussed, inter alia, the relevance of the non-discrimination jurisprudence of the European Court of Justice (ECJ) for bilateral tax treaties
comparison between the non-discrimination principles expressed in Article 24(3) of the OECD Model and those of EU law.

4.2.2.3. The treaty between the PE state and the source state

A PE is generally not considered a resident of the PE state for treaty purposes, and as a result, the PE-S treaty will not apply to income derived by the PE.227 To the extent that the PE-S treaty follows the OECD Model, the PE state will therefore have no obligation under that treaty to grant double taxation relief in relation to income derived by the PE. It may be possible, however, for the PE-S treaty to contain specific provisions extending treaty benefits to PEs; the possibility of extending treaty benefits to PEs will be discussed in Chapters 7, 8 and 9.

4.2.2.4. The treaty between the residence state and the PE state

As mentioned above, the PE state may have an obligation to grant relief for taxes imposed in the source state under the non-discrimination article (Article 24(3)) of the R-PE treaty, however, the extent of this obligation is subject to debate. It is quite clear that the non-discrimination article obliges the PE state to extend domestic relief provisions to PEs, but whether the PE state is also obliged to extend treaty relief to PEs (i.e., relief equivalent to that which would be available to a resident enterprise of the PE state under the PE-S treaty) is more controversial. The remainder of this chapter explores the scope of the PE state’s relief obligation under the non-discrimination article of the R-PE treaty.

4.3. The PE non-discrimination principle and double taxation relief

4.3.1. Introduction to Article 24(3)

The purpose of Article 24(3) is to ensure that non-resident enterprises conducting business activities in a particular state are not put at a disadvantage, from a tax perspective, in comparison to enterprises carried on by residents of that state.228 Article 24(3) provides:

"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."229

The term "enterprise of a Contracting State" is defined in Article 3 to mean "an enterprise carried on by a resident of a Contracting state."230 Thus, the subject of the PE non-discrimination clause, and the person entitled to benefit from it, is the person carrying on business through a PE (who is resident in the other contracting state).231 In a PE triangular case, it is therefore the non-discrimination article of the R-PE treaty which must be considered in determining whether the PE state is obliged to grant relief.232 The non-discrimination article of the R-S treaty is irrelevant, as is the non-discrimination article of the PE-S treaty, since neither of these treaties apply in the PE state with respect to the income arising in a PE triangular case.


227 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases," para 15; Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems…"

228 Van Raad, K., Nondiscrimination… at p. 127.

229 Article 24(3) continues: "This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.” This sentence is not relevant for the present analysis.

230 Article 3(1)(d), OECD Model.

231 Van Raad, K., Nondiscrimination… at p. 133.

232 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases," para. 15; Van Raad, K., "The 1992 OECD Model…"
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 in the PE state to the tax burden which would be imposed on a resident enterprise carrying on the same activities. For the purposes of this comparison, it is only the result that must be considered; differential tax treatment of PEs is permitted so long as it does not produce a less favourable result. Furthermore, consideration is limited to the tax imposed in the PE state; the PE state is not required to compensate for less favourable treatment elsewhere, and more favourable treatment elsewhere does not justify a greater tax burden in the PE state. In general terms, the object of comparison is a resident enterprise "that has a legal structure similar to that of the enterprise to which the PE belongs." Thus, if the PE is operated by a company then the taxation of the PE should be compared to the taxation of a company resident in the PE state and carrying on the same activities as the PE. The object of comparison will be discussed further below, along with the meaning of the term "carrying on the same activities" (see Sections 4.3.3., 4.3.4. and 4.3.5.).

4.3.2. Obligation to extend unilateral relief to PEs

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. If such relief is not extended to PEs, then a non-resident deriving income through a local PE 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). While the OECD Commentary refers only to the extension of credit relief, there seems to be no basis for denying the extension of unilateral relief to PEs where the PE state provides relief to resident taxpayers using the exemption method. Thus, the PE should be entitled to the relief available to resident enterprises under the domestic law of the PE state, regardless of whether the PE states provides relief using the credit method or the exemption method.

In practice, not all states extend their domestic double taxation relief measures to PEs in accordance with the non-discrimination provisions of tax treaties. In a case in the UK, for example, the PE of a Canadian insurance company was denied relief even though the court accepted that an obligation to provide relief equivalent to that available to residents under domestic law existed under the non-discrimination article of the Canada-UK treaty. Relief was denied on the basis that the legislation giving effect to the treaty did so subject to certain provisions of domestic law, including the provision limiting relief solely to residents, which was said to override the treaty. This reasoning is generally considered to be contrary to Article 27 of the Vienna Convention, which provides that: "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty." Other states simply do not accept that the PE non-discrimination provision obliges them to grant unilateral relief to PEs at all.

233 OECD Commentary on Article 24, para. 34. See also: Van Raad, K., Nondiscrimination..., at p. 141; Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1316 (m.no. 126).
235 OECD Commentary on Article 24, para 37.
236 Van Raad, K., Nondiscrimination..., at p. 137.
238 OECD Commentary on Article 24, para 67.
239 Van Raad, K., "The 1992 OECD Model..."
243 Avery Jones, J.F., et al., "The Non-discrimination Article..."
244 OECD Committee on Fiscal Affairs, "Triangular Cases", para. 30. The extent to which this is still the case is not clear, but it seems likely that there are at least some states which continue to maintain this position.
In some states, unilateral relief measures are not available in relation to income which is considered to have a domestic source under domestic law. Even if such states accept that the PE non-discrimination article requires them to extend their unilateral relief measures to PEs, no relief would generally be available in such states to the extent that the income attributable to the PE is considered to be domestic source income. This could occur, for example, as a result of the business activities conducted by the PE in the PE state. This may be quite a common situation since the income is derived by a non-resident and thus, would generally only be taxed in the PE state if it is considered to be locally sourced income. In addition, not all states grant relief to resident enterprises under domestic law, in which case there is clearly no domestic relief which could be extended to PEs on the basis of the non-discrimination provision.

Given that relief may not always be available to PEs by the extension of domestic law relief provisions under non-discrimination principles, or alternatively, that such relief may be less favourable than the treaty relief available to resident enterprises, it is also important to consider whether the relief available to resident enterprises under the PE-S treaty should also be available to PEs under the non-discrimination article of the R-PE treaty. This issue is considered in the following section.

4.3.3. Obligation to extend treaty relief to PEs

This section discusses whether PEs should be entitled to double taxation relief in the PE state equivalent to that which is available to residents of the PE state under the PE-S treaty. Such relief is referred to herein as "treaty relief" but it should be borne in mind that to the extent that such relief is available, it is available only as a result of the obligations imposed on the PE state by the non-discrimination article of its treaty with the residence state; the PE is not entitled to treaty benefits and cannot claim relief directly under the treaty between the PE state and the source state.

4.3.3.1. Preliminary analysis

The OECD Commentary does not take a clear position on whether treaty relief should be available to PEs in PE triangular cases under Article 24(3), but instead suggests wording which could be included in the treaty between the PE state and the residence state to specifically allow the PE to claim such relief. It does not appear that this proposed wording has been adopted in any concluded treaty. This may reflect a reluctance to extend treaty relief to PEs; states may prefer to rely on the relief provisions of their domestic law or even to deny relief. Alternatively, to the extent that states do wish to extend treaty relief to PEs, they may consider it that this is already required (or at least possible) under the existing wording of Article 24(3).

The basic starting point for the application of Article 24(3) is that the tax imposed on the PE in the PE state should not be "less favourably levied" than that which would be imposed on a resident entity carrying on the same activities. The legal framework that must be taken into account for comparing the

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245 This was the case in Australia, for example, prior to changes to the foreign tax credit rules in 2008: Section 160AF, Income Tax Assessment Act 1936 (repealed by the Tax Laws Amendment (2007 Measures No. 4) Act, 2007, with effect from income years starting after 1 July 2008).
246 Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems….”
247 The 1977 OECD Commentary on Article 24, paras. 52 and 54, stated that such 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.
248 OECD Commentary on Article 24, para. 70. The suggested wording is as follows: "When a permanent establishment of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt-claim in respect of which the dividends or interest are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that a resident of the first-mentioned State can claim under that State’s convention on income and capital with the third State.”
249 Based on a search of IBFD’s tax treaty database, conducted 30 September 2010.
250 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases", para. 31.
tax imposed on a PE to the tax imposed on a hypothetical resident enterprise carrying on the same activities includes all the provisions which are normally applicable to such an enterprise, including the provisions of tax treaties.\textsuperscript{251} The comparison required by Article 24(3) is not limited to the result of applying the domestic laws of the PE state.\textsuperscript{252} In PE triangular cases there is thus, in my view, no basis for confining the comparison to the relief available under the domestic law of the PE state and ignoring the result of relief provided to resident enterprises of the PE state under tax treaties.\textsuperscript{253} Where the resident enterprise to which the PE is being compared (referred to herein as the "comparison entity") would be entitled to relief under a treaty between the PE state and the source state 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 the tax burden which would be imposed on the resident enterprise.\textsuperscript{254} In principle, therefore, the PE state should be obliged to extend treaty relief to PEs in accordance with the non-discrimination article of the R-PE treaty. Extension of treaty relief to PEs under non-discrimination principles may, however, result in an unbalanced application of the PE-S treaty and may therefore be undesirable from a policy perspective without a corresponding application of the PE-S treaty in the source state (this will be discussed further in Chapter 7).

4.3.3.2. Comparison entity’s eligibility for treaty benefits

For treaty relief to be extended to the PE in accordance with non-discrimination principles, it is essential that the comparison entity would be entitled to relief under the treaty between the PE state and the source state. 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 (ii) it must be eligible for relief under the relief provision of the PE-S treaty. Each of these conditions will be discussed in turn below.

Residence for the purposes of the PE-S treaty

For the purposes of Article 24(3) of the R-PE treaty, the PE is being compared to an enterprise which is carried on by a resident of the PE state within the meaning of the term "resident" under the R-PE treaty.\textsuperscript{255} It does not necessarily follow that the comparison entity will be a resident of the PE state for the purposes of the PE-S treaty, given that determining residence for the purposes of the PE-S treaty would require the application of the definition contained in the PE-S treaty. Under the OECD Model, however, the definition of residence refers to domestic law, treating an entity as a resident of a particular state for treaty purposes if it is resident under the domestic laws of that state.\textsuperscript{256} It therefore seems likely that in most cases, the comparison entity will be considered to be resident in the PE state for the purposes of the PE-S treaty.


\textsuperscript{255} The term "resident" is a defined term for the purposes of the R-PE treaty. Article 4 of the OECD Model provides that: "For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."

\textsuperscript{256} OECD Model, Article 4.
For the purposes of the following analysis, it will be assumed that the comparison entity is a resident of the PE state for the purposes of the PE-S treaty. The comparison entity’s eligibility for treaty benefits under the PE-S treaty will be discussed further in Section 4.3.4., which deals with PEs belonging to partnerships and treaties containing Limitation on Benefits (LOB) provisions.

**Source of income**

The comparison entity would only be entitled to relief under the PE-S treaty if it derived income to which the PE-S treaty applied (i.e., from sources in the source state); therefore, in order for treaty relief to be available to the PE, the PE must be compared to an enterprise that earns the same income as the PE from the same geographical sources. Article 24(3) requires that the taxation imposed on the PE is compared to the taxation imposed on an enterprise of the PE state "carrying on the same activities" as the PE. Therefore, relief will only be required if the "same activities" requirement means that the comparison entity is considered to derive income from the same geographical sources as the PE.

One approach which has been suggested is to compare the PE to all resident enterprises of the PE state carrying on the same activities (e.g., all resident enterprises in the same industry), including those which earn income from non-treaty states. In this case, no treaty relief would be available to the comparison entity, and thus, no treaty relief would be available to the PE. The problem with this approach is that there does not seem to be any basis for limiting the term "same activities" to the type of activities carried on. The better comparison, particularly in light of the objective of Article 24(3), seems to be to a resident enterprise that carries on the exact same activities as the PE, including earning the same income from the same geographical sources.

**Availability of relief under the relief provision of the PE-S treaty**

The relief provisions of the OECD Model require the residence state to grant relief for tax imposed in the source state to the extent that the terms of the treaty permit the source state to impose tax on the income. In considering whether the comparison entity would be entitled to relief under the PE-S treaty, it is therefore important to consider whether the source state would have been entitled to impose tax on the income under the terms of the PE-S treaty if that income had been derived by a resident of the PE state. If the source state would have been prevented from imposing tax on the income then no relief should be available to the comparison entity under the PE-S treaty (either credit or exemption) and consequently, no such relief should be available to the PE.

In most cases where the terms of the PE-S treaty would prevent the source state from imposing tax on the income (if it applied), the source state will in fact be prevented from imposing tax on the income attributable to the PE by the application of the R-S treaty (assuming both treaties follow the OECD Model). Where the source state is prevented from imposing tax under the R-S treaty, there should clearly be no relief in the PE state. However, if there is no R-S treaty, or if there is a difference between the terms of the R-S treaty and the PE-S treaty, then the source state may impose tax in circumstances where it would be prevented from imposing tax under the PE-S treaty if the income were derived by a

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257 Avery Jones, J.F., et al., "The Non-discrimination Article…." It has also been argued that the PE should be compared to a resident enterprise engaging only in domestic activities (in which case no relief would be available) (see: Blahova, R., "Treaty Benefits…," at p. 92); the difficulty with this is that it seems hard to consider purely domestic activities to be the "same activities" as those carried on by the PE. In addition, if the comparison were limited to an enterprise with purely domestic activities, then the PE state would also have no obligation to extend domestic relief measures to PEs under non-discrimination principles, which is clearly not correct.

258 Article 23A ("Exemption Method") and Article 23B ("Credit Method").

259 Under various articles of the OECD Model, the source state is prevented from imposing tax on particular categories of income, including business profits (in the absence of a PE) (Article 7), royalties (Article 12), certain capital gains (Article 13), and other income (Article 21). For analysis, refer to Chapter 2.

260 This is the case with respect to business profits (Article 7), income from shipping, inland waterways transport and air transport (Article 8), certain types of capital gains (Article 13) and "other income" (Article 21). Refer to Chapter 2 for further detail.
resident of the PE state. If this were the case, then the comparison entity would generally not be entitled to relief under the PE-S treaty, and thus, prima facie, no relief should be available to the PE.

This will depend, however, on the comparison which is made for the purposes of applying Article 24(3), i.e., whether the PE is being compared to a resident enterprise which is earning the same income as the PE and paying the same tax in the source state as was actually paid by the PE or, alternatively, whether it is being compared to a resident of the PE state which earns the same income as the PE from the same sources and paying the amount of tax in the source state that a resident enterprise would pay. This is discussed in greater detail below (in Section 4.3.5.) in relation to the amount of relief which should be provided in the PE state.

4.3.3.3. Arguments against extending treaty relief to PEs

One of the primary arguments against extending treaty relief to PEs under the non-discrimination principle is based on the relative (or bilateral) effect of treaties. According to this principle, 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. However, the fact that the PE is not entitled to the benefits of the PE-S treaty should not prevent the PE state from granting equivalent relief in order to place the PE in the same position as a resident taxpayer. Granting such relief does not represent an extension of the personal scope of the PE-S treaty because the PE state's obligation to grant relief does not arise under the PE-S treaty. Rather, it arises under Article 24(3) of the R-PE treaty and as a result of the application of the PE-S treaty's relief provisions to eligible residents of the PE state.

This view is supported by the fact that there are no additional obligations imposed on the source state and the rights of the source state are in no way affected. The source state is free to apply its tax laws to the income attributable to the PE without any limitation under the PE-S treaty. In addition, where the application of Article 24(3) of the R-PE treaty requires the PE state to grant relief equivalent to that available to resident enterprises, it should not be possible to invoke Article 1 of the PE-S treaty to limit the amount of relief available and, in effect, to fail to meet the obligation arising under Article 24(3) of the R-PE treaty.

Another common (and related) 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. Tax treaties are based on the principle of reciprocity; the idea that each contracting state gives up

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261 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. This argument was also presented by Van Raad (Van Raad, k., Nondiscrimination..., at p. 153, but contra: Van Raad, k., "Issues in the Application..." and Van Raad, k., "The 1992 OECD Model..."). Vogel has stated that treaty relief should not be available to PEs, but without presenting the reasoning behind this view (Vogel, k., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at pp. 1317-8, (m.no. 129)). 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., García Prats, F.J., & Calderón Carrero, J.M., "Triangular Cases..."; Friedhelm, J., "Discriminatory Tax Treatment..." (referring to several German authors); Zhai, G. "Triangular Cases...".

262 IBFD International Tax Glossary, p. 335.


certain taxing rights under a treaty in exchange for the other contracting state agreeing to do the same.\footnote{IBFD International Tax Glossary, p. 329.} If one state is required to extend the relief available under a treaty to income attributable to PEs of residents of third states then, so the argument runs, the reciprocity of the treaty is compromised because the PE state is required to sacrifice tax revenue with no corresponding sacrifice in the source state. The reciprocity argument was soundly rejected in the \textit{Saint-Gobain} case,\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97. The Saint-Gobain case concerned a German PE of a French company which received dividends from companies resident in various countries. It involved a request for three tax concessions with respect to the dividends received by the PE on the basis of the non-discrimination principles of EU law (specifically, the freedom of establishment). These concessions were: (1) an exemption from the German corporation tax for dividends received from companies resident in the US and Switzerland which was available to German resident companies under the treaties concluded between Germany and those states; (2) an indirect tax credit for taxes imposed on the profits from which foreign dividends were paid available to German resident companies under German domestic law; and (3) a capital tax concession available to German resident companies under German domestic law.} where the ECJ clearly of the view that the balance and reciprocity of the treaties between the PE state (in this case, Germany) and the source states (Switzerland and the US) would not be disturbed by the allowance of double taxation relief in the PE state.\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, paras 59-60.} While the Saint-Gobain case was decided on the basis of EU law, and partly with respect to economic rather than juridical double taxation,\footnote{The Saint-Gobain case involved a request for three tax concessions with respect to the dividends received: (1) an exemption from German corporation tax for dividends received from companies resident in the US and Switzerland which was available to German resident companies under the treaties concluded between Germany and those states; (2) an indirect tax credit for taxes imposed on the profits from which foreign dividends were paid available to companies resident in Germany under German domestic law; and (3) a capital tax concession available to German resident companies under German domestic law (ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, paras 16-22.} the arguments regarding the impact on the balance and reciprocity of treaties are equally relevant where the potential extension of treaty relief arises under tax treaty non-discrimination principles. 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\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, para 59.} and likened the double taxation relief to be provided under non-discrimination principles to a unilateral extension of relief in the PE state.\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, para 59.} The ECJ also noted that the German legislature had never considered that the provisions of double tax treaties precluded any unilateral renunciation of taxing rights, and that the balance and reciprocity of the treaties would not be called into question by a unilateral extension of relief measures to PEs.\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, para 60.} Similarly, if Article 24(3) of the R-PE treaty requires the PE state to extend treaty relief to a PE, then from the perspective of the PE-S treaty, that relief is, in a sense, equivalent to a unilateral extension of relief by the PE state. For these reasons, the relief obligation should not be considered to upset the balance and reciprocity of the PE-S treaty.

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 in particular, on the prevalence of PEs of non-residents which derive income from the other state),\footnote{The Saint-Gobain case,269 in which the ECJ was clearly of the view that the balance and reciprocity of the treaties between the PE state (in this case, Germany) and the source states (Switzerland and the US) would not be disturbed by the allowance of double taxation relief in the PE state.270 While the Saint-Gobain case was decided on the basis of EU law, and partly with respect to economic rather than juridical double taxation,271 the arguments regarding the impact on the balance and reciprocity of treaties are equally relevant where the potential extension of treaty relief arises under tax treaty non-discrimination principles. 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 states272 and likened the double taxation relief to be provided under non-discrimination principles to a unilateral extension of relief in the PE state.273 The ECJ also noted that the German legislature had never considered that the provisions of double tax treaties precluded any unilateral renunciation of taxing rights, and that the balance and reciprocity of the treaties would not be called into question by a unilateral extension of relief measures to PEs.274 Similarly, if Article 24(3) of the R-PE treaty requires the PE state to extend treaty relief to a PE, then from the perspective of the PE-S treaty, that relief is, in a sense, equivalent to a unilateral extension of relief by the PE state. For these reasons, the relief obligation should not be considered to upset the balance and reciprocity of the PE-S treaty.} the domestic tax laws of each state.\footnote{The reciprocity argument also fails to take into account the potential impact of denying relief on the balance and reciprocity of the R-PE treaty. If the state which is, in this case, the residence state entered into the R-PE treaty with the view that Article 24(3) requires the state where a PE is located to extend treaty relief to PEs, and the first state (State R) does in fact grant such relief to PEs} The balance and reciprocity argument is soundly rejected in the \textit{Saint-Gobain} case,\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, paras 59-60.} where the ECJ clearly of the view that the balance and reciprocity of the treaties between the PE state (in this case, Germany) and the source states (Switzerland and the US) would not be disturbed by the allowance of double taxation relief in the PE state.\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, para 59.} While the Saint-Gobain case was decided on the basis of EU law, and partly with respect to economic rather than juridical double taxation,\footnote{ECJ, 21 September 1999, \textit{Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt}, C-307/97, para 60.} the arguments regarding the impact on the balance and reciprocity of treaties are equally relevant where the potential extension of treaty relief arises under tax treaty non-discrimination principles. 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\footnote{Assuming the principle of granting treaty relief to PEs under non-discrimination principles is applied consistently by both states.} and likened the double taxation relief to be provided under non-discrimination principles to a unilateral extension of relief in the PE state.\footnote{For example, the extent to which PEs are taxed on income from sources in third states and the extent to which relief is available under domestic law.} 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 in particular, on the prevalence of PEs of non-residents which derive income from the other state),\footnote{The reciprocity argument also fails to take into account the potential impact of denying relief on the balance and reciprocity of the R-PE treaty. If the state which is, in this case, the residence state entered into the R-PE treaty with the view that Article 24(3) requires the state where a PE is located to extend treaty relief to PEs, and the first state (State R) does in fact grant such relief to PEs} the domestic tax laws of each state.\footnote{The reciprocity argument also fails to take into account the potential impact of denying relief on the balance and reciprocity of the R-PE treaty. If the state which is, in this case, the residence state entered into the R-PE treaty with the view that Article 24(3) requires the state where a PE is located to extend treaty relief to PEs, and the first state (State R) does in fact grant such relief to PEs} The reciprocity argument also fails to take into account the potential impact of denying relief on the balance and reciprocity of the R-PE treaty. If the state which is, in this case, the residence state entered into the R-PE treaty with the view that Article 24(3) requires the state where a PE is located to extend treaty relief to PEs, and the first state (State R) does in fact grant such relief to PEs
located within its borders, then the failure of the other state (State PE) to extend treaty relief to PEs arguably upsets the balance and reciprocity of the R-PE treaty.277

The non-application of the conditions of the PE-S treaty in the source state suggests, however, that the extension of treaty relief to the PE would not be appropriate, even if it may be technically required under the terms of the R-PE treaty. Without a corresponding application of the conditions of the PE-S treaty in the source state in relation to the income attributable to the PE, the extension of treaty relief in the PE state results in an unbalanced application of the PE-S treaty being unbalanced. This could be resolved by also requiring the source state to apply the conditions of the PE-S treaty in relation to the income attributable to the PE (this will be revisited in later chapters).

4.3.3.4. Conclusions

It has been argued above that the PE non-discrimination provision in Article 24(3) of the R-PE treaty imposes an obligation on the PE state to extend treaty relief to PEs in PE triangular cases. If such relief is not granted, then the tax imposed on the PE is arguably less favourably levied than that which would be imposed on a resident enterprise carrying on the same activities, and the PE state contravenes Article 24(3). Neither the principle of the relative effect of treaties nor the reciprocity principle offers sufficient justification for failing to extend double taxation relief to PEs equivalent to that which would be available to a resident enterprise under the PE-S treaty. It would, however, be preferably for the PE state to have an explicit obligation to extend treaty benefits to PEs to remove any doubt regarding the extent to which it is required to grant relief. In addition, the extension of treaty relief to PEs may be considered problematic from a policy perspective unless there is a corresponding application of the conditions of the PE-S treaty in the source state because it results in an unbalanced application of the PE-S treaty. As will be discussed in Chapter 5, the source state should also be required to apply the conditions of the PE-S treaty in relation to income attributable to the PE, in which case the potentially unbalanced application of the PE-S treaty would no longer be an issue.

4.3.4. Comparison entity’s eligibility for treaty benefits in special circumstances

Regardless of the general requirement for relief discussed above, the PE state will not have any obligation to extend treaty relief to a PE the extent that the comparison entity would not be entitled to relief under the PE-S treaty. This section discusses the comparison entity’s eligibility for relief under the PE-S treaty in situations where the PE belongs to a partnership and in situations where the PE-S treaty contains a limitation on benefits (LOB) provision which restricts eligibility for treaty benefits. In such cases, it may be difficult to demonstrate that the comparison entity should be entitled to relief under the PE-S treaty and thus, that the PE should be entitled to relief.

4.3.4.1. Partnerships

For the purposes of applying Article 24(3), the taxation imposed on the PE should be compared to the taxation imposed on a resident enterprise that has the same legal form as the enterprise to which the PE belongs.278 In the case of companies and individuals, this does not raise any particular issues regarding treaty entitlement; however, it may be somewhat more difficult in the case of partnerships.

277 It has been pointed out that if the PE state were concerned about upsetting the reciprocity of its treaties by providing equivalent relief to PEs, then it could have negotiated for a limitation to be included in the non-discrimination article of its treaty with the residence state (Friedhelm, J., “Discriminatory Tax Treatment…”). However, if a particular state holds the view that no such relief obligation exists on the basis of the wording of Article 24(3), then it seems unlikely that it would seek to negotiate any specific limitation in its treaties.

278 OECD Commentary on Article 24, para 35. See also: Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1315, (m.no. 125); Van Raad, K., Nondiscrimination..., at pp. 135, 137.
In general, partnerships that are transparent for tax purposes are not themselves eligible for treaty benefits because they do not meet the criteria for residence. Instead, it is the partners in the partnership who must claim treaty benefits and the "residence state" will generally be the state where the partners are resident. If a PE belonging to a transparent partnership (formed in State R) is compared, for the purposes of Article 24(3), to a similarly transparent partnership which is established in the PE state but which has partners resident outside the PE state, then the hypothetical enterprise to which the PE is being compared would not be entitled to relief under the PE-S treaty. It follows that no such relief should be available to the PE. However, given that it is the partners themselves and not the partnership which is claiming treaty benefits, a better approach seems to be to compare the taxation of the PE to the taxation that would have been imposed on a partnership formed by residents of the PE state. Provided the partnership is treated as a transparent entity for tax purposes by all the states involved, then the partnership itself is effectively irrelevant for the purposes of applying Article 24(3). In this case, the partners in the partnership would presumably be entitled to relief under the PE-S treaty and consequently, such relief should also be extended to the PE.

More complicated is the situation where the PE state, the source state, and the state where the partnership is formed and/or where the partners are resident, do not tax the income of the partnership on the same basis; i.e., one or more states treat it as a separate taxable entity and one or more other states treat it as transparent and impose tax directly on the partners. Such hybrid entity situations are beyond the scope of this thesis, but it should be noted that in such situations it may be more difficult for the PE to demonstrate that it should be entitled to treaty relief in the PE state under Article 24(3) of the R-PE treaty and it is likely that in some cases, no relief will be available.

4.3.4.2 Limitation on benefits provisions

A Limitation on Benefits (LOB) article restricts the availability of treaty benefits by providing that such benefits are only available if certain conditions are satisfied. The existence of an LOB provision in the PE-S treaty makes determining whether treaty relief should be available to the PE under Article 24(3) of the R-PE treaty more complicated because where there is an LOB provision, determining whether treaty benefits would be available to the comparison entity requires a much more in-depth consideration of the structure, activities and circumstances of that comparison entity.

LOB articles are contained in virtually all the treaties concluded by the United States and the United States is one of the contracting states in the majority of treaties containing an LOB article. Keeping this in mind, the following discussion will focus on the LOB article contained in the 2006 US Model Convention. The Commentary to the OECD Model Convention also contains suggested wording for an LOB provision, which may form the basis for LOB provisions included in tax treaties, and which will also be referred to below. Many of the provisions of the OECD Commentary's LOB are similar to those of the US Model LOB provision.
Please note that this analysis is intended simply to highlight some of the issues associated with applying Article 24(3) when the treaty between the PE state and the source state contains an LOB article and does not seek to conduct an in-depth analysis of an LOB provision.

Active business test

The LOB article of the US Model Convention provides that the benefits under the convention will be available with respect to an item of income derived in connection with (or incidental to) the active conduct of a trade or business in the residence state286 (referred to herein as the "active trade or business test").287 Consideration of the circumstances in which there may be a "trade or business", and in which income may be derived in connection with (or incidental to) that trade or business, are beyond the scope of this study.288 However, given the nature of a PE and the methods used to determine the income attributable to a PE, it is possible that the income derived by a PE will have been derived in connection with a trade or business carried on by the PE in the PE state.

If the income is derived in connection with the active conduct of a trade or business carried on by the PE,289 then it should also be considered to be derived in connection with the active conduct of a trade or business by the comparison entity. This is because the comparison entity must be considered to carry on the "same activities" as the PE. If the comparison entity satisfies the active trade or business test, then it should be (hypothetically) entitled to relief under the PE-S treaty and consequently, the PE should be entitled to equivalent relief under Article 24(3) of the R-PE treaty.

Stock exchange listing test

A company is a "qualified person," and thus not excluded from entitlement to treaty benefits under the US Model LOB, if the principal class of its shares is regularly traded on one or more recognized stock exchanges and either (a) its principal class of shares is traded on a recognized stock exchange in its residence state, or (b) its primary place of management and control is in its residence state.290 If the PE

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286 2006 US Model Convention, Article 22, para 3(a) reads: "A resident of a Contracting State will be entitled to benefits of the Convention with respect to an items of income derived from the other State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a trade or business in the first-mentioned state (other than the business of making or managing investments for the residents' own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business."

287 The equivalent provision of the OECD Commentary's LOB provides that benefits will be available with respect to an item of income "if the resident is actively carrying on business" in its residence state and the income "is derived in connection with, or is incidental to, that business" (2010 OECD Commentary on Article 1, para 20, clause 3(a)). Given that the definition of a PE refers to "a fixed place of business through which the business of an enterprise is wholly or partly carried on" (2010 OECD Model, Article 5(1)) and that the income which is taxable in the PE state is the income which is "attributable" to the PE, it seems that the PE would generally be considered to be "actively carrying on business" and that its income would generally be considered to be derived in connection with that business. Therefore, the comparison entity could generally be expected to meet the requirements of the active business test contained in the OECD Commentary's LOB provision.

288 For a discussion of these issues in the US context, see: 2006 US Model Technical Explanation, pp. 69-72.

289 Or in connection with "actively carrying on a business," depending on the specific terms used in the LOB provision.

290 These are the primary tests, but there is also a test which looks at the ownership of the company by entities that meet the listing test (see the provision included in this footnote). 2006 US Model Convention, Article 22, para 2 reads: "A resident of a Contracting State shall be a qualified person for a taxable year if the resident is: ... (c) a company, if: (i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges, and either: (A) its principle class of shares is traded on one or more recognised stock exchanges located in the Contracting State of which the company is resident; or (B) the company's primary place of management and control is in the Contracting State of which it is a resident; or (ii) at least 50% of the aggregate vote and value of the shares (and at least 50% of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies entitled to benefits under clause (i) of this sub-paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State."
belongs to a company that is listed on a recognised stock exchange, it may be possible to apply the stock exchange listing test to the comparison entity.

A stock exchange listing does not fit neatly into the principle that the comparison entity should be considered to have the same legal form as the entity to which the PE belongs, since it is not a legal characteristic of the entity. It also does not fall within the "same activities" requirement of Article 24(3), since it is highly unlikely that the activities associated with listing on the stock exchange (e.g., investor relations, compliance with listing rules) would be carried out by the PE. The listing is, however, part of the circumstances surrounding the PE and the key question is therefore whether there is an implied "same circumstances" test in Article 24(3) and, if there is, how it should be applied.

Article 24(3) does not expressly require that the taxation of the PE be compared to a resident enterprise that is in the same circumstances. This is in contrast to Article 24(1), which deals with discrimination on the basis of nationality. Van Raad argues that, because Article 24(3) is not considered to be limited to prohibiting rules that differentiate based on activities, the circumstances which must be kept the same for determining whether there has been discrimination are not restricted to the activities conducted by the PE and thus, that there is an implied same circumstances test. Adonnino dismisses this argument, but notes that it is important that that the PE and the resident enterprise are comparable.

Even if there is an implied same circumstances requirement in Article 24(3), it is not clear exactly what the circumstances of the comparison entity should be with respect to a stock exchange listing. That is, whether the taxation of the PE should be compared to a hypothetical entity that is itself listed, or alternatively, whether it should be compared to a hypothetical subsidiary of the listed company to which the PE belongs. In general, the taxation imposed on the PE must be compared to the taxation imposed on a purely domestic enterprise of the PE state; it should not be compared to a domestic subsidiary controlled by a foreign company. The appropriate comparison therefore seems to be to an entity which is itself listed rather than to a subsidiary of the listed entity to which the PE belongs. If the taxation of the PE is compared to a listed company resident in the PE state, the next question is on which stock exchange the hypothetical comparison entity should be considered to be listed, and where its place of management should be considered to be located. It is submitted that the comparison entity should be considered to be listed on the same stock exchange as the entity to which the PE belongs. There seems to be no basis for making an assumption that the comparison entity is listed in the PE state. It follows that unless the entity to which the PE belongs is listed in the PE state (or the source state – both of which seem relatively unlikely), then even if there is an implied same circumstances test, the comparison entity should not be considered to meet the stock exchange listing test on the basis of being listed in its residence state.

Determining the place of management and control of the comparison entity may also be difficult. Prima facie, it would appear that the place of management and control of the PE should coincide with the place of management and control of the entity to which it belongs, generally the residence state. However, if the PE is completely autonomous from an operational perspective, then it is possible that the

The equivalent provision in the OECD Commentary LOB provides for the contracting states to list the specific stock exchanges which will be recognised for the purposes of the treaty and does not refer to the primary place of management (2010 Commentary on Article 1, para 20, clause 2(c) and clause 6.)

Van Raad, K., Nondiscrimination..., at p. 140.

Van Raad, K., Nondiscrimination..., at p. 140.


If the taxation imposed on the PE is compared to a company which is a subsidiary of the listed company to which the PE belongs, then the listing test could not be met. A company is a qualified person if at least 50% of the aggregate vote and value of the shares in the company is owned directly or indirectly by five or fewer companies that are residents in one of the contracting states and meet the listing test. These requirements would clearly not be met because the parent company would not be a resident of the PE state and therefore, the listing test could not be relied upon for the comparison entity to satisfy the LOB provision of the treaty between the PE state and the source state.

Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at pp. 1314-5, (m.no. 123).

Or is a subsidiary of a listed company which is resident in the PE state.

A company will often be resident for treaty purposes in the state where its "place of effective management" is located because the residence tie breaker for treaty purposes allocates companies' residence on the basis of "place of effective management."

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management and control of the PE (and thus the comparison entity, on the basis that it carries on the same activities as the PE) should be considered to be located in the PE state. Another alternative, if the residence rules of the PE state are based solely upon the place of management, is that the entity would be considered to be managed in the PE state on the basis that it would otherwise not be a "resident enterprise" as required by Article 24(3).

In general, it seems that it would be very difficult, if not impossible, to demonstrate that a PE should be entitled to treaty relief on the basis that the comparison entity satisfies the listing test. This would require firstly that Article 24(3) contains an implied same circumstances requirement, and secondly, that the comparison entity is considered to meet the listing test, either by being listed on an exchange in the PE state or by being managed and controlled in the PE state.

Ownership and base erosion test

The ownership and base erosion test requires (i) that on at least half the days in the taxable year, qualified residents of the entity's residence state own at least 50% of the aggregate voting power in the entity (the "ownership test"), and (ii) that less than 50% of the entity's gross income is paid or accrued to persons who are not resident in either of the contracting states in the form of payments that are deductible (excluding arm's length payments in the ordinary course of business for services or tangible property) (the "base erosion test").298 Both these requirements must be met in order for the benefits of the treaty to be available under this paragraph of the LOB provision. The equivalent provisions of the OECD Commentary LOB are very similar.299

Whether the comparison entity meets the ownership test will depend upon the hypothesised ownership structure of that entity. If the PE is compared to an entity which is a subsidiary of the entity to which the PE belongs, then the test will clearly not be met; however, this is not generally considered to be the appropriate comparison.300 Alternatively, if the PE is compared to an entity which is owned by residents of the PE state, as suggested by Vogel,301 then the ownership test generally would be met. Another possible approach is to consider a comparison entity which has the same ownership structure as the entity to which the PE belongs;302 in this case, the ownership test could only be met if the entity to which the PE belongs is more than 50% owned by residents of the PE state, which is possible but seems an unlikely scenario.

The application of the base erosion test to the comparison entity should be relatively straightforward. For determining whether the base erosion test is satisfied, any payments deducted in calculating the profit attributable to the PE (other than arm's length payments in the ordinary course of business) should, prima facie, be considered to be base eroding payments and should be compared to the gross income attributable to the PE to determine whether the base erosion test is met. However, even where the comparison entity does satisfy the base erosion test, it will only be entitled to relief under the PE-S treaty if it also meets the ownership test which, as discussed above, is likely to be difficult.

Conclusion

If the treaty between the PE state and the source state contains an LOB provision, then it will be very difficult to determine whether the comparison entity would be entitled to treaty relief, and thus, whether the PE should be entitled to equivalent relief under the Article 24(3) of the R-PE treaty. Such relief will only be available if the comparison entity satisfies one of the tests discussed above. Of these, the active business test may potentially be satisfied, depending on the circumstances, but in most cases it would generally not be possible to satisfy any of the other tests. The application of these tests is made considerably more difficult in the context of applying Article 24(3) than in the case of a direct application

298 2006 US Model Convention, Article 22, para 2(e).
299 OECD Commentary on Article 1, para 20, clause 2(e).
300 Vogel, K., Engelschall, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at pp. 1314-5, (m.no. 123).
301 Vogel, K., Engelschall, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at pp. 1314-5, (m.no. 123).
302 See, for example, the discussion in: Vogel, K., Engelschall, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1314, (m.no. 122).
to a resident enterprise by the need to determine the appropriate characteristics to attribute to the hypothetical comparison entity. Therefore, where the PE-S treaty contains an LOB provision, the PE is unlikely to be able to claim relief for tax imposed in the source state on the basis of the non-discrimination article of the R-PE treaty.

4.3.5. Amount of credit relief

If the PE state grants relief for tax imposed in the source state on the basis of domestic law, then it seems quite clear that the credit available in the PE state should be subject to any limitations contained in that domestic law. In most cases, the credit is likely to be the lesser of (i) the tax actually imposed on the income in the source state and (ii) the tax attributable to the income in the PE state. However, the appropriate limitations to apply to the amount of the credit are not quite so clear when treaty relief is being extended to the PE. This is particularly relevant in triangular cases involving dividends and interest (and potentially also royalties) if the rate of source-based taxation which would be allowed under the PE-S treaty differs from the rate actually imposed in the source state.

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. The credit is of course also limited to the amount of tax attributable to the income in the PE state. The two limitations suggested by the OECD will be discussed in turn below. It will be assumed for the purposes of discussion that the tax attributable to the income in the PE state exceeds both these limitations, such that the limitation based on the amount of tax in the PE state is not relevant.

4.3.5.1. The first limitation: Tax imposed in the source state

The first limitation, which limits the credit to the amount of tax imposed in the source state, will be relevant in situations where the amount of tax actually imposed in the source state is lower than the amount it could impose if it applied the terms of the PE-S treaty. It would be relevant, for example, in a situation where the source state imposes withholding tax of 10% on, e.g., interest, under its domestic law and in accordance with the R-S treaty, while the maximum rate allowed under the PE-S treaty is 15%.

One of the basic principles of foreign tax credit relief is that the credit should not exceed the amount of foreign tax paid. For the purposes of applying Article 24(3), however, it is the tax burden imposed on the PE's income in the PE state which must be considered and which must be compared to the tax burden imposed on a resident enterprise; the means by which the tax is imposed is irrelevant. It follows from this that the principles applied to resident taxpayers do not have to be applied to the PE under Article 24(3) and if Article 24(3) is being applied to determine the amount of the credit that should be available, it is the result which must be compared and not the specific rules and principles that are applied. What seems like an obvious limitation on the credit available in the PE state depends, in fact, on the comparison which is made for the purposes of Article 24(3).

If the PE is compared to a resident enterprise earning the same income as the PE from the source state, then the amount of credit should be equal to the amount of the credit that would be available to that resident enterprise. If the income attributable to the PE were derived by a resident of the PE state, then the amount of tax imposed in the source state would be the lower of (i) the amount it may impose under

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303 There may also be other limitations applicable under domestic law, such as a country-by-country limitation or a basket system (see Chapter 3 (Section 3.2.3.1.) for a discussion of various credit limitations in the context of the residence state).
304 The OECD Model does not provide for any source based taxation of royalties under Article 12, however, many concluded treaties do allow for limited source-based taxation.
305 OECD Commentary on Article 24, para 70, which goes on to suggest specific wording to achieve this outcome. See also: OECD Committee on Fiscal Affairs, "Triangular Cases", para. 49.
306 Van Raad, K., "The 1992 OECD Model…".
307 OECD Commentary on Article 24, para 34.
the PE-S treaty and (ii) the amount it would impose under domestic law in the absence of any limitation. Thus, if the correct comparison is to an entity paying the same amount of tax in the source state as a resident of the PE state would pay, then there is no technical basis for limiting the credit available to the PE to the amount of tax actually imposed in the source state. This is demonstrated in the following example.

**Example**

In a PE triangular case, the income attributable to the PE includes $100 of income from sources in State S. The PE does not earn any other income and has no expenses. The domestic withholding tax rate in the source state is 20%, but the rate of tax the source state may impose is limited to 10% under the R-S treaty. The source state therefore imposes $10 of tax. The PE state imposes $20 of tax on the income and does not provide any double taxation relief under its domestic law. The residence state exempts the income attributable to the PE. If the income had been derived by a resident of the PE state then, under the PE-S treaty, the tax imposed in the source state would have been limited to 15% of the gross amount of the income and the PE state would have been obliged to provide relief using the credit method. The PE state extends treaty relief to the PE under Article 24(3) of the R-PE treaty. The relief is limited to either:

(i) The lesser of the amount of tax that could be imposed in the source state if it applied the PE-S treaty and the amount of tax actually imposed in the source state; and

(ii) The amount of tax that could be imposed in the source state if it applied the PE-S treaty (but not limited to the amount of tax actually imposed in the source state).

This situation is illustrated in the following diagram.

*Figure 4.1.: Example demonstrating impact of credit limitations in the PE state*

The table illustrates the different outcomes that may arise if the credit is, or is not, limited to the amount of tax imposed in the source state.

*Table 1: Example demonstrating different outcomes that may arise if credit in PE state is or is not limited to the amount of tax imposed in the source state*

<table>
<thead>
<tr>
<th></th>
<th>Comparison - Income derived by resident of PE State</th>
<th>(i) Relief limited to tax imposed in the source state</th>
<th>(ii) Relief not limited to tax imposed in the source state</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Tax imposed in source state</td>
<td>15</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Tax imposed in the PE state prior to relief</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Relief available</td>
<td>15</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Tax imposed in the PE state</td>
<td>5</td>
<td>10</td>
<td>5</td>
</tr>
</tbody>
</table>
This table demonstrates that if the PE is compared to a resident enterprise which is (i) earning the same income as the PE from sources in the source state and (ii) paying the same amount of tax in the source state that a resident of the PE state would pay, and the relief available to the PE is limited to the amount of tax actually imposed in the source state, then the amount of tax imposed in the PE state ($10) will be greater than that imposed on the comparable resident enterprise ($5). If this limitation did not apply and the credit in the PE state was instead only limited to the tax that could be imposed by the source state if the PE-S treaty applied, then the PE state would impose the same amount of tax on the PE as would be imposed on a resident enterprise (i.e., $5). However, this also demonstrates a significant problem with not applying a limitation based on the amount of tax effectively imposed in the source state, namely, that the PE state may be required to grant a credit for tax which was not actually paid.

In order for this limitation to apply, the PE would have to be compared to a resident enterprise earning the same income as the PE and paying the same amount of tax in the source state as was paid by the PE. That is, the payment of a certain amount of tax in the source state would have to be considered an aspect of carrying on the "same activities" as the PE. It is difficult to accept this view. If this is the right approach, however, then to continue the example above, the resident enterprise to which the PE is being compared would be considered to have paid $10 of tax in the source state and would be entitled to a credit of only $10, resulting in a tax liability in the PE state of $10.

### 4.3.5.2. The second limitation: Tax that could be imposed in the source state if the PE-S treaty applied

The second limitation, based on the tax which could be imposed under the PE-S treaty, will be relevant where the tax imposed in the source state is higher than it could have imposed if the PE-S treaty had applied. So, for example, it would be relevant if the R-S treaty provides for a maximum rate of source-based taxation of 15% and the PE-S treaty provides for a maximum rate of 10%.

The second limitation compares the taxation imposed on the PE to the taxation that would be imposed on a resident enterprise earning the same income as the PE from the same sources. Unlike in the previous limitation, this limitation considers what the outcome would be in the source state (and the credit that would be required) if the income were derived by a resident enterprise of the PE state. It is thus based on the comparison entity paying the same amount of tax in the source state as a resident of the PE state would pay, taking into account the application of the PE-S treaty. This is demonstrated in the following example.

#### Example

In a PE triangular case, the income attributable to the PE includes $100 of income from sources in State S. The PE does not earn any other income and has no expenses. Under the R-S treaty the source state may impose tax on the income, but the tax may not exceed 15% of the gross amount of the income. The source state imposes $15 of tax. The PE state, prior to any relief from double taxation, imposes tax of $20 on the income. The PE state does not provide any double taxation relief under its domestic law. If the income had been derived by a resident of the PE state then, under the PE-S treaty, the tax imposed in the source state would have been limited to 10% of the gross amount of the income and the PE state would have been obliged to provide relief from double taxation using the credit method. Under Article 24(3) of the R-PE treaty, the PE state extends treaty relief to the PE. The relief is limited to either:

(i) the lesser of the tax imposed in the source state and the amount of tax that could be imposed in the source state if it applied the conditions of the PE-S treaty; or

(ii) the tax imposed in the source state (i.e., the relief is not limited to the amount of tax that could be imposed if the source state applied the conditions of the PE-S treaty).

This situation is illustrated in the following diagram, and the two alternatives are shown in the table below.
Figure 4.2: Example showing the impact of limiting relief in the PE state to the amount of tax the source state could impose if it applied the PE-S treaty

Table 2: Example illustrating the potential outcome where relief (i) is and (ii) is not limited to the amount of tax the source state could impose if it applied the conditions of the PE-S treaty

<table>
<thead>
<tr>
<th>Comparison – resident of PE State</th>
<th>(i) Relief limited to amount that could be imposed under PE-S treaty</th>
<th>(ii) Relief not limited to amount that could be imposed under PE-S treaty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Tax imposed in source state</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Tax imposed in the PE state prior to relief</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Relief available</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Tax imposed in the PE state</td>
<td>10</td>
<td>5</td>
</tr>
</tbody>
</table>

This table demonstrates that limiting the amount of relief available to the PE to the amount of tax that could be imposed in the source state under the PE-S treaty if it applied (see (i) in the table above), means that the PE pays the same amount of tax in the PE state as a resident enterprise would pay (i.e., $10). One potential problem with this limitation is that the PE is not granted sufficient relief to fully compensate for the tax it pays in the source state and thus to prevent double taxation. In the example above, the comparison entity bears an overall tax burden of $20, while the PE bears an overall tax burden of $25. This should not, however, prevent this limitation from being applied because Article 24(3) only requires the taxation in the PE state to be considered; the PE state is not required to compensate for less favourable treatment in a third state (i.e., the source state). If this limitation is not applied (see (ii) in the table above), then the PE state may end up collecting less tax than it would collect if the income were earned by a resident of the PE state. In the example above, for instance, the PE state collects $5 while it would have collected $10 from a comparable resident enterprise.

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308 Article 24(3), OECD Model: "The taxation on a permanent establishment which an enterprise of a Contracting State [State R] has in the other Contracting State [State PE] shall not be less favourably levied in that other State [State PE]..." [emphasis added]. See also: Avery Jones, J.F., et al., "The Non-discrimination Article...."

309 Avery Jones, J.F., et al, "The Non-discrimination Article...".
4.3.5.3. Inconsistency between the limitations

While the two limitations discussed above do seem reasonable from a practical perspective, the logic behind them is not entirely consistent 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. The second limitation, on the other hand, effectively considers how much tax a resident of the PE state would pay in State S (taking into account the conditions of the PE-S treaty). This means that applying both limitations 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. From a technical perspective, the comparison should arguably be consistent regardless of the applicable rate under the PE-S treaty, however, applying a consistent comparison would mean that only one of the two limitations could apply.

4.3.5.4. Appropriate limitation to apply

It is difficult to determine which limitation is more appropriate from a theoretical perspective, although arguably it would be the limitation based on the rate applicable under the PE-S treaty, since this will result in the PE paying the same amount of tax in the PE state as a resident enterprise would pay. 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, as mentioned above, the PE state may collect less tax than it would be 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. As mentioned above, this is the approach taken in the suggested wording contained in the OECD Commentary.310 Specific wording requiring the PE state to grant relief would also have the significant advantage of forestalling any questions regarding whether the PE state actually has an obligation to extend treaty relief to PEs under Article 24(3) of the R-PE treaty.

4.3.6. Relief in sub-PE triangular cases

In sub-PE triangular cases the income in question is attributable to both the PE and the sub-PE and the sub-PE state effectively operates as the source state with respect to the PE state. This may occur, for example, where there is a regional headquarters in the PE state and a local operation in the sub-PE state. It seems clear that in this case the PE state should provide relief for tax imposed in the sub-PE state and indeed, the PE state would generally have an obligation to provide relief under the non-discrimination article of the R-PE treaty as discussed above. The complication in sub-PE triangular cases is that a PE also exists for the purposes of the R-SPE treaty (the sub-PE) and the income attributable to that sub-PE is also taxable in another state on a source basis (i.e., in the PE state). If a resident of the sub-PE state derived the income which is attributable to the sub-PE then it would typically be entitled to relief for tax imposed in the PE state. It therefore seems likely that the sub-PE state would also have an obligation to provide relief under the non-discrimination provision of the R-SPE treaty. This doesn’t present any

310 OECD Commentary on Article 24, para 70. The suggested provision is as follows: "When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt-claim in respect of which the dividends or interest are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first-mentioned State can claim under that State’s convention on income and capital with the third State."
particular issues if viewed in isolation, however, the provision of relief in both the sub-PE state and the PE state is clearly problematic. If both states use the exemption method then presumably the income would not be taxed in either state which would tend to give rise to opportunities for tax avoidance. If both states use the credit method then the credit available in each state depends on the tax imposed in the other state and thus the credit available in the other state; this quickly becomes circular and it is not clear how the final credit should be calculated. The only case in which problems don’t arise is where one state to use the credit method and the other state uses the exemption method. Problems arise in sub-PE triangular cases with respect to the relief provided to PEs regardless of whether such relief arises from non-discrimination principles or under domestic laws and these problems should be dealt with in any solution for PE triangular cases.

4.3.7. Comparison between Article 24(3) and non-discrimination principles of EU law

In the Saint-Gobain case, the ECJ decided that under the non-discrimination principles of European law, the PE state in a PE triangular case is obliged to extend both the domestic double taxation relief measures and the treaty relief measures available to resident enterprises to PEs.

The Saint-Gobain case involved a PE established in Germany by a French company. The income attributable to the PE included dividends received from companies located in various source states, which were fully taxable in Germany. Under the tax treaties between Germany and two of the source states, the United States and Switzerland, dividends received by residents of Germany from those states were exempt in Germany. The taxpayer in Saint-Gobain claimed that, in order to comply with the freedom of establishment provisions of the EU treaty, these exemptions should also have been granted to the PE.

The Saint-Gobain case was based on the freedom of establishment contained in Articles 49 and 54 of the EC Treaty. The scope and purpose of these non-discrimination principles is as follows:

311 ECJ, 21 September 1999, Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt, C-307/97.
312 The Saint-Gobain case involved a request for three tax concessions with respect to the dividends received: (1) an exemption from the German corporation tax for dividends received from companies resident in the US and Switzerland which was available to German resident companies under the treaties concluded between Germany and those states; (2) an indirect tax credit for taxes imposed on the profits from which foreign dividends were paid which was available to German resident companies under German domestic law; and (3) A capital tax concession available to German resident companies under German domestic law (ECJ, 21 September 1999, Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt, C-307/97, paras 16-22. The company also claimed an indirect credit and a capital tax concession, but these claims are not relevant for the analysis here.
313 ECJ, 21 September 1999, Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt, C-307/97, paras 9-14. ECJ, 21 September 1999, Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt, C-307/97, paras 15-18. The company also claimed an indirect credit and a capital tax concession, but these claims are not relevant for the analysis here.
314 Articles 49 and 54 (then, Articles 52 and 58, respectively) of the EC Treaty (then, the EC treaty). The company also claimed an indirect credit and a capital tax concession, but these claims are not relevant for the analysis here.
315 Article 49, titled "Right of Establishment" reads: "Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches, or subsidiaries by nationals of any Member State established in the territory of any Member State. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."
316 Article 54 reads: "Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States. 'Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit making."
317 Now called the Treaty on the Functioning of the European Union (TFEU).
discrimination principles of EU law are very different to those of Article 24(3) of the OECD Model, which means that the ECJ case law should not be directly applied to the interpretation of Article 24(3).320 The intention of both provisions is to promote international trade and investment, however, the EU law provisions have the much broader aim of achieving a European Single Market, whereas the various provisions of Article 24(3) are very specific, aimed at preventing discrimination in certain defined circumstances.321 Nevertheless, there may still be certain aspects of the analysis of the non-discrimination principles of EU law in the Saint-Gobain case which are relevant for the interpretation of Article 24(3) in PE triangular cases.

The first step in applying the freedom of establishment in the Saint-Gobain case was to determine that the PE was in an objectively comparable situation to that of a resident taxpayer.322 In this respect, the German government argued that a non-resident deriving income through a PE and a resident enterprise are not in an objectively comparable situation because the non-resident is subject to only a limited tax liability, i.e., it is only taxed on income which is attributable to the PE, whereas a resident is subject to an unlimited tax liability.323 The ECJ rejected this argument on the basis that the dividends were taxed in Germany regardless of whether they were derived by a resident taxpayer or by a non-resident through a PE, and on the basis that the only difference in the tax treatment arose with respect to the tax concessions in question.324 For the purposes of applying Article 24(3), on the other hand, it is not necessary to establish that the PE is in a comparable situation to a resident of the PE state. This is because Article 24(3) specifically provides that the tax imposed on a PE must not be less favourable than that imposed on a resident enterprise carrying on the same activities. It does not require any preliminary consideration of whether a resident enterprise and a PE of a non-resident are in a comparable situation,325 which could mean that less favourable tax treatment of PEs is prohibited even if the situation of the PE is not objectively comparable to that of a resident enterprise.

The German government argued in the Saint-Gobain case that not granting relief to PEs was justified by the need to prevent a reduction in tax revenue and that, unlike in the case of resident companies, which were taxed on dividend distributions, the lost revenue could not be made up by imposing tax on profits distributed by the PE.326 This was not regarded as sufficient justification for the unequal treatment.327 Similarly, for the purposes of the application of Article 24(3), a potential loss of tax revenue should not be a sufficient justification for taxing a PE less favourably than a resident enterprise; if it were, then the PE state would arguably never be required to do anything under Article 24(3) because where Article 24(3) operates, it will always reduce the tax imposed in the PE state.328 However, an important difference between Article 24(3) and the EU non-discrimination principles discussed in Saint-Gobain is that Article 24(3) considers the overall tax burden imposed in the PE state and does not require that the PE is taxed in the same way as a resident enterprise.329 Thus, if the PE is given other advantages under the tax laws of the PE state that outweigh the disadvantage of the lack of double taxation relief, then, provided the overall tax burden imposed on the PE in the PE state is not less favourable than that which would be imposed on a resident enterprise, there should be no contravention of Article 24(3) of the R-PE treaty.330 The specific compensating aspect of the German tax law which was referred to in the Saint-Gobain case was that withholding tax imposed on dividends paid by a subsidiary to its parent company could not be imposed on the distribution of profits by the PE, given that a PE is merely part of the entity to which it belongs and is not a separate legal entity.331 As mentioned above, the ECJ did not consider this

320 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1283 (m.no. 5e).
321 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1283, (m.no. 5e).
325 Van Raad, K., Nondiscrimination..., at pp. 125, 128, 133.
328 This follows from the wording of Article 24(3) and the interpretation of Article 24(3) which requires that the tax burden on the PE is not greater than that imposed on a resident enterprise carrying on the same activities.
329 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1316, (m.no. 126); Van Raad, K., Nondiscrimination..., at p. 141.
330 Van Raad, K., Nondiscrimination..., at p. 141.
sufficient justification for failing to grant relief to the PE. The lack of withholding tax on distributions by a PE should also not be considered sufficient justification for denying double taxation relief under Article 24(3). Dividend withholding tax, while it may be collected from the company paying the dividend, is generally a tax imposed on the recipient of the income and is therefore not relevant for determining whether the tax imposed on the income attributable to a PE is more burdensome than that imposed on the income of a resident enterprise. Nevertheless, it is at least theoretically possible for there to be some aspect of the domestic law of the PE state which has the effect that the taxation imposed on the PE in the PE state is not less favourable than that imposed on a resident enterprise carrying on the same activities, despite the lack of any double taxation relief available to the PE.

Another important justification which was presented in the Saint-Gobain case was that extending the relief available under the treaties with the source states to PEs in Germany would upset the balance and reciprocity of those treaties. As was discussed above, this argument was rejected by the ECJ and should also be rejected in the context of Article 24(3).

One important difference between the principles of EU law and Article 24(3) is that, where all three of the states involved in a PE triangular situation are EU member states, EU law may also require the source state to apply the conditions of the PE-S treaty to the income attributable to the PE. This debate is beyond the scope of this thesis but it should be noted that, in contrast to EU law, Article 24(3) of the treaty between the residence state and the PE state will never have any impact on the source state.

Taxation in the source state in PE triangular cases will be discussed in the following chapter (Chapter 5).

4.4. Conclusions

Where the income attributable to a PE includes income sourced in third states, the PE should clearly be entitled to relief from double taxation in the PE state. Such relief ensures that double taxation can be fully relieved in PE triangular cases without the residence state reducing the tax it collects in relation to other sources of income, and thus ensures a more equitable distribution of taxing revenues between the PE state and the residence state. Various states allow double taxation relief to PEs under their domestic law, however, this is not always the case and even where it is, the relief available to resident taxpayers may be more favourable than that available to PEs. It is therefore important to consider the operation of the PE non-discrimination article (Article 24(3)) of the treaty between the residence state and the PE state.

Under Article 24(3) of the R-PE treaty, the PE state should be obliged to extend its domestic relief measures to PEs as well as relief equivalent to that which would be available to a resident of the PE state under the treaty between the PE state and the source state. In practice, however, states do not always consider themselves bound by this obligation to provide relief. Moreover, the extension of treaty relief to PEs under non-discrimination principles may result in an unbalanced application of the PE-S treaty, given that the source state is not required to apply the conditions of that treaty in relation to the income attributable to the PE.

It would therefore be desirable for the PE state to have an explicit obligation to provide relief for tax imposed in the source state in PE triangular cases. Such a provision should also specify, in cases where the PE state uses the credit method of relief, the applicable limitations on the amount of relief to be provided. Similarly, if the exemption method applies, it should be made clear that the PE state is not required to exempt the income if the source state is prevented from imposing tax under the R-S treaty. A provision requiring the PE state to grant relief for tax imposed in the source state could take a number of forms, and will be discussed further in Chapter 7.

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332 Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions...*, at p. 1317, (m.no. 128).
334 For discussion of this issue, see, for example: Kostense, H.E., "The Saint-Gobain Case..."; Martín Jiménez, A.J., García Prats, F.J., & Calderón Carrero, J.M., "Triangular Cases...".
335 It will be discussed again briefly in Chapter 5 (see Section 5.2.7.).
Chapter 5
Limitation of the source state's taxing rights

5.1. Introduction

Taxation in the source state in PE triangular cases is subject to the conditions of the treaty between the source state and the residence state (the R-S treaty). The treaty between the source state and the PE state (the PE-S treaty) does not apply because the income is not received by a person who is resident in the PE state for treaty purposes. Whether this is the right result has been widely questioned, however, and various authors have argued that it would be more appropriate for taxation in the source state to be subject to the conditions of the PE-S treaty, and not those of the R-S treaty.336 This is primarily because in a PE triangular case, the treaty between the residence state and the PE state (the R-PE treaty) effectively transfers primary or even exclusive taxing rights to the PE state.337 Underlying this argument is the view that, although the PE concept is simply a threshold for determining whether source based taxation can be imposed, it effectively operates as a quasi-residence basis of taxation. This chapter will expand on this theme and examine the similarities between PE taxation and residence-based taxation.

The main concerns with applying the PE-S treaty in triangular cases, and the reason this approach was rejected in the OECD's 1992 triangular cases report, are that to do so would depart too much from the established principles underlying the OECD Model and that it would open up opportunities for treaty shopping.338 The primary questions to be addressed in this chapter are therefore whether there are sufficient reasons to justify such a departure from existing principles and whether treaty shopping concerns can be adequately addressed.

In this chapter, the application of the PE-S treaty to the income attributable to a PE in a PE triangular case will sometimes be referred to as the extension of treaty benefits to PEs. It should be noted, however, that the application of the PE-S treaty could be achieved in various ways, either by making the PE equivalent to a treaty eligible person in some way, or by allowing the entity to which the PE belongs to claim the benefit of the PE-S treaty in relation to the income arising in State S and attributable to the PE. Either approach would essentially result in treaty benefits being extended to PEs and, for ease of expression, this chapter will refer generally to the extension of treaty benefits to PEs (and to PEs being entitled to claim treaty benefits) without making a distinction between the two approaches.339 It should also be noted that this chapter deals only with considerations of applying the PE-S treaty in the source state. It does not address the application of the PE-S treaty in the PE state and any benefits that may arise from that, i.e., an explicit requirement for the PE state to provide relief.

5.2. Whether source state taxation should be subject to the conditions of the PE-S treaty

This section discusses issues associated with whether source state should apply the conditions of the PE-S treaty. This could be either in addition to or instead of the conditions of the R-S treaty. The


337 The R-PE treaty may transfer either sole taxing rights to the PE state, if the residence state is required to exempt the income attributable to the PE, or prior taxing rights, in situations where the residence state is required to grant credit relief for tax imposed in the PE state. Regardless of the method of relief, the residence state may effectively be prevented from imposing any tax on the income. That is, if the residence state provides relief using the credit method, the amount of credit required for tax imposed in the source state and the PE state may mean that no residual tax is payable in the residence state. Refer to Chapter 3 for discussion of the residence state's relief obligations in PE triangular cases.

338 OECD Committee on Fiscal Affairs, "Triangular Cases," paras 39 and 46.

339 These two approaches will be discussed in Chapter 8 (see Section 8.2.1.).
appropriateness of the source state applying the conditions of the R-S treaty will be discussed separately in Section 5.3., below.

5.2.1. Potential impact of applying PE-S treaty conditions in the source state

The impact of applying the conditions of the PE-S treaty in the source state, either instead of or in addition to the conditions of the R-S treaty, will depend on the relative terms of the two treaties. If the terms of the R-S treaty and the PE-S treaty are the same with respect to a certain category of income earned by the PE (where they both follow the OECD Model, for example) then the application of the PE-S treaty would have no impact on the amount of tax that the source state could impose. If the conditions of the two treaties differ, however, as is generally the case in practice, then the application of the PE-S treaty instead of the R-S treaty would clearly have an impact on the amount of tax that the source state can impose. In the case of passive income, for instance, it is common for different treaties to specify different maximum rates of source-based taxation. If the source state applies the conditions of the PE-S treaty instead of the R-S treaty then it would clearly be subject to a different upper limit on the amount of tax it can impose. If, on the other hand, the source state applies the conditions of both the R-S treaty and the PE-S treaty, the source state can only meet its treaty obligations by applying the conditions that are most favourable to the recipient of the income. Where this is the PE-S treaty, the source state would be able to impose less tax that if it imposed only the conditions of the R-S treaty.

One advantage of applying the PE-S treaty in the source state is that it would simplify the determination of the amount of credit relief that the PE state may be obliged to grant under the non-discrimination article of the R-PE treaty. This is because the tax imposed in the source state would not exceed the amount that the source state could impose if the income were derived by a resident of the PE state. For discussion of the provision of relief in the PE state under non-discrimination principles (and particularly under Article 24(3) of the R-PE treaty), please refer to Chapter 4.

5.2.2. Why states agree to restrictions on their taxing rights under treaties

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 view that taxation in the source state should be subject to the conditions of the PE-S treaty in PE triangular cases.

5.2.2.1. To eliminate double taxation

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.340 In a PE triangular case, the application of the conditions of the PE-S treaty in the source state may be important for achieving this aim. This is because if the PE state grants credit relief for tax imposed in the source state under non-discrimination principles,341 then the amount of the credit available in the PE state may be limited to the amount of tax that the source state could have imposed if the PE-S treaty had applied.342 To the extent that the taxation actually imposed in the source state exceeds that amount, unrelieved double taxation may persist. This is demonstrated in the following example.

Example

In a PE triangular case, a resident of State R derives $100 of interest income from sources in State S, and that income is attributable to a PE in State PE. The company has no other income and no expenses. The

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340 See, for example: 2010 OECD Model Convention, Introduction, paras 1-3.
341 That is, under Article 24(3) of the R-PE treaty. Refer to Chapter 4 for further detail.
342 This is one of the limitations suggested in the OECD Commentary to Article 24 (see para 70). For further discussion, see Chapter 4, Section 4.3.5.
tax rate in State R is 30%, however, State R exempts the income attributable to the PE in accordance with the R-PE treaty. The tax rate in State PE is also 30%. State PE provides credit relief for tax imposed in State S in accordance with Article 24(3) of the R-PE treaty; the credit is limited to the amount of tax that could be imposed in State S if the PE-S treaty applied. The highest applicable tax rate in any of the three states is 30% (the rate in both State PE and State R) and thus, there will be unrelieved double taxation to the extent that the combined tax burden imposed on the income exceeds 30%. Under the domestic law of State S, there is a 15% withholding tax on interest. State S applies either:

(i) the R-S treaty, which limits the tax that can be imposed on interest to 15%, and not the PE-S treaty; or

(ii) the PE-S treaty (either alone or in addition to the R-S treaty), which limits the tax that can be imposed on interest arising to 10%.

The outcome of these two alternatives is shown in the table below. Firstly however, this situation is illustrated in the following diagram.

*Figure 5.1.: Example showing impact of application of PE-S treaty on relief of double taxation*

<table>
<thead>
<tr>
<th>State</th>
<th>Income</th>
<th>R-S treaty does not apply in the source state</th>
<th>PE-S treaty does apply in the source state</th>
</tr>
</thead>
<tbody>
<tr>
<td>S</td>
<td>100</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>PE</td>
<td>100</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>HO</td>
<td>100</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>PE</td>
<td>100</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>S</td>
<td>100</td>
<td>15</td>
<td>10</td>
</tr>
</tbody>
</table>

343 It is also assumed that the residence state does not provide any additional relief for the tax imposed in the source state. For discussion of the residence state’s potential obligation to grant dual relief, refer to Chapter 3 (Section 3.3.). It was concluded in that section that the residence state should not be obliged to both exempt the income and grant a credit.

344 For discussion of the way in which the existence of unrelieved double taxation should be assessed in multilateral situations, refer to Chapter 3 (Section 3.2.1.). Broadly, it was concluded in that section that unrelieved double taxation should be considered to occur only where the overall effective tax rate imposed on the income exceeds the highest of the applicable rates in the three states involved.

345 It is assumed that the PE state provides credit relief on the basis of the non-discrimination article (Article 24(3)) of the R-PE treaty. It is further assumed that the amount of the credit in the PE state is limited to the amount of tax that the source state could impose if it applied the terms of the PE-S treaty in relation to the income attributable to the PE.
Where the source state doesn’t apply the PE-S treaty then, in this example, the PE state does not provide full relief for the tax imposed in the source state. This occurs because the relief in the PE state is limited to the amount of tax that could be imposed in the source state under the PE-S treaty, if it applied, and the tax imposed in the source state exceeds this amount. Furthermore, the residence state is unable to provide any additional relief to compensate for the lack of full relief in the PE state. Ultimately, the non-application of the PE-S treaty in the source state in this case results in unrelieved double taxation.

The non-application of the PE-S treaty in the source state will not always have an impact on whether there is unrelieved double taxation in PE triangular cases. In particular, the fact that the source state does not apply the PE-S treaty will not always mean that the tax imposed in the source state will exceed the limits set by the PE-S treaty treaty, e.g., the amount of tax imposed under domestic law could be less than the maximum allowed under the treaty. In addition, in some circumstances the residence state may provide sufficient relief to prevent unrelieved double taxation even though the PE state has not provided relief for all the tax imposed in the source state. This could occur, for example, where the residence state uses the credit method and the total tax imposed in State PE and State S is less than the tax in State R prior to relief. Nevertheless, if the source state is required to apply the conditions of the PE-S treaty, then the potential for unrelieved double taxation identified in the above example will be avoided and, more broadly, the application of the conditions of the PE-S treaty in the source state may be necessary in some cases to prevent unrelieved double taxation.

5.2.2.2. To allocate taxing jurisdiction

Whilst reducing source-based taxation under tax treaties is a means of eliminating double taxation, it also serves to allocate taxing jurisdiction between the two contracting states. That is, the extent to which source-based taxation is allowed under a particular treaty determines how much tax revenue each contracting state collects in relation to cross-border activities and income flows. In PE triangular cases, the non-application of the PE-S treaty in the source state means that 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 (i.e., under Article 24(3)). Thus, the amount of tax collected in the PE state and the source state will depend on the result of their respective negotiations with the residence state. This is clearly not appropriate since the residence state has no interest in the split of revenues between the source state and the PE state. This is especially true where the residence state exempts the income (i.e., as a result of it being attributable to the PE), but even where the residence state uses the credit method of relief, the total amount of the credit available the residence state will, in many cases, be the same regardless of the relative amounts of tax collected by the source state and the PE state. This is demonstrated in the following example.

**Example**

In a PE triangular case, a resident of State R derives $100 of interest income from sources in State S, and that income is attributable to a PE in State PE. The company has no other income and no expenses. The tax rate in both State PE and State R is 30%. Both the R-PE treaty and the R-S treaty require the residence state to grant relief using the credit method. The PE state grants relief using the credit method (as a result of Article 24(3) of the R-PE treaty). The applicable withholding tax rate under the domestic law of the source state is 20%. The table below compares three situations:

346 Refer to Chapter 3 for further discussion of the impact which the relative tax rates of the three states involved and the applicable credit limitations may have on the residence state’s ability to fully relieve double taxation in PE triangular cases (see Sections 3.2.2.1. and 3.2.3.1., respectively).

347 Under the non-discrimination provision in Article 24(3); refer to Chapter 4 for discussion regarding relief in the PE state.
(i) State S applies the R-S treaty and, under Article 11, may impose tax at a maximum rate of 5% of the gross amount of the interest;

(ii) State S applies the R-S treaty and, under Article 11, may impose tax at a maximum rate of 15% of the gross amount of the interest; or

(iii) State S applies the PE-S treaty and, under Article 11, may impose tax at a maximum rate of 10% of the gross amount of the interest.

This situation is illustrated in the following diagram.

Figure 5.2.: Example showing impact of application of PE-S treaty on allocation of taxing jurisdiction

Table 2: Example showing the impact of the application of the PE-S treaty on the allocation of taxing jurisdiction

<table>
<thead>
<tr>
<th></th>
<th>(i) R-S treaty applies (5% rate)</th>
<th>(ii) R-S treaty applies (15% rate)</th>
<th>(iii) PE-S treaty applies (10% rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Tax collected in State S (A)</td>
<td>5</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>Tax in State PE prior to relief</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Relief in State PE</td>
<td>(5)</td>
<td>(15)</td>
<td>(10)</td>
</tr>
<tr>
<td>Tax collected in State PE (B)</td>
<td>25</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Tax in State R prior to relief</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Relief in State R (A + B)</td>
<td>(30)</td>
<td>(30)</td>
<td>(30)</td>
</tr>
<tr>
<td>Tax collected in State R</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

As can be seen in the table above, if the R-S treaty applies and the rate agreed between the source state and the residence state is 5%, then the source state collects $5 of tax and the PE state collects $25 of tax. However, if the rate agreed between the source state and the residence state is 15%, then the source state and the PE state each collect $15 of tax. Thus, in this example, the allocation of tax revenue between the source state and the PE state depends primarily on the result of the negotiation between the residence state and the source state even though, in both cases, the residence state does not collect any tax in relation to the income.348 By contrast, if the source state applies the PE-S treaty instead of the R-S treaty,

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348 This will not occur so clearly in all situations. If, for example, the PE state grants relief using the exemption method, then the amount of tax it collects (i.e., none) will not be influenced by the amount of tax imposed in the source state. If, however, the PE state is required to grant the exemption as a result of the non-discrimination article (Article 24(3)) of the R-PE treaty, then it is still the PE state’s bargain with the residence state (rather than with the source state) that is controlling the amount of tax it collects. In addition, if the PE state uses the credit method and the credit available in the PE state is limited to the amount of tax that the source state would be entitled to impose if
then the relative amounts of tax collected in the PE state and the source state depend on the bargain struck between those two states as reflected in the PE-S treaty. Discussing the *Crown Forrest Industries* case,349 Vann writes:

"It is not self-evident that the Canadian [source country] rate on royalties received by a US business [i.e., US PE] should be determined by the treaty between Canada and a country which would very likely collect no tax on the income [i.e., the residence state], rather than the treaty with the country which would collect tax on the income and so can provide relief for third country tax."350

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 in relation to income attributable to the PE.

5.2.2.3. To facilitate international trade and investment

Tax treaties facilitate international trade and investment by restricting source-based taxation and by preventing double taxation.351 These aims would be further promoted by applying the conditions contained in the PE-S treaty in the source state to income derived by PEs. The main rationale behind the aim of facilitating international trade and investment is to improve overall economic efficiency. In general, economic efficiency is promoted by ensuring that taxes have the smallest possible impact on economic decisions, such as where to invest, and on the form of investments. Under the existing treaty framework enterprises may be influenced in their choice of legal form, i.e., the choice of whether to operate through a branch or a subsidiary, by the availability or otherwise of treaty benefits. Allowing PEs to claim reductions in source-based taxation under tax treaties would reduce the disparity between PEs and subsidiaries and would generally allow more flexibility for structuring investments.352 However, to the extent that an equivalent reduction in source based taxation would be available under the R-S treaty, the additional benefit of applying the PE-S treaty in the source state (instead of the R-S treaty) may be marginal. Moreover, this additional flexibility may raise concerns about tax avoidance, as will be discussed in detail in Section 5.2.6., below.

5.2.2.4. To prevent tax evasion

It is widely accepted that one purpose of tax treaties is to prevent tax evasion, such as the failure to report taxable income.353 The primary way in which tax treaties assist in preventing tax evasion is through the exchange of information article (Article 26).354 Article 26(1) provides that:

"The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind it applied the PE-S treaty, then the tax collected in the PE state would depend on the terms of the PE-S treaty. Even in this case, however, the amount of tax collected in the PE state is ultimately controlled by the provisions of the R-PE treaty, which gives rise to the obligation to grant relief (i.e., under Article 24(3)). In the source state, the impact of applying the R-S treaty conditions rather than the PE-S treaty conditions may also be less clear, for example where the source state imposes less tax under its domestic law than the maximum allowed under the R-S treaty. Even in this case, however, the source state is nevertheless bound by the conditions it has agreed with State R rather than those it has agreed with State PE.

350 Vann, R., "Liable to Tax"… at p. 249 (Section 7.4.1.3.).
351 Shelton, N., *Interpretation and Application…* at p. 15.
352 The flip side of this flexibility is the potential for tax avoidance through treaty shopping (see Section 5.2.6., below).
353 A note on the cover of the OECD Model states that: “States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.”
and description imposed on behalf of the Contracting States... The exchange of information is not restricted by Articles 1 and 2."

The wording of Article 26 is quite broad and it would not be necessary for the source state to apply the PE-S treaty to the income attributable to the PE in order for the PE state and the source state to be able to exchange information regarding the taxation of that income under Article 26 of the PE-S treaty. Thus, the application of the PE-S treaty in PE triangular cases would generally not give any additional benefit in relation to countering tax evasion, however it would also not frustrate these aims. In general, the prevention of tax evasion seems to be a neutral factor.

Tax evasion should be distinguished from tax avoidance, e.g., treaty shopping. As will be discussed below, there is some controversy regarding whether preventing tax avoidance is also a purpose of tax treaties. The potential impact that an extension of treaty benefits to PEs may have on opportunities for improper access to treaties will be considered in detail in Section 5.2.6.

5.2.2.5. The reciprocity principle

Tax treaties are based on the principle of reciprocity; each state agrees to restrictions on its taxing rights under a treaty in exchange for the other state agreeing to do the same.355 The source state in a triangular case is unlikely to be willing to apply the conditions of the PE-S treaty to income derived by a PE unless a corresponding obligation is imposed on the other contracting state.

As will be discussed in Chapter 7, the application of the conditions of the PE-S treaty in the source state may be achieved by including provisions to that effect in either (i) the domestic law of the source state, (ii) the PE-S treaty, or (iii) the R-S treaty.356 If the application of the PE-S treaty is achieved by provisions in the domestic law of the source state, then the reciprocity principle is not relevant.357 However, if the source state does include such a provision in its domestic law, then it will have very little negotiating power to convince other states to extend treaty benefits to PEs. The most likely source of the obligation is therefore either the R-S treaty or the PE-S treaty.

If the application of the PE-S treaty is achieved through specific provisions included in that treaty, then those provisions could be expected to apply equally in both states. That is, the source state would generally only be willing to apply the conditions of the PE-S treaty to income attributable to PEs in the PE state if the PE state also applies the conditions of the treaty to income attributable to PEs in the source state (i.e., when the position of the PE state and the source state are reversed). There would be no contravention of the reciprocity principle.

If the application of the PE-S treaty derives from specific provisions included in the R-S treaty, then it is possible that the PE-S treaty may be applied in the source state but not in the PE state. This unbalanced application of the PE-S treaty may point to a lack of reciprocity in that treaty. However, it is not the case that the source state has agreed to do something under the PE-S treaty that the PE state has not. The source state has agreed to apply certain conditions as a result of provisions included in the R-S treaty and it is therefore the reciprocity of the R-S treaty that must be considered. Provided the relevant provision of the R-S treaty applies equally in both states, the reciprocity of the R-S treaty would be maintained, i.e., provided the "residence state" applies the conditions of the R-PE treaty to income derived by residents of the "source state" and attributable to PEs in third states when the positions of the residence state and the source state are reversed.

357 Although the provisions of the source state could of course make the application of the treaty conditional on a reciprocal grant of treaty benefits to its residents under the domestic laws of the PE state. This would be a policy decision for the state involved, and would have no impact on the reciprocity principle in the context of tax treaties.
358 This will be discussed in Chapter 7. The obligation could not arise from the R-PE treaty, because that treaty cannot bind the source state.
One argument against applying the PE-S treaty in PE triangular cases is that this would essentially involve granting residents of third states access to the treaty. To the extent that this is intended by the contracting states, however, and operates reciprocally, then it would not compromise the reciprocity of the PE-S treaty. Thus, 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 the other contracting state. It may, however, influence the way in which the provisions of the PE-S treaty are made to apply; this will be discussed further in Chapter 7 (see Section 7.3).

5.2.2.6. Conclusions

There are various reasons why states agree to restrictions on their taxing rights under tax treaties, and many of these apply equally regardless of whether the income is derived by a PE or a resident of the other contracting. In particular, the application of the PE-S treaty in PE triangular cases would further the aim of preventing unrelieved double taxation and would facilitate international trade and investment and promote economic efficiency. Perhaps most importantly, however, the application of the PE-S treaty would ensure that the relative amounts of tax collected by the PE state and the source state reflect the agreement reached by those two states in the PE-S treaty.

5.2.3. The role of the residence concept in tax treaties

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.359 This is established in Article 1 of the OECD Model, which defines the "persons covered" by the treaty, and is also reflected in the wording of many specific treaty provisions.360 Residence is determined under Article 4, which provides that:

"1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State or any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that state in respect only of income from sources in that state or capital situated therein." 361

The approach of limiting treaty benefits to residents seems to be based on the assumption that there is a clear distinction between the imposition of tax on a residence basis, where tax is imposed on worldwide income based on a strong "personal connection" to the jurisdiction, and the imposition of tax on a source-basis. However, as will be discussed below, in reality this distinction is often not so clear-cut. For instance, there may be different levels of tax liability imposed on "residents" due to, e.g., tax incentives for particular industries and exemptions for charitable organizations. In addition, it is now common for states to exempt many types of foreign income derived by residents, further blurring the distinction between residence and source taxation (as will be discussed below). Conversely, the taxation of income attributable to a PE, commonly viewed as source-based taxation, may be based on the worldwide income attributable

359 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...."

360 Residence is referred to in the distributive rules of Article 6. Article 7 (indirectly; Article 7 applies to "profits of an enterprise of a Contracting State" with "enterprise of a Contracting State being defined in Article 3 as an "enterprise carried on by a resident of a Contracting State"), Article 10, Article 11, Article 12, Article 13, Article 15, Article 16, Article 17, Article 18, Article 19, Article 20, and Article 21.

361 Clearly this cannot include PEs since they are not "persons" for treaty purposes and are furthermore not "liable to tax," given that any tax imposed on the profit attributable to the PE is imposed on the enterprise to which the PE belongs, not on the PE itself. See: Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions... at p. 88 (m.no. 17).
to the PE and shares a number of features with residence-based taxation (as will be discussed in Section 5.2.4., below).

The purpose of this section is not to present an in-depth discussion of the requirements for qualifying as a resident for treaty purposes. It will instead focus on the broader role and history of the residence concept and the underlying reasons for limiting treaty benefits to residents and will touch briefly on some of the difficulties that arise in determining residence for treaty purposes. This section will focus primarily on corporate residence because there is a much closer parallel between the PE concept and corporate residence than between the PE concept and individual residence. Furthermore, where an individual derives income which is attributable to a PE outside their residence state, that PE can be compared to an incorporated company which is resident in the PE state and which is owned and operated by the individual.

5.2.3.1. The residence concept in early treaties

In modern tax treaties the residence concept plays a central role, but, as will be outlined below, this was not always the case.

The League of Nations period

Some of the earliest work on tax treaties was undertaken by the League of Nations between the 1920s and the 1940s. The League of Nations began its work on international taxation by referring the question of double taxation and the way in which it could be removed by international conventions to four economists, asking them to prepare a report, which was published in 1923. The four economists’ considered that the imposition of tax should be based on "economic allegiance," with one of the most important factors in determining economic allegiance being the "fiscal domicile" of the person deriving the income. Their report contained very little discussion of "fiscal domicile" and the discussion it did contain was largely in the context of individuals. The report concluded that the best way of preventing

362 The residence concept in tax treaties will be discussed further in Chapters 9 and 10, dealing with dual resident triangular cases. See also: Couzin, R., Corporate Residence and International Taxation, (Amsterdam: IBFD Publications, 2002) and Maisto, G. (Ed.), Residence of Companies under Tax Treaties and EC Law, (Amsterdam: IBFD, 2006).
365 The current commentary on Article 1 of the OECD Model states that: "Whereas the earliest conventions in general were applicable to 'citizens' of the Contracting States, more recent conventions usually apply to 'residents' of one or both of the Contracting States. Some conventions are of even wider scope because they apply more generally to 'taxpayers' of the Contracting States; they are, therefore, also applicable to persons, who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. It has been deemed preferable for practical reasons to provided that the Convention is to apply to persons who are residents of one or both of the Contracting States." (OECD Commentary on Article 1, para 1.) Based on keyword searches of IBFD's tax treaty database, I have been unable to identify any income tax treaties which apply to "taxpayers" rather than residents.
366 League of Nations, "Report on Double Taxation submitted to the Fiscal Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp" (Geneva, League of Nations, 1925), Document EF S73 F19. This is commonly referred to as the "four economists' report."
367 The four economists divided economic allegiance into four factors: (1) Where is the yield physically or economically produced? (2) Where are the final results of the process as a complete production of wealth actually to be found? (3) Where can the rights to the handing-over of assets be enforced? and (4) Where is the wealth spent or consumed or otherwise disposed of? They considered the first factor ("origin") and the fourth factor ("fiscal domicile") to be the most important, although the importance of each factor was also considered to depend on the type of income involved. See: League of Nations, Document EF S73 F19 at pp. 22-25 and pp. 26-39.
368 Vann, R., "Liable to Tax'…" at p. 209 (Section 7.3.1.1). For the discussion of fiscal domicile, see pp. 25-26 of the four economists' report. The report stated, under the heading "Residence and Domicile" (at p. 25), that: "It is clear that by residence in this sense we mean not mere temporary residence, but permanent residence, or what in some
double taxation was for countries to impose only residence-based taxation, and to reciprocally exempt the income of non-residents, although recognised that this may not be acceptable to many countries.\textsuperscript{368}

The four economists' report was followed, in 1925, by a report prepared by a committee of technical experts appointed by the League of Nations.\textsuperscript{369} The 1925 report made a distinction between "impôts réels" imposed by the country of origin, and personal taxes imposed on the basis of fiscal domicile,\textsuperscript{370} although it contained very little discussion of fiscal domicile. The report also included "resolutions" of the committee, which laid out their proposals for the distribution of taxing rights under international treaties.\textsuperscript{371} These resolutions included definitions of the term "fiscal domicile" for both individuals and companies; for individuals it was the state where the taxpayer normally had this permanent home for a portion of the year\textsuperscript{372} and for companies it was the state where the "real centre of management and control" was situated.\textsuperscript{373} However, under these resolutions the purpose of the fiscal domicile concept was to determine which state would be entitled to impose tax on certain categories of income.\textsuperscript{374} Thus, fiscal domicile played a role in determining which state may impose tax on certain income, but not in determining the persons to whom a convention would apply.

This pattern was followed in the model conventions published by the League of Nations in 1927\textsuperscript{375} and 1928,\textsuperscript{376} which applied to "taxpayers" of the contracting states. Article 1 of the 1927 Model provided that:

"The present Convention is designed to avoid double taxation in the sphere of direct impersonal or personal taxes, in the case of the taxpayers of the Contracting Parties, whether nationals or otherwise."\textsuperscript{377}

The Commentary to the 1927 Model notes that states which wish to limit the scope of the convention to their own nationals may delete the last part of this provision;\textsuperscript{378} this is likely to have been a reaction to the practice in some early treaties of limiting treaty benefits to nationals of the contracting states.\textsuperscript{379} The
Model contains a definition of fiscal domicile for individuals, based again on their "permanent home".380 but contains no definition or discussion of fiscal domicile for companies.381 Article 1 of the 1928 Models contain similar wording to Article 1 of the 1927 Model, and are likewise limited to "taxpayers" of the contracting states.382 The 1928 report also defines fiscal domicile only in the context of individuals, and contains no discussion of fiscal domicile in relation to companies.

In the 1930s, the Fiscal Committee of the League of Nations focussed on developing models for multilateral treaties.383 It was during this period that a version of Article 1 limiting treaty benefits to those having their "fiscal domicile" in one of the contracting states first appeared.384 It provided as follows:

"Taxable persons and entities having their fiscal domicile in the territory of one of the contracting States and deriving, in whole or in part, from the territory of one or more of the other contracting States any of the forms of income to which the Convention relates, shall, in so far as such income is concerned, be accorded the special treatment defined in the following articles."385

This provision was included in a model that was intended to be the basis for multilateral, rather than for bilateral treaties, and consequently, limiting the personal scope of the treaty is unlikely to have been a major concern.386

The work of the League of Nations in the 1930s and into the early 1940s culminated in the London and Mexico Models, both published in 1946.387 These models were both intended to apply to "taxpayers" of the contracting states, however, unlike the 1928 Model, the term "taxpayer of a contracting state" was defined to include only those taxpayers who had their fiscal domicile in the state in question.388 Thus, the term "taxpayer" had a different meaning in the London and Mexico Models to that which it had in the earlier model treaties.389 There is little explanation for this change to the scope of the model (as compared to the earlier models), but the Commentary does indicate a concern that:

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380 League of Nations, Document C.216 M.85., Article 10 at p. 11.
381 Vann, R., "'Liable to Tax'…" at pp. 197-274 at p. 215 (Section 7.3.1.2).
382 League of Nations, Document C.562 M.178. 1928.II, at p. 7, p. 16 and p. 19. The 1928 report contained three model conventions (models 1a, 1b and 1c). Model 1a was based closely on the 1927 model, whereas Model 1b and Model 1c were designed to be concluded between states which do not draw a distinction between personal and impersonal taxes (see p. 7 of the 1928 report). The wording of Article 1 of the three models differs accordingly.
383 Along with the PE concept, royalties and transfer pricing. These issues were identified for further work during the preparation of the original models. For further detail of the work conducted by the League of Nations during this period, see: Vann, R., "'Liable to Tax'…" at pp. 216-223 (Section 7.3.1.3.).
384 Vann, R., "'Liable to Tax'…" at p. 217 (Section 7.3.1.3.).
386 Vann, R., "'Liable to Tax'…" at p. 217 (Section 7.3.1.3.). The report contains no explanation of why the convention would be limited to those with "fiscal domicile" in one of the contracting states. For an explanation of the draft, see: League of Nations, Document C. 415.M.171. at pp. 8-10.
387 League of Nations Fiscal Committee, "London and Mexico Model Tax Conventions, Commentary and Text," (Geneva, League of Nations, 1946), Document C.88.M.88.1946.I.A. The Mexico Model resulted from the work of a group of experts, a Sub-Committee of the League of Nations Fiscal Committee, who met in Mexico in 1940 and 1943, while the London Model resulted from the work of a similar Sub-Committee (although with considerably different membership) which met in London in 1946.
388 Article 1 of the Mexico Model provided that: "The present Convention is designed to prevent double taxation in the case of the taxpayers of the contracting States, whether nationals or not, as regards the following taxes..." Article 1 of the Protocol to the Model provides that: "The terms 'taxpayer of a contracting State' and 'enterprise of a contracting State mean a taxpayer or an enterprise whose fiscal domicile is in the said state." The corresponding articles of the London Model (Article 1 of the Model and Article 1 of the Protocol) contain exactly the same wording. One significant difference between the two models is that the Mexico Model provides that companies' fiscal domicile is in "...the State under the laws of which they were constituted" (Protocol, Article II(4)) whereas the London Model continues to refer to the "real centre of management" (Protocol, Article II(4)). League of Nations, Document C.88.M.88.1946.I.A. pp. 58-59, and 72-73.
389 Hattingh, P.J., "Article 1 of the OECD Model...."
"Any person who is taxable in one country on account of his personal status and who receives income from another country or holds property therein is exposed to such double taxation."

Thus, it seems that the treaty was expressed to apply to persons who had their "fiscal domicile" in one of the contracting states simply because these were the persons thought to be at risk of suffering double taxation.

The work of the OEEC and the OECD

In the 1950s the work on model tax treaties was taken over by the OEEC, the forerunner to the present-day OECD. The work of the Fiscal Committee of the OEEC ultimately led to the publication of four reports which formed the basis for the 1963 OECD Model. One of the first observable changes in the OEEC period is that the term "resident" was introduced; it was intended to be a more convenient shorthand for referring to the concept of "fiscal domicile". It was also during this period that the modern form of the residence definition appeared; that is, one referring to the existence of a tax liability under domestic laws.

With respect to limiting the personal scope of the treaty, the reports of the Working Parties of the Fiscal Committee seem to have based their recommendations primarily on the existing treaty practice of limiting treaty benefits to persons with fiscal domicile in one or both of the contracting states. However, their recommendations also seem to have been motivated by the desire to exclude residents of non-OEEC countries (at a time when multilateral conventions were still being considered), in order to preserve the OEEC countries' freedom to negotiate with non-OEEC countries. It was recognised that, as a result of this limitation, double taxation would not be resolved in situations where a person had a limited tax liability (as opposed to a full tax liability) in two different states; the resolution of such cases was left to "agreement in each individual case". Interestingly, the OEEC also recognised the difficulty of providing solutions (under bilateral treaties) for cases involving third states, i.e., triangular cases.

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391 The League of Nations was dissolved in 1946 and was succeeded by the United Nations. The Organisation for European Economic Co-operation (the OEEC) was formed in 1948 and was transformed in 1961 into the Organisation for Economic Co-operation and Development (the OECD).
392 Hattingh, P.J., "Article 1 of the OECD Model…." at p. 224 (Section 7.3.2.1).
393 Vann, R., "'Liable to Tax'…" at p. 224 (Section 7.3.2.1).
394 It was proposed by Switzerland, and was reported in Annex 2 to the third report of Working Party 2 of the Fiscal Committee of the OEEC and was incorporated into the second report of the Fiscal Committee. See: OEEC, Working Party 2 of the Fiscal Committee, "Third Report on the Concept of Fiscal Domicile" (Paris: OEEC, 1957), Document FC/WP2(57)2 at p. 9; and OEEC Fiscal Committee, "The Elimination of Double Taxation: 1st Report of the Fiscal Committee of the OEEC" (Paris: OEEC, 1958) at p. 35). The requirement for there to be a liability to tax under domestic law will be discussed further below (see Section 5.2.2.3.). See also: Vann, R., "'Liable to Tax'…" at p. 226 (Section 7.3.2.2.).
395 In 1956, the Fiscal Committee of the OEEC formed Working Party 2 ("WP2") to study the concept of fiscal domicile. WP2 initially examined fiscal domicile from the perspective of the coverage of the convention (i.e., the current Article 1) and from the perspective of defining fiscal domicile (i.e., the current Article 4), however, the Fiscal Committee ultimately instructed WP2 to focus solely on the definition. Nevertheless, when Working Party 14 ("WP14") returned to consider the scope of the convention, it drew on the earlier work of WP2. For a detailed overview of the work of the OEEC in this respect, see: Vann, R., "'Liable to Tax'…" at pp. 224-238 (Section 7.3.2.).
397 OEEC WP2, "Third Report on…” (Document FC/WP2(57)2) at p. 1; OEEC, WP14, “Interim Report…” (Document FC/WP14(60)1), at p. 3. See also: Vann, R., "'Liable to Tax'…" at p. 228 (Section 7.3.2.3.).
399 OEEC Fiscal Committee, "The Elimination of…” at p. 11.
The wording proposed in the reports of the Fiscal Committee of the OEEC was adopted in Article 1 and Article 4 of the 1963 OECD Model. The wording of Article 1 has remained the same ever since (with the exception of a change to the title from "Personal Scope" to "Persons Covered" in 1995\footnote{For a brief discussion of this change, see: Hattingh, P.J., "Article 1 of the OECD Model...".}) and Article 4 of the OECD Model has also undergone very little change.\footnote{The second sentence of Article 4(1) was added in 1977. It provides that a person will not be resident in a particular state if they are taxed only on income from sources in that state. This provision will be discussed in detail in Chapter 10, which deals with dual-resident triangular cases.} Nevertheless, the OECD has put significant work into considering the circumstances in which treaty benefits should be available and in further developing the residence concept, particularly in relation to treaty shopping and the meaning of the phrase "liable to tax", which has been reflected in changes to the OECD commentary (and will be discussed briefly below).\footnote{Refer to the OECD Commentary on Article 1 and Article 4.}

Conclusions

In the development of the early model treaties there was little focus on the residence concept and, apparently, little focus on the personal scope of tax treaties. During the League of Nations period in particular, the focus was often on the place of management as a sourcing principle rather than as a residence principle.\footnote{Vann, R., ""Liable to Tax"..." at pp. 209-223 (Section 7.3.1). The distinction, or lack thereof, between residence and source principles in relation to companies will be discussed below.} After examining the history of the residence concept in tax treaties, Vann writes:

"The history outlined above … indicates that this limitation [i.e., that contained in Article 1] was not regarded as fundamental … and it developed without too much consideration of its policy and implications."\footnote{Vann, R., ""Liable to Tax"..." at p. 244 (Section 7.4.1.).}

It was in this context that Article 1 was developed, and it wasn't until sometime after the 1963 update of the OECD Model that treaty shopping, and thus limiting the availability treaty benefits, became a major concern.\footnote{Vann, R., ""Liable to Tax"..." at p. 240 (Section 7.3.3. 2.). Vann mentions that there was some concern expressed about treaty shopping prior to this, but not in the modern form involving companies (at p. 230).}

5.2.3.2. Reasons for confining treaty benefits to residents

In light of the history outlined above, it is interesting to consider the reasons why modern treaties continue to confine treaty benefits to residents of the contracting states. The arguments for doing so are generally discussed in the context of treaty shopping and, in particular, in explaining why residents of third states should be prevented from accessing a particular treaty (e.g., by diverting income through a conduit company resident in one of the contracting states}\footnote{Treaty shopping is discussed further below. See Section 5.2.6., below, which includes a brief description of "conduit company" structures and "stepping-stone conduit" structures.}. The most common arguments are:


2. **Insufficient taxation:** Income may escape taxation or may be subject to less taxation than was intended by the contracting states.\footnote{Treaty shopping is discussed further below. See Section 5.2.6., below, which includes a brief description of "conduit company" structures and "stepping-stone conduit" structures.} In a related vein, treaty shopping is perceived to result in a significant loss of tax revenue to source states.\footnote{Treaty shopping is discussed further below. See Section 5.2.6., below, which includes a brief description of "conduit company" structures and "stepping-stone conduit" structures.}
3. Diminished incentive to negotiate treaties: To the extent that the benefits of existing treaties can be accessed through treaty shopping, states will have less of an incentive to negotiate new treaties.410

Taking these factors into account, it seems that, in the context of treaty entitlement, the residence concept primarily aims to achieve two things.411 Firstly, the residence concept attempts to define those taxpayers who may be subject to double taxation as a result of being taxed in one of the contracting states on the basis of their worldwide income (i.e., on a residence basis) whilst being taxed on a source basis in the other. This is clearly evident from some of the early work on tax treaties412 and is supported by the stated purpose of double tax conventions, which is to prevent juridical double taxation.413 It is also reflected in the general structure of modern tax treaties, which are framed around relieving double taxation where taxation is imposed on a source basis in one state and on a residence basis in the other.414 Finally, it is evident in the expectation that the income derived by a resident of one of the contracting states will be taxed in their residence state (reflected in the second argument against treaty shopping mentioned above).

Secondly, the residence concept attempts to define those persons who have a sufficient personal or economic connection to a particular state to benefit from that state's treaty network, even though they may not suffer any double taxation as a result.415 This is closely tied in to the reciprocity principle and is reflected in the fact that there is no requirement for a person to actually pay tax in a particular state to be resident there for treaty purposes, and in the fact that reductions in source based taxation are generally available regardless of whether the particular income in question is actually taxed in the residence state.416 It is also closely related to the concern that states will not have a sufficient incentive to conclude further treaties if the benefits of the existing treaty network are available to residents of third states through treaty shopping.

Implications for the extension of treaty benefits to PEs

The residence concept's role in tax treaties should not prevent treaty benefits from being extended to apply to income derived by residents of third states through a PE located in one of the contracting states. As will be discussed below (in Section 5.2.4.), the taxation of a PE closely resembles the taxation of a resident enterprise and it is the taxation of the worldwide income attributable to the PE that gives rise to the potential double taxation in PE triangular cases. Thus, the attempt to identify those who are subject to worldwide taxation in one of the contracting states and who may therefore be subject to double taxation need not limit consideration solely to persons who are residents of the contracting states, but may also include PEs (with respect to the income that is attributable to them). Moreover, the existence of a PE arguably involves a sufficient connection to the PE state to warrant the application of treaties concluded between the PE state and third states with respect to any income arising in those third states and attributable to the PE. As will be seen below, the existence of a PE and the attribution of income to the PE may even, in some cases, represent a stronger connection to a particular state than corporate residence.417 Finally, extending treaty benefits to residents of third states deriving income through PEs in PE triangular cases would not eliminate the incentive to conclude further treaties, since third state
residents would only be entitled to treaty benefits in certain limited circumstances. These points will be
developed further throughout the remainder of this chapter.

5.2.3.3. Difficulties in determining residence for treaty purposes

In many cases, the application of the residence concept will be quite clear and it will be relatively easy to
determine whether a person is resident in a particular state for treaty purposes. However, applying the
residence article of treaties is not always so straight-forward and there are a number of issues which may
arise in determining whether a particular person qualifies as a treaty resident. One of the key criteria for
qualifying for treaty benefits, and the one which perhaps gives rise to the greatest practical and theoretical
difficulties, is the requirement for a person to be "liable to tax" in a particular state in order to be resident
there for treaty purposes. In particular, the extent of the liability to tax required by Article 4(1) is not
always clear and there is disagreement as to whether it has to be a full and comprehensive liability.418 With
respect to the "liable to tax" criterion, Wheeler writes:

“There is a scale of non-taxability, which runs from the use of losses or personal
allowances to reduce the tax bill to zero, through the exemption of a specific item of
income, an exemption for income from certain types of activity and an exemption for
certain types of person, to the complete exclusion of a person from the reach of the
income tax system. One of the interpretation problems of the current OECD Model is
to know at which point along this scale a person ceases to be 'liable to tax’ and is
therefore not entitled to treaty protection."419

There is thus no clear-cut distinction between entities subject to worldwide taxation on the one hand and
entities which are not on the other. At one end of this spectrum, where there is no tax liability due to, e.g.,
the application of losses or the exemption of a specific item of income, it is quite clear that treaty benefits
should continue to be available. The requirement that a person be "liable to tax" does not require them to
have an actual tax liability.420 Things start to get more difficult, however, in relation to entities that are tax
exempt, such as pension funds and charities.421 In principle, the fact that a state chooses not to exercise
its taxing rights, and thus exempts certain types of entities on public policy grounds, should not prevent
such entities from claiming treaty benefits. Many countries take the view that such entities are eligible for
treaty benefits, on the basis that they are subject to the tax system of the country where they are formed
and are only exempt because they meet certain criteria for exemption, however this argument is not
universally accepted.422 Exempt entities such as charities and pension funds can be contrasted with
entities which are exempt in relation to all or part of their income as a result of preferential tax regimes.
Source states may wish to deny treaty benefits to such entities in certain circumstances, due to a
perception of treaty shopping, on the basis that they do not meet the requirements of Article 4. The
OECD Commentary provides that Article 4 should be read "in light of its object and purpose" and
therefore, companies exempt from tax under a preferential tax regime in the state where they are
established should not be resident for treaty purposes.423 This illustrates, however, the inherent tension in
applying the “liable to tax” requirement both to identify those persons who should legitimately be entitled
to treaty benefits and to limit or deny claims for treaty benefits which are considered improper. There is
often a fine line between those entities that should be considered resident in a particular state for treaty
purposes and those which should not, and in many cases, the proper application of the residence article is

418 For a much more detailed discussion of the residence concept in tax treaties and the issues associated with
applying it see: Couzin, R., Corporate Residence… – particularly Chapter 3; and Maisto, G., (Ed.), Residence of
Companies…. Refer also to the OECD Commentary on Article 4. This section does not deal with the residence of a
dual-resident company in its “losing” residence state for the purposes treaties between that state and third states,
which will be addressed in detail in Chapter 10.
420 Vogel, K., Engelschall, M., & Gorf, M., Klaus Vogel on Double Tax Conventions…., at p. 229 (m.no. 24a).
421 For discussion of this issue, see: Couzin, R., Corporate Residence… at pp. 112-115 (Section 3.1.1.3.).
422 OECD Commentary to Article 4, paras 8.5 and 8.6.
423 OECD Model Commentary to Article 4, para 8.2. For a more detailed discussion, see inter alia: OECD, “Double
Tax Convention and the Use of Conduit Companies”; Vann, R., "'Liable to Tax’…” at pp. 254-259 (Section
7.4.2.2.).
unclear. Difficulties in determining treaty residence also arise, for example, in relation to partnerships and hybrid entities, collective investment vehicles, sovereign wealth funds, persons taxed on a remittance basis and dual residents. Thus, the residence concept does not always provide a solid basis upon which to determine eligibility for treaty benefits.

5.2.3.4. Declining factual basis for corporate residence

Domestic law corporate residence rules, upon which treaty residence depends, are generally based on either incorporation or, in one way or another, the place of management of the company. Satisfying either of these two tests will usually result in a company being considered resident for tax purposes. In a domestic context, residence rules are generally relatively easy for a company to satisfy and, as Graetz writes, “…flexibility in determining a corporation’s residence is a universal phenomenon.” In a treaty context, however, this means that corporate residence is often open to manipulation. A company can be a resident of a particular state with little or no activity or economic presence in that state and furthermore, a company can often change its place of residence with little or no change in its economic activities. In this respect, Schön writes:

“… the factual basis for identifying corporate residence is gradually eroding. Firstly, it is far easier for companies than for individuals to move their residence around. Depending on the benchmark for residence under national and international law, this requires reincorporation in another jurisdiction or transfer of central management and control, but it does not require a different allocation for the large bulk of profit-generating operative and auxiliary structures around the world. Moreover, the allocation of central management functions and other indicators for corporate residence can be more easily divided today among different jurisdictions…”

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 a similar vein, Arnold, Sasseville and Zolt (describing the proceedings of a seminar on tax treaties) write:

426 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).
427 OECD Commentary on Article 1, para. 26.1.
428 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). This will be discussed in Chapter 10.
429 For a more detailed discussion of corporate residence rules, refer to Chapter 10 (Section 10.2.2.), which gives an overview of the common tests employed for determining corporate residence under domestic laws.
430 Vann, R., “Liable to Tax…” at p. 251 (Section 7.4.2.)
“The participants remarked that both the place of incorporation test and the place of management test are subject to manipulation by taxpayers. Traditionally, the shareholders of a corporation were generally resident in the same country as the corporation. Therefore, corporate residence could be used as a proxy for determining the residency of the shareholders. With the increased mobility of capital and increased tax planning, however, the tie between corporate residence and individual residence has become weaker.”

Thus, the fact that a company is resident in a particular state for domestic law purposes does not necessarily represent a strong factual or economic attachment to that state. Given the international mobility of capital and of management personnel, it is increasingly possible for a company to be resident in a jurisdiction with which it has only a limited economic connection.

5.2.3.5. Source role of corporate taxation in an international context

The residence and source principles are generally discussed as though there is a clear and obvious distinction between the two concepts. Whilst this may be the case with respect to the taxation of individuals, it is less clear cut in the case of corporate taxation, as illustrated by the earlier discussion with respect to “fiscal domicile”. In economic theory, taxation is always ultimately borne by natural persons since legal persons do not have any capacity to consume. 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. Due to the international mobility of capital in the modern world, however, most companies, particularly large ones and those that are part of multinational groups, are likely to have ultimate shareholders residing in various countries around the world. Where a company has shareholders who are resident outside the state where the company itself is resident, the corporate taxation imposed on the company cannot be considered a prepayment of the residence-based taxation which would ultimately be imposed on the individual shareholders. Indeed, taxation on the basis of corporate residence may result in tax effectively being imposed on foreign income that is ultimately attributable to non-resident individuals. In this way, it appears more akin to some kind of source-based taxation. Discussing a situation where a jurisdiction claims taxing rights over foreign income derived by a resident company but ultimately attributable to foreign shareholders, Nikolakakis writes:

“…it is submitted that such an assertion of jurisdiction cannot be grounded in residence – at least not in any substantive conception of residence since the ultimate economic beneficiary is not resident in that jurisdiction.”

In an international context, corporate taxation therefore effectively operates as a kind of source-based taxation, and thus, corporate residence effectively operates at least partly as a sourcing rule. One implication of this is that corporate residence concepts and the PE concept have more in common than

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438 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 E.C. 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.”
439 Fantozzi, A., Et al., “Round Table…” at p. 916 (Chapter 24, Section 24.4.2.)
may appear at first sight.\textsuperscript{441} 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. As Schön writes, “Residence and source are not clearly discernible anymore.”\textsuperscript{442}

5.2.3.6. Conclusions

The residence concept plays a central role in modern treaties, but this was not always the case. Given the lack of focus on the formulation and purpose of the residence concept during the development of the earliest model treaties, it is not surprising that its application continues to give rise to so many issues. Treaty residence principles as they are currently formulated can be difficult to apply and do not always provide a solid foundation for determining when treaties should be applied and who should be entitled to treaty benefits. This suggests that residence should not be seen as the only possible basis upon which treaty entitlement could be determined. In fact, as will be seen below, many of the features of residence and of residence taxation which give rise to treaty entitlement in the case of legal persons are also present in relation to PEs despite their usual lack of separate legal capacity. Moreover, the policy rationale for allowing residents to claim treaty benefits, namely the potential for double taxation due to taxation of their worldwide income and their substantial connection to the residence state, may apply equally in the case of PEs.

5.2.4. The PE concept and the taxation of PEs

In many ways, there is a strong resemblance between the taxation of income attributable to PEs and the taxation of income of resident enterprises, reflected both in common patterns of taxation under domestic laws as well as in the provisions of tax treaties. This section seeks to identify similarities between PE taxation and residence taxation which may tend to support the extension of treaty benefits to PEs. It will also address the impact of the differing legal structure of PEs and resident entities which are subject to corporate taxation, and will consider whether the existing PE threshold is an appropriate one for determining the entitlement to treaty benefits.

The similarity between PE taxation and residence taxation will be further explored in the discussion of the separate entity approach for determining the profit attributable to a PE (Section 5.2.5.) and certain differences between the taxation of PEs and resident persons will be addressed in the discussion of the potential for tax avoidance if treaty benefits are extended to PEs (Section 5.2.6.).

5.2.4.1. The existence of a PE

The aim of this section is to give a very brief introduction to the PE definition and the circumstances in which a PE may exist for treaty purposes. The basic definition of a PE is contained in Article 5(1), which provides that:

“For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”

There are several features which must be present in order for this definition to be satisfied, which are identified in the OECD Commentary as follows:

\begin{itemize}
  \item i. the enterprise must have a place of business;
\end{itemize}

\textsuperscript{441} 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.).

\textsuperscript{442} Schön, W., “International Tax Coordination…” at p. 90.
ii. the place of business must be "fixed"; and

iii. the enterprise must carry on its business through the fixed place.443

Examples of a "place of business" are given in Article 5(2), which provides that a PE includes a place of management, a branch, an office, a factory, a workshop and any place of extraction of natural resources. While these places will, prima facie, give rise to a PE, the requirements of the basic test in Article 5(1) must still be satisfied.444

The requirement that the place of business is "fixed" means that there must be "a link between the place of business and a specific geographical point".445 In certain circumstances, however, a relationship or connection to a specific geographical area may be sufficient.446 In addition, the business activity must be conducted through the fixed place of business. This requires a connection between the place of business and the business activity, and can be expressed as a "right of use" test.447 The test will generally be met when the enterprise has a legal right to use the place of business as an owner or lessee, however, no formal legal right is required.448 In addition, the right to use the place of business must have "a certain degree of permanency",449 this means that it must be more than temporary, but does not require that it is "everlasting".450

Activities of a preparatory or auxiliary character do not constitute a PE. This is provided in Article 5(4) which contains a list of exceptions to the PE concept. Whether the activities carried out in a particular place are preparatory or auxiliary will depend on the nature of the enterprise as a whole. In order to be preparatory or auxiliary, the activities must be of "no or very little significance in view of the other work performed by the enterprise".451 Such activities are excluded from the PE concept because the link between the activities and the generation of income is more remote, making taxation by the state where they are conducted less legitimate and making it particularly difficult to determine the amount of profit that should be attributed to the activities.452

Article 5(3) contains a specific rule for building sites and other construction activities, providing that "a building site or construction or installation project constitutes a permanent establishment only if it lasts more than 12 months." In the UN model treaty, this period is reduced to 6 months, and some treaties between developed and developing countries specify an even shorter period, or no minimum period at all.453 There is some uncertainty regarding whether Article 5(3) operates only as an exception, preventing a building site or construction or installation projects from giving rise to a PE where the minimum time period is not met, or whether it can also have a "deeming effect"; that is, whether it can create a PE where one would not exist under the basic rule.454

Article 5 of the OECD Model also includes an "agency PE" rule, which deems a PE to exist where an enterprise operates in a contracting state through a person who "has, and habitually exercises... an authority to conclude contracts in the name of the enterprise" (Article 5(5)).455 However, no PE will exist if the activities of the agent are limited to "preparatory and auxiliary activities" or fall under any of the other exceptions listed in Article 5(4). There is also an exception for independent agents; Article 5(6)

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443 OECD Commentary to Article 5, para 2.
444 OECD Commentary to Article 5, para 12.
445 OECD Commentary to Article 5, para 5. See also: Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions... at p. 286 (m.no. 24).
446 Skaar, A.A., Permanent Establishment... at pp. 128-52. See also: Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions... at p. 286 (m.no. 24a).
447 Skaar, A.A., Permanent Establishment... at pp. 103-7, p. 155.
448 OECD Commentary to Article 5, para 4.1. See also: Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions... at pp. 286-7 (m.no. 25); Skaar, A.A., Permanent Establishment... at p. 157.
449 OECD Commentary to Article 5, para 6.
450 Skaar, A.A., Permanent Establishment... at p. 210 (see also pp. 217-26).
451 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 321 (m.no. 116).
452 OECD Commentary to Article 5, para 23.
453 Skaar, A.A., Permanent Establishment..., at p. 344.
455 For discussion of the practical application of the agency PE rule, see: Sasseville, J., & Skaar, A., “General Report” at pp. 49-55.
provides that an enterprise shall not be deemed to have a PE “merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.” The main practical issue which arises in applying Article 5(6) is determining whether an agent qualifies as an “agent of independent status.”

Many concluded treaties also contain a “service PE” rule, based either on service PE provision of the UN Model or on the alternative wording outlined in the OECD Commentary. As a result of such provisions, an enterprise which provides services in another state may have a PE there for treaty purposes even though the enterprise’s activities in that state would not satisfy the requirements of the basic PE definition. Article 5(3) of the UN Model provides that the term ‘permanent establishment’ encompasses:

“the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 6 months within any twelve-month period.”

The services PE provision of the OECD Commentary, introduced in 2008, is somewhat different and contains two alternative thresholds. Subparagraph a) deals with situations where the enterprise providing services is carried on by an individual (i.e., operating as a sole proprietorship) or derives most of its revenue from services provided by one individual. The main conditions for a PE to arise under this paragraph are: (i) that services are performed by an individual who is present in a state for more than 183 days in any twelve month period; and (ii) that more than 50% of the gross revenue of the active business activities of the enterprise is derived from the services in question. Subparagraph b) applies where an enterprise performs services in a state in relation to a single project, or a series of connected projects, over a period of more than 183 days within any 12 month period.

Some guidance is given in the OECD Commentary on Article 5 (at paras. 42.40 and 42.41.).
The UN Model also contains a provision deeming an insurance enterprise to have a PE in a state if it “collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of independent status” (with an exception for reinsurance). 464

Finally, some treaties also contain a rule deeming the use or operation of “substantial equipment” in a particular state to give rise to a PE. 465 The main issue with respect to the application of such provisions is determining when equipment will be considered to be “substantial.” 466

5.2.4.2. Taxation under domestic laws

Most states define their jurisdiction to tax by reference to the residence and source principles, taxing residents on worldwide income and taxing those who do not qualify as residents only on income which has a local source. However, in many states, the category of taxpayers who are subject to source-based taxation is further divided into two distinct groups. 467 The first group comprises taxpayers who have a sufficient presence within the jurisdiction to justify taxing at least part of their income in the same way as the income of resident taxpayers, i.e., on a net basis. 468 This type of source-based taxation commonly applies in relation to business income which is either derived through a PE or in situations where an equivalent domestic law threshold is satisfied. 469 The overall objective is generally to impose a tax burden on the income attributable to the PE that is the same as that which would be imposed on a resident enterprise deriving the same income. 470 This is typically achieved by imposing equivalent tax rates on the income of the PE, computed in accordance with the same or similar rules as apply for resident taxpayers, generally on the basis of net income. 471 The other main group of non-resident taxpayers subject to source-based taxation are those deriving certain types of passive income, such as dividends and interest, 472 which are commonly taxed on a gross basis by way of withholding tax. 473

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 by way of withholding on one hand, and full residence-based taxation imposed on a net basis on the other. Some states go even further, considering a local PE to be a resident taxpayer in its own right. 474 Of course, given the extent of variation in domestic laws, not all states will follow this pattern, but the fact that it is common for PEs and resident enterprises to be taxed similarly under domestic laws lends support to the notion that it may be appropriate to treat PEs more like resident enterprises for treaty purposes.

5.2.4.3. Quasi-resident status of PEs under tax treaties

The role of the PE concept in tax treaties may seem to be relatively straight forward, in that it can be viewed simply as a threshold for determining when source-based taxation can be imposed on business income (and certain other income attributable to the PE). In many ways, however, the PE concept has a broader role and effectively operates as a kind of quasi-residence concept. 475 This is perhaps clearest in...
way in which the overall structure of the OECD Model reflects the distinction between different types of source-based taxation found under the domestic laws of many states, and discussed above. That is, where a treaty based on the OECD Model applies, the PE concept operates to distinguish between those situations where the source state is either (i) 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 or (ii) prevented from imposing tax on business profits and entitled to impose only a limited rate of tax on dividends, interest and often royalties, determined by reference to the gross amount of the income.

The quasi-residence nature of the PE concept is also reflected in the way in which the existence of a PE in the source state overrides the implicit sourcing rules which are contained in the OECD Model for various categories of income. Dividends, for instance, are generally only taxable in the non-residence state under Article 10 if they are paid by a resident of that state. Similarly, interest is generally only taxable outside the residence state if it “arises” in the other contracting state by being paid by a resident of that state or borne by a local PE. Where 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, i.e., even if the income would not be considered to be sourced in that state in the absence of a PE. This is similar to the way in which the residence principle overrides the source principle in states that tax residents on their worldwide income. That is, if the taxpayer is a resident of a particular state then the source of the income is usually irrelevant for determining whether it is taxable.

In a similar vein, treaties based on the OECD Model allow the state where a PE is located to impose tax on the worldwide income attributable to the PE, even if that income may be considered to have a stronger connection to a third state. The PE state would, for instance, be entitled to impose tax on any dividends attributable to the PE even if they are paid by a resident of a third state and would thus generally be considered to be sourced in that third state under the implicit sourcing rules of the treaty. Essentially, taxation allowed due to the "personal" connection which part of the entity has with the PE state by virtue of having a fixed place of business there. Mere economic attachment to a particular state generally results in a tax liability only in relation to the income from local sources, whereas a personal attachment (i.e., residence) generally triggers a tax liability based on worldwide income. The taxation of the worldwide income attributable to a PE indicates that the existence of a PE establishes a connection to the PE state that may be considered somehow more of a “personal connection” than an economic one.

The quasi-residence nature of the PE concept in tax treaties is also evident in the sourcing rule for interest. Article 11(5) of the OECD Model provides that interest arises in a particular state if it is paid by a resident of that state. 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. 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.

Another way in which the OECD Model likens the taxation of a PE to that of a resident taxpayer is 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. The underlying principle behind Article 24(3) is evidently that the taxation of a PE is similar enough to residence-based taxation that a PE should not suffer a greater tax burden in the PE state than that which a resident enterprise carrying on the same activities would suffer.

does not represent the reality of multinational enterprises, where "...value arises not from transactions but from attributes of the firm and so cannot be captured in a system entirely based on market transactions." (at p. 140).

476 Vann, R., "International Aspects..." at p. 736.


479 2010 OECD Model, Article 11(5).

480 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..." at p. 144.

481 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); reverse PE triangular cases and the application of Article 11(5) will be discussed in Chapter 11.
Finally, and perhaps most clearly, the residence-like nature of the PE concept can be seen by considering its role in supporting the residence concept in tax treaties. Vann illustrates this by considering the likely result (at least in OECD countries) of abandoning the taxation of PEs. He writes:

"... given the lack of robustness of the rules for corporate residence, going forward the removal of taxation of PEs would have several obvious results:

- removal of subsidiaries and divisionalizing of MNEs [multinational enterprises] (to remove taxing rights from countries where there are currently subsidiaries);
- inversion transactions (to remove the residence of the MNE to more favourable tax climates);
- tax competition amongst major OECD countries (to attract the large MNE tax base); and
- most MNEs resident in one or a few countries with good treaty networks and low corporate tax rates.

... [the PE concept] overcomes the problems of defining corporate residence by ensuring that taxing rights follow corporate residence. In other words, in the developed world the PE concept is mainly a residence-based or at least a supporting concept for entities."\(^{482}\)

And further (in a footnote to the above text):

"Effectively, a resident entity is created for taxation purposes in a country when there are substantial business activities there, and we are not concerned whether it is a separate company in a legal and tax sense or whether it is a part of a larger entity."\(^{483}\)

Thus, the PE concept is revealed as something of a hybrid between the source and residence concepts.

5.2.4.4. Importance of the differing legal nature of subsidiaries and PEs

The classic image of a PE is simply a branch established by a company resident in another state, with no separate legal existence, no ability to own assets or to be subject to liabilities, no ability to enter into contracts and no ability to sue or be sued. A corporate taxpayer, on the other hand, is usually a separate legal entity. The question to be addressed here is whether, in spite of all the similarities between PEs and resident persons outlined above, the essential difference in the legal nature of a PE and a resident enterprise warrants different treatment with respect to treaty eligibility.

The OECD, in its “Authorised OECD Approach”, clearly takes the view that the different legal nature of a PE and a company should be largely ignored for profit attribution purposes, that PEs should be treated as though they are able to (economically) own assets, to assume risks and to have a capital structure (as will be discussed below in Section 5.2.5.). However, this approach has been subjected to a great deal of criticism\(^{484}\) and further, is limited to determining the profit attributable to the PE, which is explicitly based on the assumption that the PE is a “separate and independent” enterprise.\(^{485}\) More generally, there

\(^{482}\) Vann, R., "Reflections on Business…" at p. 147.

\(^{483}\) Vann, R., "Reflections on Business…" at p. 147, note 41.


\(^{485}\) Article 5(2) of the 2010 OECD Model provides that: "...the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise." Similarly, Article 5(2) of the 2008 OECD Model (and earlier models) provided that: "...there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make
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.\footnote{Schön, W., “International Tax Coordination…” at p. 106.} To the extent that this is the case, i.e., to the extent that the economic substance of a PE and a subsidiary is the same, this would support treating the two forms of business enterprise in the same way for treaty purposes, and thus extending treaty benefits to income earned through PEs. The question then, is the extent to which the difference in the legal nature of a PE and a subsidiary impacts upon the economic substance of the situation.

Schön argues that the legal partitioning of assets and liabilities “does not have any decisive meaning” for the allocation of risk, since the value of the subsidiaries assets, and thus the value of the parent company’s shares in the subsidiary, ultimately depend on the outcome of the risks assumed by the subsidiary.\footnote{Schön, W., “International Tax Coordination…” at pp. 167-168.} If the subsidiary loses all its assets, then that also represents a loss to the parent company. The primary difference in the case of a PE is that the parent company is also risking its other assets, although even here the difference may be minimal if the parent company guarantees the subsidiary’s debts. This supports a view that the lack of separate legal personality of a PE is likely to have only a limited impact on the economic substance of the situation, and should therefore not be accepted as an argument against extending treaty benefits to PEs. Nevertheless, in a more general sense, the lack of separate legal personality can have real economic consequences, at least in some cases. This will be discussed further below (in Section 5.2.6.) in the context of the potential impact which the extension of treaty benefits to PEs may have on the scope for tax avoidance.

\textit{Variations in the legal nature of PEs and subsidiaries}

It is generally assumed that the legal structure of PEs and subsidiaries follow the classic pattern outlined above, i.e., with a PE simply being part of a broader enterprise from a legal perspective, whilst a subsidiary is a separate legal entity. In many cases, however, the reality is not so clear-cut. For tax purposes, it is clearly the case that a PE is not treated as a separate taxable entity. However, where an entity with foreign owners is treated as fiscally transparent in the state where it is located, then depending on its activities and whether its presence in the state where it is located meets the requirements of the PE definition, it may be give rise to a PE of those foreign owners for treaty purposes.\footnote{Sasseville, J., & Skaar, A., “General Report” at pp. 37-38 and 50-51.} Thus, a PE may effectively arise as a result of activities conducted by what may be considered a separate entity from a legal perspective.\footnote{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.} 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.\footnote{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., \textit{Taxation of Cross-Border Partnerships...}; OECD, “The Application of the OECD Model Convention to Partnerships...”} The classic example of where this may occur is under the US check-the-box rules, which essentially allow certain entities to elect to be taxed either as corporations or on a flow-through basis,\footnote{US Internal Revenue Code, Treas. Reg. § 301.7701-1 through 3. The “check-the-box” regulations were issued in 1996 and permit owners of certain eligible business entities to select how the business entity will be classified for federal tax purposes.} but it can also occur under the domestic tax laws of other states. The income of the resulting PE would of course have to be determined through a process of attribution, and not by simply looking at the income of the fiscally transparent entity giving rise to the PE, but in many cases the income earned by that entity and the income attributable to the PE are likely to coincide.

Conversely, there are also situations where various other types of 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.\textsuperscript{492} 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. It thus becomes evident that legal form falls along a continuum, particularly in an international context.\textsuperscript{493} At one end of the spectrum are entities which are clearly corporate, with limited liability and free transferability of interests for shareholders, the ability to hold assets, to enter into contracts and to sue and be sued. At the other end are, for example, partnerships constituted simply by a relationship between parties and not considered to be separate entities from a legal perspective. In between, there are all manner of entities with varying combinations of features, some more similar to the classic idea of a corporation and others less so. States use their own criteria for determining whether a particular entity is fiscally transparent or pays tax in its own name,\textsuperscript{494} and ultimately it is this determination, rather than the nature of the entity itself, which may determine whether there is a PE or a treaty eligible “subsidiary” in a particular state. As Schön writes:

“On the face of it, it seems to make a difference whether the subsidiary is fully incorporated, including asset partitioning and distinct allocation of liabilities to the subsidiary and the parent company. But this distinction no longer holds true once domestic tax law grants full taxpayer status to partnerships and other hybrid entities, including sole proprietors, and once domestic tax law grants transparent treatment to incorporated entities (LLCs, S corporations in the United States.)”\textsuperscript{495}

Thus, 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.\textsuperscript{496} 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 in the legal nature of a PE and a subsidiary. Furthermore, the fact that certain entities which are taxed as corporations do not have separate legal personality does not prevent them from claiming treaty benefits, and this factor should similarly not prevent claims for treaty benefits by PEs. Again, Schön writes:

“If civil and corporate law do not draw a meaningful line between these two legal forms [i.e., incorporated and non-incorporated] for domestic tax purposes, why should international law consider it to be of any importance at all? Moreover, when domestic tax law wildly varies in allocating taxpayer status to incorporated and other entities, including widespread elections for business, why should international tax law follow suit?”\textsuperscript{497}

\textsuperscript{492} 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).

\textsuperscript{493} Schön, W., “International Tax Coordination…” at p. 107.


\textsuperscript{495} Schön, W., “International Tax Coordination…” at p. 67.

\textsuperscript{496} 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…”.

\textsuperscript{497} Schön, W., “International Tax Coordination…” at p. 108.
5.2.4.5. Whether the existing PE threshold is appropriate for treaty eligibility

The classic image of a PE is of a branch operating largely independently from the enterprise as a whole and with relatively substantial operations in the PE state.\(^498\) In reality, however, there is a wide range of different levels of presence in a country which may constitute a PE and in certain situations a PE may exist under the basic rule (i.e., under Article 5(1)) even though the presence in the PE state is relatively limited. This may occur, for example, as a result of the existence of a server,\(^499\) an employee’s home office,\(^500\) or a pipeline.\(^501\) A PE may also exist, despite a minimal presence in the PE state, under the agency PE rule, or where the applicable treaty contains a service PE rule or a rule deeming the use of substantial equipment to give rise to a PE (as discussed above). Thus, there are various types of activities that can give rise to a PE without a substantial presence in the state concerned, and without any substantial degree of operational independence. Certain authors have noted a trend towards lowering the PE threshold, and reducing the degree of organizational independence required, which stands in contrast to the increasing notional independence of PEs for profit attribution purposes (as will be discussed below).\(^502\) Of these, some have expressed the view that treaty entitlement for PEs would require a narrow PE definition, one which excluded certain PEs such as service PEs, PEs created by the use of substantial equipment in a particular state, or PEs arising from business sites and installation projects.\(^503\)

It should be remembered, however, that not all companies conduct substantial business activities or are operationally independent from the broader enterprise to which they belong (e.g., in the case of a multinational group), and in principle this does not prevent them from being eligible for treaty benefits. A company’s eligibility for treaty benefits depends on its residence status which in turn depends on it being “liable to tax” in the residence state as a result of one of the connecting factors listed in Article 4(1), e.g., a place of management. The requirement for one of the connecting factors to be present does not, however, ensure any substantial connection to the residence state, as mentioned above. Incorporation is a purely formal act which can be easily achieved in most states. Having a place of management in a certain state may require something more but even in this case the level of activity required, e.g., holding board meetings, does not imply that there is any significant business presence in that state and does not require the entity to have operational independence from the broader enterprise.

As in the case of PEs, there is wide variation in the level and type of activities conducted by subsidiary companies. As Schön writes: “Both a permanent establishment and a subsidiary might act largely independently in their business operations and both might function as an element of a highly integrated value chain.”\(^504\) A company may be established for a single purpose, e.g., for a building or construction project or to provide services. A company may also be established to hold a single investment or to act as a holding company for multiple investments. Although claims for treaty benefits by such entities may potentially be challenged where there is evidence of tax avoidance, and may be denied if the company does not meet the beneficial ownership or other specific requirements of the treaty (e.g., those of an LOB provision), treaty benefits are generally available to resident companies regardless of their level of activity.

If, on the other hand, the activities of a PE are very limited, then there would generally be little income attributable to the PE and, in particular, the income attributable to the PE is unlikely to include foreign

\(^{498}\) Schön writes: “Because the PE is described in Article 5(1), OECD model tax convention as a ‘fixed place of business’, one thereby associates some organizational degree of independence that could also be used as a basis for legal isolation.” See Schön, W., “Attribution of Profits…” at p. 1000.


\(^{502}\) Schön, W., “Persons and Territories…”; Schön, W., “Attribution of Profits…” at p. 1000; Wheeler, J.C., “The Missing Keystone…” at p. 286. The attribution of profit to PEs, and the increasing notional independence of PEs for this purpose, will be discussed in detail below (see Section 5.2.5.)


\(^{504}\) Schön, W., “International Tax Coordination…” at p. 111.
income (e.g., dividends, interest or royalties arising in a third state). To the extent that there is no foreign income included in the income attributable to the PE, the eligibility for treaty benefits is purely theoretical, since there is no income for which the PE could actually claim such benefits. If the income of a PE does include foreign income, then the PE must have sufficient activities and a sufficient presence in the PE state for the income to be attributable to it. Where this is the case, the fact that the PE does not have sufficient activities to be considered equivalent to a fully functioning separate enterprise, operating independently from the enterprise to which it belongs, should not prevent treaties between the PE state and third states from applying to that income. Nevertheless, to put a PE on the same footing as a resident enterprise, the eligibility for treaty benefits could depend on the PE being “liable to tax” in the PE state (i.e., in the sense required for residence under Article 4(1)). This will be discussed further in Chapter 8.

5.2.4.6. Conclusions

The similarities between the PE concept and the residence concept, as well as the similarities between PE taxation and residence taxation under the domestic laws of many states and under tax treaties, reveal the PE principle as something of a hybrid between the source and residence principles. Vann argues that, at least in the context of treaties between developed countries, the PE concept is mainly a residence-supporting concept, in that it "...overcomes problems of defining corporate residence by ensuring that taxing rights follow substantial activities." That is, if substantial activities are conducted in a particular state, then these activities justify residence-like taxation and a resident entity is effectively created there regardless of whether the business activities are conducted through a separate legal entity or by part of a larger entity. Furthermore, the legal distinction between PEs and subsidiaries is not as clear cut as it is generally considered to be, with the legal nature of different entities falling along a continuum, particularly in an international context. For the reasons outlined above, the presumption that a PE does not have any separate legal existence should not prevent treaty benefits from being extended to PEs.

5.2.5. Separate entity approach to attributing profit to PEs

For the purposes of determining the profit attributable to a PE, the PE must be considered a "separate and independent enterprise engaged in the same or similar activities under the same or similar conditions..." This is known as the “separate entity approach” and in a broad sense, it requires the application of transfer pricing concepts to determine the profit attributable to a PE as though that PE operated independently from the enterprise as a whole. The first part of this section will trace the historical development of the separate entity approach to attributing profits to PEs, while the second will discuss the recent work of the OECD and the new "Authorised OECD Approach" (AOA) for the

505 With respect to the service PE, for instance, the OECD Commentary provides that “taxation should not extend to services performed outside the territory” of the state where the PE is located. See: 2010 OECD Commentary on Article 5, para. 42.23.
506 Vann, R., "Reflections on Business…” at p. 147.
507 Vann, R., "Reflections on Business…” at p. 147. Vann also suggests that the application of the exemption method to income attributable to a PE could be seen as recognition of the quasi-resident nature of PEs and identifies the potential for overlaps between PE concepts and corporate residence principles (p 144-5, note 37).
508 In the treaty context, this is based on the existence of a PE. Domestic source rules vary and, under domestic laws, net basis taxation of business income may or may not depend upon the existence of a PE. Many countries do use a PE concept for domestic law purposes, and only tax business profits of non-residents if they are carrying on business within the country through a PE (or the local equivalent), while others supplement a domestic PE concept with other source rules, and tax non-residents on certain business income even in the absence of a PE. Some countries tax business income derived by non-residents on a net basis if they are "trading" or "carrying on a business" within that country's jurisdiction, without the need for a fixed place of business or PE. For example, the US, taxes non-residents on income that is effectively connected to the conduct of a "trade or business" in the United States (IRC Sec 871(b)(1), IFA Cahiers, Vol. 90a, p713.). In France, business income of a non-resident will be subject to corporate income tax if the non-resident carries out a "complete commercial cycle" in France (see: IBFD country analysis, Section 7.1.1.). Many countries have an even lower threshold for imposing tax on the business income of non-residents on a net basis under their domestic law (see: Rothatgi, R., Basic International Taxation at p. 224.).
509 2010 OECD Model, Article 7(2).
5.2.5.1. Historical development

The PE concept was used for the allocation of taxing rights in the earliest model treaties published by the League of Nations in 1927 and 1928. At that time, however, no specific guidance was given on how to determine the profit attributable to a PE. The commentary indicated that the profit attributable to the PE would vary between different "undertakings" and mentioned, merely as indications, that certain states take into account factors such as the amount of capital involved, the number of workers, the wages paid, and the amount of receipts.

The first substantive guidance on determining the profit attributable to a PE for treaty purposes came in a report written by M.B. Carroll for the League of Nations in 1933. This report identified two methods for attributing profits to PEs which were in use in the countries surveyed by the author; (i) the "separate accounting method," whereby the profit attributable to a PE is determined as if it were an independent enterprise, in principle on the basis of its separate accounts, and (ii) "fractional apportionment," where tax is assessed on that part of the total net income of the enterprise which corresponds to the relative economic importance of the local establishment. Carroll recommended that the model treaty include a provision based on the "separate accounting method" and the provision he recommended ultimately formed the basis for the business profits article in the 1933 Draft Convention published by the League of Nations. Article 3 of the 1933 Draft Convention provided that:

"... there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment." 516

Thus the principle was established that, for profit attribution purposes, PEs should be treated in the same manner as independent enterprises operating under the same or similar conditions. This went on to form the basis of the relevant articles of the Mexico Model Convention of 1943 and the London Model Convention of 1946, both published by the League of Nations, and was subsequently adopted in Article 7 of the 1963 OECD Model Convention. The wording of Article 7 contained in the 1963 OECD Model Convention was:


511 League of Nations, Document C.216 M.85.; League of Nations, Document C.562 M.178. 1928.II. Article 5 of the 1927 Draft Convention read (in part) as follows: "Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments." In 1928, the League of Nations released three different models (1a, 1b and 1c); the relevant articles of all three 1928 models contained similar wording to the 1927 model.

512 Russo, R., "Tax Treatment of…"


515 Burgers, I.J.J., "Commentary on…"

516 The 1933 Model also provided for an alternative method based on the percentage of turnover, to be applied in situations where there were no accounts or the accounts could not be adjusted to reflect the normal usages of the trade. See: Avery Jones, J.F., et al., "The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States" 60 Bulletin for International Taxation 6, (2006), pp. 220-54.

517 Burgers, I.J.J., "Commentary on…"
Model remained substantially unchanged until the adoption of a revised Article 7 in the 2010 OECD Model. Prior to the 2010 update, Article 7(2) of the OECD Model provided that:

"Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each contracting state be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

The OECD Model conventions published between 1963 and 2008 also contained a provision (Article 7(4)) allowing a state to determine the profits attributable to a PE by an apportionment of the total profits of the enterprise if it had been customary to do so in that state and provided the result is in accordance with the principles contained in Article 7.\(^{518}\)

Development of the "Authorised OECD Approach"

Following the publication of the "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the Transfer Pricing Guidelines) in 1995, the OECD established a project to address how those guidelines could be applied in relation to the attribution of profits to PEs.\(^{519}\) The OECD recognised that there was considerable inconsistency in the interpretation and application of Article 7 by different countries, and sought to provide greater certainty with respect to how the profit attributable to PEs should be determined.\(^{520}\) The work of the OECD was "...not constrained by either the original intent or by the historical practice and interpretation of Article 7."\(^{521}\) The intention was to examine how far the approach of treating a PE as a hypothetical separate and independent enterprise could be taken and the extent to which modifications may be needed in order to take account of the differences between a PE and a legally separate entity.\(^{522}\)

The OECD identified two different approaches which are used by various countries to determine the profits attributable to PEs. The first, referred to as the "relevant business activity" approach, considers that the "profits of an enterprise" (wording included in the pre-2010 versions of Article 7) refers only to the profits of the business activity in which the PE participates.\(^{523}\) Under this approach, the profits attributable to the PE cannot exceed the profits of the enterprise as a whole from that business activity.\(^{524}\) Thus, if the "relevant business activity" includes operations by other parts of the enterprise which incur a loss, then that loss may reduce the profit that can be attributed to the PE.\(^{525}\) This approach was rejected by the OECD in favour of "the functionally separate enterprise approach" which, upon publication of the 2008 report, became known as the "Authorised OECD Approach" (AOA).\(^{526}\) As suggested by the term "functionally separate entity approach," the profit attributable to the PE is

\(^{518}\) Article 7(4) of the 2008 OECD Model reads as follows: "Insofar as it has been customary in a contracting state to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the profits of the total enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment shall, however, be such that the result shall be in accordance with the principles contained in this Article." The 2008 Commentary states that it is generally not appropriate to use an apportionment method, and that one should only be used where, exceptionally, it has been customary to do so in the past and it is accepted by both the tax authorities and taxpayers in the country concerned (para 52 of the 2008 Commentary on Article 7).


\(^{523}\) OECD, "2008 Report on the Attribution of Profits to Permanent Establishments" (Paris: OECD, 2008), Part 1, Section C-1, para 62. References to the "relevant business activity approach" were removed from the 2010 version of the report, presumably on the basis that the wording of the 2010 version of Article 7 rules out this approach.

\(^{524}\) OECD, "2008 Report...", Part I, Section C-1, para 62.

\(^{525}\) OECD, "2008 Report...", Part I, Section C-1, para 63.

\(^{526}\) OECD, "2008 Report...", Part I, Section C-1, para 63.
determined as though the PE is operating as a functionally separate entity. In contrast to the "relevant business entity approach," the profit attributable to the PE is not limited to the overall profit of the entity as a whole, or the profit arising from the business activity in which the PE participates.527 This approach was preferred by the OECD because it is more consistent with the arm's length principle and mirrors the type of analysis that would be undertaken if the PE were a legally distinct and separate enterprise.528 The OECD also stated that this approach is more likely to produce a profit attribution that is neutral as to whether the business activity is carried on by a resident or non-resident enterprise.529

The OECD's work culminated in the rewriting of the commentary on Article 7 in 2008 and the adoption of a new Article 7 in 2010, both incorporating the new "Authorised OECD Approach" for the attribution of profits to PEs. Article 7(2) of the 2010 OECD Model reads as follows:

"For the purposes of this Article and Article [23A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."

5.2.5.2. The "Authorised OECD Approach" (AOA)

Under the AOA, the attribution of profits to a PE is based on the calculation of profits (or losses) from all its activities, including transactions with third parties and transactions with other parts of the enterprise.530 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."531 The functional and factual analysis required by the AOA is similar to the functional analysis that must be performed to apply the arm's length principle to transactions between associated enterprises (i.e., under Article 9 of the OECD Model).532 The outcome of the analysis in Step 1 of the AOA will be an allocation of assets, risks and capital to the PE.533 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.534

Under the AOA, the PE is considered to assume risks to the extent that the significant people functions relevant to the assumption (or management) of those risks are performed by personnel of the PE.535 This is the case even though the PE cannot legally assume risk separately from the enterprise as a whole. The allocation of risk to the PE must be taken into account in attributing profit to the PE and will also affect the amount of capital that must be attributed to the PE.536 In general terms, the greater the risk attributed to the PE, the more profit likely to be attributable to it and the more capital it will require to support its operations.

A PE will have "economic ownership" of an asset if it is entitled to the economic benefits of owning the asset and bears the corresponding economic burdens.537 Once an asset has been allocated to a PE, then in general, the PE should also be allocated any income, depreciation deductions, and gains or losses arising from that asset. Economic ownership of assets under the AOA generally depends upon "significant

527 OECD, "2008 Report…," Part 1, Section C-1, para 69.
528 OECD, "2008 Report …," Part 1, Section C-1, paras 74 and 77.
529 OECD, "2008 Report…," Part 1, Section C-1, para 77.
530 2010 OECD Commentary on Article 7, para 20.
532 OECD, "2010 Report …," Part 1, Section B-3, para 15.
537 OECD, "2010 Report…," Part I, Section B-3(i), note 4.
people functions.538 The significant people functions relevant for determining economic ownership of intangible assets are usually those functions which are associated with active decision-making with regard to the assumption and management of risks associated with the assets.539 In the case of tangible assets, however, there is an exception to this general principle and instead, economic ownership will generally depend on the place of use of the asset.540

Under the arm’s length principle, the PE should have sufficient capital to support its functions, assets and risks.541 The AOA distinguishes between "free capital" (i.e., funding that does not give rise to a tax deductible return in the nature of interest) and interest-bearing debt.542 It requires that PEs must be allocated sufficient capital and that that capital must include an arm’s length amount of "free capital". The amount of free capital required will depend on the activities carried on by the PE and the level of risk it assumes.543 Once the appropriate amounts of free capital and interest-bearing debt have been attributed to the PE, then the PE will be treated as incurring an arm’s length amount of interest costs in relation to the interest-bearing debt.

The functional and factual analysis also involves the identification of any dealings between the PE and other parts of the enterprise.544 However, dealings between the PE and other parts of the enterprise can only be recognised for the purposes of determining the profit attributable to the PE under the AOA if the dealing relates to a "real and identifiable event."545 This requires a determination of whether there has been an "economically significant transfer of risks, responsibilities and benefits as a result of the dealing."546 This stands in contrast to the previous commentary to Article 7 (i.e., pre-2008) which stated that certain types of internal dealings should simply not be recognised in determining the profits attributable to the PE.547

The functional and factual analysis also determines the extent to which transactions with third parties should be hypothesised to have been entered into by the PE. The OECD Report states that this "should become clear as a result of analysing the PE's functions in light of its assets used and risks assumed."548 This is particularly relevant in triangular cases, given that in order for a PE triangular case to exist in the first place, it is necessary that income arising from a transaction with a third party and which is sourced in a third state to be attributable to the PE. As will be discussed further below, if the PE-S treaty is to be applied in PE triangular cases, this will likely place additional pressure on the functional and factual analysis and the attribution of income from third states to the PE.

5.2.5.3. The AOA for financial institutions and financial assets

The final report published by the OECD in 2008 (and updated in 2010 to reflect the new wording of Article 7) contains separate sections dealing with specific issues that arise in determining the profits attributable to PEs in certain financial sectors, namely banking (Part II), global trading (Part III) and insurance (Part IV). One of the key differences in the application of the AOA in the financial sector is that the allocation of the economic ownership of financial assets is based on "key entrepreneurial risk-taking functions" (KERT functions) rather than "significant people functions." KERT functions are said to be those which "require active decision-making with respect to the acceptance and/or management of individual risk and portfolios of risks" and would generally be those involved in creating and subsequently

547 See, for example, the 2005 OECD Commentary on Article 7, paras 17.1-21.
managing a financial asset. The OECD report explains that the "KERT functions" terminology is used in the case of financial assets in the financial sector because of the close link between assets and risks.

In relation to insurance companies, the allocation of investment assets to PEs is not based on KERT functions or significant people functions, but instead follows the allocation of insurance risks. As will be discussed in Chapter 9 (Section 9.2.3.), this raises particular issues for the potential application of the PE-S treaty in relation to investment income derived by insurance companies, since the determination of the investment income attributable to the PE may not be based on an allocation of specific income derived from specific assets.

5.2.5.4. Implications of the AOA

Under the AOA, PEs are treated much more like independent enterprises than they were previously, at least for profit attribution purposes. This can be expressed as an increase in the level of independence of PEs. PEs may have different levels of theoretical independence, representing the extent to which they are treated as separate entities and the scope of any restrictions placed on the separate entity approach for determining the profits attributable to the PE. In this respect, it is possible to distinguish between absolute (hypothetical) independence and restricted independence.

In the case of absolute independence, a PE is treated in exactly the same way as a legally independent subsidiary for the purpose of determining the profits which are attributable to it, with differences between the legal form of a PE and a subsidiary considered to be irrelevant. This means, for example, that the PE may be treated as owning assets independently from the enterprise as a whole and that dealings between a PE and other parts of the enterprise are treated as binding contractual arrangements, which may be recognised in determining the profit attributable to the PE.

By contrast, where the restricted independence approach applies, more recognition is given to the fact that the PE is not a legally separate enterprise and thus, the PE and the head office cannot transact with each other in the same way as independent parties. In addition, the PE is not treated as owning assets and dealings between the PE and other parts of the enterprise are not recognised for tax purposes. The AOA clearly moves in the direction of absolute independence for PEs and results in PEs treated more like independent enterprises 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. 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." According to the OECD report, "[t]his requires a determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the 'dealing'." 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. In some circumstances, it may also be possible to recognise internal interest payments, including a profit margin; namely, where part of the enterprise conducts treasury operations. This is a significant departure from the approach reflected in the previous OECD commentary, which specifically provided that no deduction

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549 OECD, "2010 Report…," Part II, Section B-1(iii), para 8.
550 OECD, "2010 Report…," Part I, Section B-3(i), para 16.
552 OECD, "2010 Report…," Part III, Section C-1(iii), paras 165-70.
553 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions… at p. 428 (m.no. 64). See also: Baker, P., & Collier, R., “General Report” at p. 36.
554 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions… at p. 428 (m.no. 64).
556 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions… at p. 428 (m.no. 64).
559 OECD, "2010 Report…," Part I, Section B-3(v), para 35.
should be available for notional interest payments (except, in certain circumstances, for banks).562 One area where the limitation on internal dealings has not been removed is in the case of creditworthiness; the AOA requires that the PE is considered to have the same creditworthiness as the entity as a whole.563 Nevertheless, on the whole, the AOA has greatly expanded the situations in which internal dealings may be recognised.

One of the other key ways in which the AOA strengthens the independence of PEs is 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).564 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. This is a significant development and is also a departure from the previous commentary, which made no reference to the extent of the (notional) legal capacity of a 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 a PE and other parts of the enterprise or other related parties (step 2).565 Under the previous commentary, there was no specific reference to the Transfer Pricing Guidelines. By contrast, under the AOA the transfer pricing framework becomes the "fundamental tool set" for profit attribution to PEs.566 The explicit application of the Transfer Pricing Guidelines to PEs also emphasises the AOA's transactional approach to determining the profit attributable to PEs (as opposed to an "allocation" approach),567 which also brings the treatment of a PE conceptually closer to that of a separate enterprise.

An important limit on the separate entity approach, and one which is retained under the AOA, is that a PE is treated as a separate enterprise only for the purposes of determining the amount of profit attributable to the PE and the amount of relief to be provided in the residence state. The PE is not considered to be a separate entity for the purposes of applying other articles of the treaty.568 One consequence of this is that any notional payments from the PE to the head office, while they may be recognised for profit attribution purposes, cannot be subjected to withholding tax in the PE state (i.e., under Article 10 or Article 11).569 Of course, a PE is also not considered to be a "person" or a resident of the PE state for the purposes of applying tax treaties with third states. Thus, the AOA does not go to the extreme of total independence for PEs.570 Baker and Collier, noting the AOA's dramatic shift in the direction of absolute independence, write:

"Even then, it is fair to say that the AOA does not go to the absolute extreme of independence – what one might call the 'full monty' separate enterprise. On that approach, if one were to attribute assets, risks and capital to the FSE [functionally separate enterprise],... there seems no reason why the FSE should not be regarded as a resident of state H [i.e., the PE state], capable of taking the benefit of the DTCs entered into by state H, and, if domestic law requires, operating a withholding of tax on the payment of (notional) royalties, rents, interest (and possibly technical service fees) deemed to be paid to other parts of the enterprise."571

The increase in the notional independence of PEs under the AOA supports the application of the PE-S treaty in triangular cases, since it increases the similarity between a PE and a subsidiary. Allowing PEs to

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562 2005 OECD Commentary on Article 7, paras 18-18.3.
563 It also states that there is no scope for the rest of the enterprise to guarantee the creditworthiness of the PE, or for the PE to guarantee the creditworthiness of the rest of the enterprise; thus, internal guarantee fees are not recognised. OECD, "2010 Report...," Part I, Section D-2(v), paras 99-104.
566 Fris, P., Llinares, E., & Gonnet, S., "PEs and Transfer Pricing...."
567 Vann, R., "Reflections on Business...."
568 2010 OECD Commentary on Article 7, para 28.
569 2010 OECD Commentary on Article 7, para 28.
claim treaty benefits would be a logical extension of these developments and would represent the next step in the ongoing process of personalisation surrounding PEs.

5.2.6. Tax avoidance considerations

A major concern with applying the conditions of the PE-S treaty to income derived by PEs belonging to residents of third states is that this would open up opportunities for treaty shopping.\textsuperscript{572} The main alternative argument that has been advanced is that a person resident in a third state could just as easily gain access to the PE-S treaty by incorporating a company in the PE state to hold the income-generating assets and thus derive the income for treaty purposes.\textsuperscript{573} The purpose of this section is to assess the extent to which there would be an increased risk of treaty shopping if the source state were obliged to extend treaty benefits to PEs.

5.2.6.1. Treaty shopping: The current landscape

Treaty shopping can be broadly defined as any situation where a person acts through or uses a legal entity in order to obtain treaty benefits that would not be available to them directly.\textsuperscript{574} Treaty shopping is often discussed in the context of passive income, such as dividends, interest and royalties, but may also occur in relation to other types of income. The main forms of treaty shopping are "direct conduits" and "stepping-stone conduits", as outlined below.\textsuperscript{575}

Direct conduit

In the case of a direct conduit,\textsuperscript{576} a resident of one state ("ParentCo," resident in State A) establishes a company, which is resident in a second state ("SubCo", resident in State B), and transfers income-generating assets to that company in order to take advantage of the treaty between State B and a third state (State C) in respect of income arising from sources in State C. The treaty between State A and State C may be less favourable than the one between State B and State C or there may be no applicable treaty, either because one has not been concluded or because ParentCo is not eligible for treaty benefits. SubCo ultimately pays the income it receives to ParentCo in the form of dividends. In order for this structure to provide a benefit, State B must impose minimal (or no) tax on the income, and dividends paid by SubCo to ParentCo must also be subject to minimal (or no) tax; the structure would not provide a benefit if the tax saving in State C is offset by additional tax costs in States A and B. An example of a direct conduit structure is illustrated in the following diagram.

\textsuperscript{572} See: OECD Committee on Fiscal Affairs, "Triangular Cases," para 39.
\textsuperscript{574} See: 2010 OECD Commentary on Article 1, para 9 (although it does not use the term "treaty shopping"). For various definitions, see also: Van Weeghel, S., \textit{The Improper Use...}, at p. 119.
\textsuperscript{575} Van Weeghel, S., \textit{The Improper Use...}, at p. 120.
\textsuperscript{576} OECD Committee on Fiscal Affairs, "Double Tax Conventions and the Use of Conduit Companies," at p. 88-89; See also: Van Weeghel, S., \textit{The Improper Use...}, at p. 120.
Stepping-stone conduit

A stepping-stone conduit structure577 is similar to a direct conduit structure, with the exception that SubCo is fully taxable in State B but pays tax-deductible amounts (e.g., interest, service fees) to a related company, with the result that there is minimal residual tax payable in State B. Of course, the amounts paid by SubCo must not be subject to more than minimal tax in either State B (e.g., withholding tax) or the state where the recipient is resident, otherwise the additional tax liability may outweigh the benefit of the tax saving in State C. An example of a stepping-stone conduit structure is illustrated in the following diagram:

Treaty shopping is widely regarded as representing an improper use of tax treaties.578 According to the OECD Committee on Fiscal Affairs, it is undesirable for several reasons, as discussed in more detail above.579 Firstly, where treaty shopping occurs, the principle of reciprocity is breached because the benefits of a treaty concluded between two contracting states are economically extended to a resident of a third state in a way which was not intended by the contracting states.580 Secondly, income may escape taxation or may be subject to less taxation than was intended by the contracting states. 581 And finally, to the extent that residents of a particular state can gain access to tax treaties through treaty shopping, that state will have less of an incentive to enter into (or renegotiate) treaties with other states. 582 Assessing these arguments, Van Weeghel comes to the conclusion that the main problem with treaty shopping is that it may jeopardize the existence and uniformity of tax treaties:

577 OECD Committee on Fiscal Affairs, "Double Tax Conventions and the Use of Conduit Companies," at p. 88-89; See also: Van Weeghel, S., The Improper Use... at p. 120.
578 See: Van Weeghel, S., The Improper Use... at pp. 121-3.
579 OECD Committee on Fiscal Affairs, "Double Tax Conventions and the Use of Conduit Companies" at p. 90. These can be assumed to represent the most common objections to treaty shopping (see: Van Weeghel, S., The Improper Use... at p. 122).
580 OECD, "Double Tax Conventions and the Use of Conduit Companies" at p. 90.
581 OECD, "Double Tax Conventions and the Use of Conduit Companies" at p. 90.
582 OECD, "Double Tax Conventions and the Use of Conduit Companies" at p. 90.
The existence of tax treaties may be jeopardized because certain existing treaties will be terminated as a result of their treaty shopping potential, and certain countries will no longer be able to enter into tax treaties. Uniformity may be jeopardized because new tax treaties will increasingly contain provisions to counteract treaty shopping, which are not based on model language contained in the OECD Model Convention, as long as the OECD Model Convention does not contain guidance in this respect. Both the threat to the existence of tax treaties and the threat to their uniformity strike at the heart of the rationale for the avoidance of double taxation, i.e., they may hamper the international exchange of goods and services and movements of capital.583

One of the key ways in which states seek to combat treaty shopping is through the beneficial ownership concept. Most tax treaties provide that the restrictions on source-based taxation with respect to dividends, interest and royalties will only apply if the income is "beneficially owned" by a resident of the other contracting state.584 However, the meaning of beneficial ownership in a treaty context is subject to much debate and it can be difficult to apply the beneficial ownership concept in practice.585

The OECD Commentary provides little guidance on the meaning of "beneficial ownership," merely stating that "the term 'beneficial owner' is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance."586 It goes on to give two examples, firstly stating that a person receiving income as a mere "agent or nominee" would not be the beneficial owner of such income and secondly, indicating that a person "acting as a conduit for another person who in fact receives the benefit of the income concerned" may not be the beneficial owner of the income.587

The OECD released a discussion draft in July 2011, with proposed changes to the OECD Commentary to clarify the meaning of “beneficial owner” in the OECD Model.588 The discussion draft proposes to include the following wording in the OECD Commentary on Article 10 (and equivalent wording in Article 11 and Article 12):

“The recipient of a dividend is the ‘beneficial owner’ of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full

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583 Van Weeghel, S., The Improper Use… at p. 123.
584 See Articles 10, 11 and 12 of the OECD Model.
586 OECD Commentary on Article 10, para 12. Repeated in the OECD Commentary on Article 11, para 9 and the OECD Commentary on Article 12, para 4.
587 OECD Commentary on Article 10, para 12.1, repeated in the OECD Commentary on Article 11, para 10 and in the OECD Commentary on Article 12, para 4.1. The commentary goes on to refer to the OECD's Conduit Companies report (OECD Committee on Fiscal Affairs, "Double Tax Conventions and the Use of Conduit Companies"), stating that the report concludes that "a conduit company cannot normally be the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties."
588 OECD, “Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention: Discussion Draft” (Paris: OECD, 2011), dated 29 April 2011 to 15 July 2011 at p. 4 (proposed para 12.4 of the Commentary on Article 10). See also: p. 6 (proposed para 10.2. of the Commentary on Article 11) and p. 9 (proposed para. 4.3. of the Commentary on Article 11). Available online at: http://www.oecd.org/document/39/0,3746,en_2649_33747_48391591_1_1_1_1,00.html (viewed 13 January 2011).
right to use and enjoy the dividend; also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid.\(^{589}\)

The comments received in response to the discussion draft are generally supportive of the OECD’s effort to clarify the meaning of beneficial ownership, but critical of the potential for the proposed changes to create further uncertainty, particularly with respect to the type of circumstances that would prevent the recipient of income from being the beneficial owner.\(^{590}\)

One of the leading cases on beneficial ownership is the *Indofood*\(^{591}\) case, decided in the UK. In *Indofood*, the court was dealing with the hypothetical situation of a Dutch company established to hold loan notes issued by borrowers in Indonesia in order to take advantage of a reduced interest withholding tax rate available under the treaty between Indonesia and the Netherlands. The Dutch company would have been in a back-to-back situation, such that its liabilities and interest obligations were exactly the same as its assets and interest income, respectively. The court concluded that in this hypothetical case the interposed Dutch company would not be considered the beneficial owner of the interest income because, in light of the obligation to make interest payments equal to the interest income it received, the company would not have "the full privilege to directly benefit from the income."\(^{592}\) Importantly, the court decided that "beneficial ownership" should have an international fiscal meaning, and not one derived from the laws of the state applying the treaty.\(^{593}\)

The *Indofood* case seems to indicate that a company will not be the beneficial owner of income if it is obliged, in legal, commercial or practical terms, to pass on the income it receives to another entity,\(^{594}\) however, it should be borne in mind that this case does have certain limitations. Firstly, as mentioned above, *Indofood* involved a UK court deciding, in a non-tax case, on what an Indonesian court would decide with respect to beneficial ownership in a hypothetical situation. In addition, the payments received by the interposed company were very closely tied to the payments it was required to make; it was required to pay its interest liabilities the day after the interest income was received and its interest income exactly equalled its interest obligations, such that it did not earn any "spread" on the interest and could not retain any of the income it received.\(^{595}\) The Court also stated that the company was precluded by the terms of the loan documentation from meeting its interest obligations from any other source of income.\(^{596}\) The important question then, and something which is not entirely clear, is the extent to which the decision in *Indofood* may apply in other circumstances where the amounts received and paid by the intermediary company are not so closely linked,\(^{597}\) for example, where the intermediary company earns a spread on the income it receives\(^{598}\) and has more substance in the state where it is established.

Another key case on beneficial ownership is the *Prévost*\(^{599}\) case, which was decided in Canada. In *Prévost*, a Dutch holding company received dividends from a Canadian company. The shareholders in the Dutch company (one resident in the UK and the other resident in Sweden) entered into a shareholders’ agreement which provided, amongst other things, that not less than 80% of the profits of the Dutch company would be distributed by way of dividends. The Dutch company was not legally obliged to pay

\(^{589}\) OECD, “Clarification of the Meaning….”

\(^{590}\) See, for example, the responses from Richard Collier (PwC), John Avery Jones, Richard Vann and Joanna Wheeler, The City of London Law Society (CLLS), Ernst & Young, HSBC and various others.


\(^{592}\) Indofood International Finance Ltd. v JPMorgan Chase Bank N.A., London Branch, [2006] EWCA Civ 158 at 42.


\(^{594}\) Cleave, B., Editorial comments in IBFD case summary.

\(^{595}\) The Dutch company would have been remunerated through a "handling charge." It is unclear what relationship this would have with the amount of costs incurred by the company. See: R.F., & J.D.B.O., "Treaty Shopping and Beneficial Ownership: Indofood International Finance Limited v J.P. Morgan Chase Bank, N.A., London Branch" A British Tax Review (2006), pp. 422-429.

\(^{596}\) This condition may not actually have been contained in the loan documentation, see: Baker, P., "Beneficial Ownership…” at note 4.

\(^{597}\) Baker, P., "Beneficial Ownership…”

\(^{598}\) Martín Jiménez suggests that it is implicit in the Indofood decision that if the intermediary company had retained any "spread" then it could have been regarded as the beneficial owner (Martín Jiménez, A., "Beneficial Ownership…”.

dividends, however, and there was no predetermined or automatic flow of funds to its shareholders. In this case, the court found that the Dutch holding company was the beneficial owner of the dividends, stating that "the beneficial owner of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received."600 This demonstrates the difficulties inherent in applying the beneficial ownership concept in practice, particularly in cases where the intermediate company pays its income to its parent company in the form of dividends. One of the main difficulties lies in determining whether a company, which is under control of another company and therefore likely (but not legally obliged) to pay any income it receives on to its ultimate owner, could be regarded as the beneficial owner of its income.601

States can also prevent improper claims for treaty benefits by including Limitation on Benefit (LOB) provisions in tax treaties. An LOB is generally a detailed provision which sets out the circumstances in which treaty benefits should be available. In very broad terms, it prevents a claim for treaty benefits unless the person claiming treaty benefits meets one of the specified tests, e.g., it is listed on a stock exchange in its residence state, meets ownership and base erosion tests, or receives the income in the conduct of business activities in the residence state.602 It has long been the policy of the United States to include LOB provisions in its treaties, and virtually all the treaties concluded by the US now contain an LOB.603 Most other countries do not regularly include LOB provisions in their treaties.604 There are some indications, however, that this may be changing605 and the inclusion of LOB provisions in tax treaties may become more common in the future. Nevertheless, the majority of treaties currently in force do not contain an LOB provision, which clearly limits the use of such provisions in preventing treaty shopping.

Treaty shopping may also be counteracted in some cases through the application of domestic anti-avoidance rules. The nature and scope of such rules differ significantly between countries and they may take a variety of forms.606 Whether such rules can be applied to challenge improper access to treaties will depend on their scope. However, where the effect of the application of domestic anti-avoidance rules is to deny treaty benefits in situations in which they would otherwise be available, it may be questionable whether the state denying treaty benefits has met its obligations under international law.607 The OECD Commentary on Article 1 states that anti-avoidance rules such as “substance-over-form”, “economic substance” and general anti-abuse rules do not, as a general rule, conflict with tax treaties on the basis that they are “part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability” (paras 22-22.2). Various authors have questioned whether this is the case, particularly where the application of the rule results in a re-characterization of the facts after they have been determined.608

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601 Du Toit, C., "The Evolution of…"
602 For a somewhat more detailed discussion of LOB provisions (in the context of the PE state and non-discrimination principles), see Chapter 4 (Section 4.3.4.2.).
603 Exceptions include the US treaties with Poland and Hungary, although with respect to Hungary, a new treaty containing an LOB has been initialed. Negotiations for a new US-Poland treaty are ongoing. Van Weeghel, S., “General Report,” at p. 49.
606 Some of the doctrines that may be applied in various states include: sham (where the legal form of transactions does not correspond to their true nature), legally ineffective transactions, substance over form (which seeks to apply the tax law on the basis of the economic substance of transactions, rather than their legal form), abuse of law, *fraus legis*, or simply a general anti-avoidance rule that may apply, for example, where a transaction is primarily motivated by tax avoidance (see: Van Weeghel, S., “General Report,” at pp. 21-22). Some states also have specific anti-avoidance measures aimed at preventing treaty shopping, e.g., the US conduit financing rules. These rules effectively allow the US tax authorities (the IRS) to recharacterize certain back to back financing arrangements by disregarding one or more intermediate entities, and treating the ultimate provider of finance as the recipient of income (e.g., for withholding tax purposes), if the IRS determines that it is necessary to do so to prevent tax avoidance (see Treas. Reg. 1.881-3(a)(3)(i)).
608 See: Van Weeghel, S., “General Report” at p. 25
or leaves the facts unchanged but simply denies a tax benefit (or benefits) that would otherwise be associated with those facts.609

Finally, states may be able to combat treaty shopping in some cases through general principles of treaty interpretation, i.e., on the basis of an implied anti-abuse rule. In this respect, the OECD Commentary states that:

“[Some states] consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties).”610

Nevertheless, there are significant limits on the extent to which states can rely on the interpretation of the treaty to deny treaty benefits in situations where they consider a treaty claim to be improper.611 As can be seen from the discussion above, states face significant challenges in combatting treaty shopping, with the possible exception of situations where the relevant treaty contains a comprehensive LOB provision. The following section will discuss the extent to which allowing PEs to claim reductions in source-based taxation under tax treaties may increase the opportunities for treaty shopping.

5.2.6.2. Potential for treaty shopping through PEs
The fact that a PE is not a separate taxable entity and is typically not a separate legal entity has a number of consequences which are relevant for assessing the extent to which PEs may potentially be used to obtain improper access to treaty benefits. Far from making treaty shopping easier, however, the lack of legal personality may ultimately make treaty shopping through PEs less attractive than treaty shopping using legal entities. This is a result of the fact that in order for a PE to exist, and particularly in order for income to be attributable to that PE, there must be at least some level of activity there. It also results from the economic basis for determining the profit attributable to a PE. As Vann writes:

“... the PE rule is less subject to manipulation than the residence rules as it uses substantive activity based tests rather than purely formal tests such as place of incorporation or semi-formal tests such as place of board management or head office.”612

One of the ways in which it may be easier to use a PE rather than a legal entity to obtain treaty benefits is that a PE can generally be established without having to go through any formal legal procedures. In most countries, however, a company can be incorporated relatively quickly and at a relatively low cost; these legal formalities are therefore unlikely to be a significant consideration.

Internal transactions have no legal effect
An important aspect of the PE having no separate legal personality is that an allocation of income or assets to the PE will have no legal effect on the entity as a whole, and dealings entered into between the PE and other parts of the enterprise will not be legally binding. The OECD report on the attribution of profits to PEs makes note of this, and states that it "implies a need for greater scrutiny" of such internal

609 De Broe, L., International Tax Planning... at p. 391 (Part 3, Chapter 4, Section 4.1.2., para. 158).
610 OECD Commentary on Article 1, para. 9.3.
611 For a detailed discussion of the extent to which there may be an implied anti-abuse rule in treaties, see: De Broe, L., International Tax Planning... Part 3, Chapter 3 (pp.301-376). For further discussion, and an overview of the case law of various countries in this respect, see: Van Weeghel, S., “General Report” at pp. 35-42. Van Weeghel notes that it is difficult to find a distinct pattern in the cases reported in the branch reports (at p. 41). For discussion of various provisions of the OECD Commentary dealing with tax avoidance, see: Arnold, B.J., “Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model” 58 Bulletin for International Fiscal Documentation 6, (2004) pp. 244-260.
612 Vann, R., “Liable to Tax…” at p. 202 (Section 7.2.1.).
dealings. However, this situation may not be so different from the situation that exists within a corporate group; the OECD’s Transfer Pricing Guidelines note that "contracts within an MNE [Multi-National Enterprise] could be quite easily altered, suspended, extended or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively." In a practical sense, therefore, the implications of dealings entered into between a PE and other parts of the enterprise may not be vastly different from the implications of those entered into between different companies in a corporate group; in both cases, the enterprise as a whole (i.e., the legal entity or the corporate group) may effectively choose to disregard or alter whatever agreement has been made.

Perhaps more significantly, transactions within a single legal entity (e.g., a "sale" of assets to a PE) also have no legal effect in relation to third parties. It is difficult to identify any specific ways in which this would facilitate treaty shopping, however, as Vann points out, there is a difference between entering into a transaction that has legal effect and simply recording an assumed transaction, which has effect only for tax purposes. He goes on to note that the OECD’s report on the attribution of profits to PEs suggests that the attribution of profit to PEs will initially be based on the accounts of the enterprise and other internal documentation and emphasises "the potentially destructive nature for the international tax system of purely elective tax treatment where the election has no other commercial consequences." Overall, it is difficult to assess the extent to which PEs' lack of legal personality could facilitate treaty shopping.

**Economic basis for allocation of income**

The income of a company is generally determined by looking at the legal arrangements. So, for example, if the assets of a company include shares or debt, the income of that company generally includes any dividends or interest paid in relation to those assets. In the absence of any circumstances indicating otherwise, the entity owning the asset will generally also be the beneficial owner of the income arising from it and may be entitled to reduced source based taxation under an applicable treaty. This could be the case even if the company undertakes only minimal activities in relation to the investment.

By contrast, 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. Under the AOA, the first step in this process is a "functional and factual analysis," by which the economically significant activities and responsibilities undertaken by the PE are identified. As outlined above, the outcome of the functional and factual analysis will be an allocation of the economic ownership of assets, risks and capital to the PE, as well as an allocation of the appropriate rights and obligations arising out of transactions with third parties. This allocation must be based on the "significant people functions" performed by the PE.

Of particular relevance for assessing the potential for treaty shopping through PEs, especially in relation to passive income, is the allocation of assets. This is because once an asset has been allocated to a PE, the PE is also likely to be allocated any income arising from the asset, especially in the case of financial assets such as shares and debts. Thus, if shares are allocated to a PE, the income attributable to the PE would generally include any dividends paid in relation to those shares. Similarly, if interest bearing debt or intangible assets, such as patents or copyrights, are allocated to a PE then the income attributable to the PE would generally include any interest or royalties arising from those assets. A PE will have "economic ownership" of an asset if it is entitled to the economic benefits of owning the asset and bears the

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613 OECD, "2010 Report…," Part I, Section B-3, para 34.
614 OECD, "OECD Transfer Pricing Guidelines" (Paris: OECD, 2010), Part I, Chapter I, Section D-2, para 1.67.
615 Referring to the effect of the US check-the-box regulations in an international context. Vann, R., "Reflections on Business…" at p. 165.
617 Vann, R., "Reflections on Business…," at p. 165. Here he points to the operation of the US check-the-box rules in an international context.
corresponding economic burdens. Economic ownership of assets under the AOA generally depends upon "significant people functions." In the case of intangible assets (including shares, debts and intellectual property), the significant people functions relevant for determining economic ownership will be those functions associated with active decision-making with regard to the assumption and management of risks. Thus, assets giving rise to passive income will only be economically owned by a PE, and the associated income will only be attributable to a PE, if personnel employed in the PE are responsible for active decision making with regard to whether to make the investment and with regard to the ongoing management of the investment. This is clearly a much higher standard than is required in order for income to be earned (and beneficially owned) by a subsidiary company.

The AOA is a new approach to determining the profits attributable to PEs, and it remains to be seen how quickly and how extensively it will be implemented in different countries and under treaties which do not contain the new version of Article 7. Nevertheless, even without the application of the AOA, the attribution of income to PEs is still generally based on an economic analysis, considering the business activities conducted through the PE. Thus, regardless of the extent to which the AOA is implemented, it is possible for tax authorities to challenge the amount of profits which the taxpayer asserts are attributable to a PE.

As a result of the income of PEs being determined on an economic basis, 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. As discussed above, one of the primary means by which treaty shopping is countered under the existing framework is through the beneficial ownership concept, and there is a great deal of uncertainty surrounding its meaning for treaty purposes. In the case of a PE making a (potentially improper) claim for treaty benefits, the difficulties with the concept of beneficial ownership could be bypassed. Instead, the discussion regarding whether the claim for treaty benefits is appropriate can be based directly on whether the income is properly attributable to the PE. Thus, the focus would shift to the economic situation identified as part of the functional and factual analysis and to the significant people functions carried out by the PE. In the case of a PE, it is not possible for the taxpayer to rely on the legal arrangements to demonstrate that treaty benefits should be available and it may therefore be easier for the source state to challenge claims for treaty benefits through PEs than it would be in the case of legal entities. In addition, 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 should not apply the conditions of the PE-S treaty in relation to that income.

One consequence of applying the PE-S treaty in PE triangular cases would be to place more pressure on the determination of the profit attributable to the PE, since the attribution would determine not only the taxing rights of the PE state and the residence state under the R-PE treaty but also the applicable treaty conditions in the source state. The attribution of profits to PEs as part of a multinational’s broader transfer pricing is already a key aspect of international taxation, and an area of significant focus for enterprises that operate internationally as well as tax administrations. Given the existing consequences which can arise as a result of an item of income being attributable (or not attributable) to a PE, e.g., where there is a wide discrepancy in tax rates between the PE state and the residence state and the residence state uses the exemption method of relief, this should not argue against requiring the source state to apply the conditions of the PE-S treaty. Nevertheless, it may further increase the focus on making sure the attribution of profits to PEs is as fair and accurate as possible, particularly in relation to income arising in third states.

621 OECD, "2010 Report...," Part I, Section B-3(i), note 4.
623 These types of intangible assets are not specifically mentioned in the OECD Report, but can be presumed to fall within the meaning of intangible property in accordance with general principles.
625 In this respect, see: Baker, P., & Collier, R., “General Report” at pp. 56-61.
Taxation of income attributable to the PE

One reason why extending treaty benefits to PEs could facilitate the improper use of treaties is that it could make it easier for treaty benefits to be obtained without giving rise to any additional tax liability, i.e., in the PE State. Assessing this argument requires a comparison between the typical patterns of international taxation applicable to companies and those applicable to PEs.

Assuming the all the states involved impose tax on the worldwide income of resident companies and impose tax on non-resident companies on a source basis, the tax consequences of using a conduit company structure should theoretically be as follows:

- The income received by the conduit company is taxable in its state of residence (subject to deductions for expenses – this is particularly relevant in the case of a stepping-stone conduit);
- Dividends paid by the conduit company are subject to withholding tax and are taxed in the parent company’s state of residence (relevant in the case of a direct conduit); and
- Any deductible payments made by the conduit company (e.g., interest payments) may be subject to withholding tax and are also taxed in the state where the recipient of the income is resident (relevant in the case of a stepping-stone conduit).

Obviously not all tax systems follow these patterns and tax will not always be imposed in the manner set out above, otherwise the additional tax liability would likely outweigh the benefit of the reduced rates of source-based taxation and conduit structures would not give rise to the issues that they do. However, to the extent that tax systems follow these general patterns, this would tend to limit the situations in which treaty shopping is feasible (and beneficial). The different international patterns which exist for the taxation of PEs may not constitute a similar limitation.

If a direct conduit structure were set up with a PE in the place of the conduit company then there would generally be no recognition for tax purposes, in either the PE state or the residence state, of any repatriations of income ("dividends") from the PE to the rest of the enterprise. To the extent that the PE state did seek to impose some form of withholding tax (or equivalent) on the payment, it would be prevented from doing so by the treaty with the residence state. The ability to claim treaty benefits through PEs which can repatriate profits without tax consequences would clearly expand the situations in which treaty shopping is feasible. This may suggest that, if treaty benefits are extended to PEs, the separate entity approach should be taken even further, such that notional transactions between the PE and the rest of the enterprise would also be recognised for the purposes of the other articles of the treaty, including the article dealing with dividend payments, allowing the PE state to impose tax on such notional payments. This is largely beyond the scope of this thesis, but will be discussed briefly in Chapter 9 (Section 9.3.2).

If a PE were substituted for the conduit company in a stepping-stone conduit structure, it may be possible to identify internal dealings which would constitute expenses for the PE and which would reduce the taxable profit attributable to the PE to a sufficiently minimal amount. This is significant because such payments would generally not be recognised other than for the purposes of determining the profit attributable to the PE. Thus, the residence state would not impose tax on the "income" received by the head office, and to the extent that the PE state did seek to impose some form of withholding tax (or equivalent), it would generally be prevented from doing so by the treaty with the residence state. It is important to note, however, that the reduction in the profit attributable to the PE will reduce the corresponding exemption or credit relief in the residence state and as a result, the income shifted to the residence state by the internal dealings may effectively be taxed in that state.

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626 2010 OECD Commentary on Article 7, para 28.
627 That is, not limited to Article 7 and Article 23A/B.
628 Baker and Collier note that the AOA does not go to this extreme of independence for PEs, see: Baker, P., & Collier, R., “General Report” at p. 37.
629 2010 OECD Commentary on Article 7, para 28.
630 This is demonstrated by the following example: The income attributable to a PE includes $100 from sources in a third state. The company earns no other income and the residence state uses the exemption method of relief for PE profits. In this case, $100 will be taxable in the PE state and no income will be taxable in the residence state.
A final aspect of the taxation of PEs which arguably facilitates treaty shopping is that many countries do not tax the business profits of non-residents to the extent that those profits are derived from foreign sources. In effect, a PE may be taxed on a territorial rather than a worldwide basis. Where a particular state does not impose tax on the foreign income attributable to the PE, but does impose tax on the foreign income of resident companies, this could facilitate the use of PEs as “conduits” in situations where a conduit company could not be used without triggering a tax liability. In practice, however, the income attributable to the PE for treaty purposes is likely to be considered to have its source in the PE state under that state’s domestic laws, i.e., as a result of the business activities carried out there. For example, interest income derived in the context of business activities may be considered, under the domestic laws of the PE state, to have its source in the state where those business activities are conducted (i.e., in the PE state). In addition, some states (such as Australia, France and Japan) impose tax under domestic law by reference to the taxing rights given by the treaty. Australia, for example, includes in all its treaties a provision that deems most items of income which are taxable in Australia under the treaty to be Australian source income. Nevertheless, there are likely to be situations where the income arising in a triangular situation is not included in the tax base in the PE state. To counter such situations, the availability of treaty benefits to PEs could be conditioned on the income being “subject to tax” in the PE state. This will be discussed further in Chapter 8.

5.2.7. Impact of EU law

It is quite clear that European law requires the PE state in a PE triangular case to extend to the PE any relief that would be available to a local resident, including relief available under a treaty with the source state, provided that both the residence state and the PE state are within the European Union (EU). This was established in the European Court of Justice (ECJ) decision in the Saint-Gobain case, and is based on the freedom of establishment contained in Articles 49 and 54 (then, Articles 52 and 58).

Alternatively, there is a "dealing" between the PE and the head office which gives rise to a deduction of $90 for the PE (leaving profit attributable to the PE of $10). In this case, $10 is taxable in the PE state and $90 is taxable in the residence state (i.e., $100 less $10 which is exempt).

632 Arnold, B.J., & Sasseville, J., "Source Rules for Taxing…" at p. 120.
633 In the 2003 Australia-UK treaty, for example, Article 21 provides: "Income or gains derived by a resident of the United Kingdom which, under any one or more of Article 6 to 8 and 10 to 16 and 18 may be taxed in Australia shall for the purposes of the laws of Australia relating to its tax be deemed to arise from sources in Australia." Arnold, B.J., and Sasseville, J., "Source Rules for Taxing…" at p. 120; Avery Jones, J.F., et al., "Tax Treaty Problems….."
634 Case C-307/97, Compagnie Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, [1999] ECR I-6161. The Saint-Gobain case involved a PE established in Germany by a French company. The income attributable to the PE included dividends received from companies located in various source states (including the United States and Switzerland) which were fully taxable in Germany. The case involved a request for three tax concessions with respect to the dividends received: (1) an exemption from the German corporation tax for dividends received from companies resident in the US and Switzerland which was available to German resident companies under the treaties concluded between Germany and those states; (2) an indirect tax credit for taxes imposed on the profits from which foreign dividends were paid which was available to German resident companies under German domestic law; and (3) a capital tax concession available to German resident companies under German domestic law. The taxpayer in Saint-Gobain claimed that, in order to comply with the freedom of establishment provisions of the EU treaty, these concessions should also have been granted to the PE. (ECJ, 21 September 1999, Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt, C-307/97, paras. 9-22.)
635 Article 49, titled "Right of Establishment" reads: "Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches, or subsidiaries by nationals of any Member State established in the territory of any Member State. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."
636 Article 54 reads: "Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States. 'Companies or firms'
respectively) of the EC Treaty. Following the decision in the Saint-Gobain case some authors have questioned whether the source state, if it is within the EU, may also be obliged to apply the conditions of its treaty with the PE state in relation to the income attributable to the PE under EU law. An in-depth discussion of this issue is beyond the scope of this thesis, but broadly, the assertion that the source state may also be bound to apply the PE-S treaty rests on the fact that the source state may otherwise be considered to be discriminating between residents and branches of the PE state for the purposes of EU law and thus violating the freedom of establishment.

If it is the case that EU law requires both the PE state and the source state to apply the conditions of the PE-S treaty in PE triangular cases (where all the relevant states are EU Member States), this may provide further impetus to any push to extend treaty benefits to PEs, at least among those states which are subject to EU law. This is reflected in the 2011 Memorandum on Dutch Tax Treaty Policy (Notitie Fiscaal Verdragsbeleid 2011) published by the Dutch Ministry of Finance. The Notice refers to the Saint-Gobain case and the requirement to extend treaty relief measures to PEs under EU law, and also briefly mentions the fact that ambiguities and imperfections can arise in PE triangular cases involving dividends, interest and royalties. It then sets out the impact on Dutch treaty policy as follows:

“To ensure that the source state also grants treaty benefits to permanent establishments located in the Netherlands that are in the same position as residents of the Netherlands, the Netherlands will seek to include a provision to this effect in new tax treaties.”

Given that this is a newly introduced policy, and may run into stiff opposition from other states with which the Netherlands seeks to negotiate (or renegotiate) treaties, it may be some time before any impact is seen in concluded treaties. Furthermore, there is no indication of the way in which the proposed provision would operate, although the Notice does seem to suggest that it may be limited to passive income. Nevertheless, it does illustrate that EU law may have an impact on the terms of treaties negotiated between EU member states and between EU member states and third states. It also illustrates a more general shift towards giving serious consideration to the extension of treaty benefits to PEs.

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637 Now called the Treaty on the Functioning of the European Union (“TFEU”).
638 This was not discussed in the Saint-Gobain case itself, which dealt only with the tax treatment in the PE state. For discussion of this issue (in some cases quite brief) see, inter alia: Martín Jiménez, A.J., García Prats, F.J., & Calderón Carrero, J.M., "Triangular Cases…” at pp. 247-249; Lang, M., “Triangular Situations: Tax Treaty Entitlement in the Source State Under EC Law,” bound in Liber Amicorum Jaques Malherbe (Brussels: Bruylant, 2006), pp. 685-699; Blahova, R., "Treaty Benefits…” at pp. 99-101; Langoth, B., "Treaty Entitlement…”; Kostense, H.E., “The Saint-Gobain Case…” at pp. 222-223. Some of these authors argue quite strongly that the source state should not be obliged to apply the PE-S treaty under EU law on the basis that the freedom of establishment should not be accepted as having any “third party effect.”
5.3. Whether taxation in the source state should be subject to the conditions of the R-S treaty

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, which it can only do by applying those conditions which are most favourable to the taxpayer.

If, for example, one treaty allows tax to be imposed up to a maximum rate of 10% and the other allows tax to be imposed up to a maximum rate of 15% in relation to a particular category of income (e.g., interest), the source state would be obliged to limit the tax imposed to 10%. This section will discuss the appropriateness of the source state to continuing to apply the conditions contained in the R-S treaty to income attributable to a PE in addition to the conditions of the PE-S treaty.

The application of the R-S treaty in PE triangular cases also gives rise to significant tax avoidance concerns. That is, a resident of State R may claim a reduction in source based taxation under the R-S treaty in circumstances where the income is exempt in State R (as a result of being attributable to the PE) and is also not taxed, or is only minimally taxed, in the PE state.643 These concerns will not be addressed here but rather, will be dealt with in detail in Chapter 7. In general terms, this concern, supports denying the benefits of the R-S treaty in relation to income which is attributable to a PE.

5.3.1. Potential impact of not applying R-S treaty conditions in the source state

The impact of not applying the conditions of the R-S treaty in the source state will depend upon the comparative terms of the R-S treaty and the PE-S treaty and the type of income involved. For many categories of income the application of the PE-S treaty instead of the R-S treaty will have no practical impact on the amount of tax that may be imposed in the source state, at least to the extent that both treaties follow the OECD Model.644 The main impact is likely to occur in relation to passive income such as dividends, interest and royalties, where the maximum rates of source-based taxation commonly differ between treaties. For these categories of income, differences between the rates provided in the R-S treaty and the PE-S treaty will have a direct impact on the amount of tax that the source state can impose.

One important consideration with respect to the R-S treaty is that 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, and may even be desirable,645 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 unrelied double taxation may occur. Thus, if the residence state uses the credit method to provide relief for tax imposed in the PE state then the residence state should still have an obligation to provide relief for tax imposed in the source state.

One alternative may be to retain the operation of the R-S treaty, via a specific provision included in that treaty, but only with respect to the provision of relief in the residence state (i.e., without requiring the

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643 Van Weeghel, S., The Improper Use... at pp. 124-126. Some tax treaties contain provisions which deny reductions in source-based taxation under the treaty if the income in question is attributable to a PE in a third state.

644 As discussed above in Section 5.3.1. This would generally include: business profits (Article 7), income from immovable property located in the source state (Article 6), certain types of capital gains (Article 13), income from shipping, inland waterways and air transport (Article 8), and other income (Article 21).

645 This may be desirable because it may prevent a dual relief obligation from arising in the residence state, i.e., where the residence state is obliged to exempt the income under one treaty and provide a credit under the other applicable treaty. The potential for a dual relief obligation was discussed in Chapter 3 (Section 3.3.), where it was concluded that a dual relief obligation should not arise on the basis that the exemption under one treaty should be taken into account when determining the amount of tax imposed in the residence state in respect of the income for the purposes of applying the relief provisions of the treaty requiring credit relief. As a result, there will be no tax imposed on the income in the residence state for the purposes of that provision and no credit will be required (in accordance with the terms of Article 23A(2) or Article 23B, as applicable). Nevertheless, some states may remain concerned about this issue.
source state to apply the conditions of the treaty). However, this may also give rise to problems in certain circumstances. If the residence state uses the credit method of relief under the R-S treaty and the rate of tax imposed in the source state is higher than that which it would be entitled to impose under the R-S treaty, the question arises as to the amount of credit relief that the residence state should be required to provide. That is, whether the credit should be provided for the amount of tax actually imposed or the lower amount that the source state would be entitled to impose if the R-S treaty applied. If the credit is limited to this lower rate, then unrelieved double taxation may still occur. However, the residence state is not likely to accept an obligation to grant a credit in excess of the amount of tax that the source state would be entitled to impose if the R-S treaty applied. The question of relief in the residence state in these circumstances would be simplified if the R-S treaty continued to apply in addition to the PE-S treaty. This will be discussed further in Chapter 7 (Section 7.4.).

5.3.2. Conditions for availability of treaty benefits

Article 1 of the OECD Model identifies the persons covered by the treaty, providing that "[t]his Convention shall apply to persons who are residents of one or both of the Contracting States." The term "persons" is defined in Article 3(1) to include "...an individual, a company and any other body of persons." The OECD Commentary to Article 3 emphasises that this definition is not exhaustive, and that it should be interpreted "in a very wide sense" (OECD Commentary to Article 3, para 2.). The term "company" is defined in Article 3(1) to mean "...any body corporate or entity that is treated as a body corporate for tax purposes."

Residence for treaty purposes is determined in accordance with Article 4 and depends on the person involved being "liable to tax" in the state concerned (discussed in detail above). This concept of residence for treaty purposes supports, in principle, the continued application of the R-S treaty notwithstanding that the income is attributable to a PE and may be exempt in the residence state, e.g., under a domestic exemption. This is because the person involved continues to be liable to tax, notwithstanding the exemption of part of its income. Where, however, the residence state is required to exempt the income to satisfy its obligations under a tax treaty, the situation is arguably different from one where the residence state may impose tax on the income but simply chooses not to. Such situations seem to warrant an exception to the general principle that the availability of treaty benefits depends on the treatment of the person receiving the income, and not on whether the particular item of income in question is taxable. This general principle should not rule out the inclusion of a specific provision in tax treaties preventing their operation (in both the residence state and the source state) in relation to income which the residence state is required to exempt under a tax treaty with a third state.

5.3.3. Whether source state taxation should be subject to multiple treaty restrictions

Various authors have argued that the taxation in the source state should not be subject to multiple treaty restrictions, and thus that the conditions of the R-S treaty should not apply to the income derived in a PE triangular case. As was outlined above, the application of multiple treaty restrictions would have no impact to the extent that both the R-S treaty and the PE-S treaty follow the OECD Model. However, where the relevant conditions differ between the R-S treaty and the PE-S treaty and both treaties are applicable, the source state could only fulfil its treaty obligations by applying the conditions which are most favourable to the person deriving the income (e.g., in the case of dividends or interest, applying the lower of the two applicable rates). 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.

5.3.4. Conclusions

In general, the source state should not be required to apply the conditions of the R-S treaty in situations where it applies the conditions of the PE-S treaty in relation to income attributable to the PE. This is because applying the R-S treaty in such circumstances would result in the source state being subject to

646 The term "persons" is defined in Article 3(1) to include "...an individual, a company and any other body of persons." The OECD Commentary to Article 3 emphasises that this definition is not exhaustive, and that it should be interpreted "in a very wide sense" (OECD Commentary to Article 3, para 2.). The term "company" is defined in Article 3(1) to mean "...any body corporate or entity that is treated as a body corporate for tax purposes."

multiple treaty conditions in relation to the same income. Excluding the operation of the R-S treaty also addresses treaty shopping concerns in cases where the income is exempt in the residence state. However, the case for excluding the operation of the R-S treaty is weaker in circumstances where the residence state uses the credit method with respect to the income attributable to the PE. In such cases, the risk of treaty shopping is minimal, since any reduction in source-based taxation is likely to be offset by the tax imposed in the residence state and, in addition, the residence state may need to provide relief for tax imposed in the source state in order to prevent unrelieved double taxation. The circumstances in which the operation of the R-S treaty should be excluded, and the way in which this could best be achieved, will be discussed further in Chapter 7.

5.4. Conclusions

In PE triangular cases, the R-PE treaty effectively allocates taxing rights in relation to the income attributable to the PE to the PE state, either completely (where the residence state exempts the income) or by giving the PE state the prior right to tax (where the residence state grants relief using the credit method). This factor alone arguably does not justify the application of the PE-S treaty to income attributable to the PE, however there are a number of other factors which should be taken into account.

One important factor is the potential consequences of not applying the PE-S treaty. In some circumstances, if the conditions of the PE-S treaty are not applied in the source state, the tax imposed in the source state could exceed the amount of relief that the PE state is willing to provide, particularly where the PE state is extending treaty relief to the PE in accordance with non-discrimination principles. Thus, in certain circumstances, unrelieved double taxation could occur as a result of the non-application of the PE-S treaty. In addition, if the PE-S treaty does not apply, then the division of taxing rights between the source state and the PE state effectively depends upon the conditions of the treaties which each of those states have concluded with the residence state, rather than the conditions of the treaty between those two states. This is an inappropriate outcome, firstly because the residence state generally has no interest in the split of revenues between the source state and the PE state, and secondly because the tax collected in the source state and the PE state should arguably reflect the bargain struck between those two states and reflected in the PE-S treaty. These arguments clearly support the application of the PE-S treaty in PE triangular cases.

This raises the question of why treaty benefits are restricted to residents of the contracting states. The arguments for doing so are generally presented in the context of treaty shopping, and focus on concepts of reciprocity, the possibility that income will escape taxation (or be subject to less taxation than intended by the contracting states) and the diminished incentive to negotiate new treaties if residents of third states are able to access existing treaties. However, applying the residence concept in tax treaties is often not so straightforward, particularly when you begin to consider the scale of non-taxability that may exist under domestic laws and the difficulty in determining exactly where to draw the line between a person who is “liable to tax” and is thus a “resident” for treaty purposes and person who is not. These arguments also assume that corporate residence implies a strong connection to the jurisdiction in question, which is not necessarily the case. In general it is relatively easy for a corporation to become resident in a particular jurisdiction, e.g., though incorporation, which limits the usefulness of the residence concept for determining entitlement to treaty benefits. The arguments for limiting treaty benefits to residents also seem to be based on the idea that there is a clear distinction between the taxation of resident enterprises on a worldwide basis and the taxation of non-residents on a source basis. However, in many ways, the corporate taxation imposed on a “residence” basis effectively operates as a source-based taxation imposed on the shareholders who, in economic theory, ultimately bear the tax. Thus, the residence concept does not always provide a solid foundation upon which to determine the circumstances in which a treaty should apply.

Essentially, the residence concept seeks to identify those persons who are likely to suffer double taxation as a result of being taxed on a source basis in one state and on a residence basis in another, and to identify those who have a sufficient connection to one of the contracting states to justify the application of the treaty. However, in many cases, these features will also be present where there is a PE in one of the contracting states. Under the domestic law of the state where it is located, a PE may be taxed on a net basis in a similar way to resident enterprises; this stands in contrast to the way most states tax passive
income accruing to non-residents, which is often subject to a final withholding tax. For tax treaty purposes, PEs are also treated similarly to resident taxpayers in a number of ways. Firstly, the PE concept overrides other source rules contained in tax treaties, allowing the PE state to impose tax on the worldwide income of the PE. In addition, for determining the source of interest income under Article 11(5), payment of interest by a PE is effectively considered to be equivalent to payment by a resident enterprise. Finally, Article 24(3) requires that the taxation of the PE in the PE state is "not less favourably" levied than the tax imposed on resident enterprises, indicating that a PE is considered similar enough to a resident enterprise that it should not be subjected to a greater tax burden.

The main difference between a PE and a resident enterprise (e.g., a subsidiary) essentially lies in the differing legal form of the operations, with a PE being simply part of a broader enterprise while a subsidiary is a separate legal enterprise. But even here the distinction is blurred, with some entities that would generally be considered to have separate legal personality being fiscally transparent for tax purposes and thus effectively being treated as a "PE" of their foreign owners. Conversely, there are also situations where entities which would not normally be considered to have separate legal personality, such as partnerships, being taxed in the same way as corporations and thus eligible for treaty benefits. Clearly, the eligibility for treaty benefits does not always follow legal form. Further, even where the legal form does follow the classic pattern of a subsidiary having separate legal personality while a PE does not, it is not clear what impact this has on the economic substance of the situation. The typical pattern whereby PEs lack separate legal personality should therefore not prevent the application of the PE-S treaty in PE triangular cases.

PEs are further assimilated to separate entities under the separate entity approach for profit attribution, particularly under the recently developed AOA. The AOA increases the independence of PEs in a number of ways, ensuring that they are equated more closely to resident enterprises for profit attribution purposes. Under the AOA, the attribution of income to PEs is based on a factual and functional analysis and depends largely on the "significant people functions" carried out by the PE. The AOA expands the situations in which internal transactions (i.e., those between the PE and other parts of the enterprise) can be recognised, and introduces the notion of a PE which can assume risk and have economic ownership of assets, and which must have an appropriate capital structure to support its operations. Thus, the nature of PEs, the way in which they are taxed, and the way in which the profit attributable to the PE is determined all support the application of the conditions of the PE-S treaty to income attributable to the PE.

The main concern with extending treaty benefits to PEs is that it would open up opportunities for treaty shopping. As was discussed above, states face significant challenges in combating treaty shopping under existing principles and for this reason, they may be understandably reluctant to open up a further avenue for improper claims for treaty benefits. Treaty shopping through PEs is a legitimate concern, primarily because transactions between the PE and the rest of the enterprise have no legal consequences for the entity as a whole and because common patterns of PE taxation may make it easier to obtain treaty benefits through a PE without triggering any additional tax liability in the PE state or the residence state. It may, however, be possible to address these concerns, for example through the inclusion of a "subject to tax" requirement. In addition, the fact that taxpayers could not rely on legal arrangements to support a PE's claim for treaty benefits, and the analysis required for determining the profits attributable to a PE may actually make gaining access to tax treaties through PEs less attractive for taxpayers than obtaining treaty benefits through a legal entity. Further, the attribution of profits to PEs is based on an economic analysis and (at least under the AOA) depends on the "significant people functions" carried out by the PE; to the extent that the income is economically linked to the PE (and the PE state), it is difficult to see how the source state could legitimately object to the application of the PE-S treaty.

In principle, for the reasons set out above, the appropriate treaty conditions for the source state to apply in a PE triangular case are those contained in the PE-S treaty. This is subject, however, to the practical challenges involved in effecting such a change. Chapter 7 will address the various ways in which the PE-S treaty could be made to apply, while Chapters 8 and 9 will address some further challenges that are likely to arise in extending treaty benefits to PEs.

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648 Various ways in which treaty shopping concerns could be addressed, such as the inclusion of a "subject to tax" requirement, will be discussed in Chapter 8 (Section 8.4).
Chapter 6
Potential solutions

6.1. Introduction

The previous three chapters have discussed the issues that can arise in PE triangular cases from the perspective of the residence state, the PE state and the source state. This chapter will take a broader view; it's purpose is to identify the fundamental causes of the issues that can arise in PE triangular cases and, in particular, to identify and assess potential solutions. First, however, this introductory section will give a brief overview of the specific issues discussed in previous chapters and, in some cases, an indication of what may be required to resolve them.

The solutions considered in this study are limited to those which would operate within the existing international tax framework, i.e., with taxation imposed on income, generally on the basis of the residence and source principles. It will not consider, for example, the possibility of a global move to purely consumption based taxes or to a system of multilateral formulary apportionment. A move to either of these systems would represent a drastic change which, without other motivating factors, would be completely out of proportion to the issues arising in PE triangular cases and the frequency of such cases. In addition, whilst they may avoid the existing problems arising in PE triangular cases, such systems could give rise to other issues in situations involving more than two states which would then have to be resolved within the framework of whatever system was implemented. For the same reasons, this study will not consider the extent to which a system of territoriality (i.e., taxation of locally sourced income only), if implemented on a global basis, could resolve the issues in PE triangular cases.

6.1.1. Overview of issues arising in PE triangular cases under the existing framework

6.1.1.1 Unrelieved double taxation

In PE triangular cases, the residence state will have an obligation under the R-PE treaty to grant relief for tax imposed in the PE state and, under the R-S treaty, will have an obligation to grant relief for tax imposed in the source state. However, where tax has been imposed on a source basis in both the source state and the PE state, the residence state may not be in a position to fully relieve double taxation. This will generally occur if the total amount of tax imposed in the source state and in the PE state is greater than the amount of tax which the residence state seeks to impose on the income prior to granting any relief. As discussed in Chapter 3, this is the case regardless of whether the residence state uses the exemption method or the credit method. If the residence state uses the credit method, then in general the residence state will not be able to credit all the tax imposed in the PE state and the source state unless the total amount of tax imposed in those states is less than the amount the residence state seeks to impose prior to granting any relief. Similarly, if the residence state uses the exemption system, the residence state should only be considered to have fully relieved double taxation if the total amount of tax imposed in the source state and the PE state is less than the amount that the residence state would have imposed in the absence of the exemption.

Where the residence state uses the credit method, then depending on the applicable credit limitations, the amount of credit provided may be sufficient to fully relieve double taxation even in situations where the tax imposed in the source state and the PE state is greater than the amount of tax imposed in the residence state (prior to relief). However, in this case the residence state is effectively reducing the

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649 This section contains only a brief discussion of the residence states ability to fully relieve double taxation in PE triangular cases. For a more detailed discussion, refer to Chapter 3 (see Section 3.2.).

650 In Chapter 3, it was submitted that in multilateral situations, 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 (see Section 3.2.1.).

651 This may occur where the residence state’s credit limitation rules allow the tax imposed in the PE triangular case to be offset against the tax imposed in the residence state in relation to other income. This is discussed in Chapter 3 (see Section 3.2.3.1.).
amount of tax it collects in relation to other items of income, resulting in an inequitable distribution of tax revenue between the three states involved.

The most important contributor to the potential for unrelieved double taxation in PE triangular cases is a lack of double taxation relief in the PE state. Relief in the PE state would both ensure that unrelieved double taxation can be prevented and ensure an equitable distribution of tax revenues between the PE state and the residence state.\(^\text{652}\) In some states, unilateral relief measures are extended to situations where income is derived by a non-resident through a local PE (or where an equivalent domestic law threshold is satisfied).\(^\text{653}\) In addition, the PE state may have an obligation under the non-discrimination article (Article 24(3)) of the R-PE treaty to grant relief equivalent to that which is available to resident taxpayers.\(^\text{654}\) This obligation may extend to both the relief available to resident taxpayers under domestic law and the relief that would be available to a resident taxpayer under the PE-S treaty (referred to as "treaty relief"). However, the obligation to provide relief under non-discrimination principles is not accepted by all states, particularly with respect to the obligation to extend treaty relief to PEs. In addition, if the PE state does extend treaty relief to PEs and the PE-S treaty provides for the credit method of relief, there may be difficulties in determining the appropriate limitations that should apply to the amount of the credit to be provided.\(^\text{655}\) In general, to the extent that the PE state imposes tax on the income arising in a PE triangular case, it should be obliged to grant relief for tax imposed in the source state, and it would be preferable for this obligation to be more explicit than the existing obligations (or potential obligations) under Article 24(3).\(^\text{656}\) Alternatively, unrelieved double taxation could be avoided in PE triangular cases by preventing either the source state or the PE state from imposing tax on the income, in which case the relief provided in the residence state would be sufficient.

6.1.1.2. Applicable treaty conditions in the source state

In accordance with the existing treaty framework, a PE is not a resident person for treaty purposes and is thus generally not eligible for treaty benefits.\(^\text{657}\) As a result, the source state in PE triangular cases is required to apply the conditions of the R-S treaty to the income attributable to the PE, even though, for the reasons discussed in Chapter 5, it would arguably be more appropriate for the source state to apply

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\(^{652}\) If the PE state uses the exemption method, then tax would be imposed only in the source state and the residence state and the residence state would provide relief (either by exempting the income or by providing a credit for the tax imposed in the source state). If the PE state uses the credit method, all three states would impose tax on the income, but the PE state would provide credit for the tax imposed in the source state and the residence state would either exempt the income or provide a credit for the tax imposed in the source state and the net amount of tax imposed in the PE state (i.e., after the credit for tax imposed in the source state). In either case, there will be no unrelieved double taxation. For further discussion, see Chapter 3 (Section 3.2.2.2.).

\(^{653}\) For examples of states that extend unilateral relief to PEs, see Chapter 4 (Section 4.2.2.1.).

\(^{654}\) For a more detailed discussion of the PE state's potential obligation to provide relief under the non-discrimination article of the R-PE treaty, see Chapter 4 (Section 4.3.).

\(^{655}\) The issues associated with the amount of credit relief to be provided were discussed in detail in Chapter 4 (see Section 4.3.5.). 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 less than (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 (OECD Commentary on Article 24, para 70). It was concluded in Chapter 4 that there is an inconsistency inherent in applying both these limitations under the current wording of Article 24(3), but that it would not be appropriate to apply either one in isolation, and that therefore, it would be highly desirable for treaties to include specific wording establishing the applicable limitations.

\(^{656}\) The need for relief in the PE state was discussed in detail in Chapter 3, where it was concluded that the PE state should provide relief both to prevent unrelieved double taxation and to ensure an equitable distribution of tax revenues (see, in particular, Section 3.2.2.2.). The PE state's potential obligations to grant relief were discussed in Chapter 4, where it was concluded that the PE state should have an obligation to grant relief under the non-discrimination article of the R-PE treaty. However, it was also concluded in Chapter 4 that, given the uncertainty surrounding the extent of this obligation, it would be preferable for the PE state to have an explicit obligation to grant relief.

\(^{657}\) For further discussion, refer to Chapter 2 (Section 2.3.), which explains that treaty benefits are not available to PEs, because they are not considered "persons" but are simply part of a broader enterprise.
the conditions of the PE-S treaty. To resolve this issue, the conditions of the PE-S treaty should be made to apply in the source state and the application of the R-S treaty should be excluded.

The exclusion of the R-S treaty provisions also addresses another issue arising in triangular cases, which is the potential for a person to claim the benefits of the R-S treaty in situations which the source state considers to be abusive. This may occur where a person claims a reduction in source based taxation under the R-S treaty in relation to income which, as a result of being attributable to a PE in a third state, is exempt in the residence state and which is not subject to tax (or is subject to only minimal tax) in the PE state.658

The discussion above, and in Chapter 5, has focused on making the conditions of the PE-S treaty apply in the source state and excluding the application of the R-S treaty, however, there are certain alternative solutions where this will not be relevant. Specifically, the application of the PE-S treaty in the source state will not be relevant if either the PE state or the source state is prevented from imposing tax on the income (discussed in Section 6.4., below) or if a multilateral treaty has been concluded between the states involved (discussed in Section 6.5., below).

Further considerations which may arise if the source state applies the conditions of the PE-S treaty in PE triangular cases, including the potential for improper use of the PE-S treaty, will be discussed in Chapter 7, Chapter 8 and Chapter 9.

6.1.1.3. Potential dual-relief obligation in the residence state

The residence state’s obligation to provide relief under two separate treaties may also oblige the residence state to grant dual-relief.659 Where, for example, one of the two applicable treaties requires the residence state to exempt the income and the other requires the residence state to provide credit relief, the residence state may potentially be required to both exempt the income and provide a credit in order to meet its treaty obligations. For various reasons (as discussed in Chapter 3), the residence state should not be required to provide dual relief, but states which remain concerned about this risk may wish to take steps to ensure that they will never be obliged to grant dual relief in PE triangular cases. Some potential options which may be available to resolve this issue were discussed in Chapter 3,660 and will not be specifically discussed in this chapter.

6.2. Underlying issues and introduction to possible solutions

In order to identify potential solutions to the issues outlined above and in earlier chapters, it is helpful to examine the underlying reasons for the problems arising in PE triangular cases; these will be discussed in this section.

6.2.1. Overlap between treaty source rules

Although the articles of the OECD Model do not contain explicit source rules, they do set out the circumstances under which each contracting state may impose tax on income derived by residents of the other contracting state, which, in effect, operate as source rules.661 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

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659 This issue is discussed in further detail in Chapter 3 (see Section 3.3.).

660 See Section 3.3.9. The potential solutions proposed in that section are: (i) including a provision in the relief articles of treaties to the effect that no credit is available to the extent that the income is exempt under another income tax treaty and (ii) incorporating a provision in domestic law to the effect that income that is exempt under a tax treaty is also considered to be exempt under domestic law. See Chapter 3 for further detail (Section 3.3.9.).

661 See, for example, the Introduction to the 2010 OECD Model, para 19, which describes a contracting state which is entitled to impose tax on income derived by residents of the other contracting state as the "state of source." See also 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.
those contained in the R-PE treaty. For the purposes of the R-S treaty, the income arising in a PE triangular case is generally considered to be sourced in State S and, depending on the type of income involved, State S may be entitled to impose tax. For the purposes of the R-PE treaty, however, the income effectively considered to be sourced in the PE state and is taxable in that state as a result of being attributable to the PE. The PE concept is not generally considered a sourcing rule; rather, it establishes a minimum threshold below which no tax can be imposed on locally sourced business profits. 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. Consequently, income arising in a PE triangular case is considered to be sourced in State S for the purposes of the R-S treaty and in State PE for the purposes of the R-PE treaty and therefore has a dual source for treaty purposes. Vogel describes the concept of "state of source" as being "treaty relative" in this situation.

This suggests that the issues arising in PE triangular cases could be effectively dealt with by resolving the overlap between the tax treaty sourcing rules. This could be done either by preventing the PE state from imposing tax on income arising in PE triangular cases, or by preventing the source state from imposing tax on the income attributable to the PE. These options will be discussed in Section 6.4., below.

6.2.2. Hybrid nature of the PE concept

As discussed above, the PE concept is 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.

First among these reasons is the PE state's ability to impose tax on the worldwide income attributable to the PE. That is, the PE state may impose tax on any income that is attributable to the PE regardless of the extent to which that income is economically connected to a third state, e.g., as a result of being paid by a resident of that state. This of course gives rise to PE triangular cases. The hybrid nature of the PE concept is also evident in the non-discrimination article of tax treaties (specifically, Article 24(3)), which requires that the tax imposed in the PE state is levied "not less favourably" than the tax that would be levied on a resident enterprise. Implicit in this provision is the view that a PE is similar enough to a resident enterprise that it should generally be treated in the same way for tax purposes. This stands in contrast to the other paragraphs of Article 24, which prevent discrimination against nationals of the contracting states but which do not, in a general sense, prevent non-residents from being taxed less favourably than residents. In addition, the income attributable to a PE must generally be taxed on a net basis, in the same way as a resident taxpayer, rather than the gross basis upon which source-based taxation is often imposed. This is reflected in the wording of the treaty limitation on source based taxation for PEs (i.e., "profit attributable to the PE") under Article 7 as opposed to the limitations based on gross income that apply in the case of dividends (Article 10) and interest (Article 11) (and often also royalties (Article 12)). Additional support for the view that the PE is in effect a quasi-residence concept comes from the separate enterprise approach to determining the profit attributable to PEs, under which the PE must be hypothesised as a "distinct and separate enterprise." The recent work of the OECD, reflected in the new "Authorized OECD Approach" (or AOA) for the attribution of profit to PEs, has

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662 Vogel, K., "State of Residence'…"
663 Arnold, B.J., "Threshold Requirements…" at p. 473.
664 Vogel, K., "State of Residence'…"
665 And to tax other income attributable to the PE on a net basis.
666 See Sections 5.2.3. and 5.2.4. These reasons are outlined in the text in this section (i.e., Section 6.2.2.).
667 Vann, R., "Reflections on Business…” at pp. 133-169. See also the discussion in Chapter 5.
668 See, in particular, Article 24(1) which prevents discrimination against nationals of the other contracting state.
669 In addition to Article 24(1), which prevents discrimination on the basis of nationality, Article 24(2) prevents discrimination against stateless persons, Article 24(4) prevents states from making disbursements non-deductible on the basis of being paid to residents of the other contracting state, and Article 24(5) prevents discrimination against enterprises owned by residents of the other contracting state.
670 OECD Model, Article 7.
further increased the personalization of PEs, at least for profit attribution purposes, e.g., in its explicit requirement to apply the OECD’s transfer pricing guidelines for profit attribution purposes.671

Thus, the PE concept is revealed as something of a hybrid between the source and residence concepts. 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 and, 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 triangular cases because PEs are treated partially, but only partially, in the same way as persons who are resident in the PE state for treaty purposes.

This leads to the conclusion that the problems arising in PE triangular cases could be dealt with by resolving the hybrid nature of the PE concept. One way in which this could be achieved is by treating the PE concept more like a residence concept. This would involve, broadly, requiring the PE state to grant relief for tax imposed in the source state and requiring the source state to apply the conditions of the PE-S treaty in relation to income attributable to the PE. To date, this has been the basis for the majority of suggestions for dealing with PE triangular cases,672 but it should be noted that this approach encompasses a wide variety of specific measures which could be implemented in different ways. These are discussed primarily in Chapter 7, Chapter 8 and Chapter 9. This approach is discussed only briefly below (see Section 6.3.).

Alternatively, the problems arising in PE triangular cases could be resolved by reducing the extent to which the PE concept is treated like a residence concept. This would involve, in particular, preventing the PE state from imposing tax on the worldwide income of the PE. This second option is closely related to resolving the overlap in the source rules (as discussed above) and will be discussed in Section 6.4., below.

6.2.3. Bilateral nature of tax treaties

With only a few exceptions,673 tax treaties are bilateral in nature; they are concluded between only two states and, in broad terms, the operation of one bilateral tax treaty cannot have an impact on the operation of another.674 The bilateral nature of tax treaties is frequently identified as the main cause of the issues arising in PE triangular cases.675 However, as will be discussed below, 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.

The 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. In addition, the residence state may potentially have a dual-relief obligation as a result of its obligations to grant relief under both the R-PE treaty and the R-S treaty (although, as I have argued in Chapter 3 (Section 3.3.), this should not be the case).

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671 The AOA and the increase in the personalisation of PEs under the AOA were discussed in detail in Chapter 5 (see Section 5.2.5.).
673 Notably, the Nordic Convention, the CARICOM Convention and the Andean Convention (all discussed in Section 6.5.1., below).
674 As discussed elsewhere (see Chapter 3, Section 3.3.3.), the results of the application of one bilateral tax treaty can have an impact on the application of another bilateral tax treaty where the first treaty has an impact on the facts to which the second treaty is being applied. See: Van Raad, K., “2008 OECD Model.....”
675 See, for example: OECD Committee on Fiscal Affairs, “Triangular Cases”, para 1.
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 means that the income arising in PE triangular cases has a dual source for treaty purposes, i.e., it is considered to be sourced in the PE state for the purposes of the R-PE treaty and is considered to be sourced in the source state for the purposes of the R-S treaty.676 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 in PE triangular cases there is no mechanism to resolve this overlap.

Thus, the issues arising in PE triangular cases can be considered to arise as a result of the lack of interaction between tax treaties. However, the introduction of some kind of general principle requiring tax treaties to interact with each other, for example, by requiring those applying tax treaties to take into consideration the results of the application of other tax treaties, would most likely raise more issues than it solved. Specific solutions are required for each particular issue, identifying exactly when and how the results of the application of other tax treaties should be taken into account (this will be seen particularly in Chapter 7, Chapter 8 and Chapter 9).

The issues arising in PE triangular cases could be dealt with by including specific provisions in tax treaties which indicate when and how the results of the application of other tax treaties should be taken into account and indeed, this is how the majority of the suggested solutions to PE triangular cases operate.677 More specifically, such solutions may operate either by resolving the overlap in the sourcing rules, i.e., by preventing either the source state or the PE state from imposing tax on the income,678 or by treating the PE more like a resident of the PE state.679 Alternatively, the issues arising in PE triangular cases could be resolved through the conclusion of a multilateral tax treaty between the states involved. However, as will be discussed below (in Section 6.5.), the drafters of any multilateral treaty should still consider exactly how PE triangular cases should be dealt with in order to come to an appropriate solution and specific provisions may be required. The existence of a multilateral treaty drafted along the lines of the OECD Model would not automatically resolve the issues arising in PE triangular cases.680

The discussion above has identified certain ways in which the issues arising in PE triangular cases could be resolved. The remainder of this chapter will go on to discuss these potential solutions in much greater detail.

6.3. Treat PEs more like resident persons for treaty purposes

The vast majority of the literature to date has suggested solutions to PE triangular cases which effectively result in the PE being treated more like a resident person for treaty purposes.681 Such solutions generally, in one way or another, require the PE state to grant relief for tax imposed in the source state and require the source state to apply the conditions of the PE-S treaty in relation to income attributable to the PE. It is usually also suggested that the source state should not be required to apply the conditions of the R-S treaty. Where authors differ, however, tends to be in relation to the best way to achieve this outcome and

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676 Vogel, K., "State of Residence…"
678 As discussed above and in Section 6.4., below.
679 i.e., by imposing a direct relief obligation on the PE state and requiring the source state to apply the conditions of the PE-S treaty in relation to income attributable to the PE. It is usually also suggested that the source state should not be required to apply the conditions of the R-S treaty. Where authors differ, however, tends to be in relation to the best way to achieve this outcome and
in the extent to which PEs should be treated in the same way as resident persons. Due to the wide variety of solutions encompassed by this approach and their complexity, this approach is considered to warrant a more extensive discussion than could be undertaken in this chapter. It will therefore be the subject of Chapter 7. Further issues and implications of this approach will be discussed in Chapter 8 and Chapter 9.

6.4. Treat PE concept as a source concept and resolve overlap in sourcing rules

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 applicable treaties. 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.

This would resolve the issues arising in PE triangular cases as follows:

1. Relief in the residence state: The residence state would no longer have a relief obligation in relation to the state which was prevented from imposing tax (i.e., the source state or the PE state). The residence state would only be required to provide relief for tax imposed on a source basis in a single state and, consequently, would generally be capable of fully relieving double taxation. There would also be no possibility of a dual-relief obligation arising.

2. There would be no need for relief to be provided in the PE state: Either the PE state would be prevented from imposing tax, and thus would not have any capacity to provide relief or, alternatively, the source state would be prevented from imposing tax and there would be no need for relief in the PE state.

3. There would be no need for the source state to apply the conditions of the PE-S treaty: If the PE state is prevented from imposing tax then taxing rights would not be transferred to the PE state under the R-PE treaty. There would therefore be no basis upon which to apply the conditions of the PE-S treaty. Alternatively, the source state would be prevented from imposing tax and, as a result, the application of the conditions of the PE-S treaty in the source state would have no relevance.

It is therefore possible to resolve the issues arising in PE triangular cases by resolving the overlap between the treaty sourcing rules. However, there are several important questions to be addressed with respect to this potential solution. They include the issue of which state should sacrifice its taxing rights, the extent to which this approach would open up opportunities for tax avoidance, and whether this solution is likely to be broadly acceptable to the states involved. This section will discuss these issues, first dealing with situations where the PE state is prevented from imposing tax and then with situations where the source state is prevented from imposing tax.

6.4.1. Preventing taxation in the PE state

This approach, whereby the PE state is prevented 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

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682 In many situations involving passive income, such as dividends and interest, source-based taxation may be imposed by way of a final withholding tax on the gross amount of the income and the limits on source state taxation of such income in tax treaties are also generally based on the rate of tax that can be imposed on gross income. When expenses are taken into account, this can result in a very high effective tax rate and it is this effective tax rate that is relevant for determining whether there is any unrelieved double taxation. In addition, if one of the states (e.g., the residence state) imposes tax using a progressive rate scale, a reference to the tax rate should also be read as a reference to the effective tax rate on the net amount of the income, i.e., the average rate that applies to that income. It is also possible that the tax imposed in the source state will exceed the amount of net income in the residence state; in this case the residence state is clearly unable to prevent unrelieved double taxation (regardless of whether it is a bilateral or triangular situation). This type of unrelieved double taxation could only be prevented by sufficiently reducing (or perhaps eliminating) the tax imposed in the source state. Further discussion of this issue is beyond the scope of this thesis.
purposes of that treaty. This may involve the income being excluded from the income attributable to the PE, in which case the PE state would not be entitled to impose tax and the residence state would not be required to grant relief. It resolves the overlap between the source rules of the R-S treaty (based on, e.g., the residence of the payor) and those of the R-PE treaty (based on the existence of the PE) in favour of the source state. This solution has a number of advantages, however as will be discussed below, it gives rise to significant tax avoidance concerns and may be unacceptable to states in the position of the PE state due to the extent of the restriction on the PE state’s taxing rights.

This solution could only be implemented by including a specific provision in the R-PE treaty. It could not be implemented in the domestic law of the PE state because even if the PE state does not impose tax on the income under domestic law, the residence state may be required to exempt the income under the relief provisions of the R-PE treaty as a result of it being attributable to the PE. It could also not be implemented by provisions included in the R-S treaty because the PE state is not party to the R-S treaty and that treaty therefore cannot impose any restriction on the taxing rights of the PE state. The PE-S treaty could potentially restrict the taxation of the income in the PE state, but in this case the residence state may still be required to exempt the income under the R-PE treaty (in the absence of a specific provision excluding relief) and, even if corresponding provisions were included in the R-PE treaty, this would be an unnecessarily complex way of implementing this solution. This would be further complicated by the fact that the income is not received by a resident of either of the contracting states. The best approach is therefore to include a specific provision in the R-PE treaty.

6.4.1.1. Operation of provision preventing taxation in the PE state

One of the key issues with designing a provision to implement this solution is determining which income the PE state would be prevented from taxing. The PE state should only be prevented from taxing income which the source state is entitled to tax in accordance with the terms of the R-S treaty, since it is only in relation to this income that unrelieved double taxation may potentially arise in PE triangular cases.

It would not be appropriate to simply prevent the PE state from taxing income which does not have its "source" in the PE state as defined under that state’s domestic law. Given that the income is not derived by a resident of the PE state, the PE state is presumably imposing tax because it considers the income to be locally sourced as a result of the business activities of the PE. Similarly, it would not be appropriate to prevent the PE state from taxing any income which a third state considers to be locally sourced given the potentially broad scope of domestic sourcing rules in third states. Clearly, the provision should refer to the distributive rules in tax treaties.

One option is for the R-PE treaty provision to specify the types of income which the PE state is prevented from taxing (i.e., without reference to the actual terms of the R-S treaty). These may include dividends, interest and royalties arising in a third state, income arising from immovable property situated in a third state, and certain capital gains (e.g., capital gains arising from the alienation of
immovable property located in a third state).\textsuperscript{686} The terms of such a provision should be based either on the distributive rules of the OECD Model convention, or, to the extent that the residence states treaty policy differs from the OECD Model, on the common distributive rules that exist in the residence state's treaties (which may require different provisions applicable for each of the contracting states since they may have different treaty policies). The main problem with this approach is that while it may resolve PE triangular cases in the majority of situations, it will not be effective where the R-S treaty allows the source state to impose tax in a situation which is not covered by the provision of the R-PE treaty preventing tax in the PE state.

The better option may be for the R-PE treaty to refer directly to the R-S treaty and to prevent the PE state from imposing tax on any income which the source state is entitled to tax in accordance with the terms of that treaty. Such a provision could be worded along the following lines:

"Where an enterprise of a Contracting State has a permanent establishment in the other Contracting state, and where the profit attributable to that permanent establishment includes income which is taxable in a third state under the conditions of an applicable tax treaty between the residence state of the enterprise and that third state, then that income shall be excluded from the profit attributable to the PE for the purposes of this Convention."

This approach has the advantage that the prevention of tax in the PE state is directly linked to the source state’s taxing rights under its treaty with the residence state. States may be reluctant to take this approach, however, because it means that the extent of the PE state’s taxing rights depends on the particular terms of the treaty concluded between the residence state and the source state, over which the PE state has no control. Nevertheless, this should still be the preferred approach. One way of making it more acceptable to the states involved may be to limit its application to passive income (i.e., dividends, interest and royalties), which would make the scope and effect of the provision in the PE state more certain. These categories of income also generally present the greatest concern in PE triangular cases. A provision incorporating this limitation could be worded along the following lines:

"Where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, and where the profit attributable to that permanent establishment includes income which is taxable in a third state under an article applicable to dividends, interest or royalties of an applicable tax treaty between the residence state of the enterprise and that third state, then that income shall be excluded from the profit attributable to the PE for the purposes of this Convention."

This provision would also not prevent the PE state from imposing tax in situations where there is no treaty between the residence state and the source state, although this could be dealt at the option of the contracting states.

\textbf{6.4.1.2. Assessment of this potential solution}

Preventing the PE state from imposing tax on income which is sourced in a third state (i.e., under the R-S treaty) has a number of advantages. One of the main advantages 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 no need to be concerned about an incomplete implementation, i.e., where one of the relevant treaties does not include the required provisions. This solution also has the advantage that it avoids extending treaty benefits to PEs, with all the complications that that may entail (as will be discussed in Chapter 7, Chapter 8 and Chapter 9).

Another advantage of this approach is that it would remove the potential for what may be considered improper use of the R-S treaty in PE triangular situations, i.e., in situations where the income is exempt in the residence state (as a result of being attributable to a PE) and is not taxed or is only minimally taxed in specific treaty definition could be formulated for this purpose or the definition could rely on the meaning of immovable property in the domestic law of, e.g., the PE state.

\textsuperscript{686} The PE state should be prevented from imposing tax on gains which may be taxed in the source state under the distributive rules of the OECD Model. Refer to Chapter 2 for a discussion of these distributive rules.
the PE state. This would no longer be a concern if the PE state is prevented from taxing the income, on the basis that the income is not attributable to the PE, because the residence state would never be required to exempt the income under the R-PE treaty. This concern regarding the improper use of the R-S treaty can also be addressed by specific provisions included in the R-S treaty, but preventing the income from being attributable to the PE may be a simpler approach.

Despite these advantages, preventing taxation in the PE state presents significant tax avoidance concerns because, if implemented, it would undermine the residence-supporting role of the PE concept in tax treaties. On one hand, this may not be seen as a significant issue since the PE state is only being prevented from imposing tax on income which is, admittedly, sourced in a third country. It is certainly less problematic than eliminating the taxation of PEs in full because income sourced in the PE state would continue to be taxable in the PE state in the same way as it would have been if the company had remained resident in that state. However, it may ultimately result in states being effectively unable to impose residence based taxation, particularly in relation to passive income. 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), these companies would have a strong incentive to shift their residence to states with lower tax rates or to states which exempt the income attributable to foreign PEs. In this way, companies could lower the rate of residence-based taxation imposed on income derived from sources in third states (potentially to zero) while continuing to conduct their activities in what is now the PE state. This of course relies on the new residence state having a good treaty network, such that treaty benefits continue to be available in the source state. This may tend to limit the opportunities for relocation, but in general it should not be too difficult to identify a state which has a strong treaty network and which exempts the profit attributable to foreign PEs (either under domestic law or tax treaties). The potential for tax avoidance is illustrated in the following example involving royalties.

**Example**

Suppose a pharmaceutical enterprise ("NewPharm") is developing a new drug. The company is resident in State A and all the enterprise’s drug development operations are located in State A; i.e., all the decisions regarding whether to commence particular research, the direction of the research, and whether to continue the research are made in State A and the research itself is also conducted in State A. This research leads to the development of a drug ("MiracleCure") which cures a major illness affecting people worldwide. The enterprise patents the drug in various jurisdictions (including "State S") and intends to profit by granting enterprises in various countries licenses to manufacture and distribute MiracleCure. NewPharm expects to receive $100 million of royalties from a licensee in State S. State S imposes a withholding tax of 10% on royalties under its domestic law, however under the terms of the A-S treaty, State S is prevented from imposing any tax on the royalties. The general company tax rate in State A is 30% and, since State S is prevented from imposing tax on royalties, State A is not obliged to grant any relief under the A-S treaty.

State A has entered into a treaty with State B (the A-B treaty) containing a business profits article (Article 7) which follows the OECD Model, except that it provides that the PE state may not impose tax on any of the income attributable to the PE which arises in third states (i.e., it prevents taxation in the PE state in PE triangular cases). To take advantage of this provision, NewPharm transfers its residence to State B by transferring its place of effective management to that state. NewPharm is incorporated in State A and therefore becomes a dual resident, however, under the tie-breaker provision of the A-B treaty the company is treated as a resident in State B for the purposes of that treaty. Day-to-day licensing decisions continue to be made in State A and management of the licensing arrangements continues to be conducted

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687 This will be discussed in Chapter 8 (see Section 8.4.).
688 As outlined by: Vann, R., “Reflections on Business…” at p. 147.
689 As described by Vann (Vann, R., “Reflections on Business…” at p. 147.)
690 The following analysis is similar to that conducted by Vann in relation to the potential consequences of the non-taxation of PEs. See: Vann, R., “Reflections on Business…”.
in State A. For the purposes of the A-B treaty, the patents are economically owned by a PE in State A\(^691\) and, as a result, the royalties generated by the company are attributable to the PE in State A. State B uses the exemption method with respect to the profit attributable to the PE and therefore exempts the royalties which are derived from State S and which are attributable to the PE in State A. The general company tax rate in State B is 30%.

State B has a comprehensive treaty network. Under the treaty between State B and State S (the B-S treaty), State S may impose tax on royalties arising in State S and paid to a resident of State B, but the tax is limited to 5% of the gross amount of the royalties. After the transfer of its residence to State B, it is assumed that NewPharm is no longer resident in State A for the purposes of the A-S treaty.\(^692\) State S therefore applies the B-S treaty rate and imposes tax of $5 million on the royalties.

This situation is illustrated in the following diagrams; the first diagram illustrates the situation if NewPharm remains resident in State A, while the second diagram illustrates the situation if NewPharm transfers its residence to State B. The outcome in these two situations is outlined in the table below.

\(^691\) The OECD Report on the Attribution of Profits to PEs states that: "The significant people functions relevant to the determination of economic ownership of internally created intangibles are those which require active decision making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property." (OECD, "2010 Report on the Attribution of Profits to Permanent Establishments," Part I, Section D-2(iii), para 85. Thus, in this scenario the patents should be economically owned by the PE and the royalty income should be attributable to the PE.

\(^692\) The second sentence of Article 4(1) provides that a person will not be resident in a particular state if they are "liable to tax in that State in respect only of sources in that State." The OECD Commentary (2010 OECD Commentary on Article 4, para 8.2) takes the position that a dual resident would not be resident in the losing residence state (in this case, State A) for the purposes of treaties with third states (i.e., State S) under this provision as a result of the restrictions imposed on the losing residence state’s taxing rights under the treaty between the two residence states. This position will be assessed in detail in Chapter 10.
In this simplified scenario, the company has reduced its overall tax liability from $30m to $5m, despite the B-S treaty conditions being less favourable than the A-S treaty conditions. This occurs as a result of State A being prevented from imposing tax on the income, despite the substantial activities conducted in State A and the substantial link between those activities and the income earned by the company. Thus, the company has effectively avoided being subject to any residence-based taxation simply by transferring its residence State B, without any major change in the nature or location of its operations and while continuing to have a substantial economic presence in State A.

It would be extremely difficult to develop an anti-avoidance rule to address this type of structure and to distinguish between situations where the PE state should and should not be entitled to impose tax. This difficulty basically lies in the fact that in all cases where the income is included in the profits attributable to the PE, it will have a strong economic link to the PE state. It is also not unusual for states to use the exemption method for income attributable to a PE. Thus, it would be difficult to identify the features which, if present, should lead to a structure being considered abusive. One approach may be to allow the PE state to impose tax in situations where the residence state exempts the income, but in this case taxing rights continue to be transferred to the PE state under the R-PE treaty and the source state is again applying the “wrong” treaty; the issues are not resolved. Alternatively, the PE state could be entitled to impose tax if there is a tax avoidance motive, e.g., where a "primary purpose" of any person involved in a transaction is to avoid tax. In the above example, where there is a transfer of residence immediately after the development phase and prior to deriving income, this may not be too difficult to prove. But in most cases the application of this type of rule would face tremendous practical difficulties in distinguishing between legitimate situations and those that should be considered abusive.

The above example also illustrates another important problem with preventing taxation in the PE state, which is that the income has a legitimate economic connection to the PE state and thus, the PE state should arguably be entitled to impose tax on the income. Source-based taxation is generally justified on the basis of the benefit principle, i.e., on the basis that the person earning the income has derived a benefit from participating in the economic life of that state and that, as such, that state should be entitled to impose tax. Where the person deriving the income has a sufficient presence in the PE state to give rise to a PE, and where the income in question has a sufficient connection to the activities conducted in that state to be attributable to the PE, the person deriving the income has clearly participated in the "economic life" of the PE state and the PE state should therefore be entitled to impose tax. This is particularly clear in the example outlined above, where the vast majority of the company’s economic activities are conducted in State A. States which find themselves in the position of the PE state are unlikely to accept a complete restriction on their right to tax income arising in third states and may prefer

| WHT collected in State S | $0m | $0m |
| Tax collected in State A | $30m | $0m |
| Tax collected in State B | N/A | $0m |

693 State S is prevented from imposing tax under the A-S treaty.
694 The WHT is limited to 5% under the B-S treaty (5% x $100m = $5m).
695 State A imposes corporate tax on the royalties received at its domestic rate of 30%. It is assumed that State A uses the credit method, at least in relation to passive income, such that no relief is required in State A. Further, it is assumed that there are no carried-forward losses from the development phase available for deduction against the royalties; State A may not allow loss carry-forward, or the losses may already have been absorbed by royalty income from other countries where MiracleCure is licensed. It is also assumed that the company has no expenses, in order to simplify the example.
696 State A is prevented from imposing any tax on the income under the A-B treaty as a result of a provision which prevents PE states from imposing tax on income sourced in third states.
697 In this scenario, there is no link to State B and state B imposes no tax.
698 State B exempts the income attributable to the PE under the A-B treaty, and therefore imposes no tax on the income.
a solution that requires them simply to give relief for tax imposed in the source state, in which case the PE state may often be able to collect residual taxation, i.e., after the provision of credit relief; this is a feature of the solution discussed in Chapters 7, 8 and 9, whereby the PE is treated more like a resident of the PE state and is effectively entitled to treaty benefits.

Preventing taxation in the PE state would also contrast somewhat with the OECD Model's general approach for dealing with overlapping source rules within a single tax treaty, under which the PE concept generally overrides other sourcing rules. In a bilateral situation, for example, where a resident of one state receives dividends or interest arising in another state (the source state), those dividends and interest can generally only be taxed in the source state at a limited rate under Article 10 or Article 11 unless the recipient derives the income through a PE located in that state (i.e., they are attributable to a PE of the recipient in the source state), in which case the business profits article (Article 7) applies and there is no limitation on the rate of tax that can be imposed. This inconsistency also weighs against resolving the overlap in the treaty source rules in favour of the source state.

6.4.2. Preventing taxation in the source state

As an alternative to preventing the PE state from taxing income sourced outside the PE state, the source state could instead be prevented from taxing income which is attributable to a PE in a third state. This approach would effectively resolve the overlap in the sourcing rules in favour of the PE state.

The simplest way to achieve this outcome would be to include a provision in the R-S treaty to prevent the source state from imposing tax in PE triangular cases. This solution could also be implemented by a provision included in the domestic law of the source state, however the source state is unlikely to be willing to unilaterally give up its taxing rights in relation to any income which attributable to a PE outside the income recipient's residence state (and outside the source state). This is partly due to the lack of negotiating power which it would have to convince other states to implement reciprocal measures (either domestically or in tax treaties) but also, more importantly, due to the tax avoidance concerns discussed below. This solution could not be implemented by provisions included in either the R-PE treaty or the PE-S treaty; the R-PE treaty because it cannot impose any restriction on the source state, and the PE-S treaty because there is no treaty eligible resident of the PE state. The best approach would therefore be to include a specific provision in the R-S treaty.

6.4.2.1. Operation of provision preventing taxation in the source state

Taxation should only be prevented in the source state in situations where the income is attributable to a PE in the PE state for the purposes of the R-PE treaty, since it is only in these situations that the PE state will be entitled to impose tax, and the residence state obliged to grant relief, under the terms of the R-PE treaty. The best approach would be for the provision of the R-S treaty preventing the source state from imposing tax to refer directly to the treaty between the residence state and the PE state (i.e., the R-PE treaty). Without a specific reference to the R-PE treaty, the applicable PE definition for the purposes of the provision would be that contained in the R-S treaty. This would clearly be inappropriate because it could lead to situations where the source state is prevented from imposing tax on income which is not attributable to a PE for the purposes of the R-PE treaty. Conversely, the source state may continue to impose tax on income which is attributable to a PE in the PE state for the purposes of the R-PE treaty, in which case the issues arising as a result of the triangular situation would not be resolved.

A provision preventing taxation in the source state in PE triangular cases could be worded along the following lines:

"Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment of that enterprise in a third state for the purposes of the treaty between that Contracting State and the third state, then that income shall not be taxed in the other Contracting State."

700 This will be discussed further in Chapter 8 (see Section 8.2.3.).
6.4.2.2. Assessment of this potential solution

Similarly to preventing PE state taxation, this approach has the advantage of simplicity; it requires a provision to be included in only a single treaty, with no corresponding provisions in other treaties.\(^{701}\) It also avoids the potential difficulties associated with extending treaty benefits to PEs (which will be discussed in Chapter 7, Chapter 8 and Chapter 9).

This approach would, however, give rise to significant tax avoidance concerns. If 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). This lack of source-based taxation in PE triangular cases could ultimately result in states not being able to effectively impose any source-based taxation at all. This occurs because it would be relatively easy for companies to become resident in a jurisdiction other than the one in which they conduct their activities and derive all their income through PEs located in the state where they do conduct activities, i.e., as in the NewPharm example given above. This would result in source states being prevented from imposing any tax.

In addition, if source state taxation is prevented in PE triangular cases then, in certain circumstances, the income may escape taxation altogether, i.e., where the PE state does not impose tax and where the residence state exempts the income attributable to the PE (either under the R-PE tax treaty or under domestic law). This concern 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’s tax rate). A provision incorporating a subject to tax requirement could be worded along the following lines:

"Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment of that enterprise in a third state for the purposes of the treaty between that Contracting State and the third state, then that income shall not be taxed in the other Contracting State unless the profits of the permanent establishment are subject to an aggregate effective rate of tax in the first-mentioned Contracting State and the third state that is less than [X percent] of the effective rate of tax that would be applicable in the first-mentioned Contracting State if the income were not attributable to the permanent establishment."\(^{702}\)

Under this provision, the normal rules of the treaty would apply if the tax imposed in the PE state and the residence state is considered insufficient, i.e., by reference to the tax that would be imposed in the residence state if the income were not attributable to the PE. However, the effectiveness of this type of rule would be compromised by companies’ ability to become resident in the state with the lowest tax rate, with the result that the rule may be satisfied despite a relatively low tax burden in the PE state. There would also continue to be an incentive to derive income through PEs and thus escape source based taxation in situations where, for example, source-based taxation is imposed on a gross basis and there are significant expenses associated with the income such that the source-based taxation is effectively imposed at a very high rate. There would be similar incentives for enterprises that are tax exempt in their residence state, enterprises that have losses available for deduction,\(^{703}\) are tax exempt in their residence state, or (if the residence state uses the credit method) enterprises that have excess foreign tax credits which they are unable to use. Such enterprises would have a clear incentive to escape source-based taxation and the type of provision outlined above would not be particularly effective in such cases, since the tax that would be imposed in the residence state is likely to be minimal regardless of whether the income is attributable to a PE in another state.

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\(^{701}\) Unlike the solutions discussed in Chapter 7 (i.e., the extension of treaty benefits to PEs), which generally require provisions to be included in more than one treaty for their operation.

\(^{702}\) This wording is based in part on the wording of provisions included in many US treaties to prevent the application of the R-S treaty in certain triangular situations. Such provisions will be discussed in detail in Chapter 7 (see Section 7.5.1.1.).

\(^{703}\) Either in the current year, or in prior years where such losses can be carried forward for use in the current year.
This type of subject-to-tax provision would also not address the broader concern that even if the income is ultimately subject to the same amount of tax, none of that tax can be imposed in the source state. This would be a significant concern for capital importing states which would more often find themselves in the position of the source state. Aside from tax avoidance concerns, therefore, the main problem with this approach (aside from tax avoidance concerns) is that the income has a legitimate economic connection to the source state and that the source state should therefore be entitled to impose tax (i.e., in accordance with the benefit principle). This is especially true in relation to income from immovable property located in the source state, where the source state arguably has a much stronger taxing claim than the PE state. Thus, even if tax avoidance concerns can be addressed, the source state is unlikely to be willing to completely give up source-based taxing rights in relation to any income which is attributable to a PE in a third state.

Giving up all source-based taxing rights would likely result in the source state collecting less tax in relation to the income than it would be entitled to collect under the normal provisions of either the R-S treaty or the PE-S treaty, at least with respect to certain categories of income. This solution therefore results in the source state having significantly less taxing rights than it would have if it continued to apply the R-S treaty or, alternatively, if it applied the conditions of the PE-S treaty in relation to the income attributable to the PE (as will be discussed in Chapter 7).

6.4.3. Conclusions

This section has discussed potential solutions to the issues arising in PE triangular cases whereby the overlap in the tax treaty sourcing rules would be resolved and either the PE state or the source state would be prevented from imposing tax on income arising in PE triangular cases. The main advantage of these solutions is their relative simplicity; they would not require significant interaction between various measures included in multiple tax treaties and would not involve replacing the existing network of bilateral tax treaties with a multilateral treaty. However, due to the significant tax avoidance concerns which they present, neither of these approaches is a viable solution. If source states were prevented from imposing tax on income attributable to PEs in third states, it is likely that there would be a dramatic shift to deriving income through PEs and that, as a result, states may be unable to effectively impose source-based taxation (except where there is a PE). If states were prevented from imposing tax on income attributable to local PEs but arising in third states, companies would have a strong incentive to shift their residence to lower-taxing states and instead operate through PEs, which would allow them to reduce their (residence-based) tax burden without significantly changing the location of their operations. This would undermine the residence-supporting role of the PE concept in tax treaties. In addition, both the PE state and the source state arguably have a valid taxing claim in relation to income arising in PE triangular cases and it is expected that they would be unwilling to give up their taxing rights. Resolving the overlap in the source rules is therefore not considered an appropriate solution for the issues arising in PE triangular cases.

6.5. Multilateral treaties

This section discusses how PE triangular cases could be dealt with in a multilateral treaty context. It focuses on situations where the source state, the PE state and the residence state are all party to a single multilateral treaty. Where there is a multilateral treaty in place between the three states involved in a PE triangular case, there is no need to change the treaty conditions which are applicable in the source state in relation to income attributable to the PE, e.g., the maximum withholding tax rates applicable to passive income. This is because in the context of a multilateral treaty the same conditions will generally apply with respect to income derived by residents of any of the states that are party to the treaty; the treaty conditions which the source state applies in relation to income derived by residents of the PE state will therefore be the same as those which it applies in relation to income derived by residents of State R. The main issue which must be dealt with in a multilateral treaty context is therefore the prevention of unrelieved double taxation.

704 This is because if only two of the three states are party to the multilateral treaty, then the multilateral treaty will effectively operate as a bilateral treaty between those two states.
6.5.1. Existing multilateral treaties

This section discusses the application of existing multilateral treaties\(^{705}\) in PE triangular cases. It also briefly discusses the application of the EU Parent-Subsidiary Directive,\(^{706}\) which, although it is not a multilateral treaty, does contain provisions which could potentially be adapted for inclusion in a multilateral treaty.

As mentioned above, it is assumed for the purposes of the discussion in this section that all three of the states involved in the triangular situation are party to the multilateral treaty (or, in relation to the Parent-Subsidiary Directive, are EU Member States).

6.5.1.1. The Nordic Convention

The most well-known multilateral tax treaty is the Nordic Convention,\(^{707}\) concluded between Denmark, the Faroe Islands, Finland, Iceland, Norway, and Sweden. It is based on the OECD Model, but with certain variations necessitated by the multilateral nature of the treaty\(^{708}\) and with a number of additional provisions for dealing with special circumstances that exist between particular contracting states.\(^{709}\) This section will discuss the application of the Nordic Convention in PE triangular cases involving various categories of income.\(^{710}\)

Interest and royalties

The Nordic Convention does not allow any source-based taxation of interest and royalties.\(^{711}\) Where interest or royalties arising in one contracting state are paid to a resident of another contracting state, tax

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\(^{705}\) This section discusses the Nordic Convention, the CARICOM Convention and the Andean Convention. The East African Community Income Tax Agreement (the EAC Agreement) is a multilateral treaty between Kenya, Tanzania, and Uganda, which was concluded in 1997 but which has never entered into force. If it were in force, it would apply in triangular cases in the same way as a series of bilateral conventions, with taxation potentially being allowed in the source state, the PE state and the residence state. Unlike in the CARICOM Convention (discussed below), the business profits article of the EAC treaty (Article 7) continues to apply to income which is dealt with in another article of the treaty, thus allowing the PE state to impose tax on the income. In addition, the articles dealing with dividends, interest and royalties provide that the source state and the residence state "may" tax the income; they are not restrictive, and thus do not prevent other states from imposing tax. This is also the case with respect to certain other categories of income. By contrast, for some categories of income exclusive taxing rights are allocated to one of the contracting states (e.g., income from shipping and air transport (Article 8)), in which case all the other states will be prevented from imposing tax, and there will be no double taxation. News articles in late 2010 suggested that negotiations were commencing for a new multilateral tax treaty between the EAC member states (which now include Kenya, Tanzania, Uganda, Rwanda and Burundi).


\(^{707}\) The full title of the treaty is: "Convention Between the Nordic Countries for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital." The discussion in this section is based on an unofficial translation from IBFD's tax treaty database. The most recent version of the treaty was concluded in 1996, and was amended by protocols in 1997 and 2008.

\(^{708}\) The only additional article which was considered to be necessary to include in the treaty due to its multilateral nature is Article 26, which provides that no state may tax income derived by a resident of another contracting state unless taxation is specifically allowed under the convention (see: Hengsle, O., "The Nordic Multilateral Treaties – for the Avoidance of Double Taxation and on Mutual Assistance," 56 Bulletin for International Fiscal Documentation 8/9, (2002), pp. 371-376.)

\(^{709}\) To avoid making the treaty articles too complicated, the special provisions dealing with specific circumstances are included in a protocol to the treaty (see: Hengsle, O., "The Nordic Multilateral...").

\(^{710}\) Note that this analysis ignores provisions which are specific to particular states; it considers only the general provisions of the treaty.

\(^{711}\) Nordic Convention, Article 11 (dealing with interest) and Article 12 (dealing with royalties).
may only be imposed in the residence state. The only exception to this is in situations where the income is attributable to a PE in one of the contracting states, in which case the business profits article applies and the PE state is entitled to impose tax on the income. In PE triangular cases involving interest and royalties, therefore, the source state is prevented from imposing tax under either Article 11 or Article 12, as applicable, and the PE state is entitled to impose tax on the income in accordance with the business profits article (Article 7). The residence state may also impose tax, but will be obliged to provide relief for tax imposed in the PE state (in accordance with Article 25). There will therefore be no unrelieved double taxation.

Dividends

The dividends article (Article 10) of the Nordic Convention, unlike the interest and royalties articles, allows source-based taxation in the absence of a PE. It provides that dividends paid by a resident of one contracting state to a resident of another contracting state may be taxed in the residence state and in the source state, but the tax imposed in the source state must not exceed 15% of the gross amount of the dividends. The dividend article also contains a provision dealing with dividends attributable to a PE (Article 10(2)), which reads as follows:

"If the beneficial owner of the dividends, being a resident of a Contracting State, has a permanent establishment or a fixed base in a Contracting State other than the State of which he is a resident, and the holding by virtue of which the dividends are paid is effectively connected with a business carried on through that permanent establishment, or with independent services carried on through that fixed base, as the case may be, dividends paid by a company which is a resident of a Contracting State to such beneficial owner may, notwithstanding the provisions of paragraphs 1 and 3 [dealing with taxation in the residence state and the source state, respectively], be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State in which the permanent establishment or fixed base is situated."

This provision allows the PE state to impose tax on dividends attributable to the PE in accordance with the business profits article (Article 7). This provision does not, however, prevent the source state from continuing to impose tax on the dividends in accordance with Article 10. This is because it does not provide that Article 7 applies to the dividends (i.e., instead of Article 10), but simply that the PE state may impose tax in accordance with Article 7. In addition, nothing in its wording ("notwithstanding the provisions of paragraphs 1 and 3") prevents the other paragraphs of Article 10 from applying in relation to dividends which are attributable to a PE. As a result, the PE state will be entitled to impose tax in accordance with Article 7 and the source state will be entitled to impose tax in accordance with Article 10. This result is effectively the same as that which arises under a series of bilateral tax treaties based on the OECD Model. Unless the PE state provides relief, either under domestic law or in accordance with non-discrimination principles, unrelieved double taxation may persist. There is, however, no question as to whether the source state is applying the appropriate treaty limitations since the limitation on the rate of source-based taxation (i.e., 15%) applies equally to residents of all the states which are party to the convention.

713 Nordic Convention, Article 11(2) and Article 12(2). Unlike the current OECD Model, the Nordic Convention also contains a separate article dealing with independent personal services carried on through a fixed base (Article 14); where interest or royalties are effectively connected with such services, Article 14 will apply instead of Article 11 or Article 12 (Nordic Convention, Article 11(2) and Article 12(2)).
714 Nordic Convention, Article 10(1).
715 Nordic Convention, Article 10(3).
716 Unofficial translation from IBFD’s tax treaty database.
717 Contra: Helminen, M., "Dividends, Interest and….”
718 Contra: Helminen, M., "Dividends, Interest and….”

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Income from immovable property

In a bilateral treaty context, the definition of immovable property only applies where the property is located in one of the contracting states. As a result, the treaty article relating to income from immovable property (Article 6) does not apply if the property is located in a third state. In PE triangular cases therefore, income arising from property located in the source state is not considered to be income from immovable property for the purposes of the R-PE treaty and Article 6 of that treaty does not apply. This issue does not arise where all three states are party to the Nordic Convention because the definition of immovable property is applicable regardless of which state is applying the convention.\(^{719}\)

Article 6(1) of the Nordic Convention provides that: "Income derived by a resident of a Contracting State from immovable property... situated in another Contracting State may be taxed in that other State."\(^{720}\) Therefore, the source state in a PE triangular case involving income from immovable property will be entitled to impose tax on the income in accordance with Article 6.

From the perspective of the PE state, the applicable article of the treaty is also Article 6 (unlike in a bilateral situation). This is because income is derived by a resident of one of the contracting states (i.e., the residence state) from immovable property (as defined) situated in another contracting state (i.e., the source state). This is reinforced by Article 6(4), which provides that paragraphs 1 and 2 of Article 6 also apply to the income from immovable property of an enterprise, and by Article 7(7), which provides that where the profit attributable to a PE includes items of income dealt with separately in other articles of the convention, then the provisions of those articles shall not be affected by the provisions of Article 7.

Article 6 does not deal with how the PE state should treat the income; it neither authorises nor forbids taxation of the income in the PE state. However, the Nordic Convention contains a specific provision, Article 26(1), which prevents taxation from being imposed in a contracting state other than the residence state unless such taxation is specifically authorised by the terms of the convention. Since Article 6 does not authorise the PE state to impose tax, the PE state is prevented from taxing the income.

In a PE triangular case where all three states involved are party to the Nordic Convention, income arising from immovable property located in one of the contracting states may therefore only be taxed in the state where the property is located (the source state) and the in residence state, even if the income is attributable to a PE in a third state. In addition, the residence state will be obliged to grant relief for tax imposed in the source state in accordance with Article 25. There will therefore be no unrelieved double taxation.

Income from shipping and air transport

Under the Nordic Convention, income from shipping and air transport is only taxable in the residence state of the person deriving the income (Article 8). In PE triangular cases, therefore, there will be no tax imposed in either the PE state or the source state and there will be no unrelieved double taxation.

Capital gains

The distribution of taxing rights in relation to capital gains under Article 13 of the Nordic Convention, as under bilateral treaties, depends upon the type of property from which the gain arises.

Where capital gains arise from the alienation of immovable property, Article 13(1) of the Nordic Convention allows tax to be imposed in the state where the property is located. Unlike in a bilateral case, where the gain would not be considered to arise from the alienation of immovable property for the purposes of the R-PE treaty, Article 13(1) will be the relevant article of the Nordic Convention regardless

\(^{719}\) The definition of immovable property is contained in Article 3(1)(f), which reads as follows: "The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated; the term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources."

\(^{720}\) Unofficial translation from IBFD’s tax treaty database.
of whether it is being applied by the source state, the PE state or the residence state. Article 13(1) allows the source state to impose tax on the income. The PE state is not authorised to impose tax on the income under Article 13(1) and will therefore be prevented from imposing tax under Article 26(1).

Under the Nordic Convention, gains derived from the alienation of shares in a company where the principal object of the company is to hold immovable property and where more than 75% of its net assets consists of immovable property may be taxed in the state where the property is located (Article 13(2)). In a PE triangular case, this article should apply when both the source state and the PE state apply the treaty. This will allow the source state (i.e., the state where the underlying property is located) to impose tax on the gain, but the PE state, since it is not specifically authorised to impose tax, will be prevented from imposing tax under Article 26(1).

Gains from the alienation of movable property forming part of the business property of a PE can be taxed in the state where the PE is located (Article 13(3)). This paragraph should arguably not apply, however, in relation to property which is covered by another paragraph of Article 13, on the basis that those paragraphs are more specific. Where Article 13(3) does apply, the gain will be taxable in the PE state and the residence state but the source state will be prevented from imposing tax under Article 26(1).

Gains from the alienation of ships or aircraft operated in international traffic (and related assets) may be taxed only in the state of residence of the enterprise. Thus, in a PE triangular case involving such gains, neither the PE state nor the source state will be entitled to impose tax on the gain (under Article 13(4)). Similarly, gains from the alienation of any property not mentioned in the other paragraphs of Article 13 may only be taxed in the residence state (Article 13(6)), and thus, neither the source state nor the PE state will be entitled to impose any tax on the gain.

Other income

Under the Nordic Convention, income not covered by any of the other articles of the convention ("other income") is taxable only in the state where the person deriving the income is resident (Article 22). However, where the income is attributable to a PE in one of the contracting states, then Article 7 applies instead of Article 22, and the profit attributable to the PE may be taxed in the PE state. The outcome in a PE triangular case involving such income is therefore the same as in a bilateral situation; i.e., tax may be imposed in the PE state and in the residence state, and the residence state must provide relief. No tax may be imposed in the source state.

Overview

In situations involving interest, royalties, and income from immovable property the application of the Nordic Convention would resolve the issues which may arise from the application of bilateral tax treaties in PE triangular cases. In the case of interest and royalties, this is because the Nordic Convention prevents source based taxation in the absence of a PE. In the case of income from immovable property, the issue is resolved because a single definition of immovable property applies in relation to all the states applying the treaty; thus the income is also considered to be income from immovable property from the perspective of the PE state and the PE state is prevented from imposing tax on the income. The taxation of capital gains in PE triangular cases also benefits from the consistency in definitions and the consistent application of treaty provisions under the Nordic Convention. In the case of dividends, however, the Nordic Convention allows tax to be imposed in both the source state and the PE state (as well as the residence state) and thus may not prevent unrelieved double taxation. The extent to which unrelieved

721 This rule applies to movable property pertaining to the operation of ships or aircraft operated in international traffic. The Nordic Convention also contains a specific paragraph (Article 13(3)) dealing with the alienation of containers used for the transport of goods or merchandise; gains from the alienation of such assets may only be taxed in the residence state.

722 In addition to the paragraphs mentioned above, Article 13 of the Nordic Convention also contains a paragraph dealing with, broadly, gains derived by an individual who has become a resident of another Contracting State in relation to shares in a company which is resident in the individual's former residence state (Article 13(7)).

723 Nordic Convention, Article 22(2).
double taxation occurs depends upon the extent to which the PE state provides relief for tax imposed in the source state (i.e., under domestic law or in accordance with the non-discrimination article of the treaty724), as is the case in bilateral treaties. There is, however, no issue regarding the applicable conditions to apply in the source state since the source state will apply the same treaty conditions in relation to income derived by residents of the PE state and residents of the residence state.

6.5.1.2. The CARICOM Convention

There is also a multilateral treaty, known as the CARICOM Convention,725 in place between the member states of the Caribbean Community.726 The CARICOM Convention is quite unusual, in that it generally allocates exclusive taxing rights to the state of source, and does not allow any residual residence-based taxation.727 As a result, any income arising in triangular cases where all the states involved are party to the CARICOM Convention can generally only be taxed in one state.

The interest article of the CARICOM Convention, for example, provides that: "Interest arising in a Member State and paid to a resident of another Member State shall be taxed only by the first-mentioned State."728 It goes on to limit the rate of tax that may be imposed to 15% of the gross amount of the interest.729 The source state in a PE triangular case involving interest would therefore be entitled to impose tax on the interest at a maximum rate of 15%. From the perspective of the PE state interest paid by a resident of one Member State to a resident of another Member State will be dealt with under the distributive rules applicable to interest (Article 12) even though the PE state is not one of those two states, for the following reasons:

1. For the purposes of the CARICOM Convention the term "Member State" includes all the states that are party to the treaty.730 This stands in contrast to the operation of bilateral treaties containing similar wording; in a bilateral context the interest article of the R-PE treaty would not apply because the interest is not paid by a resident of one contracting state to a resident of the other contracting state.

2. In the CARICOM Convention, there is no exception to Article 12 for interest which is attributable to a PE of the recipient in the source state, i.e., Article 12 continues to apply and the business profits article (Article 8) does not apply. This is in contrast to terms of the OECD Model, which provide that interest attributable to a PE in the source state falls under Article 7.731

3. For the purposes of the business profits article (Article 8) of the CARICOM Convention, the income is "dealt with" in another article of the treaty, i.e., Article 12, regardless of which Member State the payor of the interest is resident in.732 This means that Article 8, which would otherwise allow the PE state to impose tax, does not apply and the PE state will be prevented from imposing any tax on the income. Again, this would not be the case in a bilateral treaty context.

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724 Article 27(2) of the Nordic Convention, equivalent to Article 24(3) of the OECD Model
725 The full title of the treaty is: "Agreement Among the Member States of the Caribbean Community for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment." The treaty was concluded in 1994.
726 Namely, Antigua and Barbuda, Jamaica, Bahamas, Montserrat, Barbados, St. Kitts and Nevis, Belize, Saint Lucia, Dominica, St. Vincent and the Grenadines, Grenada, Suriname, Guyana, and Trinidad and Tobago.
727 Article 5 states: "Irrespective of the nationality or State of residence of a person, income of whatever name accruing to or derived by such person shall be taxable only by the Member State in which the income arises, except for the cases specified in this Agreement." For discussion, see: Bierlaagh, H.M.M., "The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation?" 54 Bulletin for International Fiscal Documentation 3, (2000), pp. 99-110.
728 Article 12(1) of the CARICOM Convention.
729 Article 12(2) of the CARICOM Convention.
730 Article 3(1)(e) and Schedule II of the CARICOM Convention.
731 OECD Model, Article 11(4)
732 Article 8 of the CARICOM Convention provides that: "Where business profits includes items of income which are dealt with separately in other Articles of this Agreement, the provisions of those Articles shall, except as otherwise provided therein, supersede the provisions of this Article."
Under the CARICOM Convention, the PE state must therefore apply the interest article of the treaty and, as a result, the PE state is prevented from imposing tax, i.e., because the interest article states that tax may be imposed only in the source state. The residence state is also prevented from imposing tax on the income as a result of the interest article of the treaty. Similar rules apply in relation to dividends and royalties.733

A similar outcome (i.e., taxation only in the source state) also arises in relation to income from immovable property (which can only be taxed in the state where the property is located),734 capital gains (except those arising from the alienation of ships or aircraft),735 and management fees,736 as well as various other types of income.737 Income from shipping and air transport may only be taxed in the residence state of the person deriving the income,738 as can capital gains derived from the alienation of ships and aircraft in international traffic.739 Any income which is not covered by a specific provision will be taxable only in the state in which it arises.740

In essence, the CARICOM Convention resolves PE triangular cases by preventing the PE state (and generally also the residence state741) from imposing tax on income which, despite being business profits, is dealt with under another article of the treaty. As a result, income arising in PE triangular cases can only be taxed in one state (generally the source state) and there can be no unrelieved double taxation. This approach is unlikely to be adopted more widely, however, even in multilateral treaties, because states are unlikely to be willing to sacrifice their legitimate taxing rights to such an extent. In addition, this approach would involve drastic changes to the distribution of taxing rights under existing treaties, i.e., in purely bilateral situations, which would not be warranted simply for dealing with PE triangular cases. It may also present opportunities for tax avoidance, in that residents of a particular contracting state would be able to avoid tax by shifting their income to other contracting states which impose less or no tax on the income.742

6.5.1.3. The Andean Convention

The Andean Convention,743 concluded between Bolivia, Colombia, Ecuador and Peru, is similar to the CARICOM Convention in that it allocates exclusive taxing rights to the source state. Article 3 provides

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733 See Article 10 and Article 13 of the CARICOM Convention. Under Article 10, dividends can be taxed only in the state of residence of the payor and, under Article 13, royalties can be taxed in the state where the intangible property giving rise to the royalties is used.
734 Article 6 of the CARICOM Convention provides that: "Income from immovable property shall be taxable only in the Member State in which such property is situated."
735 See Article 7 of the CARICOM Convention. Article 7(1) provides that gains arising from the alienation of real property located in one of the member states shall be taxable only in that state. Article 7(2) defines real property to include shares in a company (or interests in a partnership, trust or estate), the assets of which consist wholly or principally of immovable property. In addition, capital gains arising from other property may only be taxed in the Member State in which the gains arise (Article 7(4)). Article 7(3) deals with gains from the alienation of ships or aircraft operated in international traffic.
736 Article 14 of the CARICOM Convention.
737 e.g., salaries and wages (Article 15 of the CARICOM Convention).
738 Article 9 of the CARICOM Convention.
739 Article 7(3) of the CARICOM Convention.
740 Article 5 of the CARICOM Convention states that: "Irrespective of the nationality or State of residence of a person, income of whatever name accruing to or derived by such person shall be taxable only by the Member State in which the income arises, except for the cases specified in this Agreement."
741 Except in the case of income from shipping and air transport, or capital gains derived from the alienation of shipping or air transport assets.
742 See: Bierlaagh, H.M.M., "The CARICOM..."
the general rule that income of any kind is taxable only in the member country where it’s "source of production" is located, except as otherwise provided in the treaty. The "source of production" is defined in general terms to be any activity, right or asset that generates or may generate income (Article 2). The other articles of the treaty effectively prescribe more specific source rules for particular categories of income, including:

- Income from immovable property (Article 4) – taxable in the member state where the property is located;
- Income from the right to exploit natural resources (Article 5) – taxable in the member state whose natural resources are being exploited;
- Business profits (Article 6) – taxable in the member state where the business activities were carried out (without the requirement for there to be a PE in that state);
- Income derived by transport enterprises (Article 7) – taxable in the member state where the person deriving the income is domiciled (this term is defined in Article 2 and is effectively a residence concept);
- Royalties (Article 8) – taxable in the member state where the intangible is used;
- Interest (Article 10) – taxable only in the member state where the payment is charged or recorded;
- Dividends and other income from shares (Article 11) – taxable only in the member state where the company making the distribution is domiciled (i.e., where it has its place of incorporation or place of effective management);
- Capital gains (Article 12) – taxable only in the member state where the property is located at the time of alienation, with exceptions for capital gains relating to transport assets (which are taxable in the member state where the owner is domiciled) and capital gains relating to bonds, shares and other securities (which are taxable only in the member state where they were issued);

Unlike the CARICOM Convention, the Andean Convention does not contain a specific rule for dealing with overlaps between the business profits article and the other articles of the convention. In PE triangular cases, this makes it difficult to determine which state would ultimately be entitled to impose tax under the treaty; the PE state on the basis of the business profits article, or the source state based on, e.g., the interest or dividends article of the treaty. This could result in two states imposing tax based on differing interpretations of the treaty. It may be that the articles dealing with specific types of income, such as dividends, interest, royalties, and immovable property take precedence over what may be considered the more general article dealing with business profits, however this is not entirely clear from the wording of the treaty. The treaty also contains no mutual agreement procedure and thus no specific mechanism to resolve inconsistencies in the way it is applied in different states.

In more general terms, assuming that the overlap between different treaty provisions can be resolved, the approach taken in the Andean Convention gives rise to the same issues as those arising with respect to the CARICOM Convention. That is, although allowing taxation in only one state (the state that is

South Asian Nations," 6 Asian Journal of Comparative Law 1, (2011), Article 8. The author is grateful for the assistance of Carlos Gutiérrez Puente from the IBFD with respect to the discussion in this section.

744 "Fuenta productora." The English equivalent used here is based on an unofficial translation of the treaty from IBFD’s tax treaty database.

745 Article 2, para. f, which reads as follows: "La expresión ‘fuente productora’ se refiere a la actividad, derecho o bien que genere o pueda generar una renta." The English version used here is based on an unofficial translation of the treaty from IBFD’s tax treaty database.

746 Jogarajan, S., "A Multilateral Tax Treaty…" at pp. 326-327. The business profits article of 2004 treaty is substantially the same as the corresponding article of the 1971 treaty.

748 Conversely, Atchabahian suggests that income from business activities dedicated to the exploitation of natural resources would be dealt with under the business profits article rather than the specific article applicable to income from natural resources, but does not suggest any specific reason for taking this approach and not deal with this issue when discussing other categories of income. See: Atchabahian, A., "The Andean Subregion…" at p. 326.
considered to be the source of the income) may prevent issues from arising in PE triangular cases, this
approach would drastically alter the distribution of taxing rights between different states and is unlikely to
be widely accepted. As mentioned above in relation to the CARICOM Convention, it also raises to tax
avoidance concerns.

6.5.1.4. The EU Parent-Subsidiary Directive

Although it is not a multilateral treaty, the EU Parent-Subsidiary Directive\(^{749}\) effectively applies
multilaterally (through its implementation in EU Member States) and contains certain provisions which
could be adapted to deal with in PE triangular cases in a multilateral treaty context. The aim of the
Parent-Subsidiary Directive is to remove any tax obstacles to distributing profits between parent and
subsidiary companies\(^ {750}\) resident in EU Member States.\(^ {751}\) These aims are achieved by exempting profit
distributions (e.g., dividends) from tax in the subsidiary’s residence state (i.e., the source state), and either
exempting the income or allowing an indirect credit (i.e., for taxes imposed on the underlying profit
which is being distributed) in the parent company’s residence state.\(^ {752}\) The Directive also applies in
situations where the profit distribution is attributable to a permanent establishment\(^ {753}\) of the parent
company which is located in a Member State other than the state where the subsidiary is resident and
requires the PE state to grant relief.\(^ {754}\) Thus, in a PE triangular situation where all three states are EU
Member States the outcome will, in principle, be as follows:

1. The source state (the member state where the subsidiary is resident) is prevented from imposing
any tax on the profit distribution;
2. The PE state is required to either exempt the income or grant an indirect tax credit (note that no
direct credit is required because no withholding tax is allowed); and
3. The residence state is required to either exempt the income or grant an indirect tax credit.

The overall result is that the will be no unrelieved double taxation and indeed, there is a good chance that
the profit distribution will not be taxed in any of the three states.\(^ {755}\) There is also no question of whether
the source state is applying the appropriate limitation, since the source state does not impose any tax
regardless of whether the dividend is paid directly to the parent company or whether it is attributable to a
PE in another Member State, and regardless of the state of residence (provided it is within the EU).

One interesting aspect of the EU Parent-Subsidiary Directive is the wording of the relief provision, which
could potentially be adapted for use in a multilateral treaty dealing with PE triangular cases. This
provision reads as follows:

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\(^{749}\) Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies
and subsidiaries of different Member States (23 July 1990). For discussion of the directive, see: Terra, B.J.M., &
Wattel, P.J., *European Tax Law* at pp. 475-515 (Chapter 9); and Helminen, M., *EU Tax Law...* at pp. 137-159
(Chapter 3, Section 3.1.).

\(^{750}\) The term "company of a Member State" is defined in Article 2(1) of the Directive. Broadly, a company must
meet all three of the following requirements to be within the scope of the directive: (i) It must take one of the forms
listed in the Annex to the Directive, (ii) it must be considered a resident of a Member State for tax purposes
according to domestic laws (and not considered resident outside the EU under an applicable tax treaty) and (iii) it
must be subject to one of the taxes listed in the Directive. Under Article 3(1) of the Directive, a company will be
considered a “parent company” if it has a minimum holding of 10% in the capital of a company of another Member
State (the 10% limit applies as of 1 January 2009; this percentage has been gradually reduced). See: Helminen, M.,
*EU Tax Law...* at pp. 143-148 (Chapter 3, Section 3.1.2.3. and Section 3.1.2.5.).

\(^{751}\) Helminen, M., *EU Tax Law...* at pp. 137 (Chapter 3, Section 3.1.1.).

\(^{752}\) Helminen, M., *EU Tax Law...* at pp. 137 (Chapter 3, Section 3.1.1.).

\(^{753}\) The PE definition in Article 2(2) of the Parent-Subsidiary Directive is similar to the basic PE definition in Article
5(1) of the OECD Model. However, it contains an additional requirement that the PE be subject to tax in the state
where it is located.

\(^{754}\) Helminen, M., *EU Tax Law...* at pp. 139-142 (Chapter 3, Section 3.1.2.2.); Terra, B.J.M., & Wattel, P.J., *European
Tax Law* at p. 482. This was not addressed prior to the 2003 changes to the directive.

\(^{755}\) In practice, the exemption method is more commonly applied (See: Helminen, M., *EU Tax Law* at p. 151
(Chapter 3, Section 3.1.3.1.2.).
“Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the State of the parent company and the state of its permanent establishment shall, except when the subsidiary is liquidated, either:

- refrain from taxing such profits, or
- tax such profits while authorising the parent company and the permanent establishment to deduct from the amount of tax due that fraction of the corporation tax related to those profits and paid by the subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary meet the requirements profited for in Articles 2 and 3, up to the limit of the amount of the corresponding tax due.”

If a provision along these lines were included in a multilateral treaty, it would impose relief obligations on both the residence state of the person deriving the income and the PE state. Note that the provision of an indirect credit is outside the scope of this study, but a provision along these lines could provide for a direct foreign tax credit in circumstances where the source state is entitled to impose tax on the income (e.g., withholding tax).

### 6.5.2. Possible multilateral treaty solutions

As mentioned above, where a multilateral treaty is in place between all the states involved in a PE triangular case there is no need to alter the treaty conditions which are applicable in the source state. The main issue which must be dealt with in a multilateral treaty context is therefore the prevention of unrelieved double taxation. Double taxation in PE triangular cases could be prevented in a multilateral treaty by:

1. Allowing all three states involved to impose tax on the income (in the same way as they would be allowed to under bilateral treaties, e.g., with respect to dividends and interest) and requiring the PE state to provide relief for tax imposed in the source state. The residence state would also be required to provide relief for tax imposed in the source state and the PE state;

2. Preventing the residence state from imposing tax on the income and requiring the PE state to grant relief for tax imposed in the source state. In this case, the income may be taxed in the source state and the PE state, and the PE state would grant relief. The previous approach would also effectively operate in this way in circumstances where the residence state uses the exemption method;

3. Preventing the source state from imposing tax on the income, in which case the income may be taxed in the PE state and the residence state, with the residence state granting relief for tax imposed in the PE state. There would be no need for the PE state to provide any relief;

4. Preventing the PE state from imposing tax on the income, in which case the source state and the residence state may tax the income and the residence state would be obliged to provide relief for tax imposed in the source state; or

5. Allowing only one state to impose tax. This is the approach taken in the CARICOM Convention discussed above and in the Nordic Convention in relation to interest and royalties; in both these cases it is the source state that is entitled to impose tax (with some exceptions in the CARICOM Convention), but it could also be the PE state or the residence state which is entitled to impose tax.

These approaches mirror the options available for resolving the issues arising in PE triangular cases under bilateral tax treaties. Therefore, many of the considerations which are relevant for determining which is

757 This was the solution identified by Schuch, who suggested a draft provision which could potentially be included in multilateral treaties to deal with PE triangular cases (see: Schuch, J., "The Methods for…").
the best approach under a multilateral treaty are the same as those for determining which is the best approach under bilateral treaties.

As discussed above (in Section 6.4.), preventing either the PE state or the source state from imposing tax on income derived in PE triangular situations (i.e., options 3 and 4 above) may lead to opportunities for tax avoidance and, in addition, neither the PE state nor the source state is likely to accept such a limitation on its taxing rights. The approach taken in the CARICOM Convention (i.e., option 5 above) also gives rise to a number of problems (as discussed previously), and is not considered to be a viable option, although it may be used with respect to certain categories of income if the contracting states are willing to accept the restriction on their taxing rights (as is the case in the Nordic Convention with respect to interest and royalties).

The preferred approach would be to allow all three states to impose tax, but to require both the residence state and the PE state to provide relief (i.e., option 1 above). This effectively treats the PE more like a resident of the PE state and resembles the bilateral treaty option which will be discussed in Chapter 7. A significant advantage of this approach is that, if it were adopted, the distribution of taxing rights under the multilateral treaty would resemble, as closely as possible, the distribution of taxing rights under the OECD Model and existing bilateral treaties.

6.5.3. Advantages of a multilateral treaty

A multilateral treaty has a number of advantages for dealing with PE triangular cases. 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). This also limits concerns regarding the potential for treaty shopping. Treaty shopping concerns can also be mitigated by the fact that in a multilateral treaty context, all the states involved know which other states may be involved in situations to which the specific treaty provisions dealing with triangular cases will apply. More specifically, where all three states are parties to the multilateral treaty, the PE state will presumably not be a tax haven. Where a multilateral treaty is concluded between a limited number of states, it should also be possible for the contracting states, when drafting the provisions applicable to PE triangular cases, to take into account the way each of those states would treat triangular cases under their domestic law, e.g., whether they impose tax on the worldwide income of PEs, at least as their domestic law stands at the time the treaty is negotiated.

Another advantage of a multilateral treaty solution is that a multilateral treaty will contain definitions which are applicable with respect to all of the states involved, preventing any issues that may arise in situations involving bilateral treaties where there are inconsistent definitions between the various treaties. The clearest example is that in a multilateral treaty there will be a single PE definition which will apply with respect to all the states involved and thus, there will be no concern that there may be a PE under the definition contained in the R-PE treaty but not under the definition contained in the R-S treaty and/or the PE-S treaty (or vice versa). However, even in a multilateral context it is possible for disagreements to arise between the taxpayer and the contracting states, or between the contracting states themselves, regarding whether there is a PE in the PE state and whether the income in question is attributable to the PE, particularly in borderline cases. This issue will be discussed in Chapter 9 (Section 9.2.1.).

Another aspect of multilateral treaties which is advantageous for resolving the issues which arise in PE triangular cases is that there will be no question of the applicable treaties not containing corresponding provisions. As will be seen in Chapter 7, bilateral treaty solutions to PE triangular cases generally rely on more than one treaty containing specific provisions and issues can arise if one or more of the relevant

758 Schuch, J., “The Methods for….”
759 Although it should be noted that even countries which are not generally considered to be tax havens and which have comprehensive income tax systems can have features in their tax law which would enable the avoidance of tax.
760 This issue will be discussed in the context of a solution based on terms included in bilateral treaties in Chapter 8 (see Section 8.2.3.).

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treaties do not contain the required provisions. This issue will simply not arise in the context of a multilateral treaty.

6.5.4. Practical limitations

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 of getting multiple states to agree to the terms of the treaty. Even in the case of bilateral treaties, negotiations can stretch on for years before two states are able to reach agreement on the terms of a treaty and the difficulty of reaching agreement increases substantially where more states are involved. 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.

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. Of course, special provisions and/or exclusions could be included to deal with specific issues, but such provisions would increase the complexity of the treaty and may cancel out the benefit of the simplification which a multilateral treaty might be expected to achieve. It has been suggested that national tax systems would have to be harmonized to a much greater extent before a multilateral treaty would be feasible. The conclusion of a multilateral treaty may be more feasible for small groups of countries which are in similar circumstances. However, if the treaty is concluded between a small group of countries then the benefit with respect to triangular cases will be reduced, because this benefit only exists in situations where all three of the states involved are party to the treaty. If the PE triangular situation involves a state which is not a party to the treaty, then the multilateral treaty will effectively operate as a bilateral treaty between the two states involved which are party to it, and will therefore not offer any advantages over a bilateral treaty. A multilateral treaty could still contain specific provisions to deal with triangular situations involving third states, but such provisions could only operate in the same way as provisions included in bilateral treaties. Given the difficulties involved in concluding multilateral treaties, they would generally not provide enough of an advantage over bilateral treaties to make pursuing them worthwhile.

Multilateral treaties would also alter the distribution of taxing rights as currently agreed between states and embodied in their bilateral tax treaties. Currently, different tax treaties contain different provisions, e.g., different maximum rates of source based taxation on passive income, whereas in a multilateral treaty the provisions would generally be standardized. The conclusion of a multilateral treaty could therefore substantially alter the global distribution of tax revenues in relation to cross-border income, which would

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761 Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings…"; Schön, W., "International Tax Coordination…"
763 Schön, M.J., "Options for Greater…"
764 Schön, M.J., "Options for Greater…"
765 Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings…"
766 Schön states that "a multinational agreement is only recommendable for a small group of countries with converging economic situations and a common political background (like the Nordic states of Europe)." (Schön, W., "International Tax Coordination…") Similarly, Mattsson states that: "The countries involved must have an attitude towards international tax issues which makes it possible to find common solutions to those rules which should be part of a tax treaty. And such solutions are probably possible only if the tax systems do not show basic differences." (Mattsson, N., "Multilateral Tax Treaties – A Model for the Future?" bound in International Studies in Taxation: Law and Economics: Liber amicorum Leif Mutén, (The Hague, Kluwer Law International, 1999), pp. 243-258 at p. 256).
767 Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings…"
768 See: Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings…"; McIntyre, M.J., "Options for Greater…"; Schön, W., "International Tax Coordination…"; Avery Jones, J.F., "The David R. Tillinghast Lecture…" (who states: "Indeed, there seems no obvious advantage in having multilateral tax treaties." (at p. 6)).
769 Although specific provisions could still be included to deal with special issues arising between particular states, as in the Nordic Convention, discussed above in Section 6.5.1.1.
clearly be unrelated to PE triangular cases and would be in excess of what is required for dealing with the issues arising in PE triangular cases. Importantly, the main impact of this change in the distribution of taxing rights would be felt in purely bilateral situations, given that such situations are vastly more common than triangular cases.

6.6. Conclusions

The issues arising in PE triangular cases are the result of a number of interrelated factors, including the overlap in treaty sourcing rules (such that the income effectively has a dual source for treaty purposes) and the bilateral nature of tax treaties. Chief among these factors though, is the hybrid nature of the PE concept. Although the PE concept is generally considered to be a source-based concept, the taxation of PEs exhibits a number of features of residence-based taxation and may be more appropriately thought of as a quasi-residence based concept. The hybrid nature of the PE concept leads directly to the issues arising in PE triangular cases because, whilst the state where a PE is located is entitled to impose tax on the worldwide income attributable to the PE, a PE is generally not eligible for treaty benefits. This means that the PE state has no direct obligation to grant relief for tax imposed in the source state and the source state is not required to apply the conditions of its treaty with the PE state in relation to the income attributable to the PE.

One of the simplest solutions to the issues arising in PE triangular cases would be to resolve the hybrid nature of the PE concept by treating it purely as a source concept and to then resolve the overlap in the tax treaty sourcing rules. This could be done either by preventing the source state from imposing tax on the income (i.e., resolving the overlap in favour of the PE state) or by preventing the PE state from imposing tax on the income (i.e., resolving the overlap in favour of the source state). In either case, the situation would effectively become bilateral and, as a result, there would generally be no unrelieved double taxation, no need for relief in the PE state, and no issue would arise regarding the appropriate treaty conditions to apply in the source state. Neither of these approaches is viable, however, due to the potential for tax avoidance. In particular, if the PE state is prevented from imposing tax on income which is attributable to a local PE but which is sourced in a third state (i.e., the source state), enterprises could avoid paying residence-based taxes by shifting their residence to a state which exempts the income attributable to PEs, while continuing to conduct all their activities in what is now the PE state. Alternatively, if tax treaties prevent source states from imposing taxation on income which is attributable to PEs in a third state (i.e., not the source state or the residence state), then enterprises could avoid source based taxation by ensuring that income is attributable to a PE in a third state. It would be extremely difficult to formulate effective anti-avoidance provisions to deal with these concerns. Perhaps more importantly, states are unlikely to be willing to accept such extensive restrictions on their taxing rights.

Multilateral treaties could also resolve the issues arising in PE triangular cases, and there are a number of ways in which this could be achieved. However, the difficulty inherent in concluding and updating multilateral treaties means that, unless there are other strong motivating factors, this solution is unlikely to be implemented in practice. The standardisation of distributive rules under a multilateral treaty could also substantially alter the global distribution of taxing rights, which would largely be felt in bilateral situations and would be unwarranted if the intention is simply to deal with PE triangular cases.

We will now turn, in Chapter 7, to potential solutions to the issues arising in PE triangular cases that involve treating the PE more like a resident enterprise of the PE state. For various reasons (which will be discussed further in Chapter 7), this is the preferred approach for dealing with PE triangular cases. However, it does give rise to a number of issues which must be addressed, not least the extent to which a PE should be treated in the same way as a resident person for treaty purposes and means by which such a solution should be implemented. These issues will be discussed in Chapter 7, Chapter 8 and Chapter 9.
Chapter 7
Extending treaty benefits to PEs

7.1. Introduction

The previous chapter introduced potential solutions to PE triangular cases and discussed two options for dealing with PE triangular cases; (i) resolving the overlap in tax treaty sourcing rules and thus preventing either the source state or the PE state from imposing tax on the income or (ii) by replacing the existing network of bilateral income tax treaties with one or more multilateral treaties. It was concluded that neither of these options provides a satisfactory solution to the issues arising in PE triangular cases. The discussion in this chapter will focus on resolving the issues in PE triangular cases by treating the PE concept more like a residence concept; broadly, by ensuring that double taxation relief is provided in the PE state and by ensuring that the source state applies the conditions of the PE-S treaty (rather than the conditions of the R-S treaty) in relation to income attributable to the PE. This means that PEs would effectively be entitled to treaty benefits. Extending treaty benefits to PEs would substantially resolve the hybrid nature of the PE concept in tax treaties, and would be consistent with the residence-like nature of PE taxation and the residence-supporting role of the PE concept in tax treaties (as discussed in Chapter 5), as well as the OECD’s recent work on the attribution of profit to PEs (also discussed in Chapter 5).

This approach forms the basis for the vast majority of solutions which have been advocated for dealing with PE triangular cases (as will be seen below in Section 7.2.). If implemented, it would generally resolve the issues arising in PE triangular cases as follows:

1. The source state applies the conditions of the PE-S treaty instead of those contained in the R-S treaty in relation to the income attributable to the PE. The source state is therefore applying the more appropriate treaty conditions (as discussed in Chapter 5);
2. The PE state is required to provide relief for tax imposed in the source state, using either the exemption method or the credit method. 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 (as discussed in Chapter 5).
3. The residence state provides relief 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.

Of the potential approaches identified in Chapter 6, treating the PE more like a resident enterprise of the PE state and effectively extending treaty benefits to PEs is considered to be the best approach for dealing with PE triangular cases. Allowing PEs to claim treaty benefits would represent a dramatic departure from the existing principles of treaty application, however given the hybrid nature of the PE concept, the implications of this approach would perhaps be less drastic than they may appear at first glance. Allowing PEs to claim treaty benefits would certainly represent less of a departure from the existing international tax framework than a solution based on the conclusion of multilateral treaties. It 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.

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. This may occur, for example, where the residence state exempts the income attributable to the PE and the PE state does not impose tax (or imposes very little tax) on the income arising in the source state. As was discussed in Chapter 5 (Section 5.2.6.), states face significant challenges in combatting treaty shopping under existing principles and for this reason, they may be understandably reluctant to open up a further avenue for improper claims for treaty benefits. Treaty shopping through PEs is a legitimate concern, primarily because transactions between the PE and the rest of the enterprise have no legal consequences and because common patterns of PE taxation may make it easier to obtain treaty benefits through a PE without triggering any additional tax liability in the PE state or the residence state. It should be possible to address these concerns,

770 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).
however, for example through the inclusion of a "subject to tax" requirement. In addition, the fact that taxpayers could not rely on legal arrangements to support a PE’s claim for treaty benefits, and the analysis required for determining the profits attributable to a PE may actually make gaining improper access to tax treaties through PEs less attractive for taxpayers than obtaining improper access to treaties through a legal entity. Further, the attribution of profits to PEs is based on an economic analysis and (at least under the AOA) depends on the "significant people functions" carried out by the PE. To the extent that the income is economically linked to the PE (and the PE state), it is difficult to see how the source state could legitimately object to the application of the PE-S treaty. The potential for improper access to treaties through PEs was discussed in detail in Chapter 5, and will be discussed further in Chapter 8 (Section 8.4.), which will outline specific provisions which could be included in treaties to address treaty shopping concerns. It will generally not be discussed further in this chapter.

It should also be noted that the approach discussed in this chapter encompasses a range of possible solutions, from simple measures allowing PEs to claim certain specific benefits under tax treaties (e.g., relief in the PE state or a limitation on source based taxation of passive income) through to comprehensive measures which would treat PEs in exactly the same way as resident persons for treaty purposes. The extent of the treaty benefits which should be available to PEs, along with potential implications of extending treaty benefits to PEs, will be discussed in Chapter 8 and Chapter 9.

Even if it is not accepted that the PE-S treaty should apply in relation to the income arising in PE triangular cases, it would still be desirable to apply the other aspects of this solution. That is, the PE state should be explicitly required to grant relief for tax imposed in the source state and a provision could be included in the R-S treaty to ensure that it doesn’t apply in circumstances which are considered abusive. This would only be a partial solution, since the source state would continue to apply the “incorrect” treaty provisions, but it would prevent unrelieved double taxation and would prevent improper use of the R-S treaty. This alternative “minimalist approach” would thus resolve many of the issues that arise in PE triangular cases and it is likely to be much simpler to gain acceptance of this approach and to implement it. The minimalist approach is considered to be the next best solution if the more comprehensive solution is not accepted.

This chapter will first outline the history of the idea that PEs should be entitled to treaty benefits before comparing the various ways in which this could be achieved. It will then go on to consider issues related to granting relief in the PE state under tax treaties and, finally, will discuss the exclusion of the R-S treaty in PE triangular cases.

7.2. Overview of existing treaty provisions and proposals

The suggestion that PEs should be entitled to treaty benefits has a long history, which will be outlined briefly in this section. Some of the items discussed here are provisions included in existing treaties, while others are merely expressions of the view that PEs should be entitled to treaty benefits. Still others comprise proposals for ways in which PE triangular cases could be resolved by effectively, in one way or another, extending either full or partial treaty benefits to PEs.

7.2.1. The 1964 France-Belgium treaty

The treaty between France and Belgium, concluded in 1964,\textsuperscript{771} contains a provision which allows (but does not require) the contracting states to apply the terms of the treaty in relation to income derived in certain PE triangular cases under the mutual agreement procedure. This provision, found in Article 24(2), reads as follows:

"Where the carrying out of certain provisions of this Convention would give rise to difficulties or doubts the competent authorities of both Contracting States shall consult together in order to apply such provisions in accordance with the spirit of the Convention. They may, in such special cases, by mutual agreement apply the rules laid down in this Convention to individuals or legal entities who are not resident in either of

\textsuperscript{771} Still in force, but modified by various protocols over the intervening years.
the Contracting States but who have in one of those States a permanent establishment
certain income from which arises in the other State."\textsuperscript{772}

Thus, where a person who is not resident in either France or Belgium earns income from one of those
states which is attributable to a PE in the other, it may be possible for the Belgium-France treaty to apply
(i.e., where it operates as the PE-S treaty). This would presumably result in the source state applying the
relevant conditions of the treaty in relation to the income (e.g., reduced rates of withholding tax on
passive income) and the PE state granting relief for tax imposed in the source state in accordance with the
relief provisions of the treaty.

\textbf{7.2.2. IFA Cahiers "The Taxation of Enterprises with Permanent Establishments Abroad" (1973)}

The 1973 IFA Cahiers on the topic of the taxation of enterprises with permanent establishments
abroad\textsuperscript{773} contained some brief comments regarding the extension of treaty benefits to PEs. The general
reporter stopped short of suggesting that PEs should be entitled to treaty benefits in the same way as
resident enterprises but did consider it "sufficiently important to call for close examination"\textsuperscript{774} The
French reporter went further, however, contending that PEs ineligibility for treaty benefits is
discriminatory\textsuperscript{775} and arguing that:

"As a general rule, the disparity of treatment [between a PE and a resident enterprise] is
basically a result of the restrictive application of the agreements to "residents" of a
Contracting State only (Article 1 of the draft convention), so much so that a French
secondary establishment which has business dealings with a state other than that of the
to which it belongs may not have recourse to the agreement signed between
France and that other Country.

One can then ask oneself if the permanent establishment's lack of legal personality,
(which is nevertheless considered fiscally as a separate enterprise), justifies a distortion
which runs counter to the flow of the international business cycle and accordingly
whether it is desirable that the choice between the creation of a strictly controlled
subsidiary and that of a branch should be influenced by reasons of a purely fiscal nature
in defiance at times of sound management."\textsuperscript{776}

These comments support the extension of treaty benefits to PEs on the basis that PEs are treated as
separate taxpayers for domestic tax purposes and that the eligibility for treaty benefits should not turn
merely on the legal form chosen to conduct business activities, and further, that the choice between
operating through a subsidiary and through a branch should not be influenced by the availability (or non-
availability) of treaty benefits. The French reporter does not suggest a specific approach for extending
treaty benefits to PEs, but the general reporter states that the personal scope of the convention (in Article
1) would need to be expanded and goes on to suggest that the mutual agreement provision of the
Belgium-France treaty (discussed above) may "point the way."\textsuperscript{777}

\textsuperscript{772} This is an unofficial translation from IBFD's tax treaty database.
\textsuperscript{773} International Fiscal Association, \textit{The Taxation of Enterprises with Permanent Establishments Abroad}, IFA Cahiers de
\textsuperscript{774} Ludwig, M.B., “General Report” bound in \textit{The Taxation of Enterprises with Permanent Establishments Abroad}, IFA
\textsuperscript{775} Mouillan-Hogberg, N., “French Report” bound in \textit{The Taxation of Enterprises with Permanent Establishments Abroad},
this section is based on the English summary of the French report.
\textsuperscript{776} This quote is extracted from the English summary of the French report. See: Mouillan-Hogberg, N., “French
Report” at p. 1/146.
7.2.3. The 1989 France-Italy treaty

The PE non-discrimination article (Article 25(2)(b)) of the treaty between France and Italy, concluded in 1989, includes a specific provision which extends treaty benefits to PEs in relation to dividends, interest and royalty income. It reads as follows:

"Where a permanent establishment situated in a State receives dividends, interest or royalties arising in the other State and pertaining to property or rights effectively connected with its activities, such income may be taxed in the state in which it arises in accordance with the respective provisions of paragraph 2(b) of Article 10 [dividends], paragraph 2 of Article 11 [interest] and paragraph 2 of Article 12 [royalties]. The State in which the permanent establishment is situated shall eliminate double taxation in accordance with the provisions provided in paragraph 1(a) or paragraph 2 of Article 24 [the relief provisions], disregarding the last clause. This provision shall apply wherever the enterprise of which the permanent establishment is a part has its place of management."\(^{778}\)

This provision grants partial treaty entitlement to PEs, regardless of the place where the entity to which the PE belongs is resident. Where a PE located in one of the contracting states (i.e., the PE state) earns dividends, interest or royalties which arise in the other contracting state (i.e., the source state), it requires the source state to apply the conditions of the interest, dividends and royalties articles of the treaty. These provisions specify a maximum rate of tax which the source state can impose.

Like the provision of the Belgium-France treaty, discussed above, this provision operates when the contracting states are in the position of the source state and the PE state (i.e., the PE-S treaty). However, unlike that provision, it imposes a definite obligation on the contracting states to apply the terms of the treaty in PE triangular cases. Notably, however, it only applies in cases involving passive income. In addition, there is no means of excluding the operation of the R-S treaty which means that the source state may be subject to multiple treaty conditions in respect of the same income; in this situation, it would only be able to meet its treaty obligations by applying the conditions that are most favourable to the taxpayer.

7.2.4. The Ruding report (1992)

The Ruding Report,\(^{779}\) a report prepared in 1992 for the European Commission, recommended (in an annex to the report\(^{780}\)) that the OECD Model be expanded to allow PEs to claim treaty benefits. It stated that:

"The cause for many mutual agreement procedures arises from the fact that most treaty rights cannot be invoked by permanent establishments. On the other hand, in many countries taxation of permanent establishments approaches that of resident businesses. Therefore, a permanent establishment or fixed place of business should be considered a resident of the Member State in which it is situated for the application of the tax treaties including those on capital gains and dividends."

\(^{778}\) This is an unofficial translation from IBFD's tax treaty database.

\(^{779}\) The Ruding Committee began work in January 1991 on three questions posed by the European Commission: (1) Do differences in business taxation among Member States cause major distortions in the functioning of the internal market, particularly with respect to investment decisions and competition? (2) In so far as such distortions do arise, are they likely to be alleviated or eliminated simply through the interplay of market forces and competition between national tax regimes, or is action at the Community level required? (3) What specific measures are required at the Community level to remove or mitigate these distortions? The Ruding Committee recommended a program of action to eliminate double taxation, harmonise corporation tax rates within a 30%-40% band and ensure the full transparency of the various "tax breaks" given by Member States to promote investment. See: Ruding, O., et al., "Report of the Committee of Independent Experts on Company Taxation" (Luxembourg: Office for Official Publications of the European Communities, 1992), at pp. 11-16.

\(^{780}\) The preface to the report states that: "Much of the rather more detailed background material considered by the Committee (but not necessarily endorsed by it) is contained in the annexes, which are referred to in the relevant chapters." (Emphasis added.) (Ruding, O., et al., "Report of the Committee…" at p. 6.)
of this Member State with other Member States. Article 4 of the OECD Model Treaty should be expanded accordingly."

Thus it suggests that, due to the similarity between the taxation of PEs and resident enterprises, the concept of residence for treaty purposes should be expanded to allow PEs to claim treaty benefits. This approach would mean that PEs would be treated as residents of the PE state for the purposes of the entire treaty.

7.2.5. The OECD triangular cases report (1992)

The OECD's triangular cases report, published in 1992, contemplates a solution to PE triangular cases involving passive income whereby PEs would be treated as residents of the PE state for the purposes of the PE-S treaty.\(^7\)\(^8\) PEs could then claim reduced rates of source-based taxation provided for in the PE-S treaty, and could claim relief in the PE state.\(^7\)\(^9\) The report refers to the provision of the France-Italy treaty dealing with PE triangular cases as an example of how this solution might be implemented.\(^7\)\(^2\) In the final analysis, however, it recommends against extending treaty benefits to PEs on the basis that the majority of states are opposed to this type of solution.\(^7\)\(^3\) The report identifies two main reasons for this opposition. The first is the danger of treaty shopping, particularly in situations where the residence state uses the exemption method, i.e., residents of State R may establish PEs for the purpose of taking advantage of reduced source state taxation under the PE-S treaty.\(^7\)\(^4\) The second reason is that "...such a solution... departs too much from the principles underlying the Model Convention and current practices."\(^7\)\(^5\)

The final recommendation of the OECD's triangular cases report is much more limited; it effectively recommends only that the PE state should clearly be required to provide relief in PE triangular cases under the terms of the R-PE treaty (i.e., rather than implicitly under Article 24(3) of that treaty).\(^7\)\(^6\) It recommends changes to the OECD Commentary to this effect, primarily to Article 24,\(^7\)\(^7\) which were included in the Commentary as part of the 1992 update to the OECD Model.\(^7\)\(^8\) As mentioned elsewhere, I have not been able to identify any concluded treaties which incorporate the OECD commentary's suggested wording to explicitly require relief in the PE state.\(^7\)\(^9\)

7.2.6. Avery Jones proposal: Provisions included in all three treaties (1999)

Avery Jones proposes a solution to PE triangular cases whereby the residence state would transfer to the PE state the right to claim to be the "residence state" in relation to income attributable to the PE for the
He describes the proposed solution as follows:

"I suggest that what is required is not to treat the permanent establishment as if it were a resident of PE in all cases, but for HO [i.e., the State R] to transfer to PE [i.e., State PE] the right in certain circumstances to claim to be the taxpayer's residence state, instead of HO, in treaties with third states. This requires an addition to Article 4 to be contained in all relevant treaties between Source, HO, PE and Recipient [relevant for reverse triangular cases – see Chapter 12]. Article 4 would then say that, in addition to a treaty resident of a state being a person who is liable to tax in that state under internal law by reason of the listed criteria, a person would be a treaty resident of a state in which there was a permanent establishment under any other treaty containing a provision to that effect."\(^{793}\)

He goes on to say:

"Under the proposed solution, it is HO that decides whether to give PE the right to claim to be the taxpayer's residence state in its treaty with Source, and it will only do so if there is normal taxation in PE of income arising in a third state."\(^{794}\)

The transfer of residence may be limited to dividends, interest and royalties and may be limited to situations where the income is fully taxable in the PE state.\(^{795}\) In addition, the transfer of residence could be made conditional on the PE state giving relief for tax imposed in the source state.\(^{796}\) Where the right to claim to be the residence state is transferred to the PE state, the operation of the R-S treaty would be prevented by provisions included in that treaty.\(^{797}\) This would have the effect that the source state would be required to apply the conditions of the PE-S treaty instead of the conditions of the R-S treaty, and the PE state would be obliged to grant relief for tax imposed in the source state. This potential approach to extending treaty benefits to PEs will be discussed further in Section 7.3.3. below.

7.2.7. Zhai proposal: Indirect treaty entitlement for PEs (2009)

Zhai proposes a solution to PE triangular cases whereby the source state would be required, under a specific provision included in the R-S treaty, to apply the conditions of the PE-S treaty in relation to income attributable to a PE in the PE state.\(^{798}\) To address tax avoidance concerns, the conditions of the PE-S treaty would only apply if the income is taxed "normally" in the PE state; Zhai proposes that income would generally be considered to be taxed normally in the PE state unless the PE state exempts the income.\(^{799}\) The provision requiring the source state to apply the conditions of the PE-S treaty would also exclude the operation of the R-S treaty in the source state in relation to the income attributable to the PE, so that the source state would only be subject to the conditions of the PE-S treaty. Zhai's proposal would exclude the application of the R-S treaty even in situations where there is no PE-S treaty, meaning that in such cases the source state would be able to apply its domestic law without restriction. Zhai's solution would not specifically require the PE state to grant relief for tax imposed in the source state, but instead relies on the PE state providing relief under the PE non-discrimination article (Article 24(3)) of the R-PE treaty.

\(^{792}\) Avery Jones, J.F., "The David R. Tillinghast Lecture…." This solution is also mentioned very briefly in: Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems……" Zhai also discusses this proposal, referring to unpublished work of J.F. Avery Jones (see: Zhai, G., "Triangular Cases….")

\(^{793}\) Avery Jones, J.F., "The David R. Tillinghast Lecture…." at p. 30.

\(^{794}\) Avery Jones, J.F., "The David R. Tillinghast Lecture…." at p. 31.

\(^{795}\) Avery Jones, J.F., "The David R. Tillinghast Lecture….."

\(^{796}\) Avery Jones, J.F., "The David R. Tillinghast Lecture….."

\(^{797}\) Referring to unpublished work by J.F., Avery Jones: Zhai, G., "Triangular Cases….."

\(^{798}\) Zhai, G., "Triangular Cases….."

\(^{799}\) Zhai, G., "Triangular Cases….." Tax avoidance concerns will be discussed further in Chapter 8 (Section 8.4.).

Wheeler proposes a new approach for determining treaty entitlement under which “…the imposition of a tax liability in respect of a specific item of income under domestic law constitutes the first step towards entitlement to the benefit of a treaty.” States which are asked to grant treaty benefits would then assess whether the tax liability in the other state is a sufficient basis upon which to grant such benefits. In making this assessment, source states would most likely take into consideration the strength of the connection between the income and the person deriving it, and the strength of the connection between that person and the residence state. Residence states, in considering whether to grant relief, would focus on the nature of the tax liability in the other state and on the connection between the income and the person claiming relief.

Although this approach is not specifically intended to address PE triangular cases, it could involve an extension of treaty benefits to PEs. After referring to the problem of the source state applying the “wrong” treaty conditions in PE triangular cases, Wheeler writes:

“The new approach could solve this problem by recognising the tax liability of the enterprise in respect of its permanent establishment as a liability imposed on it in a taxpaying capacity distinct from the taxpaying capacity of the entity as a whole. The permanent establishment would, in other words, be regarded as having a ‘treaty capacity’ and therefore be capable of claiming the benefit of the treaties concluded by the state in which it is situated.”

Wheeler then goes on to outline certain qualifications to the extension of treaty benefits in these circumstances. One of these qualifications is that the treaty benefits would be available “…only to the extent that the enterprise is liable to tax in the state of the permanent establishment in respect of income from worldwide sources derived through the permanent establishment.” Further, treaty benefits would only be available to PEs that met a higher threshold than the existing PE threshold. It is also proposed that the treaty entitlement of the PE would take priority over the treaty entitlement of the enterprise as a whole, meaning that the R-S treaty would not apply in a PE triangular case to the extent that the PE-S treaty applied. Whilst it is a very attractive approach, this method of extending treaty benefits to PEs will not be discussed extensively in this chapter since it requires a fundamental change in the way treaties operate, not only in triangular cases but also in bilateral situations, and is therefore outside the scope of the solutions being considered here.

7.2.9. Instances where treaty benefits have been claimed on behalf of a PE

There have been two cases where a resident of a third state has made a treaty claim on the basis of income arising in one contracting state and attributable to a PE in the other. The first of these cases involves an older treaty, the 1945 UK-US treaty, which did not contain a provision equivalent to Article 1 of the OECD Model, and the second involves the more recent US-Canada treaty. These two cases will be discussed in turn below.

7.2.9.1. Commerzbank

The Commerzbank case concerned the 1945 treaty between the UK and the US (since terminated). It involved a German bank and a Brazilian bank which operated through PEs in the UK and which derived

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809 Inland Revenue Commissioners v. Commerzbank AG [1990] STC 285
interest income from US corporations. Under the 1945 UK-US treaty, the income would have been exempt in the UK if it had been derived by a treaty-eligible UK resident. The relevant treaty article, Article XV, provided that:

“Dividends and interest paid by a corporation of one Contracting Party shall be exempt from tax by the other Contracting Party except where the recipient is a citizen, resident, or corporation of that other Contracting Party. This exemption shall not apply if the corporation paying such dividend or interest is a resident of the other Contracting Party.”

The taxpayer argued that even though it was not a resident of either contracting state, this treaty provisions should prevent the UK from imposing tax on the income attributable to the UK branch. Importantly, the treaty did not contain an equivalent to Article 1 of the OECD Model, meaning that the treaty as a whole was not explicitly limited to residents of the contracting states. The court, in reaching its decision, noted that the other articles of the treaty were worded to apply only to residents of the contracting states and contrasted this to the article upon which the taxpayer was relying. This case establishes that in the absence of specific language included in the treaty itself there is no general principle that tax treaties apply only to residents of the two contracting states. This is an unusual outcome given that the UK was denied taxing rights over income of a UK-based business, although it does follow from quite an unusual treaty provision.

7.2.9.2. Crown Forrest Industries

Crown Forrest Industries involved a company (“Norsk”) which was incorporated in the Bahamas but which conducted all its operations in the US. These operations in the US amounted to a “US trade or business” but the company’s income was exempt in the US under a reciprocal exemption between the US and the Bahamas applicable to shipping companies. The case concerned royalties which Norsk received from an associated company resident in Canada. Norsk claimed a reduction in Canadian withholding tax (from 25% to 10%) under the US-Canada treaty on the basis that the company was a resident of the US for the purposes of the treaty. This was said to result from the fact that the company’s place of management was in the US and that, since this led to the company having a “US trade or business”, it also led to the company being liable to tax in the US. Thus, the company argued that it was “liable to tax” in the US “by reason of” its “place of management” or an “other criterion of a similar nature.” This argument was rejected by the court, stating that:

“Although the fact that [the company’s] ‘place of management’ is located in the United States is one factor contributing to the finding that its trade or business is connected with the United States, it does not constitute the basis for Norsk’s tax liability in the first place.”

The court also noted that the residence test sought to identify those taxpayers subject to worldwide taxation in one of the contracting states, and contrasted this to the source-based liability to tax imposed as a result of having a US trade or business. The company was therefore ultimately unsuccessful in its claim for treaty benefits. As Vann notes however:

“If the taxpayer had not had the benefit of the reciprocal exemption, would it have been so outrageous for it to claim treaty benefits? The United States would have been taxing

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810 Vann, R., “Liable to Tax’…” at p. 244 (Section 7.4.1.).
811 Vann, R., “Liable to Tax’…” at p. 245 (Section 7.4.1.1.).
813 Crucially, the US determines corporate residence based solely on incorporation and thus, the place of management in the US did not make the Bahamian company resident there. The vast majority of countries do have a corporate residence test based on management and, if the activities of the Bahamian company were located in a state other than the US then it is quite likely that those activities would have made the company a local resident. For further discussion of the common corporate residence rules found in domestic laws, see Chapter 9 (Section 9.2.2.).
815 Although the court of first instance (the Federal Court Trial Division, 92 DTC 6305) and the Federal Court of Appeal (94 DTC 6107) decided otherwise.
it on a net basis at the company rate on income that was sourced in Canada under the passive source rules for royalties and so would Canada at a 25% gross basis apart from the treaty. ... In this kind of scenario, it is highly unlikely that the residence State of the taxpayer would have collected any tax even if it were not a tax haven and had treaties in standard form with both Canada and the United States.

It is not self-evident that the Canadian tax rate on royalties received by the US business should be determined by the treaty between Canada and a third country which very likely would collect no tax on the income, rather than the treaty with the country which would collect tax on the income and so can provide relief for third-country tax.816

7.2.10. Conclusions

The idea that PE triangular cases should be resolved by extending treaty benefits to PEs clearly has a long history. It has been advocated by numerous authors, including some not mentioned above,817 and has been implemented in two isolated cases; the Belgium-France and France-Italy treaties discussed above. However, there is still no widespread acceptance of this approach, presumably for the reasons identified in the OECD’s 1992 report on triangular cases, i.e., the potential for tax avoidance and the extensive departure from existing principles and practices which it would represent. As outlined in Chapter 5, however, it may be possible to address the tax avoidance concerns and, in addition, the extension of treaty benefits to PEs would be consistent with the residence-like nature and role of the PE concept. The following section will discuss and compare the various different approaches for extending treaty benefits to PEs.

7.3. Approaches to extending treaty benefits to PEs

Where there are treaties in place between all the states involved in a PE triangular case, there are three possible bilateral tax treaties that can apply. Each of these treaties can bind only the contracting states in relation to that particular treaty; bilateral treaties cannot impose any obligations on a state which is not party to the treaty.818 This naturally limits the number of ways in which tax treaties can require the source state to apply the conditions of the PE-S treaty, exclude the operation of the R-S treaty in the source state, and require the PE state to grant relief. These aspects of extending treaty benefits to PEs can be achieved by provisions included in tax treaties as follows:

- **Application of the PE-S treaty conditions in the source state:** The source state is bound by both the R-S treaty and the PE-S treaty and could therefore be required to apply the conditions of the PE-S treaty under specific provisions included in either of those two treaties. The applicable treaty conditions in the source state cannot be affected by the terms of the R-PE treaty, which therefore cannot require the source state to apply the conditions of the PE-S treaty.

- **Non-application of the R-S treaty:** The operation of the R-S treaty can only be excluded by provisions included in that treaty. Neither the R-PE treaty nor the PE-S treaty can prevent the source state from being obliged to apply the conditions of the R-S treaty in relation to income derived by a person who is resident in State R.819

- **Relief in the PE state:** An explicit obligation for the PE state to provide relief could be included in either the R-PE treaty or in the PE-S treaty. The PE state is not party to the R-S treaty and it

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816 Vann, R., "'Liable to Tax'..." at pp. 248-249 (Section 7.4.1.3.).
817 García Prats, F.A., "Triangular Cases..."; Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions... at p. 102, (m.no. 30a); Vogel., K., "Tax Treaty Monitor..."; Langoth, B., "Treaty Entitlement..."; Yong, S., "Triangular Treaty Cases..."; and Vann, R., "'Liable to Tax'..." at pp. 248-250 (Section 7.4.1.3.) and p. 263-270 (Section 7.4.2.4.) (Vann writes: “In summary, a substantial argument can be mounted that a PE test is appropriate for granting treaty benefits in place of or in addition to a residence test for companies, although such an approach involves issues of overlapping treaties” at p. 269).
818 Article 34 of the Vienna Convention on the Law of Treaties (1964), which provides that: "A treaty does not create either obligations or rights for a third state without its consent."
819 This point was made by: Zhai, G., "Triangular Cases..."
follows that the R-S treaty cannot require the PE state to grant relief for tax imposed in the source state.

In general, where specific provisions are included in the PE-S treaty to deal with PE triangular cases, it can be expected that these provisions would impose corresponding obligations on both the source state and the PE state. It is unlikely that a treaty would be concluded which, where it operated as the PE-S treaty, would either limit the tax imposed in the source state but not require relief in the PE state or, conversely, require relief in the PE state but without limiting the tax that can be imposed in the source state. There are therefore two primary ways of resolving the issues in PE triangular cases by way of measures included in the treaties between the three states involved, which are distinguished by the way in which the conditions of the 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 a PE in the PE state 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.820

It should be borne in mind that regardless of the approach taken, the exclusion of the provisions of the R-S treaty can only be achieved by specific provisions included in that treaty. In addition, any state could find itself in the position of the PE state, the source state, or the residence state in a PE triangular case and any treaty could therefore be the R-S treaty, the R-PE treaty or the PE-S treaty in a given situation. It follows that appropriately worded provisions would have to be included in every treaty for treaty benefits to be extended to PEs in all triangular cases. It is also important to note that the direct approach does not necessarily require the PE to be treated as a treaty eligible resident person; the person claiming treaty benefits in relation to the income attributable to the PE could still be person to which the PE belongs. This will be discussed further in Chapter 8 (Section 8.2.1.). For ease of expression, reference will continue to be made to a PE claiming treaty benefits even though this may not be strictly accurate.

The direct and indirect approaches to extending treaty benefits will each be discussed in turn below. The direct approach could also encompass a solution whereby the PE state and the source state can apply the conditions of the PE-S treaty in PE triangular cases under the mutual agreement procedure (as is the case in the Belgium-France treaty discussed above). Nevertheless, this potential solution will be discussed separately (see Section 7.3.4.). The approach proposed by Avery-Jones, which involves provisions included in all three treaties, will also be discussed separately below (see Section 7.3.3.). Furthermore, it may be possible to extend treaty benefits to PEs unilaterally under domestic laws; this will be discussed in Section 7.3.5., below.

The various approaches discussed in this section are, in general terms, not mutually exclusive. That is, if it is the treaty policy of a particular state that the PE-S treaty should apply to income attributable to a PE, then that state could seek to include terms in its treaties that operate to extend treaty benefits to PEs both indirectly where that treaty is operating as the R-S treaty and directly where that treaty is operating as the PE-S treaty. This may make PEs in more states eligible for treaty benefits in a shorter period of time, but it could be problematic in the sense that there may be inconsistencies between the provisions of various treaties. It would be preferable for states to agree on a single approach and apply it consistently in all treaties.

820 The indirect approach was proposed by Zhai (Zhai, G., "Triangular Cases…") who relied on the application of the PE non-discrimination provision (Article 24(3)) of the R-PE treaty to require the PE state to grant relief. However, as discussed in Chapter 4 (see Section 4.3.), many states do not accept that a relief obligation arises under Article 24(3), particularly with respect to treaty relief (as opposed to the relief available under their domestic laws). It is also problematic to rely on Article 24(3) to require the PE state to extend treaty relief to PEs because in situations where the source state doesn't apply the conditions of the PE-S treaty this effectively leads to an unbalanced application of the PE-S treaty. The better approach would be for the PE state to have an explicit obligation to grant relief for tax imposed in the source state. The relief obligation in the PE state will be discussed further in Section 7.4., below.
The remainder of this section will assess the various approaches for extending treaty benefits to PEs. However, it will not specifically consider issues related to the relief available in the PE state, which will be discussed in Section 7.4., below, or the exclusion of the R-S treaty, which will be discussed in Section 7.5., below.

7.3.1. Direct treaty entitlement

Direct treaty entitlement for PEs has a number of significant advantages over the other approaches identified above. Where the direct approach is employed, the provisions extending treaty benefits to PEs would be included in the PE-S treaty itself and would require both the PE state and the source state to apply the terms of the treaty. This would prevent any risk of an unbalanced application of the PE-S treaty which, as will be seen below, underlies the main disadvantage of the indirect approach.

If the PE-S treaty conditions are applied directly, however, the source state may be required to apply the conditions of the PE-S treaty in relation to income which is derived by a resident of a state which does not have a treaty with the source state (i.e., in situations where there is no R-S treaty). This may be considered inappropriate on the basis that residents of a state which does not have a treaty with the source state should not be entitled to treaty benefits, regardless of whether the income is attributable to a PE in a third state. However, once it is accepted that the appropriate treaty to apply in a PE triangular case is the PE-S treaty, then the existence of an R-S treaty is effectively irrelevant and the absence of an R-S treaty should not prevent the application of the PE-S treaty.\(^\text{821}\)

A significant advantage of the direct approach is that the direct application of the PE-S treaty allows the PE state and the source state to negotiate the extent to which treaty benefits should be available to PEs, e.g., whether such benefits should be limited to certain categories of income. As discussed in Chapter 5 (section 5.2.2.2.), one of the arguments for extending treaty benefits to PEs is that the split of tax revenues between the PE state and the source state should depend upon the bargain struck between them and reflected in the PE-S treaty, and the direct application of the PE-S treaty is the most certain way of ensuring that this is the case. The direct approach also means that the terms of the PE-S treaty can, where necessary, address any unusual circumstances in one or both of the contracting states which are relevant to the extension of treaty benefits to PEs. Furthermore, where treaty benefits are extended to PEs directly, the PE-S treaty can deal with any other specific consequences for the application of the PE-S treaty, such whether and how a limitation on benefits (LOB) provision contained in the treaty should apply in the context of a PE claiming treaty benefits. Finally, the operation of a direct extension of treaty benefits to PEs could potentially be simpler than an indirect extension of treaty benefits, in that there would be no need to consult multiple treaties to understand the operation of the PE-S treaty.\(^\text{822}\) It may also simplify the provision of relief in the PE state, particularly where the PE state uses the credit method of relief (as will be seen in Section 7.4.1., below).

7.3.2. Indirect treaty entitlement

A significant advantage of the indirect approach is that the provisions of the R-S treaty requiring the source state to apply the PE-S treaty would presumably also exclude the operation of the R-S treaty in relation to income attributable to the PE. This means that the source state will never be obliged to apply the conditions of two tax treaties simultaneously. By contrast, if treaty benefits are extended to PEs directly, then it is more likely that situations will arise where the source state is required to apply the conditions of both treaties. This impact of the application of multiple treaty conditions will depend upon the relative terms of the two treaties. To the extent that the terms of the treaties are the same in relation to the category or categories of income attributable to the PE, the application of multiple treaty

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\(^{821}\) The OECD’s 1992 report on triangular cases also makes the point that in this case, the PE-S treaty is operating on the principle of reciprocity and implying that overall, the principle of reciprocity is not compromised by requiring the source state to apply the conditions of the PE-S treaty in situations where there is no R-S treaty. See: OECD Committee on Fiscal Affairs, "Triangular Cases," para 44.

\(^{822}\) It should be noted, however, that specific terms would still need to be included in the R-S treaty to prevent the source state from being subject to multiple treaty restrictions; this will be discussed in Section 7.5.2., below.
conditions will have no impact on the amount of tax the source state is entitled to impose. However, it is common for treaties to differ with respect to the rate of source-based taxation which can be imposed on dividends, interest and royalties; where two treaties apply, the source state will only be able to fulfil its treaty obligations by applying the lower of the two rates. Clearly, this would be undesirable for the source state.

The primary disadvantage of the indirect approach is that the application of the PE-S treaty depends, firstly, upon the residence state having treaties with the source state and the PE state, and secondly, on the specific provisions contained within those treaties. This could lead to an unbalanced application of the PE-S treaty, whereby the terms of the PE-S treaty would be applied only in the source state or only in the PE state, in situations where either there is no R-PE treaty or no R-S treaty, or where one of those treaties does not contain specific provisions dealing with PE triangular cases. This is clearly undesirable and can potentially lead to adverse consequences, including unrelieved double taxation as will be seen below.

The unbalanced application of the PE-S treaty can lead to unrelieved double taxation regardless of whether it is the PE state or the source state that does not apply the PE-S treaty. If no relief is provided in the PE state, then the relief of double taxation will fall to the residence state, which may or may not be capable of providing sufficient relief (refer to the discussion in Chapter 3, Section 3.2.). Alternatively, if the source state is not required to apply the conditions of the PE-S treaty and the PE state is required to provide relief, but that relief is limited to that which would be available to residents of the PE state under the PE-S treaty, then unrelieved double taxation can persist to the extent that the source state imposes more tax than would be allowed under the conditions of the PE-S treaty. The potential for unrelieved double taxation in circumstances where there is an unbalanced application of the PE-S treaty is a clear disadvantage of the indirect approach.

Another disadvantage of the indirect approach is that the extent to which reductions in source based taxation under the PE-S treaty are available to the PE depends upon the agreement reached between the residence state and the source state, and embodied in the R-S treaty. So, for example, the R-S treaty may require the source state to apply the conditions of the PE-S treaty, but only with respect to passive income. This could potentially result in the split of tax revenues between the PE state and the source state being dependent upon the terms of the R-S treaty rather than those of PE-S treaty, which is arguably inappropriate.

The reliance on treaties concluded by the residence state also means that two PEs located in a particular state (the PE state), in what are effectively the same circumstances (e.g., both earning the same income, both exempt in their residence state, both taxable in the PE state), may be subject to different treaty conditions by virtue of the enterprises to which they belong being resident in different states. That is, treaty between the residence state of one of the enterprises and the source state may require the source state to apply the conditions of the PE-S treaty, while the treaty between the other enterprise's residence state and the source state does not.

The issues associated with the indirect approach to extending treaty benefits to PEs mean that the direct approach is to be preferred. However, if the full extension of treaty benefits to PEs is rejected, then it would still be desirable to require the PE state to provide relief for tax imposed in the source state. In circumstances where the PE-S treaty doesn't apply, this could best be achieved by provisions included in the R-PE treaty (i.e., as suggested in the OECD's triangular cases report). The inclusion of provisions in the R-PE treaty to require the PE state to grant relief will be discussed further in Section 7.4.2., below.

### 7.3.3. Provisions included in all three treaties (Avery-Jones proposal)

Avery Jones proposes a solution to PE triangular cases whereby the residence state would transfer to the PE state the right to claim to be the “residence state” in relation to income attributable to the PE for the purposes of treaties between the PE state and third states. This proposal has been outlined in further detail above (see Section 7.2.6.). This approach would ensure that the source state applies the conditions

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823 Avery Jones, J.F., "The David R. Tillinghast Lecture..." This solution is also mentioned very briefly in: Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems..." Zhai also discusses this proposal, referring to unpublished work of J.F., Avery Jones (see: Zhai, G., "Triangular Cases...")).
of the PE-S treaty instead of those contained in the R-S treaty, and would ensure that the PE state grants relief for tax imposed in the source state. It also addresses treaty shopping concerns by ensuring that the PE-S treaty only applies (instead of the R-S treaty) if the PE state taxes the income normally. However, there are certain problems with this approach. Firstly, this solution will not be effective unless there are treaties in place between all three of the contracting states and all three treaties contain specific provisions for dealing with PE triangular cases.\textsuperscript{824} If there is either no PE-S treaty or no R-PE treaty, or if either of those treaties does not contain the necessary provisions, then the transfer of residence under the R-PE treaty will have no effect. The fact that this proposed solution requires all three treaties to contain corresponding provisions may make it more difficult to implement in practice than the direct and indirect approaches, discussed above, which can be fully implemented with provisions included in only two treaties.

In addition, this proposed solution requires the residence state (presumably the tax authority of the residence state) to be involved in making the decision to transfer the "residence" claim to PE state, and makes the residence state responsible for determining whether the income is sufficiently taxed in the PE state. The residence state's obligations under this proposal seem to be greatly in excess of the normal obligations which a residence state may have to, e.g., certify the residence of locally resident companies. In addition, the residence state is not in the best position to assess the extent to which the income attributable to the PE is taxed in the PE state. In most cases it will presumably rely on the taxpayer to provide the information regarding the taxation of the income in the PE state, which the taxpayer could just as easily provide to the source state. It also appears that this approach would require the residence state to make a decision regarding whether to transfer residence, which would be a significant departure from the normal operation of tax treaties, whereby entitlement for treaty benefits arises independently, without requiring any decision by the tax authorities of the residence state, and where claims for treaty benefits are made by the persons who are entitled to such benefits.\textsuperscript{825} Under current treaty principles, the residence state does not claim to be the residence state in relation to income derived by its residents; rather, those resident persons claim to be resident in their residence state. It is therefore unclear exactly what the residence state is transferring to the PE state. Overall, this does not seem to be the best possible approach to dealing with PE triangular cases.

7.3.4. Mutual agreement

The treaty between France and Belgium, concluded in 1964, contains a provision which allows (but does not require) the contracting states to apply the terms of the treaty in relation to income derived in certain PE triangular cases under the mutual agreement procedure. The problem with this approach is that the PE-S treaty will only apply if the Contracting States agree to apply it. A provision like this would arguably be insufficient to prompt states to more generally apply the conditions of their treaties in relation to income derived through PEs in PE triangular cases, since by granting such benefits they would effectively be giving up their taxing rights despite not having any obligation to do so. The application of the provisions of the PE-S treaty in this situation may also result in the source state being subject to multiple treaty restrictions in respect of the same income, since it would generally have no means of excluding the operation of the R-S treaty in relation to the income attributable to the PE.

This approach minimises any concerns of treaty shopping through PEs, since the competent authorities of both contracting states must agree to apply the treaty in each particular case, and would allow states to deal with PE triangular cases in situations which are clearly problematic and in which there is no suggestion of treaty shopping. However, due to the essentially optional nature of the application of the treaty to income derived by PEs and the impossibility of enforcing the provision in a uniform way, it is not a satisfactory approach for dealing with PE triangular cases more generally.

\textsuperscript{824} Zhai, G., "Triangular Cases...."

\textsuperscript{825} Administrative aspects of extending treaty benefits to PEs will be discussed in Chapter 8 (see Section 8.3.3., which deals with how the claim for treaty benefits should be made and with certification requirements).
7.3.5. Domestic law

It is possible for states in the position of the source state to unilaterally apply the conditions of the PE-S treaty\textsuperscript{826} in relation to income attributable to a PE in the PE state and thus, to unilaterally extend treaty benefits to PEs. They could do this by enacting a provision in their domestic law to the effect that any income which is attributable to a foreign PE will be taxed as though it were derived by a treaty-eligible resident of the state where the PE is located (i.e., the PE state), in accordance with the provisions of its treaty with that state (i.e., PE-S treaty)\textsuperscript{827}. As a result, the source state may, for example, unilaterally reduce the amount of withholding tax it imposes on dividends or interest paid to a foreign PE\textsuperscript{828} so that it is equal to the amount that would be imposed if the PE-S treaty applied. An advantage of this approach is that it could be implemented without specific provisions being included in tax treaties.

In practice, states are unlikely to extend treaty benefits to PEs unilaterally because any state that did so would, as a result, have virtually no negotiating power to convince other states to implement similar measures, either in their domestic law or in tax treaties. In effect, the source state would be giving up tax revenue with little chance of reciprocal measures in other states. One alternative may be for the extension of treaty benefits to PEs under domestic law to be dependent on a reciprocal (domestic law) application of the treaty in the other state. However, if both states agree to apply the treaty to PEs, then it would generally be preferable for the extension of treaty benefits to PEs to be included in the treaty itself (or in a protocol to the treaty). A domestic law extension of treaty benefits to PEs would also result in the source state being subject to the conditions of both the PE-S treaty and the R-S treaty. This is because the source state cannot unilaterally refuse to grant a reduction in source based taxation to residents of State R which is available under the R-S treaty on the basis that the income is attributable to a PE in another state. The source state is bound to apply the conditions of R-S treaty, and any unilateral provision which purported to deny treaty benefits would contravene that state’s obligations under international law\textsuperscript{829}. For these reasons, a treaty solution would be preferable to one relying on domestic laws.

Even if states do not unilaterally extend treaty reductions in source based taxation to PEs, they can clearly grant unilateral relief to PEs located within their borders. This would go a long way to resolving the issues arising in PE triangular cases, in that it would prevent unrelieved double taxation\textsuperscript{830}. Various states already extend their domestic relief measures to income which is derived by non-residents through PEs or in cases where an equivalent domestic law threshold is met\textsuperscript{831}. Where relief is granted under domestic law, it is important to ensure that the relief provided is compatible with the result arising under the applicable tax treaties. Unrelieved double taxation may still arise, for example, in states that only allow relief in

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\textsuperscript{827} If the source state is concerned about extending the benefits of the PE-S treaty to PEs in situations where the PE state either does not tax the income attributable to the PE, or imposes only a minimal amount of tax, the application of the PE-S treaty conditions could be made conditional on the PE state imposing a certain level of tax on the income. This type of anti-avoidance provision will be discussed in Chapter 8 (see Section 8.4.2.).

\textsuperscript{828} The benefits of the PE-S treaty should be made available only in situations where the recipient of the income has a PE in the PE state for the purposes of the R-S treaty. Otherwise, if the definition used for domestic law purposes is wider than that contained in the R-PE treaty, the source state may find itself granting treaty benefits in situations where the PE state is prevented from imposing tax on the income under the R-S treaty. Alternatively, if the definition used for domestic law purposes is narrower than the definition under the R-PE treaty, then the provision extending treaty benefits to PEs may be ineffective in certain situations, and may not allow the benefits of the PE-S treaty in relation to certain income which is attributable to a PE for the purposes of the R-PE treaty. To be effective, therefore, any domestic law provision extending treaty benefits to PEs should refer to the PE definition contained in the R-PE treaty. This will be discussed further in Chapter 8 (see Section 8.2.3.).

\textsuperscript{829} Vienna Convention on the Law of Treaties, Articles 26 and 27. Article 26 provides that: “Every treaty in force is binding upon the parties and must be performed by them in good faith.” Article 27 provides that: “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”

\textsuperscript{830} For further discussion and an illustration of how relief in the PE state ensures that there is no unrelieved double taxation, refer to Chapter 3 (Section 3.2.2.2.).

\textsuperscript{831} This was discussed in Chapter 4. For examples of states that extend domestic relief provisions to non-residents deriving income through local PEs, see Section 4.2.2.1.
relation to income which is considered to be foreign source income under domestic sourcing rules.\textsuperscript{832} Where there is an overlap between the source rules of the PE state and those of the source state, the source state may impose tax on income which the PE state does not consider to be "foreign source income" and thus, the PE state may not provide relief under its domestic relief provisions.\textsuperscript{833} To overcome this potential problem, the limitation on double taxation relief in relation to domestic source income could be relaxed in the case of PEs, such that relief would be available for foreign tax imposed on a source basis in relation to income attributable to a PE regardless of whether the income is considered to have a foreign source under domestic law.\textsuperscript{834}

7.3.6. Conclusions

Extending treaty benefits to PEs directly under the terms of the PE-S treaty is clearly preferable to the other alternatives discussed above. 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 state where the person to which the PE belongs is resident. 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 treaty conditions agreed between those two states, rather than with the residence state. Furthermore, in contrast to the indirect approach, the direct approach avoids the potential for unbalanced applications of the PE-S treaty, i.e., where the PE-S treaty is applied in only one of the contracting states. Thus, it would be preferable to apply the PE-S treaty to the income attributable to the PE directly rather than indirectly. The exact form and wording of the provisions will be discussed in Chapter 8.

If it is not accepted that the PE-S treaty should apply in relation to the income arising in PE triangular cases, then it would still be desirable to nevertheless apply the other aspects of this solution. That is, the PE state should be explicitly required to grant relief for tax imposed in the source state and a provision could be included in the R-S treaty to ensure that it doesn’t apply in circumstances which are considered abusive. This would only be a partial solution, since the source state would continue to apply the “incorrect” treaty provisions, but it would prevent unrelieved double taxation and would prevent improper use of the R-S treaty. The discussion in the remainder of this chapter will therefore address both situations where the source state does apply the conditions of the PE-S treaty and situations where it does not.

This minimalist approach would resolve many of the issues that arise in PE triangular cases and it is likely to be much simpler to gain acceptance of this approach and to implement it. However, a more comprehensive approach, under which a person deriving income in a PE triangular case would be entitled to invoke the provisions of the PE-S treaty, would nevertheless be a better approach. The minimalist approach is considered to be the next best solution if the more comprehensive solution is not accepted.

7.4. Double taxation relief in the PE state

As discussed in Chapter 4, the PE state may have an obligation under the non-discrimination article (Article 24(3)) of the R-PE treaty to provide relief for tax imposed in the source state. However, given the disagreement surrounding the obligation to provide relief and the difficulties with determining the amount of relief to be provided, it would be preferable for there to be an explicit treaty obligation for the PE state to provide relief. The PE state could potentially be required to grant relief either under a specific provision included in either the PE-S treaty or the R-PE treaty. The specific provisions which could be included in treaties to require the PE state to grant relief will be discussed in Chapter 8; the discussion in this section will focus on the limitations which should be imposed on the relief available in the PE state,

\textsuperscript{832} This is the case in the US, for example, under IRC Section 901. This was also the case in Australia prior to 2008 (former Section 160AF, Income Tax Assessment Act 1936 (repealed by the Tax Laws Amendment (2007 Measures No. 4) Act, 2007, with effect from income years starting after 1 July 2008)).

\textsuperscript{833} This issue can also arise in the residence state in bilateral situations, however in most bilateral situations the issue would be resolved by the residence state having a relief obligation under an applicable tax treaty.

\textsuperscript{834} Australia took this approach in reforms enacted in 2007 by the Tax Laws Amendment (2007 Measures No. 4) Act, 2007, with effect from income years starting after 1 July 2008.
and on certain additional issues which may arise if the PE state is required to grant relief under the R-PE treaty.

7.4.1. Limitations on relief

Regardless of whether the PE state is required to provide relief under provisions included in the PE-S treaty or in the R-PE treaty, it is important to consider the limitations on that relief. This is particularly relevant where the PE state uses the credit method. The limitations on the amount of relief to be provided in the PE state are complicated by the fact that if certain states begin to extend treaty benefits to PEs, then it is possible that the source state may apply the conditions of the R-S treaty, the PE-S treaty or both depending on the provisions (if any) included in each of the relevant treaties to deal with PE triangular cases. The aim of this section is therefore to determine the appropriate limitations to apply in relation to the relief in the PE state, taking into account that they must be capable of being applied regardless of the applicable treaty conditions in the source state.

7.4.1.1. Basic criteria for relief

The relief provisions of the OECD Model require the residence state to grant relief in relation to income which may be taxed in the other Contracting State "in accordance with the provisions of this Convention"835 If the PE state is required to extend treaty relief to PEs (as a result of provisions included in either the R-PE treaty or the PE-S treaty), then such relief should only be required if the income may be taxed in the source state in accordance with the provisions of the PE-S treaty and in accordance with the terms of any applicable treaty between the source state and a third state (i.e., the R-S treaty). This will have the effect that no relief will be required in the PE state if either the R-S treaty or the PE-S treaty prevents the source state from imposing tax. It is possible to apply both these conditions regardless of which treaty conditions actually apply in the source state in a particular case with no ill-effect; if the source state is not required to apply the conditions of either the PE-S treaty or the R-S treaty, then nothing in the non-applicable treaty will prevent the source state from imposing tax and consequently, the condition in the relief article relating to that particular treaty will (correctly) have no effect. There is therefore no need to include specific wording to deal with each possible combination of applicable treaty conditions in the source state.836

7.4.1.2. Limitations on the amount of credit relief

In situations where the PE state provides relief using the credit method (either generally or only in relation to passive income), the provision requiring relief should specify the applicable limitations on the amount of the credit available. This is the case regardless of whether the relief provision is included in the PE-S treaty or the R-PE treaty.

Clearly, any credit which the PE state is required to grant should be limited to the amount of tax paid in the source state and to the amount of tax in the PE state which is attributable to the income as is the case under the existing relief provisions of the OECD Model.837 The relief provisions of the OECD Model also limit the credit to the amount of tax that may be imposed in accordance with the convention.838 In a PE triangular case, the application of this type of limitation is more complicated because the source state may potentially apply the conditions of the R-S treaty, the PE-S treaty, no treaty or both treaties.

The OECD Commentary suggests that credit relief in the PE state should be limited to the lesser of:

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835 2010 OECD Model, Article 23A(1). Similar wording is contained in Article 23A(2) (regarding the credit method for interest and dividends in situations where exemption is the primary method of relief) and Article 23B(1) (where the credit method is the primary method of relief).
836 Taking into account that even if the PE-S treaty does not require the source state to apply its conditions in PE triangular cases, the source state may be required to apply the PE-S treaty conditions as a result of provisions included in the R-S treaty, as discussed below.
837 2010 OECD Model, Article 23A(2) and Article 23B(1).
838 2010 OECD Model, Article 23A(2) and Article 23B(1).
1. The tax paid in the source state;
2. The amount of tax the source state may impose under the terms of the R-S treaty; and
3. the amount of tax the source state would have been entitled to impose under the terms of the PE-S treaty, if they applied.839

These limitations assume that the source state applies the conditions of the R-S treaty and does not apply the conditions of the PE-S treaty, but could be easily adapted to cover other situations. The amount of the credit should clearly be limited to the amount of tax that the source state may impose under any applicable treaty, i.e., the R-S treaty and/or the PE-S treaty. However, even if the source state is not required to apply the conditions of the PE-S treaty in relation to income attributable to the PE, the contracting states may wish to limit the amount of the credit in the PE state to the amount of tax that the source state could have imposed if it had applied the conditions of the PE-S treaty. If such a limitation is included, the states are effectively accepting that there will be unrelieved double taxation in certain. This supports the application of the conditions of the PE-S treaty in the source state.

7.4.2. Provisions included in the R-PE treaty

As discussed above, the issues associated with the indirect approach to extending treaty benefits to PEs mean that the direct approach is to be preferred. However, if the application of the conditions of the PE-S treaty in the source state is rejected, then it would still be desirable for the PE state to be required to provide relief for tax imposed in the source state. Where the PE-S treaty doesn’t apply in the source state, this could best be achieved by provisions included in the R-PE treaty, since otherwise the PE-S treaty would need to be made applicable solely for this purpose.

The main question to be addressed in relation to a provision of the R-PE treaty requiring relief in the PE state is whether it should require the PE state to provide relief directly, or whether it should link the relief available to PEs to the relief that would be available to residents of the PE state under the PE-S treaty. Thus there are two main alternatives for the operation of a provision of the R-PE treaty requiring the PE state to grant relief, namely:

1. A provision which requires the PE state to grant relief by reference to the relief available to residents of the PE state under the PE-S treaty; and
2. A provision which requires the PE state to grant relief directly, without reference to the PE-S treaty.

From a theoretical perspective, the preferred approach would be to link the relief to that available to a resident of the PE state under the PE-S treaty. This would put the PE, as closely as possible, in the same position as a resident of the PE state. However the practical implications of these two approaches should also be considered. As will be discussed below, the main difference between these two approaches becomes clear in situations where there is either no PE-S treaty or where the PE-S treaty requires the PE state to use a different method of relief (i.e., credit or exemption) than that which would apply under the R-PE treaty.

The OECD Commentary contains a suggested addition to the non-discrimination article which would oblige the PE state to provide double taxation relief to PEs. Although the provision is included in the non-discrimination article, it requires the PE state to provide relief directly, without reference to the relief that would be available to a resident of the PE state. This provision reads as follows:

839 2010 OECD Commentary on Article 24, para 70, which reads: "When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt claim in respect of which the dividends or interest are paid is effectively connected with the permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the state of which the enterprise is resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is resident in the first-mentioned Contracting State can claim under that state's convention with the third State." These limitations are discussed in detail in Chapter 4 (see Section 4.3.5.).
"When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt claim in respect of which the dividends or interest are paid is effectively connected with the permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the state of which the enterprise is resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is resident in the first-mentioned Contracting State can claim under that state's convention with the third State."840

This provision will be discussed below, particularly in relation to the method of relief. It should be noted that this provision only requires the PE state to grant relief with respect to certain categories of income; the extent to which the treaty benefits available to PEs should be limited to certain categories of income will be discussed in Chapter 8 (Section 8.2.4.).

7.4.2.1. Method of relief

Where the PE state is required to grant relief by reference to the relief provisions of the PE-S treaty, the relief available to the PE will always be the same method of relief as that which would be available to a resident of the PE state under the PE-S treaty. This may be either the credit method or the exemption method depending on the terms of the PE-S treaty and the category of income involved.

If the relief provision doesn’t refer to the PE-S treaty then it must specify the method of relief available. It would preferable, in order to place the PE in the same position as a resident of the PE state, for the method of relief available to the PE to be the same as the method which would be available to a resident of the PE state under the PE-S treaty. Where the PE state uses the same primary method of relief (i.e., exemption or credit) in all its treaties then the R-PE treaty should clearly require the PE state to use that method of relief in relation to the income attributable to the PE, and this will not be an issue. This may also be the case in relation to passive income, such as dividends, interest, and royalties where the credit method typically applies regardless of the general method of relief used in the treaty.841 However, where the PE state does not use the same method of relief in all its treaties, the method of relief available to the PE may differ from that available to residents of the PE state. This is a potential disadvantage of a direct relief requirement, and suggests that it would be preferable for the PE relief provision to operate by reference to the relief provision of the PE-S treaty.

The suggested relief provision in the OECD Commentary requires the PE state to apply the credit method of relief regardless of the method of relief generally required by the PE-S treaty (or, indeed, the R-PE treaty). However, it also limits relief in the PE state to cases involving dividends and interest842 sourced in a third state and does not apply to other categories of income. Under the OECD Model, the credit method always applies in relation to dividends and interest, regardless of the method of relief applicable to other categories of income (see Article 23A and Article 23B). Therefore, assuming the applicable treaties follow the OECD Model, the method of relief will be the same as that which would be available to residents of the PE state. The Commentary does go on to say that, where the convention (presumably the R-S treaty) allows source-based taxation in relation to other categories of income, such as royalties, then the relief provision could be extended to cover those categories of income.843 Where other categories of income are involved, however, the credit method may not always be the appropriate method of relief. If a resident of the PE state would be entitled to exemption relief then arguably the PE should

840 2010 OECD Commentary on Article 24, para 70.
841 See: 2010 OECD Model, Article 23A and Article 23B.
842 Under the OECD Model, royalties may only be taxed in the residence state (under Article 12, except where they are attributable to a PE). This explains why royalties are not included in the relief provision suggested in the OECD Commentary. In reality, however, treaties commonly allow source-based taxation of royalties (limited to a certain percentage of the gross amount of the income) and thus even under a provison based explicitly on that suggested in the OECD Commentary, relief should also be available in relation to royalties.
843 2010 OECD Commentary on Article 24, para 70.
also be entitled to exemption relief, as this would place the PE as closely as possible in the same position as a resident enterprise.

7.4.2.2. Situations where there is no PE-S treaty

In situations where there is no PE-S treaty, the PE should arguably not be entitled to any relief for tax imposed in the source state. The lack of relief could result in unrelieved double taxation in certain situations, but in this case unrelieved double taxation could also occur if a resident of the PE state derives income from the source state. If relief were to be provided, the PE would potentially be in a more favourable position than a resident of the PE state, since residents of the PE state would not be entitled to any form of treaty relief (although unilateral relief may still be available). In addition, extending relief to PEs may enable enterprises to obtain relief when operating through a PE in circumstances where no relief would be available if they were operating through a locally resident enterprise in the PE state. The PE state could potentially consider this an improper use of the R-PE treaty. The extension of relief to PEs may also reduce the incentive for the source state and the PE state to negotiate a treaty, since enterprises would be able to obtain relief by operating through a PE. The preferred approach would therefore be to oblige the PE state to grant relief only where relief would be available to residents of the PE state under a treaty with the source state (or under the domestic law). This would serve to put the PE as closely as possible in the same position as a resident taxpayer. If the R-PE treaty requires the PE state to provide relief by reference to the relief available under the PE-S treaty then, in the absence of a PE-S treaty, the PE state will not be required to provide any relief. The relief in the PE state will automatically be limited to situations where there is a PE-S treaty. If, however, the R-PE treaty requires the PE state to provide relief directly, without reference to the PE-S treaty, then the contracting states may wish to include an exception for situations where there is no PE-S treaty. This again suggests that the better approach would be for the PE relief provision of the R-PE treaty to operate by reference to the relief provisions of the PE-S treaty.

7.4.2.3. Proposed relief provision

As discussed above, the PE state could be obliged to provide relief in PE triangular cases under the R-PE treaty either directly or by reference to the relief available to resident enterprises of the PE state under the PE-S treaty. If a relief obligation is included in the R-PE treaty, the better approach would be to link the relief to that available under the PE-S treaty, because this would ensure that the PE state uses the same method of relief as it would if the income were derived by a resident of the PE state and would prevent the PE state from being obliged to provide treaty relief in situations where there is no PE-S treaty.

A provision included in the R-PE treaty and requiring the PE state to grant relief for tax imposed in the source state in PE triangular cases could be worded along the following lines:

"(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.

(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 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.

(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."

This provision has a number of features which reflect the discussion earlier in this section regarding the situations in which relief should be provided, and the appropriate limitations on relief. Firstly, this provision operates by reference to the relief that would be available to a resident of the PE state, either under domestic law or under a treaty with the source state. It applies only where the source state is entitled to impose tax on the income in accordance with the R-S treaty, meaning that if the source state is prevented from imposing tax under the R-S treaty, then no relief is required in the PE state.844

Paragraph 2 deals with the extension of treaty relief to the PE, and requires the PE state to apply the relief provision of the PE-S treaty. However, it allows the PE state to provide relief as though the source state had also applied the terms of the PE-S treaty in relation to the income and taking into account any limitations under the R-S treaty. Where the exemption method applies, this means that no relief will be available if the source state would have been prevented from imposing tax if it had applied the PE-S treaty, or if it is prevented from imposing tax under the R-S treaty.

Where the credit method applies, the amount of relief would be limited to:

(i) the amount of tax actually imposed in the source state, by virtue of the reference to the terms of the PE-S treaty;

(ii) the amount of tax the source state could have imposed if it had applied the PE-S treaty; and

(iii) the amount of tax the source state can impose under the R-S treaty.

The suggested provision is worded in such a way that the second and third limitations are optional ("may"), which would allow the PE state, if it wished, to provide a credit in excess of the amount of tax that the source state could impose under the PE-S treaty. However, the third limitation is effectively not optional, and the reference to the terms of the R-S treaty could even be omitted, since relief is limited to the amount of tax imposed in the source state and the amount of tax imposed will already be limited by the terms of the R-S treaty; it is included in the suggested provision more for the avoidance of doubt.

Paragraph 3 deals with the extension of domestic relief provisions to a PE deriving income from a third state, and requires the PE state to grant relief under the same conditions and using the same method as would apply to residents of the PE state. This could apply, for example, in circumstances where there is no PE-S treaty.

7.5. Non-application of R-S treaty conditions in the source state

One of the main concerns arising in PE triangular cases under the current framework is the potential for improper access to the R-S treaty. States may therefore wish to exclude the operation of the R-S treaty in PE triangular cases as an anti-avoidance measure. In addition, if the source state applies the conditions of the PE-S treaty then it will in all likelihood seek to exclude the operation of the R-S treaty. As discussed above, the operation of the R-S treaty can only be excluded by provisions included in that treaty; neither the R-PE treaty nor the PE-S treaty can prevent the source state from being obliged to apply the conditions of the R-S treaty in relation to income derived by a person who is resident in State R.845 The following section will discuss the exclusion of the R-S treaty as an anti-avoidance measure, while the following section will go on to discuss the exclusion of the R-S treaty in circumstances where the source state applies the conditions of the PE-S treaty.

844 This arises from the following wording in the first paragraph: "...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..."

845 This point was made by Zhai, G., "Triangular Cases...."
7.5.1. Excluding the application of the R-S treaty in tax avoidance situations

One of the primary concerns relating 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 as a result of the application of the R-S treaty in a situation 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.846 It should be noted that the main concern for the source state is not existing residents of State R establishing a PE in a third state and transferring income-generating assets to that PE, in which case there may be a reduction in the amount of tax collected in the residence state (e.g., due to exemption of the income) but no impact in the source state. The concern for the source state is, rather, situations where a person who is deriving income847 (or expecting to derive income) from the source state establishes a company, resident in State R, to derive the income from the source state and ensures that the income is attributable to a PE in a third state so that the benefit of reduced rates of taxation in the source state is not offset by a tax liability in the residence state. This results in the source state being able to impose less tax than it would be able to impose if the income were derived directly.

Clearly, this type of improper access to treaties could be addressed using the same approaches as are used to attack treaty shopping more generally, such as the beneficial ownership concept, general anti-avoidance rules and LOB provisions. These approaches were discussed in Chapter 5, and this section will not include any additional discussion of them. Instead, this section will focus on possible approaches for dealing specifically with improper access to tax treaties in PE triangular cases.

7.5.1.1. Specific provisions included in existing treaties

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. These provisions generally exclude the normal reductions in source based taxation under the treaty in certain situations where income is attributable to a PE located in a third state. Most of the existing provisions of this type are included in treaties concluded by the United States,848 and they are generally found in the LOB provision.849 Similar provisions are included in the Canada-France treaty (added to the 1975 treaty by protocol in 1995), the Canada-Belgium treaty (2002), the Canada-Lebanon treaty (2008) and the Netherlands-UK treaty (2008).850

847 Who is most likely resident outside the three states involved in the triangular case.
848 Including the US treaties with: Austria (Article 16(4), 1996), Belgium (Article 21(6), 2006), Bulgaria (Article 21(5), included in 2007 treaty by protocol in 2008), Chile (Article 24(5), 2010), Denmark (Article 22(6), included in 1999 treaty by protocol in 2006), Finland (Article 16(5), included in 1989 treaty by protocol in 2006), France (Article 30(5), 1994), Germany (Article 28(5), included in 1989 treaty by protocol in 2006), Hungary (Article 22(6), treaty signed in 2010 but has not yet entered into force (as at 17 January 2012)), Iceland (Article 21(5), 2007), Ireland (Article 23(7), 1997), Luxembourg (Article 24(5), 1996), Malta (Article 22(5), 2008), the Netherlands (Article 12(8) and Article 13(6), included in 1992 treaty by protocol in 1993), New Zealand (Article 16(5), included in 1982 treaty by protocol in 2008), South Africa (Article 22(6), 1997), Sweden (Article 17(5), included in 1994 treaty by protocol in 2005), and Switzerland (Art 22(4), 1996).
849 Interestingly, the 2006 US Model convention does not contain a provision of this type, even though such provisions have been included in numerous US treaties since at least the mid-90s. They generally seem only to be included in treaties under which the other state uses the exemption method of relief (e.g., the 2001 protocol to the Australia-US treaty does not contain such a provision), and it may be that this is the reason for not including it in the US model.
850 The identification of treaties containing provisions of the type discussed in this section was based on a review of certain published articles and searches of the IBFD's tax treaty database carried out between [21 and 23 December 2010]. Due to the impossibility of reviewing all concluded treaties and the limitations of searching using key words, the list of both US and non-US treaties containing such provisions is likely to be incomplete.
A recent example of a provision excluding the operation of the R-S treaty in PE triangular situation which are considered to be abusive is that included in Article 22 (the LOB) of the Hungary-US treaty, signed in 2010, which reads as follows:

"6. Notwithstanding the proceeding provisions of this Article [i.e., the LOB], 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, 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 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 trade or business carried on by the permanent establishment in third state (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are securities activities carried on by a registered securities dealer, or, in the case of an enterprise of the United States, are banking activities carried on by a bank, or, in the case of an enterprise of Hungary, are regulated financial services carried on by a financial institution)."

The earliest provisions excluding the application of the R-S treaty in PE triangular cases were included in the US-Netherlands treaty in 1993. These provisions are included in the interest and royalties articles of the treaty, and thus applied only to those categories of income. By contrast, more recent provisions tend to apply to all categories of income, which is a better approach given that triangular situations can

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851 Note that as of April 2012, this treaty has not yet entered into force.

852 The provisions are worded to apply equally to both contracting states, but effectively apply only in relation to income arising in the US. They are included in the interest and the royalties articles (Article 12 and Article 13) of the treaty, and provide that if interest or royalties arising in one of the contracting states and beneficially owned by a resident of the other contracting state are attributable to a PE in a third state, and the income attributable to the PE is subject to an aggregate rate of tax in the residence state and the PE state of less than 60% of the general company tax rate in the residence state, then the provisions of the interest or royalties article (as applicable) do not apply to that income. Instead, the taxation in the source state is limited to 15% of the gross amount of the income. There is an exception for interest derived in connection with or incidental to the active conduct of a trade or business in the PE state, and for royalties received in relation to intangible property which has been produced or developed by the PE. If one of these exceptions applies, the treaty will apply in the normal way. (See: Turro, J., "U.S. and Dutch Negotiators..."; Specter, P. "'Triangular Problem'...")


854 This is also the case in the US treaties with Chile (Article 24(5)), Germany (Article 28(5)), Iceland (Article 21(5)), Ireland (Article 23(7)), Luxembourg (Article 24(5)), Malta (Article 22(5)), New Zealand (Article 16(5)), South Africa (Article 22(6)), and Switzerland (Art 22(4)). Similarly, the Canada-France treaty (Article 28(8)), and the Canada-Lebanon treaty (Article 27(4)) apply to all categories of income. The following US treaties limit this PE provision to interest and royalties: Austria (Article 16(4)), Belgium (Article 21(6)), Bulgaria (Article 21(5)), Denmark (Article 22(6)), France (Article 30(5)). Interestingly, the provisions included in the treaties with Finland (Article 16(5)) and Sweden (Article 17(5)) apply to insurance premiums, as well as interest and royalties. The relevant provision of the Netherlands-UK treaty (Article VII of the 2008 protocol) also applies only to interest and royalties. The relevant provision of the Belgium-Canada treaty (Article 27(5)) applies only to royalties.
also involve other categories of income (as discussed in Chapter 2). So, for example, a company resident in State R could derive "other income" from State S, which is attributable to a PE in State PE (which may be a tax haven), and which is exempt from tax in the residence state as a result of being attributable to the PE. In this case, State S would generally be prevented from imposing any tax under the "other income" article of the R-S treaty. Assuming that the source state would not be prevented from imposing tax if the income had not been attributable to the PE, this would clearly be just as much (if not more) of a concern for the source state than cases where interest or royalties are involved.

Treaties which exclude limitations on source based taxation for income which is attributable to a PE in a third state commonly contain exceptions for certain situations which are not considered to be abusive. The normal operation of the treaty is typically only excluded if the PE state does not impose sufficient tax on the income attributable to the PE. Thus, a reduction in source-based taxation available under the treaty is generally not excluded if the tax on the income attributable to the PE is subject to a combined rate of tax in the PE state and the residence state which is equal to at least 60% (or in some treaties 50%856) of the amount of tax that would be payable in the residence state857 if the income was not attributable to the PE. One difficulty which may arise with applying a limitation of this kind is that the calculation of the taxable income may differ between the three states involved. The US overcomes this problem by relying on detailed calculation rules which are included in its domestic law.859

In addition to exceptions for situations where income is sufficiently taxed, the normal reductions in source based taxation available under the treaty will virtually always continue to apply if the income is derived by the PE "in connection with or incidental to the active conduct of a trade or business" in the PE state. This may apply generally to all types of income or only to interest income, depending on the overall scope of the provision.860 It is also common for reductions in source based taxation to continue to apply in relation to royalties to the extent they are derived from "the use of, or the right to use, intangible property produced or developed by the permanent establishment itself."861 Less commonly, reductions in

855 This is the case in the US treaties with: Austria (Article 16(4)), Belgium (Article 21(6)), Bulgaria (Article 21(5)), Chile (Article 24(5)), Denmark (Article 22(6)), Finland (Article 16(5)), France (Article 30(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Malta (Article 22(5)), New Zealand (Article 16(5)), Sweden (Article 17(5)), Switzerland (Art 22(4)). Similarly, the Netherlands-UK treaty (Article VII of the 2008 protocol), the Canada-France treaty (Article 28(8)), the Canada-Lebanon treaty (Article 27(4)) and the Canada-Belgium treaty (Article 27(5)) also apply a 60% threshold.

856 This is the case in the US treaties with: Ireland (Article 23(7)), Luxembourg (Article 24(5)), and South Africa (Article 22(6)).

857 In some cases, consideration is limited to the tax imposed in the source state, on the basis that the income is exempt in the residence state, but this should generally give the same result. This is the case in the US treaties with: Belgium (Article 21(6)), Bulgaria (Article 21(5)), Denmark (Article 22(6)), Finland (Article 16(5)), Luxembourg (Article 24(5)), and Sweden (Article 17(5)).

858 This is the case in the US treaties with: Austria (Article 16(4)), Chile (Article 24(5)), France (Article 30(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Ireland (Article 23(7)), Malta (Article 22(5)), the Netherlands (Article 12(8) and Art 13(6)), New Zealand (Article 16(5)), South Africa (Article 22(6)), and Switzerland (Art 22(4)). This is also the case in the Canada-France treaty (Article 28(8)), the Canada-Lebanon treaty (Article 27(4)) and the Canada-Belgium treaty (Article 27(5)).

859 See, for example, the US Technical Explanation (published in 2007) to Article 21 of the US-Belgium treaty, which states: "In general, the principles employed under Code section 954(b)(4) will be employed to determine whether the profits are subject to an effective rate of taxation that is above the specified threshold." Similar comments are included in the US technical explanation accompanying other treaties.

860 Such provisions are included in the US treaties with: Austria (interest only, Article 16(4)), Belgium (interest only, Article 21(6)), Bulgaria (interest only, Article 21(5)), Chile (Article 24(5)), Denmark (interest only, Article 22(6)), Finland (interest only, Article 16(5)), France (Article 30(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Ireland (Article 23(7)), Luxembourg (Article 24(5)), the Netherlands (interest only, Article 12(8)), New Zealand (Article 16(5)), Sweden (interest only, Article 17(5)), Switzerland (Art 22(4)). This is also the case in the Canada-France treaty (Article 28(8)), the Canada-Lebanon treaty (Article 27(4)) and the Canada-Belgium treaty (Article 27(5)). The provisions included in the Maltes-US treaty (Article 22(5)) and the South Africa-US treaty (Article 22(6)) do not contain any exclusion for income derived by the PE in the active conduct of a trade or business. Neither does the provision contained in the Netherlands-UK treaty (Article VII of the 2008 protocol).

861 This is the case in the US treaties with: Austria (Article 16(4)), Belgium (Article 21(6)), Bulgaria (Article 21(5)), Chile (Article 24(5)), Denmark (Article 22(6)), Finland (Article 16(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Ireland (Article 23(7)), Luxembourg (Article 24(5)), Malta (Article 22(5)), the
source based taxation may continue to be available if the income which is attributable to the PE is taxed under controlled foreign companies (CFC) provisions in the source state, e.g., where the company deriving the income is controlled by residents of the source state.862  

Many of these provisions excluding the normal reduction in source based taxation in PE triangular cases provide an alternative limitation on the rate of tax which the source state can impose on dividends, interest and/or royalties. In most cases, this alternative maximum rate is 15%.863 Where no such limitation applies, the source state will simply apply the relevant provisions of its domestic law, which may result in the income being subject to a very high rate of source-based taxation. The limitation of the source based taxation to 15% can soften the impact of the ordinary treaty rate (which may be 0%864) being unavailable, at least with respect to the categories of income to which the 15% rate applies. 

Finally, by referring to the exclusion of "tax benefits" these provisions generally preserve the operation of aspects of the treaty which are not "tax benefits", such as the provisions of the associated enterprises article (Article 9), the exchange of information article (Article 26), and the assistance in the collection of taxes article (Article 27).

Assessment of this approach

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 or the suggestions of the OECD Commentary (discussed below), 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, a challenge 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 met its treaty obligations by denying benefits.865 Specific provisions are also more transparent and give taxpayers greater certainty as to the way in which the treaty will apply in their particular circumstances.

One argument against combating tax avoidance (including improper access to treaties) through specific provisions is that specific provisions can generally only apply in the case of tax avoidance strategies that have already been identified. This is particularly relevant in the case of tax treaties, since treaties cannot easily be amended and are generally in force for a long period of time before being renegotiated.866
7.5.1.2. Application of a specific anti-avoidance rule under domestic law

If the source state considers a claim for treaty benefits under the R-S treaty to be improper, it may potentially counteract the claim through the application of anti-avoidance rules contained in its domestic law. States may therefore be tempted to include a provision in their domestic law along the lines of the provisions which are included in some tax treaties (discussed above) to exclude the operation of the R-S treaty in PE triangular cases which they consider to be abusive. However, where the effect of a domestic anti-avoidance rule is to deny treaty benefits in situations in which they would otherwise be available, it is questionable whether the state denying treaty benefits has met its obligations under international law.867 If the rule implemented under domestic law does not depend on the taxpayer having a tax avoidance motive or does not seek to deny treaty benefits by re-characterizing the facts of the situation, it is not clear that it would fit within the OECD commentary’s approach, which allows states to apply domestic anti-avoidance rules in certain circumstances, and by denying treaty benefits, the source state would arguably fail to meet its treaty obligations. It would therefore generally not be sufficient to rely on domestic anti-avoidance measures to prevent improper application of the R-S treaty in PE triangular cases.

7.5.1.3. Treat profit as not attributable to the PE

The OECD Commentary on Article 21 (dealing with other income) notes that states which apply the exemption method may be concerned about assets which give rise to "other income" being attached to a PE in the other contracting state in order to obtain more favourable tax treatment (i.e., in bilateral situations).868 The concern here arises from the fact that if the residence state uses the exemption method, then income attached to a PE in the source state will only be taxed in the source state. Taxpayers may have an incentive to set up this type of structure because, to the extent that the tax rate in the source state is lower than that in the residence state, it will result in the income being subject to a lower rate of tax than it would be if it were not attributable to a PE. The OECD Commentary suggests that states which are concerned about this type of abuse may take the view that the transaction is artificial, and therefore, that the assets are not effectively connected to the PE.869 Although these comments deal with bilateral situations, the OECD triangular cases report suggests that this approach could also be applied to deal with PE triangular cases.870 That is, where the income is attributable to a PE located in a third state (rather than in the source state as outlined in the OECD Commentary), the residence state (or potentially the source state) could take the position that the income is not properly attributable to the PE.

One serious problem with this approach, regardless of whether the situation is bilateral or multilateral, is that (as the OECD points out elsewhere) it may be "extremely difficult, not to say impossible, to apply" and it disregards states that exempt income attributable to PEs under domestic law.871 It is also not really appropriate for dealing with the source state’s concern about being required to apply the conditions of the R-S treaty, since the source state will be required to apply the conditions of the R-S treaty regardless of whether the profit is attributable to the PE. As a result, the source state has no real incentive to argue that the profit is not attributable to the PE since it will have no impact on the tax which the source state can impose. It is also difficult to see how the source state could reject an attribution of profit to the PE under the R-PE treaty which has been accepted by both the PE state and the residence state. The application of this approach in PE triangular cases may therefore discourage taxpayers who are considering establishing triangular structures to gain access to the R-S treaty, but it is not appropriate as a general approach for dealing with particular cases of improper access to the R-S treaty.

867 This section contains only a very brief discussion of this issue, which was discussed in greater detail in Chapter 5. For further discussion, see, inter alia: De Broe, L., International Tax Planning… at pp. 377-460, Part 3, Chapter 4; Arnold, B.J., & Van Weeghel, S., “The Relationship between….”
868 2010 OECD Commentary on Article 21, para 6.
869 2010 OECD Commentary on Article 21, para 6. The OECD Commentary also suggests that states could strengthen their position by adding a condition to Article 21(2) providing that it does not apply (and thus the other income article continues to apply, instead of the business profits article) “in cases where the arrangements were primarily made for the purposes of taking advantage of this provision.” (2010 OECD Commentary on Article 21, para 6. In relation to PE triangular cases, this provision would need to be included in the R-PE treaty.)
870 OECD Committee on Fiscal Affairs, "Triangular Cases", para 23.
871 OECD Committee on Fiscal Affairs, "Triangular Cases," para 23.
7.5.1.4. Conclusions

The best approach for dealing with improper access to the R-S treaty in PE triangular cases is to include a specific provision in tax treaties along the lines of the provision currently included in various US treaties. This approach has a number of advantages, as outlined above, particularly the relative ease of application by tax authorities and greater certainty for taxpayers. Furthermore, where the source state denies treaty benefits under a specific provision included in the treaty there can be no question regarding whether the source state has met (or failed to meet) its treaty obligations.

7.5.2. Excluding the R-S treaty where the PE-S treaty may apply in the source state

If treaty benefits are extended to PEs, then in addition to dealing with treaty shopping concerns, the exclusion of the normal provisions of the R-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. The exclusion of the R-S treaty where the source state applies the PE-S treaty will be the focus of this section.

7.5.2.1. Situations where there is no PE-S treaty or the PE-S treaty doesn't apply

The provision excluding the operation of the R-S treaty must take into account the possibility that the source state will not apply the conditions of the PE-S treaty, either because there is no treaty in force between the PE state and the source state or because there are no specific provisions requiring the source state to apply it. In these circumstances, the question arises as to whether the source state should revert to applying the conditions of the R-S treaty to the income. If the source state doesn't apply the conditions of the R-S treaty, then the source state will not apply the conditions of any treaty and will simply apply its domestic law, which may provide for a high rate of taxation. In this case, insufficient relief may be available in the PE state and/or the residence state and there may be unrelieved double taxation. However, if the source state does apply the conditions of the R-S treaty, then the situation is effectively the same as it is under the current treaty framework, with the same potential for tax avoidance. One alternative would be to make the non-application of the R-S treaty dependent on the application of the PE-S treaty in the source state, i.e., such that the source state will always apply either the PE-S treaty or the R-S treaty. However, if the PE state is a tax haven then there is unlikely to be any PE-S treaty, so the application of the R-S treaty (in the absence of a PE-S treaty) may disproportionately occur in tax avoidance situations.

7.5.2.2. Proposed approach

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 may 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 certain specified situations where access to the treaty is considered improper. This 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 (either indirectly as a result of provisions included in the R-S treaty, or directly under the PE-S treaty); or

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872 Zhai suggests that this may be the proper outcome, in that the taxation in the source state would then reflect that state's ordinary tax policy towards persons resident in the PE state (see: Zhai, G., "Triangular Cases...").
873 It is important that the conditions of the R-S treaty are excluded if, and only if, there is a PE in the PE state for the purposes of the PE-PE treaty. The provisions excluding the operation of the R-S treaty should therefore refer to the PE definition contained in the R-PE treaty for their operation.
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 according to certain specified criteria set out in the provision (i.e., similar to the provisions included in certain existing treaties, discussed above).

There would thus be three alternative scenarios. First, the source state may apply the PE-S treaty, in which case the R-S treaty would be excluded. Second, the source state may not apply the PE-S treaty but the situation may fall within those situations considered to be abusive, in which case the operation of the R-S treaty would be excluded and the source state would not apply the conditions of any treaty (although may still be subject to some alternative maximum rate, e.g., 15%, under the R-S treaty). Finally, the source state may not apply the conditions of the PE-S treaty and the application of the R-S treaty may not be considered abusive, in which case the source state would simply continue to apply the conditions of the R-S treaty. A suggested treaty provision to this effect will be set out below (see Section 7.5.4.).

7.5.3. Relief in the residence state if source state doesn’t apply R-S treaty

If the operation of the R-S treaty is completely excluded in relation to income which is attributable to a PE in a third state, then the residence state will not have any obligation to provide relief for tax imposed in the source state. If the residence state exempts the income attributable to the PE, then this outcome is appropriate; no further relief is required in the residence state. However, if the residence state uses the credit method of relief with respect to the income attributable to the PE, then the residence state should still be obliged to provide relief for tax imposed in the source state and the relief provisions of the R-S treaty should continue to operate.

Provided the application of the R-S treaty is not excluded in its entirety, a relief obligation may continue to arise under the terms of the R-S treaty, even though the source state is not required to apply its conditions in relation to the income. In accordance with the existing wording of exemption relief article of the OECD Model, Article 23A, relief is required in the residence state to the extent that the source state may impose tax on the income in accordance with the terms of the treaty. Where the R-S treaty places no restriction on the source state’s ability to impose tax, the residence state would arguably continue to have an obligation to exempt the income. Similarly, in accordance with the existing wording of the credit relief provisions of Article 23A and 23B of the OECD Model, the credit relief in the residence state is limited to the amount of tax which the source state is entitled to impose under the terms of the R-S treaty. Where the R-S treaty does not limit the amount of tax imposed in the source state, then arguably any tax imposed in the source state is imposed in accordance with the terms of the treaty and the residence state should be obliged to grant relief. The residence state may not be satisfied with this interpretation, however, particularly in abusive situations. The residence state may therefore may wish to limit its relief obligation to situations where the source state would be entitled to impose tax in accordance with the terms of the treaty and, if it uses the credit method, to limit the amount of relief to the amount of tax that the source state could impose if it were required to apply the conditions of the R-S treaty. These limitations seem to be reasonable, but could potentially give rise to unrelieved double taxation in some cases. This is demonstrated in the following example.

Example

A company resident in State R earns interest income of $100 in a PE triangular case. The interest is the company’s only income and the company has no expenses. State S applies the PE-S treaty and imposes tax at a rate of 20% (i.e., $20). State PE imposes tax at a rate of 30% and provides a credit for tax imposed in the source state; the tax paid in the PE state is therefore $10 ($30 tax less $20 credit). The tax rate in the residence state is 30%. The residence state provides relief using the credit method under both the R-PE treaty and the R-S treaty, but the relief provided under the R-S treaty is limited to 10% of the gross amount of the income (i.e., the maximum rate of tax allowed under the R-S treaty). This is illustrated in the following diagram.
Figure 7.1: Example demonstrating the potential impact of limiting relief in State R to R-S treaty rate in situations where State S applies the PE-S treaty.

Table 2: Example demonstrating the potential impact of limiting the relief in State R to the R-S treaty rate in situations where State S applies the PE-S treaty.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from PE triangular case</td>
<td>100</td>
</tr>
<tr>
<td>Tax in State S (20%)</td>
<td>20</td>
</tr>
<tr>
<td>Tax in State PE (30%, less $20 credit relief)</td>
<td>10</td>
</tr>
<tr>
<td>Tax in State R (30%)</td>
<td>30</td>
</tr>
<tr>
<td>Credit in State R for tax imposed in State S (limited to R-S treaty rate)</td>
<td>(10)</td>
</tr>
<tr>
<td>Credit in State R for tax imposed in State PE</td>
<td>(10)</td>
</tr>
<tr>
<td>Tax in State R after credit</td>
<td>10</td>
</tr>
<tr>
<td>Unrelieved double taxation (excess credit)</td>
<td>10</td>
</tr>
</tbody>
</table>

In this example, the residence state only credits $10 of the $20 tax imposed in the source state, and there is $10 of unrelieved double taxation.

To ensure that double taxation is prevented, the residence state should provide relief for the total amount of tax imposed in the source state, regardless of the amount of tax the source state could have imposed if it applied the conditions of the R-S treaty (but limited of course to the amount of tax imposed in the residence state). This may, however, be unacceptable to certain states. States that wish to limit the amount of relief they provide should include specific wording in the relief provisions of the treaty to this effect. This wording should provide that where the source state is not required to apply the conditions of the treaty with respect to income attributable to a PE in a third state, then relief is only available to the extent that the source state could have imposed tax, had it applied the conditions of the R-S treaty. It should also specify that, where the credit method applies, that amount of the credit is limited to the amount of tax that the source state could have imposed if it had applied the conditions of the R-S treaty in relation to the income.
7.5.4. Conclusions and proposed treaty provision

The exclusion of the conditions of the R-S treaty in the source state in PE triangular cases may serve either to prevent improper access to the R-S treaty or to prevent the source state from being subject to multiple treaty conditions in cases where it applies the conditions of the PE-S treaty in relation to the income attributable to the PE. It is proposed that treaties should include a specific provision to the effect that the source state is not required to apply the conditions of the treaty 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 (either indirectly as a result of provisions included in the R-S treaty, or directly under the PE-S treaty); 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.

(3) This article shall apply to capital gains and profits in the same way as it applies to income."

Paragraph 1 of this provision is based on the wording of the provision of the US-Hungary treaty which was discussed above, with minor modifications. One of these modifications clarifies that the provision applies if a PE exists for the purposes of the R-PE treaty, the importance of which will be discussed in Chapter 8 (see Section 8.2.3.). The other modification simplifies the exception for the active conduct of a trade or business; the exact wording of this exception would of course have to be determined by the contracting states. The contracting states should also determine the appropriate rate of tax that is required.
in the PE state for the R-S treaty conditions to continue to apply, and the appropriate tax rate to apply to passive income where the source state doesn't apply the normal conditions of the treaty. Paragraph 2 excludes the operation of the R-S treaty if the source state applies the conditions of the PE-S treaty in relation to the income attributable to the PE. Paragraph 3 is included for the avoidance of doubt, and ensures that the provision applies equally to capital gains and to profits.

Where the residence state exempts the income attributable to the PE, there will be no need for relief in the residence state. However, where the residence state uses the credit method in relation to the income attributable to the PE, 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):

"(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."

This provision requires the residence state to continue applying the relief provisions of the 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 the R-S treaty had applied. It also means that, in relation to dividends and interest, 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. This limitation is included because it is expected that few states would be willing to grant relief in excess of that which they would be obliged to grant under a normal application of the R-S treaty. In doing so, however, states are accepting the potential for unrelieved double taxation. The limitation on the amount of relief, particularly credit relief, could be excluded if the contracting states are willing to grant relief for the entire amount of tax imposed in the source state.

This provision also 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 on the income under the terms of the PE-S treaty. In many cases where the source state is prevented from imposing tax under the PE-S treaty, it would also have been prevented from imposing tax under the conditions of the R-S treaty, had they applied. This may occur, for example, in relation to business profits which are not attributable to a PE in the source state. In this case, this additional limitation would not be required since the residence state applies the relief provisions as though the source state had applied the terms of the R-S treaty. However, there may be situations where the source state is prevented from imposing tax under the PE-S treaty but would have been entitled to impose tax under the terms of the R-S treaty; this may occur, for example, where the PE definition differs between the two treaties. In this case, the residence state should not be obliged to provide relief (e.g., an exemption) under the R-S treaty and specific wording is required to achieve this outcome.

When considering the provision outlined above it is also important to keep in mind the interaction between this provision and the relief provisions of the R-PE treaty. Where State R exempts the income attributable to the PE in accordance with the terms of the R-PE treaty, then no further relief would be provided and the provision above would have no practical impact (as outlined in Chapter 3). Where State R uses the credit method under the R-PE treaty, then the relief provision of the R-S treaty may require State R to either exempt the income or provide a credit for tax imposed in State S. For the reasons discussed in Chapter 3 (Section 3.3.), State R would not be required to both exempt the income and grant credit relief. The possible outcomes are summarised in the following table:
<table>
<thead>
<tr>
<th>R-PE treaty method</th>
<th>R-S treaty method</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exemption</td>
<td>Exemption</td>
<td>State R exempts the income.</td>
</tr>
<tr>
<td>Exemption</td>
<td>Credit</td>
<td>State R exempts the income (no credit is required).</td>
</tr>
<tr>
<td>Credit</td>
<td>Exemption</td>
<td>State R exempts the income (no credit is required)</td>
</tr>
<tr>
<td>Credit</td>
<td>Credit</td>
<td>State R grants a credit for tax imposed in State S and for tax imposed in State PE (net of any relief provided in that state for tax imposed in State S).</td>
</tr>
</tbody>
</table>

States may wish to allow the method provided for in the R-PE treaty to govern the method of relief in State R. In practical terms, this would mean that the residence state would either provide no relief under the R-S treaty (where the income is already exempt under the R-PE treaty), or would use the credit method of relief under the R-S treaty regardless of the general method of relief specified in that treaty. This could be achieved by altering the wording of the proposed provision set out above.

### 7.7. Conclusions

Issues arise in PE triangular cases because PEs are treated partially, but only partially, in the same way as persons who are resident in the PE state for treaty purposes. Extending treaty benefits to PEs would involve a requirement for the source state to apply the conditions of the PE-S treaty in relation to the income attributable to the PE, and a requirement for the PE state to provide relief, in accordance with the PE-S treaty, for tax imposed in the source state. This ensures that the source state applies the appropriate treaty conditions and that unrelieved double taxation can generally be prevented. In addition, the source state should not be subject to the conditions of multiple treaties in relation to the same item of income and thus, where it applies the conditions of the PE-S treaty, the source state should not be required to apply the conditions of the R-S treaty.

There are two primary ways of extending treaty benefits to PEs under provisions included in the bilateral tax treaties. These 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 a PE in the PE state 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.

The operation of the R-S treaty can only be excluded by the terms of that treaty and so, irrespective of whether treaty benefits are extended to PEs directly or indirectly, specific provisions would need to be included in the R-S treaty to ensure that the source state is not subject to multiple treaty conditions in respect to the income attributable to the PE.

Regardless of whether treaty benefits are extended to PEs directly or indirectly, the source state applies the conditions of the PE-S treaty to income attributable to the PE instead of the conditions of the R-S treaty, and the PE state is obliged to grant relief for tax imposed in the source state. However, the direct

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Note that where passive income is involved (dividends, interest or royalties), State R would generally be obliged to grant relief under the R-S treaty using the credit method, regardless of the general method of relief provided in the treaty. Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 or Article 11. Article 12 is usually also mentioned if the treaty allows source-based taxation of royalties under Article 12.
approach is preferable for a number of reasons. Perhaps the most important of these is that, unlike the indirect approach, the direct approach can never result in an unbalanced application of the PE-S treaty, i.e., where only one of the contracting state applies the treaty to the income attributable to the PE. It also avoids the need to consult multiple treaties to understand the operation of the PE-S treaty, and would allow the PE-S treaty to deal with any unusual circumstances in one or both of the contracting states, as well as any other consequences for the application of the PE-S treaty which arise from extending treaty benefits to PEs.

It is also possible for states to effectively extend treaty benefits to PEs unilaterally under their domestic law. It would be appropriate for states to extend their unilateral relief measures to PEs, and a number of states do this already, but it seems highly unlikely that any state would unilaterally apply the conditions of its tax treaties to income derived by PEs located in treaty-partner states. This is because any state that implemented such a provision would, as a result, have virtually no negotiating power to convince other states to implement reciprocal measures, and because the operation of the R-S treaty could not be excluded under domestic law, resulting in the application of multiple treaty conditions in the source state.

PE triangular cases also give rise to concerns regarding improper access to the R-S treaty, particularly in situations where the PE state and the residence state impose no (or minimal) tax on the income. The best way to address this issue would be to include specific provisions in tax treaties, along the lines of those included in many US tax treaties, which exclude the operation of the treaty in certain specified circumstances where their application would be considered improper. This approach has a number of advantages, as outlined above, including relative ease of application by tax authorities and greater certainty for taxpayers. Furthermore, where the source state denies treaty benefits under a specific provision included in the treaty there can be no question regarding whether the source state has met (or failed to meet) its treaty obligations. This provision should be coupled with a provision excluding the operation of the R-S treaty in circumstances where the source state applies the conditions of the PE-S treaty, to ensure that the source state is not subject to multiple treaty conditions in respect of the same income. Thus, the source state should only continue to apply the conditions of the R-S treaty in PE triangular cases where it does not apply the conditions of the PE-S treaty and where the application of the R-S treaty is not considered to be improper.

This chapter has proposed a solution to PE triangular cases whereby treaty benefits would be extended to PEs by provisions included in the PE-S treaty. This leads inevitably to further issues associated with how such a solution should operate, including whether PEs should be treated for resident persons for the purpose of the entire treaty or simply entitled to certain specified benefits under the treaty, how tax avoidance concerns can best be addressed, and whether notional payments from the PE to its head office should be recognised for treaty purposes. These issues, among others, will be addressed in the following two chapters (Chapter 8 and Chapter 9).

It should also be noted that various aspects of this solution could be implemented even if the overall application of the PE-S treaty is not accepted. That is, even if the source state does not apply the conditions of the PE-S treaty, the PE state should nevertheless have an explicit obligation to grant relief for tax imposed in the source state (under a specific provision of the R-PE treaty) and a specific provision should be included in tax treaties to ensure that the R-S treaty does not apply in situations that are considered to be abusive. Whilst not presenting a comprehensive solution, these measures would go a long way towards resolving the issues that arise in PE triangular cases.
Chapter 8
Provisions extending treaty entitlement to PEs

8.1. Introduction
If it is accepted that treaty benefits should be extended to PEs, and once the basic approach has been determined, there are still a number of issues which must be addressed. Perhaps the most important of these is the exact mechanism by which the PE-S treaty will be made to apply, namely, whether the PE will be deemed to be a resident of the PE state or whether the person to whom the PE belongs will be made eligible to apply the treaty with respect to the income attributable to the PE. It is also important to consider the prerequisites that should be satisfied before a PE will be entitled to claim treaty benefits, and the extent to which specific provisions should be included in the treaty to prevent treaty shopping through PEs. These issues are the subject of this chapter.

8.2. Provisions extending treaty benefits to PEs
This chapter will proceed on the basis that treaty benefits are being extended to PEs directly under specific provisions included in the PE-S treaty, rather than indirectly by provisions included in the R-S treaty (as discussed in Chapter 7). This section will consider how such provisions should be structured in terms of the person who is intended to claim benefits under the provisions, the personal scope of the treaty, the definition which should apply for determining whether there is a treaty eligible PE, and the income to which the PE-S treaty should apply.

8.2.1. Person claiming treaty benefits in relation to PE income
The first issue to be addressed in designing a provision to extend treaty entitlement to PEs is determining who is intended to claim the benefit of the provision. That is, whether treaty benefits will be claimed by the PE itself, or by the entity to which the PE belongs. 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 certain PEs would become treaty-eligible resident persons. 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, treaty-eligible entity, and would generally result in the treaty being applied to PEs in the same way as it applies to residents of the PE state. The problem with this approach is that PEs generally have no separate legal existence and are not treated as separate entities for tax purposes. As a result, the income which is attributable to the PE would generally be considered to be derived by the entity to which the PE belongs for the purposes of the domestic laws of the three states involved. Thus, even though tax may be calculated as though the PE is a separate taxable entity, the PE state, as well as the source state and the residence state, would generally impose any applicable tax liability on the entity to which the PE belongs. Treating the PE as a person for treaty purposes and allowing it to claim treaty benefits directly would thus result in a mismatch between the "person" claiming treaty benefits and the person upon whom tax is imposed under domestic law. This would clearly be problematic.

875 See discussion in Section 8.2.3., below, regarding the situations in which a treaty-eligible PE should be considered to exist.
876 See, for example: Yong, S., "Triangular Treaty Cases..."; Langoth, B., "Treaty Entitlement..."
877 As will be seen in this chapter, certain modifications would almost certainly be necessary to deal with the fact that PEs typically lack separate legal existence.
878 Note that in some cases, PEs may be separate legal entities (even if they are not separate taxable entities). A good example is an entity which has elected to be fiscally transparent under the US check-the-box rules. This was discussed in Chapter 5 (Section 5.2.4.4.).
879 This is effectively the main issue that arises in relation to hybrid entities, such as partnerships, which are recognised as separate taxable entities in one state and are treated as flow-through entities in one or more other states. For discussion of the issues associated with hybrid entities, see, for example: Barenfeld, J., Taxation of Cross-Border Partnerships... For a discussion of the attribution of income to persons for treaty purposes, and the problems...
to reduce the tax it imposes on the entity deriving the income on the basis that that entity on which it is imposing tax is not entitled to any treaty reduction. In addition, from a more administrative perspective, the income would generally be included in the tax return(s) filed by the entity as a whole (to the extent tax returns are required), and it would be that entity which would be responsible for dealing with any controversies which arise in relation to the tax liability (or lack of tax liability), and to whom any other administrative aspects of the tax laws of the three states would apply. These problems could potentially be resolved by amendments to the domestic laws of the states involved, i.e., by treating PEs as separate taxpayers for domestic law purposes. However, the treaty provisions should clearly be capable of being effective without relying on such fundamental changes to the imposition of tax in 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 is entitled to claim treaty benefits under the PE-S treaty in relation to the income attributable to the PE. This approach could be implemented by including a specific article in the PE-S treaty which requires the contracting states to apply the terms of the treaty in relation to income derived by persons who are not resident in either of the contracting states but which is attributable to a PE located in either of the contracting states. As will be discussed in the following section (Section 8.2.2.), this approach would generally require a modification or exception to the personal scope of the treaty established in Article 1.

Note that for ease of expression, this chapter will generally refer to a PE claiming treaty benefits, but it should be borne in mind that such claims (i.e., treaty claims in relation to the income attributable to the PE) should in actual fact, in accordance with this approach, be made by the entity to which the PE belongs.

8.2.2. Personal scope of treaties

In general, the application of tax treaties is limited under Article 1 to "persons who are resident of one or both of the contracting states." Where specific provisions are included in the PE-S treaty to extend treaty benefits to PEs, and where it is intended that the benefit of such provisions will be claimed by the entity to which the PE belongs (as discussed above), the person deriving the income is resident in State R and is not resident in either of the contracting states. As a result, the personal scope of the treaty would, prima facie, need to be expanded to encompass a non-resident carrying on business through a PE in one of the contracting states.880

An alternative to expanding the scope of Article 1 is to create an exception to Article 1. There are several existing provisions in the OECD Model which represent either express or implied exceptions to Article 1.881 such as the exchange of information article (Article 26882) and Article 10(5).883 It follows that it may be possible for treaty entitlement to be extended to PEs without any amendments to the personal scope of the treaty, by simply creating an exception to Article 1. This seems to be the better approach. The circumstances in which the exception applies should of course be limited, since residents of a third state should not fall within the personal scope of the treaty in a general sense, but only with respect to the income arising in one contracting state and attributable to a PE in the other.

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880 If, on the other hand, treaty benefits are extended to PEs by expanding the definitions of "person" and "resident" to include PEs, this would automatically enlarge the personal scope of the treaty, since it refers to those definitions. However, as discussed above, this is not the preferred approach for extending treaty benefits to PEs.

881 Hattingh, P.J., “The Role and Function of…”

882 Which provides that its operation not restricted by Article 1.

883 Article 10(5) relates to the taxation in one contracting state of dividends paid by a resident of the other contracting state, and which applies regardless of where the recipient of the dividends is resident (e.g., in reverse triangular cases). This provision will be discussed in detail in Chapter 11, which deals with reverse triangular cases.
8.2.3. Applicable PE definition

If specific provisions are included in the PE-S treaty to extend treaty benefits to PEs, those provisions should only apply in circumstances where the income is attributable to a PE in the PE state for the purposes of the R-PE treaty. Otherwise, if the definition used for the purposes of determining whether the PE-S treaty applies is wider than the definition contained in the R-PE treaty:

(i) The source state could find itself applying the PE-S treaty in a situation where taxing rights remain with the residence state under the R-PE treaty and the PE state is prevented from imposing tax on the income and

(ii) The PE state could have an obligation to grant relief in relation to income which is prevented from taxing under the R-PE treaty (although presumably in this case the PE state would have no relief obligation as a result of there being no tax payable in the PE state in relation to the income).

Alternatively, if the definition used for the purposes of determining whether the PE-S treaty applies is narrower than the definition contained in the R-PE treaty:

(i) The source state may fail to apply the conditions of the PE-S treaty in circumstances where the income is attributable to a PE in the PE state for the purposes of the R-PE treaty (i.e., in a PE triangular case); and

(ii) The PE state may have no obligation to provide relief for tax imposed in the source state in situations where the income is taxable in the PE state in accordance with the provisions of the R-PE treaty, thus potentially leading to unrelieved double taxation.

If provisions are included in either the PE-S treaty to deal with PE triangular cases and no specific reference is made to the R-PE treaty, then the applicable PE definition will be that contained in the PE-S treaty. This follows from Article 5(1) (or the equivalent provision of the treaty) which provides that; "For the purposes of this convention, the term 'permanent establishment' means..." The PE definition contained in Article 5 therefore applies wherever the term "permanent establishment" is used in the treaty. This would be the case even though, in relation to provisions which are clearly intended to deal with triangular cases, it may seem more reasonable to apply the definition contained in the R-PE treaty. It may be possible to apply the R-PE treaty definition (without it being specifically referred to) where there

884 Similarly, if the R-S treaty contains provisions which either set out circumstances where its conditions will not apply in PE triangular cases, those provisions should apply only if the income is attributable to a PE in the PE state for the purposes of the R-PE treaty. The discussion below therefore applies equally with respect to such provisions. It should also be noted that aside from differences in the wording of the relevant treaties, there may also be disagreements between the three states involved regarding the existence of a PE or the attribution of profit to the PE, based on the facts in a particular case. This will be discussed in Chapter 9.

885 Under Article 7 of the OECD Model, business profits can only be taxed in the residence state unless they are attributable to a PE in the other contracting state. If there is no PE in the "PE state" for the purposes of the R-PE treaty, then that state would be prevented from imposing any tax on the income. In this case the situation would effectively be bilateral rather than triangular.

886 This will depend on whether the result of the R-PE treaty (which prevents the PE state from imposing tax) is taken into account for the purposes of the relief provision contained in the PE-S treaty. This is effectively the same as the question of whether a dual relief obligation may arise in the residence state in PE triangular cases. Refer to discussion in Chapter 3 (see Section 3.3.), where I have argued that the result of one treaty should be taken into account for the purposes of applying the relief provisions of another applicable treaty.

887 A court in Denmark addressed this issue in a triangular case involving the taxation of employment income under Article 15(2) (Poseidon Personnel Services S.A. v. Ministry of Taxation, 18th Dept., Case No. B 2581/05, published in TFS 2006, 635). Article 15(2) allows a particular state to tax employment income which is paid to residents of the other contracting state and which is borne by a PE of the employer in the employment state. The question in this case was, broadly, whether the applicable PE definition for the purposes of applying the treaties between Denmark and the residence states of the employees (various states) was the definitions contained in those treaties, or the definition in the treaty between Denmark and the employer's residence state (Switzerland). It was found that the relevant definitions were those contained in the treaties with the employees' residence states. This meant that the income was not taxable in Denmark even though the employer had a PE in Denmark for the purposes of the treaty between Denmark and Switzerland. For further discussion see: Møll Pedersen, B., "Triangular Cases: Article 15 of the OECD Model, Income from Employment and the Definition of Terms," 47 European Taxation 2, (2007), pp. 90-92.
are materials showing that the contracting states intended the term "permanent establishment" to have a different meaning in the context of the provisions dealing with triangular cases than that set out in Article 5.\textsuperscript{888} However, where states are considering including provisions in their tax treaties to deal with PE triangular cases, the most straight-forward and the most certain approach would be to specify that the PE definition contained in the R-PE treaty applies for the purposes of those provisions. Thus, where provisions are included in the PE-S treaty to deal with PE triangular cases, those provisions should refer to the PE definition contained in the R-PE treaty for their operation.

Where, however, the enterprise to which the PE belongs is resident in a state which does not have a treaty with the PE state, then clearly a reference to the treaty definition of PE would not operate effectively. If the contracting states which to extend treaty benefits in situations where there is no R-PE treaty, e.g., in situations where there is a PE under the domestic law of one of the states, then the treaty provisions should refer to the criteria for the existence of a PE (or the equivalent threshold) under the domestic law of each of the contracting states.

\section{8.2.4. Income to which the PE-S treaty should apply}

In general terms, the PE-S treaty should apply to the income which is attributable to the PE for the purposes of the R-PE treaty.\textsuperscript{889} This section gives further consideration, however, to some potential limitations on the type of income to which the PE-S treaty would apply. It first discusses potentially limiting the application of the PE-S treaty to passive income, before going on to discuss income which the PE state is prevented from taxing and income which the PE state can tax, but not as a result of the existence of the PE. Depending on the category of income involved, the application of the R-S treaty instead of the PE-S treaty may have no practical impact since the source state is likely to be prevented from imposing tax (along with the PE state) under its treaty with the residence state (e.g., under Article 8). However, it could be very important if there were no R-S treaty or if there is a significant difference between the relevant terms of the two treaties.

\subsection{8.2.4.1. Potential limitation to passive income}

Virtually all the discussion on PE triangular cases focuses on situations involving dividends, interest and royalties. This perhaps follows from the focus of the OECD's triangular cases report in 1992 on those categories of income.\textsuperscript{890} As a consequence, however, many of the solutions which have been advocated for dealing with PE triangular cases are proposed to apply only to passive income.\textsuperscript{891} The issues arising in PE triangular cases are certainly most apparent in cases involving passive income, however treaties also vary in the extent to which they allow source based taxation in relation to other categories of income – a good example being capital gains. If the PE-S treaty and the R-S treaty both follow the OECD Model with respect to the category of income involved, the application of the PE-S treaty in the source state instead of the R-S treaty will have no impact on whether or not the source state is entitled to impose tax; however, to the extent that one or both of these treaties differs from the OECD Model, the source state should arguably apply the conditions of the PE-S treaty regardless of the category of income involved. Moreover, to the extent that taxation is allowed in the source state, triangular cases involving other categories of income may also result in tax being imposed in all three states.\textsuperscript{892} The PE state should therefore be required to grant exemption or credit relief in accordance with the terms of the PE-S treaty, i.e., in situations where the source state is entitled to impose tax, regardless of the category of income involved. Once it is accepted that PEs should be entitled to treaty benefits then there seems to be no

\footnotesize{\textsuperscript{888} Article 31 of the Vienna Convention, dealing with the interpretation of treaties, provides that: "A special meaning will be given to a term if it is established that the parties so intended." (Article 31(4)). For further discussion see: Møll Pedersen, B., "Triangular Cases..."

\textsuperscript{889} For discussion of the attribution of profits to PEs, particularly focusing on the new “Authorized OECD Approach” (AOA), please refer to Chapter 5 (Section 5.2.5.).

\textsuperscript{890} OECD, "Triangular Cases."

\textsuperscript{891} See, for example: Avery Jones, J.F., "The David R. Tillinghast Lecture..." at p 30; Langoth, B., "Treaty Entitlement...”; Zhai, G., "Triangular Cases...”; Yong, S., "Triangular Treaty Cases...”

\textsuperscript{892} Refer to Chapter 2 for analysis of PE triangular cases involving various categories of income.}
basis for limiting those benefits to passive income. Nevertheless, if the contracting states cannot reach agreement on extending full treaty benefits to PEs, then extending treaty benefits to PEs with respect to passive income would at least resolve PE triangular cases involving those categories of income.

### 8.2.4.2. Income which the PE state is prevented from taxing under the R-PE treaty

For many categories of income, the PE state will be entitled to impose tax as a result of the income being attributable to the PE. This is the case, for example, with respect to business profits, dividends, interest and royalties. In relation to other categories of income, however, the PE state may be prevented from imposing tax under the terms of the R-PE treaty despite the income being attributable to a PE in the PE state. One clear example of this is income from shipping, air transport and inland waterways transport, dealt with under Article 8.\(^{893}\) Under Article 8, such income may only be taxed in the state where the place of effective management of the enterprise is located.\(^{894}\) This means that in a PE triangular case the PE state will generally be prevented from imposing any tax under Article 8 of the R-PE treaty. A similar rule applies in relation to capital gains from the alienation of assets used in shipping, inland waterways transport and air transport and the PE state will be similarly prevented from imposing tax.\(^{895}\)

The application of the PE-S treaty in relation to the income attributable to the PE is premised on the R-PE treaty allocating either primary or exclusive taxing rights to the PE state. Where the PE state is prevented from imposing tax on certain income, then clearly the conditions of the PE-S treaty should not be applied to such income even if it is attributable to a PE in the PE state. Instead, the source state should continue to apply the conditions of the R-S treaty. This result could be achieved by a providing that the PE-S treaty only applies to certain categories of income attributable to the PE. It would be better, however, to take a more general approach, ensuring that the PE-S treaty does not apply in situations where the PE state is prevented from imposing tax on the income under the terms of the R-PE treaty. This would be preferable because it will also be effective in situations where the R-PE treaty prevents the PE state from imposing tax on certain income which the PE state would normally be entitled to tax if the applicable treaty followed the OECD Model.

### 8.2.4.3. Income which the PE state can tax otherwise than under Article 7

The exclusion of income which the PE state is prevented from taxing under the R-PE treaty also raises the interesting question of whether the PE-S treaty should apply to income which is attributable to the PE and is taxable in the PE state under the R-PE treaty, but not as a result of the existence of the PE (i.e., not under the business profits article). This could occur, for example, where the income attributable to the PE includes income from immovable property which is located in the PE state but which, for some reason, is considered to be locally sourced income (and is consequently taxable) under the domestic laws of a third state.\(^{896}\) In this situation, the income would be taxable in the PE state under Article 6 of the R-PE treaty, but it would be taxable because it arises from immovable property located in the PE state, not because it is attributable to the PE. Arguably, the PE-S treaty should apply in this situation. If the key to the application of the PE-S treaty is the creation of a quasi-resident in the PE state as a result of the existence of the PE, and the transfer of primary taxing rights to the PE state under the R-PE treaty, then there seems to be no reason to exclude income taxable in the PE state otherwise than as a result of the existence of the PE. This approach would not result in the PE-S treaty applying to all income that is

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\(^{893}\) Refer also to the discussion in Chapter 2 (Section 2.7.).

\(^{894}\) Article 8(1) provides that: "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is resident." Article 8(2) provides that: "Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated." This will usually be the residence state and in fact, it is common for treaties to allocate taxing rights by reference to the residence state, rather than the place of effective management. See: 2010 OECD Commentary on Article 8, para 2; Maisto, G., "Shipping, Inland Waterways…” at pp. 37-38.

\(^{895}\) Article 13(3). Refer also to the analysis in Chapter 2 (Section 2.8.3.)

\(^{896}\) This could occur, for example, where the source rules of that third state provide that any payment made by a resident of that state is considered to have a local source. This is perhaps an unusual source rule, particularly for income from immovable property, but not unheard of.
taxable in the PE state under the R-PE treaty, because it is still necessary for the income to be attributable to a PE in that state. Furthermore, in practical terms, there are unlikely to be many situations where a state can impose tax on income which is attributable to a PE other than as a result of the existence of the PE. Thus, there seems to be no reason to create a specific exclusion to prevent the application of the PE-S treaty to this type of income.

8.2.5. Proposed treaty provision extending treaty entitlement to PEs

A treaty provision extending treaty entitlement to PEs, by allowing the enterprise to claim the benefits of the PE-S treaty in relation to income attributable to the PE, could be worded as follows:

"(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 and derived 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. 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 clearly 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 extend
treaty benefits only in situations where there is a treaty between the residence state and the PE state.

These provisions include 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 a treaty. 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 (see above).

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 because the various articles of the
OECD Model use varying terms to establish when they apply, as illustrated in the following table:\textsuperscript{897}

<table>
<thead>
<tr>
<th>Treaty article</th>
<th>Term used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 6</td>
<td>“derived by”</td>
</tr>
<tr>
<td>Article 7</td>
<td>“profits of”</td>
</tr>
<tr>
<td>Article 10</td>
<td>“paid … to”</td>
</tr>
<tr>
<td>Article 11</td>
<td>“paid to”</td>
</tr>
<tr>
<td>Article 12</td>
<td>“beneficially owned by”</td>
</tr>
<tr>
<td>Article 13</td>
<td>“derived by”, “gains from…”</td>
</tr>
<tr>
<td>Article 21</td>
<td>“income of”</td>
</tr>
</tbody>
</table>

Paragraph 3 is intended to ensure that the treaty applies as intended regardless of the exact term used in
the relevant treaty article. For discussion of the beneficial ownership requirement, see Section 8.3.2.,
below.

8.3. Pre-requisites for availability of treaty benefits

Before an entity is eligible for reductions in source based taxation under a tax treaty, it must naturally
satisfy the requirements of the treaty. The most common requirements are that the entity must be
resident in one of the contracting states\textsuperscript{898} and, in relation to dividends, interest and royalties, that it must
be the beneficial owner of the income.\textsuperscript{899} This section will address whether the availability of treaty
benefits to PEs should be dependent on any prerequisites being satisfied in relation to residence or
beneficial ownership. It will also discuss the certification of claims for treaty benefits by PEs.

8.3.1. Residence

8.3.1.1. Residence of the entity to which the PE belongs

The PE-S treaty should apply in PE triangular cases regardless of the residence state of the entity to
which the PE belongs. It would not be appropriate to make treaty benefits for PEs dependent on the

\textsuperscript{897} Note that Article 8 (which uses the term “profits from”) is not included in this table because, as mentioned
above, income falling under Article 8 would generally not be taxable in the PE state and therefore the treaties
between the PE state and third states would not generally apply.

\textsuperscript{898} In accordance with the residence definition contained in the treaty (in the OECD Model, Article 4).

\textsuperscript{899} See: OECD Model, Article 10 (2), Article 11(2) and Article 12(1).
residence state of the entity as a whole because it is likely that the income attributable to the PE will be
either not taxed in the residence state at all (e.g., if it is exempt) or will be only minimally taxed (e.g., if the
credit method of relief applies⁹⁰⁰). 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 as a whole is resident should
therefore not have any influence on whether treaty benefits are available to the PE.

One possible exception is in situations where the enterprise to which the PE belongs is resident in the
state where the income arises, i.e., where the income attributable to the PE includes income sourced in
the residence state. This type of situation is effectively bilateral, with the PE-S treaty also operating as the
R-PE treaty; the potential application of the R-PE treaty in circumstances where treaty benefits are
extended to PEs under treaties with third states will be discussed in Chapter 9.

8.3.1.2. "Residence" at the level of the PE:

In general, treaty benefits are only available to persons who are resident in one of the contracting states in
accordance with Article 4 of the treaty. For a person to be a resident of a particular state, that person
must be "liable to tax by reason of his domicile, residence, place of management or any other criterion of
a similar nature."⁹⁰¹ Article 4 also states that a person will not be resident in a particular state if they are
"liable to tax in that State in respect only of income from sources in that State."⁹⁰² The question arises as
to whether these criteria can be adapted to PEs and, if so, whether PEs should be required to satisfy such
criteria in order to be eligible for treaty benefits.

The first criterion which must be satisfied in order for a person to be resident in a particular state for
treaty purposes is the requirement that the person be "liable to tax" in that state. For the purposes of
Article 4(1), being liable to tax is an attribute of the person whose residence is being determined, not an
attribute of the income in question.⁹⁰³ A PE can never be "liable to tax" in a technical sense since it is not
a separate taxable entity, but this requirement could potentially be adapted to PEs, such that they would
only be entitled to treaty benefits if the person to whom the PE belongs is liable to tax in the PE state in
relation to the income attributable to the PE. This will be discussed further below in the context of
preventing improper access to treaties through PEs.

The second sentence of Article 4(1) of the OECD Model provides that a person is not resident in a
contracting state if they are only taxable in that state in respect of locally sourced income.⁹⁰⁴ As discussed
in Chapter 5, the PE principle is something of a hybrid between the residence and source principles. If
this type of criteria were adapted to PEs, it could be argued that all the income attributable to the PE is
sourced in the PE state and thus, the PE is only taxable on locally sourced income. However, for the
purposes of treaties between the residence state and a third state (i.e., the R-S treaty) the same income
may be considered to be sourced in that third state (i.e., State S). Given the uncertainty in identifying a
single geographical source for the income attributable to the PE, and the likelihood that this criterion
would not provide any meaningful basis upon which to extend or deny treaty benefits, it would not be
appropriate for PEs to be required to satisfy this type of condition in order to be entitled to treaty
benefits.

A PE should not therefore be required to satisfy any additional "residence-type" criteria in order to be
entitled to treaty benefits. Arguably, a resident enterprise is created in the PE state as a result of the PE
being located there, as discussed in Chapter 5, and thus, the existence of a PE should be sufficient for the
PE-S treaty to apply. The contracting states may, however, wish to include specific provisions in the
treaty to prevent PEs from claiming treaty benefits in situations where such claims would be considered
improper, e.g., a subject-to-tax clause. This will be discussed in Section 8.4., below.

⁹⁰⁰ This is because if the residence state uses the credit method exclusively in its treaties, it would generally be
obliged to provide credit relief both for the tax imposed in the PE state and the tax imposed in the source state.
Even if the residence state is a high taxing country, there is likely to be minimal tax imposed after the provision of
these credits. Refer to Chapter 3 for discussion of the residence state’s relief obligations in PE triangular cases.
⁹⁰¹ OECD Model, Article 4(1).
⁹⁰² OECD Model, Article 4(1).
⁹⁰³ Couzin, R., Corporate Residence… at p. 109 (Section 3.1.1.1.).
⁹⁰⁴ This provision will be discussed in greater detail in Chapter 10, dealing with dual-resident companies.
8.3.2. Beneficial ownership

In most tax treaties, source based taxation of dividends, interest and royalties is limited to a certain maximum rate of tax that can be imposed on the gross amount of the income, however, these limitations apply only if the beneficial owner of the income is resident in the other contracting state.\footnote{OECD Model, Article 10(2) and Article 11(1).} The beneficial ownership concept is thus relevant for the availability of treaty benefits in relation to dividends, interest and royalties. It is also commonly used by source states to attack what they perceive to be improper claims for treaty benefits in relation to such income, i.e., by denying treaty benefits on the basis that the recipient of the income is not the beneficial owner.\footnote{The meaning of beneficial ownership and its role in addressing treaty shopping was discussed in Chapter 5 (see Section 5.2.6.1.).}

If treaty benefits are extended to PEs, there are two beneficial ownership issues which should be addressed. The first is whether the entity to which the PE belongs should be required to be the beneficial owner of dividends, interest and/or royalties attributable to the PE, and the second is whether the PE itself should be required to satisfy some kind of beneficial ownership-type test. These two issues will be discussed in turn below.

8.3.2.1. Beneficial ownership by the entity as a whole

If treaty benefits are extended to PEs, the entity to which the PE belongs may formally make the claim for treaty benefits,\footnote{As discussed above, see Section 8.2.1.} but those benefits are available by virtue of the income being attributable to the PE. As discussed above, the availability of treaty benefits in relation to the income attributable to the PE should not depend upon the state of residence of the entity to which the PE belongs. This seems to suggest that the entity to which the PE belongs should also not be required to be the beneficial owner of the income, since it would not matter if the true beneficial owner were in fact resident in another state. Beneficial ownership of the income may potentially be relevant, however, in situations where the income would not have been attributable to a PE in the PE state if the beneficial owner had received it directly, e.g., where a custodian, acting as an agent or nominee, receives income on behalf of another person and the income is attributable to a PE of the custodian, but is not attributable to a PE of the true beneficial owner of the income. It is, however, difficult to reconcile the receipt of income as an agent or nominee and the attribution of that income to a PE, since the receipt of income as an agent or nominee implies that the income is received simply on behalf of another person. It is therefore difficult to see how such income could have a sufficient connection to the activities of a PE. Nevertheless, the contracting states may wish to consider whether a specific exception to the availability of treaty benefits to PEs would be warranted to deal with these types of cases, i.e., where the income would not be attributable to a PE in the hands of the beneficial owner.

Another situation where identity of the beneficial owner may be relevant is in cases where that entity is resident in the source state. Where the income is beneficially owned by a resident of the source state, the situation is effectively bilateral, with the PE-S treaty also operating as the R-PE treaty; the potential application of the R-PE treaty in circumstances where treaty benefits are extended to PEs under treaties with third states will be discussed in Chapter 9.

8.3.2.2. Beneficial ownership at the level of the PE

The direct application of a beneficial ownership concept to PEs is not feasible because PEs are generally not separate legal entities. The question arises, however, as to whether the beneficial ownership concept can and should be adapted to PEs or whether there is some equivalent concept which could be applied. One of the main difficulties in adapting the beneficial ownership concept to PEs, in addition to PEs' lack
of legal capacity, lies in the uncertainty surrounding the meaning of beneficial ownership and how it should be applied in the context of legal entities.\textsuperscript{908} This would make it extremely difficult to develop an equivalent concept for application to PEs. One instrument which attempts to do so is the EU Interest and Royalty Directive, discussed below.

\textit{The Interest and Royalty Directive}\textsuperscript{909}

The EU Interest and Royalty Directive provides for an exemption from source-based taxation for cross-border interest and royalties payments between associated companies within the EU. It applies in situations involving both companies and PEs,\textsuperscript{910} and requires the state of the paying company or PE to exempt from tax any interest or royalty payments made to, and beneficially owned by, an associated company or PE.\textsuperscript{911} For the purposes of the Directive, a company is considered to be the beneficial owner of interest or royalties if “… it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person.”\textsuperscript{912} The directive also contains the following definition of beneficial ownership applicable to PEs:

“A permanent establishment shall be treated as the beneficial owner of interest or royalties:

(a) if the debt-claim, right or use of information in respect of which the interest or royalty payments arise is effectively connected with that permanent establishment; and

(b) if the interest or royalty payments represent income in respect of which that permanent establishment is subject in the Member State in which it is situated to one of the taxes mentioned in Article 3(a)(ii)”\textsuperscript{913}

Thus, in order for a PE to be the beneficial owner of interest or royalties for the purposes of the Interest and Royalties Directive, the asset giving rise to the interest or royalties must be “effectively connected” with the PE and the PE must be subject to tax on the income. This second requirement, that the income be subject to tax, does not correspond to any requirement which must be met in order for a company to

\textsuperscript{908} This was discussed in Chapter 5 (see Section 5.2.6.1.). For further discussion, see: Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions} at pp. 561-562 (m.no. 7-9); Van Weeghel, S., \textit{The Improper Use} at pp. 64-91; Oliver, J.D.B., Libin, J.B., Van Weeghel, S., & Du Toit, C., "Beneficial Ownership"; Martín Jiménez, A., "Beneficial Ownership”; Du Toit, C., "The Evolution of…”; and Van Weeghel, S., “General Report” at pp. 50-52.


\textsuperscript{910} The PE definition contained in the Interest and Royalty Directive (Article 3, para (c)) is similar to that contained in Article 5(1) of the OECD Model, but there are some differences. For discussion see, inter alia: Terra, B.J.M., & Wattel, P.J., \textit{European Tax Law} at p. 619; and Distaso, M., & Russo, R, “The EC Interest…” at pp. 146-147.

\textsuperscript{911} Article 1, paragraph 1, of the Directive provides that: “Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State.” Article 1, paragraph 7, provides that: “This Article shall apply only if the company which is the payer, or the company whose permanent establishment is treated as the payer, of the interest or royalties is an associated company of the company which is the beneficial owner, or whose permanent establishment is treated as the beneficial owner, of that interest or those royalties.”

\textsuperscript{912} Interest and Royalty Directive, Article 1, para. 4. The scope of this provision differs somewhat from the likely meaning of beneficial ownership in a treaty context; refer to Chapter 5 (Section 5.2.6.1.) for a discussion of the beneficial ownership concept as it applies to companies for tax treaty purposes.

\textsuperscript{913} Interest and Royalty Directive, Article 1, para. 5.
be the beneficial owner of income, either in the Interest and Royalty Directive or for treaty purposes. It is submitted that if a subject to tax requirement is introduced, it should be considered separately from the beneficial ownership concept and the two should not be combined. The potential for the extension of treaty benefits to PEs to be dependent on the PE meeting a subject to tax requirement is therefore discussed separately below (see Section 8.4.2.), and is not considered further here.

The other requirement of the beneficial ownership definition is that the asset giving rise to the income must be “effectively connected” with the PE. This mirrors the language found in Article 11(4) and Article 12(3) of the OECD Model for determining the situations in which Article 7 applies to interest or royalties instead of Article 11 or Article 12, respectively. Article 11(4), for example, provides that:

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.” [Emphasis added.]

With respect to determining when a debt claim will be “effectively connected” with a PE, the OECD Commentary provides that:

“A debt-claim in respect of which interest is paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the ‘economic’ ownership of the debt-claim is allocated to that permanent establishment under the principles developed in the Committee’s report entitled Attribution of Profits to Permanent Establishments…”

For treaty purposes therefore, whether a debt claim or an asset giving rise to royalties is “effectively connected” with a PE is determined as part of the process for determining the profit attributable to a PE and is based on the same principles. Rather than adapting the concept of beneficial ownership applicable to companies in order to apply it to PEs, the Interest and Royalty Directive therefore effectively relies on the attribution of profit to the PE. Ultimately, this is the best approach. The concepts which are used to determine the profit attributable to the PE are well developed and effectively result in an allocation of income to the PE on an economic basis, linked to the activities it carries out, as outlined below.

Reliance on the attribution of profit to the PE

Under the Authorised OECD Approach (“AOA”), the attribution of profits to a PE is based on the calculation of profits (or losses) from all its activities, including transactions with third parties and transactions with other parts of the enterprise. 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". The outcome of the analysis in Step 1 of the AOA will be an allocation of assets, risks and capital to the PE based on the "significant people functions" performed by the PE. Passive income, such as dividends, interest and royalties, would generally be included in the profit attributable to a PE.

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915 Similarly, Article 12(3) provides that: “The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”
916 OECD Commentary on Article 11, para 25.1. Similar language is contained in the OECD Commentary on Article 12 (para. 21.1.).
918 The AOA was discussed in greater detail in Chapter 5 (see Section 5.2.5.).
919 2010 OECD Commentary on Article 7, para 20.
only if the asset which gives rise to the income is economically owned by the PE.\textsuperscript{922} A PE will have 
"economic ownership" of an asset if it is entitled to the economic benefits of owning the asset and bears 
the corresponding economic burdens.\textsuperscript{923} Economic ownership of assets under the AOA generally 
depends upon "significant people functions."\textsuperscript{924} In general, the significant people functions relevant for 
determining economic ownership of intangible assets (including shares, debts, and intellectual property 
rights\textsuperscript{925}) will be those functions associated with active decision-making with regard to the assumption 
and management of risks.\textsuperscript{926} Therefore, assets giving rise to passive income 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. This is clearly a much 
higher standard than is required in order for income to be earned (and beneficially owned) by a subsidiary 
company, and this would typically be the case even where the AOA does not apply. 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.

8.3.2.3. Proposed treaty provision regarding beneficial ownership

A treaty provision to the effect that a PE is not required to satisfy the beneficial ownership requirement 
could be worded along the following lines:

"(4) Any income to which [Article 10], [Article 11] or [Article 12] of this Convention 
applies as a result of paragraph 1 shall be considered to be 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."

This provision deems the PE to satisfy the beneficial ownership requirements of the articles dealing with 
passive income. This provision is drafted as the fourth paragraph of the suggested provision outlined in 
Section 8.2.5., above, but alternatively, the third paragraph could simply be altered as follows:

"(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 \textit{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."

8.3.3. Certification procedure

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.\textsuperscript{927} This endorsement serves 
to provide the source state with some assurance that the person claiming treaty benefits is in fact a 
resident of the other contracting state\textsuperscript{928} and, depending on the exact nature of the procedure in the 
residence state, also serves to notify the residence state that the person requesting the certificate is 
deriving income from the source state. Where a PE is claiming treaty benefits, the PE state should clearly

\textsuperscript{922} OECD, "2010 Report…," Part I, Section B-3(ii), para 19. This section does not address situations involving 
notional income from other parts of the enterprise; the application of treaties to notional payments between 
different parts of a single enterprise will be discussed in Section 8.5.2., below.

\textsuperscript{923} OECD, "2010 Report…," Part I, Section B-3(i), note 4.

\textsuperscript{924} OECD, "2010 Report…," Part I, Section D-2(iii)(a), para 72.

\textsuperscript{925} These types of intangible assets are not specifically mentioned in the OECD Report, but can be presumed to fall 
within the meaning of intangible property in accordance with general principles.

\textsuperscript{926} OECD, "2010 Report…," Part I, Section D-2(iii)(c), paras 85, 94, and 97.

\textsuperscript{927} Russo, R., "Administrative Aspects of the Application of Tax Treaties," 63 \textit{Bulletin for International Taxation} 10, 
(2009), pp. 482-488.

\textsuperscript{928} Russo, R., "Administrative Aspects…."
be involved in this process,929 since the PE state is effectively functioning as the residence state with respect to that claim for treaty benefits.

One difficulty which may arise with requesting an endorsement of from the PE state is that the PE state may not have the appropriate knowledge of the situation to certify that a PE exists in that state, let alone that the income is attributable to that PE. Nevertheless, the PE state can certify that the taxpayer has represented to them that there is a PE in that state and that the income is attributable to that PE, giving assurance that the taxpayer is at least reporting the same facts and the same interpretation of those facts to both the PE state and the source state. If the taxpayer's representations turn out to be incorrect based on information that comes to light at a later date (e.g., when tax returns are filed, or when the tax authorities conduct an audit or examination), then the PE state should ideally provide this information to the source state.930

It was proposed above that any claims for treaty benefits under the PE-S treaty should be made by the entity to which the PE belongs. Where the extension of treaty benefits to PEs under the PE-S treaty does not depend upon the state of residence of the entity to which the PE belongs (which it should not), there may be no need to involve the residence state in the endorsement process in order for the source state to be satisfied that there is a proper the claim for treaty benefits. Nevertheless, involving the residence state would facilitate the application of the R-S treaty, particularly in cases where that treaty incorporates provisions dealing with PE triangular cases, e.g., excluding the operation of that treaty in certain circumstances,931 and would help to ensure that the taxpayer has presented the same facts, and the same interpretation of those facts, to all three of the states involved.

Requirements for residence certificates are not typically included in tax treaties, but rather, are part of the administrative mechanisms for the implementation of the treaty in each of the contracting states. Where states sign treaties which allow PEs to claim the benefits of the treaty, those states should ensure that they update their domestic administrative rules for the implementation of tax treaties to ensure that the endorsement procedure involves the PE state. A special procedure would usually be required since the PE state is not certifying as to the residence of a particular entity, but rather, is certifying that for the purposes of the R-PE treaty there is a PE in that state and the income in question is considered to be attributable to that PE. It may also be beneficial for states to specifically agree on the way in which such procedures should operate in the context of PEs claiming treaty benefits.

8.4. Preventing improper access to treaties through PEs

One of the primary concerns with extending treaty benefits to PEs is that it would give rise to opportunities for improper access to tax treaties, commonly referred to as treaty shopping.932 Treaty shopping through PEs is potentially more of a concern than treaty shopping through separate legal entities because transactions between the PE and the rest of the enterprise have no legal consequences for the entity as a whole and because common patterns of PE taxation may make it easier to obtain treaty benefits without triggering any additional tax liability in the PE state or in the residence state.933 However, this may be offset by the fact that the determination of the income attributable to a PE is based on an economic and factual analysis, rather than being based on legal ownership, and thus the income attributable to the PE will necessarily have a significant economic link to the PE state. These considerations were discussed in detail in Chapter 5 (Section 5.2.6.), where it was concluded that any differential between the risk of treaty shopping through PEs and through resident entities was not great enough to justify failing to extend treaty benefits to PEs, and that the risk could be further reduced by

929 OECD Committee on Fiscal Affairs, "Triangular Cases," paras 51 and 52.
930 The issue of controversies and disagreements regarding the existence of a PE and the attribution of income to PEs will be discussed below (see Section 8.6.1.).
931 Refer to Chapter 7 (Section 7.5.) for a discussion of the type of provisions which could be included in the R-S treaty to deal with PE triangular cases.
932 Treaty shopping is generally considered to occur where a person acts through or uses a legal entity in order to obtain treaty benefits that would not be available directly. The main forms of treaty shopping are "direct conduits" and "stepping-stone conduits"; these basic structures were outlined in Chapter 5 (see Section 5.2.6.1.).
933 These factors will be discussed in detail in this section, but an overview and a comparison to the common patterns for the taxation of separate entities was given in Chapter 5 (see Section 5.2.6.).
including specific provisions in tax treaties to prevent PEs from claiming treaty benefits in situations where such a claim would be considered improper. This section will discuss the types of specific provisions that could be included in tax treaties to address such concerns. These provisions are essentially optional. To the extent that a particular state considers that the attribution of income to a PE in the PE state is sufficient to guard against improper application of the PE-S treaty, there would be no need to include any specific anti-avoidance provisions in the treaty. The intention of this section is not to lay out the anti-avoidance provisions that should be included in the treaty, but rather to identify certain provisions which states could include in treaties for states that remain concerned about the potential for abuse.

8.4.1. Examples of potential treaty shopping structures involving PEs

In a practical sense, there are several ways in which the extension of treaty benefits to PEs may facilitate treaty shopping. Firstly, the income attributable to a PE may potentially be taxed more favourably in the PE state than it would be if it were derived by a resident of that state, e.g., where the PE state does not impose tax on the foreign income attributable to local PEs. Secondly, notional payments from the PE to the rest of the enterprise are not recognised for the purposes of applying tax treaties (other than for determining the income attributable to the PE) and consequently, no withholding tax can be imposed on such notional payments. This may facilitate the use of a PE to access treaty benefits either in place of a conduit company (a direct conduit) or in a base erosion scenario (a stepping stone conduit). These factors will be illustrated in the following three examples.

8.4.1.1. Example 1: PE State doesn’t tax foreign income attributable to the PE

If the PE state does not tax foreign income attributable to a local PE but does tax the foreign income of resident enterprises, the extension of treaty benefits to PEs may give rise to additional scope for treaty shopping, since the reduction in source-based taxation under the PE-S treaty could be obtained by deriving the income through a PE without attracting any additional tax liability in the PE state. In most cases, however, the PE state will impose tax on the worldwide income attributable to the PE or will at least tax the income attributable to a PE in the same way as the income of a resident enterprise, thus limiting concerns based on non-taxation in the PE state. Nevertheless, to demonstrate the use of a PE as a conduit in situations where the PE state does not tax the (foreign) income attributable to the PE, this example will compare three scenarios:

(i) A company resident in State R derives $100 of interest income from State S. The income is not attributable to a PE. Under the R-S treaty, State S is limited to imposing tax of 20% on the gross amount of the interest income, and State R is required to grant credit relief. The domestic interest withholding tax rate in State S is 20%. The corporate tax rate in State R is 30%. This situation is illustrated in the following diagram:

![Figure 8.1.: Scenario (i) – Interest income received directly by resident of State R](image-url)
(ii) A company resident in State R ("Parent") incorporates a wholly-owned subsidiary ("Sub") in State PE and that subsidiary derives interest income from sources in State S. The subsidiary is eligible for benefits under the PE-S treaty and is considered the beneficial owner of the interest income. The PE-S treaty limits the amount of tax State S may impose on the interest to 5% of the gross amount and thus, the WHT that the source state can impose is limited to 5%. The corporate tax rate in State PE is 30% and the PE state uses the credit method of relief under the PE-S treaty. The subsidiary pays the income as a dividend to its parent company, however, to remove the effects of dividend taxation (which will be illustrated in the following example) it is assumed that neither State PE nor State R imposes any tax on the dividend. This is illustrated in the following diagram.

Figure 8.2.: Scenario (ii) – Interest income received by a wholly-owned subsidiary in State PE

(iii) A company resident in State R derives $100 interest income from sources in State S. The interest income is attributable to a PE established in State PE. The PE is entitled to treaty benefits under specific provisions included in the PE-S treaty and the PE-S treaty limits the amount of tax State S may impose on the interest to 5% of the gross amount. The PE state does not impose tax on income derived by PEs from third states, and thus the interest is excluded from the tax base in the PE state and the PE state is not required to grant relief. The residence state uses the exemption method of relief under the R-PE treaty and thus exempts the income attributable to the PE. This is illustrated in the following diagram.

Figure 8.3.: Scenario (iii) – Interest income received by a resident in State R but attributable to a PE in State PE

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934 It is further assumed that the subsidiary is not excluded from claiming treaty benefits by any specific provision of the PE-S treaty, e.g., an LOB provision.
These three scenarios are compared in the following table.

**Table 8.1.: Example illustrating potential impact of non-taxation of foreign income in the PE state**

<table>
<thead>
<tr>
<th></th>
<th>(i) Interest derived by resident of State R (no PE)</th>
<th>(ii) Interest derived by a subsidiary in State PE</th>
<th>(iii) Interest attributable to a PE in State PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income from State S</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>WHT collected in State S</td>
<td>20&lt;sup&gt;935&lt;/sup&gt;</td>
<td>5&lt;sup&gt;936&lt;/sup&gt;</td>
<td>5&lt;sup&gt;937&lt;/sup&gt;</td>
</tr>
<tr>
<td>Tax collected in State PE</td>
<td>N/Av&lt;sup&gt;938&lt;/sup&gt;</td>
<td>25&lt;sup&gt;939&lt;/sup&gt;</td>
<td>.&lt;sup&gt;940&lt;/sup&gt;</td>
</tr>
<tr>
<td>Tax collected in State R</td>
<td>10&lt;sup&gt;941&lt;/sup&gt;</td>
<td>.&lt;sup&gt;942&lt;/sup&gt;</td>
<td>.&lt;sup&gt;943&lt;/sup&gt;</td>
</tr>
<tr>
<td>Total tax imposed</td>
<td>30</td>
<td>30</td>
<td>5&lt;sup&gt;944&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

Where the PE in the above example (scenario iii) claims treaty benefits in the source state, the source state may view that claim as unacceptable, on the basis that if the income were derived directly by the entity to whom the PE belongs (without being attributable to a PE) then the source state would have been able to apply the higher rate applicable under the R-PE treaty and collect $20 instead of $5. The source state may also object to extending treaty benefits to the PE in this situation on the basis that it agreed to the reduced rate of source-based taxation under the PE-S treaty on the understanding that the income would be subject to a certain rate of tax in the PE state and, in relation to the PE, this has not occurred. The table above also demonstrates that it would not have been possible, given this particular set of facts, to obtain reduction in the overall tax liability using a conduit company established in the PE state, since the benefit of reduced taxation in the source state would be completely offset by the additional taxation imposed on the subsidiary in its state of residence (i.e., the "PE State").

In this example, there is an advantage to deriving the income through a PE rather than through a conduit company because if the income is attributable to the PE it is taxed more favourably in the PE state than it would be if derived by a locally resident company. However, the advantage that arises in the case of a PE

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935 The WHT is limited to 20% under the R-S treaty (20% x $100 = $20).
936 The WHT is limited to 5% under the PE-S treaty (5% x $100 = $5).
937 The WHT is limited to 5% under the PE-S treaty (5% x $100 = $5).
938 There is no link to the PE state in this case and thus no tax imposed.
939 State PE imposes tax at a rate of 30% (i.e., $100 x 30% = $30) but allows a credit for tax imposed in State S (i.e., $5). The net tax imposed in State PE is therefore $25 (i.e., $30 - $5). The subsidiary distributes its (net) profit to its parent company in the form of a dividend, however, to remove the effects of dividend taxation (which will be illustrated in the following example) it is assumed that neither State PE nor State R imposes any tax on the dividend.
940 It is assumed that State PE imposes no tax on the interest income arising in State S and attributable to the PE.
941 Tax is imposed on $100 at a rate of 30% (i.e., $100 x 30% = $30), but there is a credit available for the tax imposed in State S (i.e., $20) under the domestic law of State R. The net amount of tax imposed in State R is therefore $10 ($30 - $20 = $10).
942 The interest income received from State S is not received by a resident of State R and is thus not taxable in State R (assuming it is not taxed in the hands of the parent company under controlled foreign companies (CFC) rules in State R). The subsidiary distributes its profit to its parent company in the form of a dividend, however, to remove the effects of dividend taxation (which will be illustrated in the following example) it is assumed that neither State PE nor State R imposes any tax on the dividend.
943 The residence state uses the exemption method of relief under the R-PE treaty and thus exempts the income attributable to the PE. Note that if State R used the credit method of relief, the additional tax imposed in State R (i.e., $25) would completely offset the tax saving in the source state in this example.
944 Note that if State R used the credit method of relief, the additional tax imposed in State R (i.e., $25) would completely offset the tax saving in the source state in this example.
depends on the facts and assumptions made above. Clearly, if the PE state does not tax the PE more favourably than a resident enterprise (e.g., it uses the exemption method of relief and consequently would not impose any tax if the income were derived by a locally resident company) then there would be no advantage in deriving the income through a PE rather than a company.943 Perhaps more importantly, however, if the residence state used the credit method of relief in relation to the income attributable to the PE, the additional tax imposed in the residence state would offset the benefit of the reduced taxation in the source state. These factors would tend to limit the situations in which there may be opportunities to reduce the overall tax burden in relation to certain income by deriving that income through a PE in order to claim treaty benefits. Nevertheless, the above example demonstrates that extending treaty benefits to PEs may create potential opportunities for treaty shopping in addition to those which currently exist in relation to legal entities. Although there is no general pattern of taxing the income attributable to PEs more favourably than the income of resident enterprises, the potential for such favourable taxation of PE income in the PE state may give rise to calls for limiting the availability of treaty benefits to PEs in certain situations.

8.4.1.2. Example 2: No tax on repatriations of income by the PE

One consequence of the PE being simply part of a broader enterprise and not a separate legal entity is that the profit attributable to the PE belongs directly to the entity as a whole, and there is no need for any formal repatriation in order for the PE’s profits to be utilised by other parts of the enterprise.946 One of the factors which may tend to limit the opportunities for treaty shopping through separate entities (i.e., conduit entities) is that dividend payments are likely to trigger a tax liability947 which may outweigh the benefit of the reduced source-based taxation.948

To demonstrate the way in which the non-taxation of repatriations from a PE to the rest of the enterprise may facilitate the use of a PE in place of a conduit company in a direct conduit structure, this example will compare three scenarios:

(i) A company resident in State R derives interest income of $200 from sources in State S. The income is not attributable to a PE. The domestic interest withholding tax rate in State S is 30%. The R-S treaty limits the tax that can be imposed on interest to 10%. The corporate tax rate in State R is 30% and State R provides credit relief under the R-S treaty. This is illustrated in the following diagram.

Figure 8.4.: Scenario (i) – Interest received directly by a resident of State R

945 With the possible exception of avoiding the dividend taxation that may be imposed in the case of a conduit company; dividend taxation is discussed in the following example.

946 In the case of a PE, income may even be paid directly into a bank account in the entity's residence state and still be attributable to the PE. Conversely, the payment of a subsidiary's income directly into its parent company's bank account may, depending on the overall facts and circumstances, raise questions regarding whether the subsidiary is the true beneficial owner of the income for treaty purposes.

947 Withholding tax in the conduit state and/or tax in the residence state of the recipient. Note that dividend payments may not be required in the case in stepping-stone structures, where the conduit makes deductible (base eroding) payments to another entity.

948 Note that dividend payments may not be required in the case in stepping-stone structures, where the conduit makes deductible (base eroding) payments to another entity. Structures involving base erosion will be illustrated in the following example.
(ii) A company resident in State R ("Parent") incorporates a wholly-owned subsidiary ("Sub") in State PE and that subsidiary derives $200 interest income from sources in State S. Under the PE-S treaty, the WHT that the source state can impose on the interest is limited to 5%. The corporate tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income. The subsidiary uses its net profit to pay a dividend of $190 (i.e., $200 less the $10 (5%) withholding tax in State S). The domestic dividend WHT rate in the PE state is 30% but the tax State PE can impose is limited to 10% under the R-PE treaty. The corporate tax rate in State R is 30%. State R provides relief under both the R-S treaty and the R-PE treaty using the credit method. This is illustrated in the following diagram.

*Figure 8.5.: Scenario (ii) – Interest received by a wholly-owned subsidiary in State PE*

(iii) A company resident in State R derives a dividend of $200 from a controlled subsidiary which is resident in State S. The dividend income is attributable to a PE established in State PE. The residence state uses the exemption method under the R-PE treaty and thus exempts the income attributable to the PE. The PE is entitled to treaty benefits under specific provisions included in the PE-S treaty. The PE-S treaty limits the amount of tax State S may impose on the interest to 5% of the gross amount. The tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income. This is illustrated in the following diagram.

*Figure 8.6.: Scenario (iii) – Interest received by a resident of state R but attributable to a PE in State PE*
These three scenarios are compared in the table below.

**Table 2: Example demonstrating the potential impact of non-taxation of repatriations from the PE to the rest of the enterprise**

<table>
<thead>
<tr>
<th></th>
<th>(i) Interest derived by resident of State R (no PE)</th>
<th>(ii) Interest derived by a subsidiary resident in State PE</th>
<th>(iii) Interest attributable to a PE in State PE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest income</strong></td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td><strong>WHT collected in State S</strong></td>
<td>949</td>
<td>950</td>
<td>951</td>
</tr>
<tr>
<td><strong>Tax collected in State PE</strong></td>
<td>.952</td>
<td>.953</td>
<td>.954</td>
</tr>
<tr>
<td><strong>WHT collected in State PE on distributions</strong></td>
<td>N/A</td>
<td>18</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Tax collected in State R</strong></td>
<td>956</td>
<td>957</td>
<td>958</td>
</tr>
<tr>
<td><strong>Total tax imposed</strong></td>
<td>60</td>
<td>60</td>
<td>10</td>
</tr>
</tbody>
</table>

In scenario (ii) in this example, where the dividend is received through a conduit company in "State PE," the benefit of the reduced withholding tax in the source state under the PE-S treaty is outweighed by the additional tax imposed on the dividend paid by the conduit company. Given that no withholding tax is imposed on any repatriations of income by a PE, the establishment of a PE to take advantage of the reduced withholding tax available under the PE-S treaty does not face this problem. This demonstrates that it may be possible to reduce the total amount of tax imposed by deriving income through a treaty-eligible PE in a situation where it would not be possible to similarly reduce the amount of tax imposed by deriving the income through a treaty-eligible entity resident in the "PE state".

### 8.4.1.3. Example 3: Base erosion through notional payments

For the purposes of determining the profit attributable to a PE, the PE must be hypothesised as a distinct and separate enterprise, and notional payments made by the PE to other parts of the enterprise can be deducted from its profit. However, this recognition of notional payments does not go beyond the

949 The WHT is limited to 10% under the R-S treaty: $200 x 10% = $20.
950 The WHT is limited to 5% under the PE-S treaty: $200 x 5% = $10.
951 The WHT is limited to 5% under the PE-S treaty: $200 x 5% = $10.
952 There is no link between the PE state and the income and the PE state therefore imposes no tax.
953 The corporate tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income.
954 The corporate tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income.
955 The company resident in State PE pays a dividend of $180 (i.e., $200 income less $20 withholding tax in State S) and State PE collects WHT at a rate of 10% ($180 x 10% = $18).
956 State R imposes tax of 30%, but provides a credit for the tax imposed in the source state. It is assumed that State R grosses up with respect to the withholding tax for the purposes of determining the taxable income, and the tax liability is therefore: ($200 x 30%) - $20 - $20 = $40.
957 State R imposes tax of 30% on the dividend paid by the subsidiary, but grants a credit for the tax imposed in the PE state ($18) and the source state ($10). It is assumed that the dividend is grossed up to determine the amount upon which tax is imposed, and the tax liability is therefore: ($200 x 30%) - $10 -$18 = $32.
958 State R exempts the profit attributable to the PE and there is therefore no tax imposed in State R.
959 However, it should be noted that if, in the above example, State R used the credit method of relief with respect to the profit attributable to the PE instead of the exemption method, then the benefit of the reduced source-based taxation would be outweighed by the additional tax imposed in State R.
determination of the profit attributable to the PE, which means that the PE state is not entitled to impose any source-based taxation (e.g., withholding taxes) on these notional payments. This non-recognition of notional payments may facilitate treaty shopping through PEs because the profit attributable to the PE, and thus taxable in the PE state, can be reduced by notional payments which do not attract any liability for withholding taxes. This stands in contrast to the situation involving a subsidiary company, since any payments made by the subsidiary company may attract withholding taxes.

To demonstrate the way in which the non-taxation of notional payments from a PE to the rest of the enterprise may facilitate the use of a PE in base erosion structures (i.e., in place of a conduit in a "stepping-stone" structure), this example will compare three scenarios:

(i) A company resident in State R derives royalties of $100 from sources in State S. The income is not attributable to a PE in State S or in any other state. Under the R-S treaty, State S is entitled to impose tax at a maximum rate of 30% on the gross amount of the income. State S imposes withholding tax at a rate of 30% of the gross income under its domestic law. The tax rate in State R is 30%, and State R provides relief using the credit method in accordance with the R-S treaty.

(ii) A company resident in State R incorporates a wholly-owned subsidiary in State PE and that subsidiary derives royalties of $100 from sources in State S. The company is eligible for benefits under the PE-S treaty, under which State S is prevented from imposing tax on the income. The corporate tax rate in State PE is 30%. The subsidiary pays royalties of $90 to its parent company, and thus has net income of $10. State PE imposes a withholding tax on royalties of 20% and the R-PE treaty allows source-based taxation of royalties up to a maximum rate of 20%. State R taxes royalties at its general corporate tax rate of 30%. Under the R-PE treaty, State R uses the credit method of relief in relation to royalty income. It is assumed that the subsidiary retains its net income and does not pay any dividends.

960 Briefly, in a stepping-stone conduit structure, a resident of one state ("ParentCo," resident in State A) establishes a company, which is resident in a second state ("SubCo," resident in State B), and transfers income-generating assets to that company in order to take advantage of the treaty between State B and a third state (State C) in respect of income arising from sources in State C. SubCo is fully taxable in State B but pays tax-deductible amounts (e.g., interest, service fees) to a related company, with the result that there is minimal residual tax payable in State B. The amounts paid by SubCo must not be subject to more than minimal tax in either State B (e.g., withholding tax) or the state where the recipient is resident, otherwise the additional tax liability may outweigh the benefit of the tax saving in State C. This was outlined in slightly more detail in Chapter 5 (see Section 5.2.6.).
(iii) A company resident in State R derives royalties of $100 from sources in State S which is attributable to a PE established in State PE. The PE is entitled to treaty benefits under specific provisions included in the PE-S treaty. State S is prevented from imposing tax on the income under the PE-S treaty. The PE makes a notional royalty payment to the head office and, after deducting this payment, the profit attributable to the PE is $10. The tax rate in the PE state is 30%. State R uses the exemption method of relief under the R-PE treaty and therefore exempts the profit attributable to the PE. It is assumed that State R exempts foreign active business income under its domestic law (even the income is not attributable to a PE) and State R therefore exempts the income derived from State S.

Figure 8.9.: Scenario (iii) – Income received by resident in State R, but attributable to a PE in State PE

These three scenarios are compared in the table below.

Table 3: Example demonstrating the potential impact of base erosion through notional payments

<table>
<thead>
<tr>
<th></th>
<th>(i) Income derived by resident of State R (no PE)</th>
<th>(ii) Income derived by a subsidiary resident in State PE</th>
<th>(iii) Income attributable to a PE in State PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Royalties paid</td>
<td>N/A</td>
<td>(90)</td>
<td>(90)</td>
</tr>
<tr>
<td>Net profit of Sub / PE</td>
<td>N/A</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>
This example demonstrates the use of a PE to obtain treaty benefits whilst avoiding tax in the PE state through base erosion, i.e., by making notional royalty payments to other parts of the enterprise. According to the AOA, such payments are recognised for determining the profit attributable to a PE, but are not recognised for other purposes of tax treaties and thus, the state where the PE is located is not entitled to impose any source-based taxation on such payments.\footnote{OECD, “2010 Report…,” Part I, Section D-2(vi), para 173.} It also shows that, given the facts specified above, if a company were used instead of a PE to gain access to treaty benefits then the reduction in source-based taxation would be outweighed by the additional tax imposed on the base eroding payments (i.e., the royalties). The potential for improper access to tax treaties through PEs could therefore potentially be reduced by taxing notional payments from the PE to the rest of the enterprise; this will be discussed in Chapter 9. It should also be noted that the conclusion in this example depends not only on the non-taxation of base eroding notional payments in the PE state, but also on the residence state using the exemption method, both in relation to the income attributable to the PE and under the R-S treaty. If State R used the credit method, then the residual tax imposed in the residence state may completely offset the tax advantage of deriving the income through a PE.\footnote{State R would impose tax of $30 (30% x ($90 + $10)) and would grant a credit of $3 (for the tax imposed in the PE state), leaving net tax imposed of $27. The overall tax burden would therefore be $30, which is equal to the amount of tax imposed in the other two scenarios.}

The remainder of this section will focus on specific anti-avoidance rules which could be included in tax treaties to prevent improper access to treaty benefits through PEs, focussing primarily on the three aspects of PE taxation identified above which may tend to facilitate such abuse. The OECD Commentary on Article 1 suggests various provisions which could be included in tax treaties to prevent treaty shopping and these provisions,\footnote{OECD Model on Article 1, paras. 13-26. The following section will not discuss, however, the suggested provisions relating to the “look-through approach” (paras 13 and 14) or those relating to entities which are taxed under preferential tax regimes (paras 21-21.2 and paras 21.5-26), since these approaches would not be suitable for dealing with improper claims for treaty benefits through PEs.} and the way in which they could be adapted to prevent treaty shopping through PEs, form the basis of the following discussion. In addition, it is generally recognised that provisions of this type may potentially have a broad scope,\footnote{De Broe, L., *International Tax Planning…*, at pp. 727-728 (Part 3, Chapter 7, Section 7.2.1.3., para. 505).} and may prevent treaty benefits in situations which should
not be considered abusive. Thus, they should be accompanied by some kind of safe harbour provision;\textsuperscript{975} such provisions will also be discussed below.

\subsection*{8.4.2. Subject to tax provisions}
A subject to tax requirement could be included in the PE-S treaty to address concerns that PEs may claim treaty benefits in a situation where their income is not appropriately taxed in the PE state.\textsuperscript{976} The OECD Commentary on Article 1 includes a suggested subject to tax provision, worded along the following lines:

"Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company,

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 under the ordinary rules of its tax law." \textsuperscript{977}

To adapt this type of provision to prevent improper access to treaties through PEs, the paragraphs regarding the control of the company would not be relevant since the PE will always be part of an enterprise resident outside the PE state, and would naturally be under the control of that enterprise. In relation to PEs, the important aspect of a subject-to-tax requirement would be the taxation of the income attributable to the PE in the PE state. Thus, a provision could be included in the PE-S treaty which provides that any exemptions or reductions available to a PE under the treaty will only apply if the income in question is subject to tax in the PE state under the ordinary rules of that state's tax law. Such a provision could be worded as follows:

"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 is applied under this Article, 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 under the ordinary rules of its tax law."

One issue which would need to be considered if such a provision is included in the treaty is what exactly is meant by the term “subject to tax”. Clearly if the PE has an overall loss, the fact that it does not actually pay any tax should not prevent the PE-S treaty from applying. Similarly, if the PE has sufficient foreign tax credits to offset the tax liability in the PE state then the income should still be considered to be subject to tax. However, things may get more difficult in other circumstances, e.g., would income be considered subject to tax if it is brought within the taxing net but is subsequently exempted? What if the PE is exempt as a result of conducting charitable activities? Clearly, the contracting states should determine the exact scope of any subject to tax provision which they include in a particular treaty.

Even if the phrase “subject to tax” can be adequately defined, a better approach may be to draft a provision that compares the tax imposed in the PE state to the tax that would be imposed if the income were derived by a resident person. Arguably, treaty benefits should only be denied if the PE’s income is taxed more favourably than it would be if derived by a resident enterprise carrying on the same activities, and requiring PEs to satisfy additional requirements would place them at a disadvantage compared to

\textsuperscript{975} OECD Commentary on Article 1, para 19; De Broe, L., \textit{International Tax Planning…}, at pp. 726-730 (Part 3, Chapter 7, Sections 7.2.1.2.-7.2.1.5., paras. 504 to 508).

\textsuperscript{976} This has been proposed by Zhai, who suggests that the income should be considered to be “taxed normally” in the PE state (and thus the benefits of the PE-S treaty should be available) as long as the PE state does not exempt the income. Zhai, G., “Triangular Cases…”

\textsuperscript{977} OECD Commentary on Article 1, para 15.
resident enterprises. Moreover, linking the denial of treaty benefits to the favourable taxation of the PEs income gets to the heart of the concern that the non-taxation of PE income may facilitate improper claims for treaty benefits in a way that the availability of treaty benefits to resident entities does not. Thus, it would be preferable for a "subject-to-tax" provision applicable to PEs to operate by reference to the tax that would be imposed on a resident enterprise deriving the same income as the PE in the same circumstances, rather than simply requiring that the PEs income is taxed in the PE state. Such a provision could be worded as follows:

"Where this Convention applies under this article to income arising in a Contracting State and included in the income attributable to a permanent establishment located in the other Contracting State, any provision of this convention conferring an exemption from tax, 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."

This assumes, of course, that tax is imposed on the income attributable to a PE in the same way that tax is imposed on income derived by resident persons, such that a comparison can reasonably be made. This may be relatively straightforward in the case of passive income, but in the case of business income the PE state may, for example, use a different tax base for PEs than for resident enterprises. Clearly states would need to take into account the way in which they impose tax on PEs when drafting a subject-to-tax provision which operates by reference to the tax that would be imposed on a resident enterprise, and must consider the extent to which such a comparison could be made. Where there would be difficulties in making the comparison the provision suggested above would need to be modified or, if a modification cannot resolve the issue, the contracting states may need to take a different approach.

8.4.3. Denial of treaty benefits in base erosion situations

The OECD Commentary contains a suggested provision, referred to as the "channel approach," which could be included in tax treaties to deal with stepping-stone structures, i.e., where the taxable income of a conduit entity is reduced to a minimal level by base eroding deductible payments. The suggested provision is worded as follows:

"Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more person who are not residents of that other Contracting State

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on material goods and possessions)."

A base erosion test is also included in the suggested Limitation on Benefits (LOB) provision contained in the OECD Model Commentary, in combination with an ownership test. This test provides that treaty benefits will only be available if, broadly:

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978 OECD Commentary on Article 1, para 17.
(i) On at least half the days of the fiscal year, persons that are qualified persons under certain provisions of the LOB own at least 50% of the aggregate vote and value of the shares or other beneficial interests in the entity\(^979\) (the "ownership test"), and

(ii) That less than 50% of the entity's gross income is paid or accrued to persons who are not resident in either of the contracting states in the form of payments that are deductible for income tax purposes (excluding arm's length payments in the ordinary course of business for services or tangible property) (the "base erosion test").\(^980\)

Both these requirements must be met in order for the benefits of the treaty to be available under this paragraph of the LOB.

Both the "channelling" provision and the LOB test refer to the ownership of the entity which is claiming treaty benefits; the general channelling provision cannot apply to deny treaty benefits unless the company claiming treaty benefits is controlled by persons who are not resident in that company's residence state, while satisfying the LOB provision (in order to be entitled to treaty benefits) requires that "qualified persons" own at least 50% of the shares in the entity. Clearly these ownership tests are not relevant and could not reasonably be applied in the case of a PE, since a PE will always be part of an enterprise resident outside the PE state, and thus under the control of a non-resident enterprise. The focus of an equivalent provision for PEs should therefore be on the base erosion aspect of the test, rather than on ownership. Such a provision could be worded as follows:

"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."

This suggested provision is based on the provision found in the OECD Commentary LOB, in that it excludes arm's length payments in the ordinary course of business for services or tangible property. A provision excluding such payments seems preferable since it would be less likely to result in the denial of treaty benefits in non-abusive situations. It is worded to be included in the provision extending treaty benefits to PEs, but could also be included in a separate treaty article (in which case the reference to "this Article" would have to be changed to refer to the article under which treaty benefits are extended to PEs.)

Where a treaty contains an anti-base erosion provision applicable to resident enterprises, then an equivalent provision should clearly apply where treaty benefits are claimed in relation to the income attributable to a PE. However, if there is no such provision then, as an alternative to considering all payments made by the PE, the anti-base erosion principle could focus solely on notional payments made by the PE to the rest of the enterprise. Such notional payments are the primary reason why PEs may give rise to greater base erosion concerns than resident enterprises, and it therefore seems reasonable to focus an anti-avoidance provision on situations involving these payments. In addition, a broader test would require PEs to satisfy more stringent requirements than resident enterprises which would arguably not be justified by the differences between PEs and resident enterprises.

A provision focusing on base-eroding notional payments could be worded as follows:

"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

\(^{979}\) The actual wording of this part of the test requires "on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph a), b) or d) or subdivision c)(i) of this paragraph [i.e., the LOB] own, directly or indirectly, at least 50 per cent of the aggregate vote and value of the shares or other beneficial interests in the person [i.e., the person claiming treaty benefits]" (OECD Commentary on Article 1, para 20, clause 1(e)(i)). A person is a "qualified person," and thus entitled to treaty benefits, if they meet certain tests contained in the LOB.

\(^{980}\) OECD Commentary on Article 1, para 20, clause 2(e). The equivalent paragraph of the US Model LOB is very similar (see: 2006 US Model Convention, Article 22, para 2(e)).
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 considered to be paid or accrued to other parts of the enterprise to which the permanent establishment belongs for the purposes of determining the profit attributable to the permanent establishment in the form of payments that are deductible (excluding arm's length payments in the ordinary course of business for services or tangible property)."

More generally, under the provisions suggested in the OECD Commentary, treaty benefits are denied regardless of whether the payments are made to related or unrelated parties. However, in cases of treaty shopping through base erosion, an important factor is that the company to which the conduit pays deductible items is controlled by the treaty shoppers. Thus the contracting states may wish to limit the scope of the provision, such that it only considers payments made to related parties. An equivalent provision applicable to PEs (assuming it is not limited to notional payments) would presumably consider payments made to related parties of the entity to which the PE belongs, and to other parts of the enterprise.

8.4.4. Denial of treaty benefits where there is a tax avoidance motive

The OECD Commentary suggests a provision which would deny reductions in source based taxation of certain types of income where a tax avoidance motive exists. The types of income to which the provision would apply are dividends (Article 10), interest (Article 11), royalties (Article 12) and other income (Article 21), and the provision is intended to be included separately in each of those articles. The suggested wording of the provision, using the example of dividends, is as follows:

"The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment."983

The wording of the provision can be relatively simple, but, as De Broe has noted, "it has the inherent difficulty of obliging the tax authorities of the source state to determine the taxpayers intentions."984 It can thus create uncertainty in the application of the treaty and lead to protracted disputes between taxpayers and tax authorities. Nevertheless, this approach could be adapted to limit improper claims for treaty benefits by PEs. Such a provision could be worded as follows, again using the example of dividends:

"The provisions of this Convention shall not apply under this Article 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 the dividends to be included in the profit attributable to the permanent establishment to take advantage of this Article by means of that creation or attribution."

Alternatively, the provision could be worded more generally to apply to all categories of income, not only dividends, interest and royalties, as follows:

981 OECD Commentary on Article 1, para 19; De Broe, L., *International Tax Planning*... at pp. 727-728 (Part 3, Chapter 7, Section 5.2.1.3., para. 505).

982 OECD Commentary on Article 1, para 21.4. This provision is similar to provisions which have been included for many years in UK treaties (see: De Broe, L., *International Tax Planning*... at Chapter 7, p. 731 (Part 3, Chapter 7, Section 5.2.1.7., para. 511).

983 OECD Commentary on Article 1, para 21.4. That paragraph contains alternative wording for inclusion in the various treaty articles as follows: "The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: "shares or other rights"; Article 11: "debt-claim"; Articles 12 and 21: "rights"] in respect of which the [Article 10: "dividends": Article 11: "interest"; Article 12: "royalties"; Article 21: "income"] is paid to take advantage of this Article by means of that creation or assignment."

"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."

Of course the exact wording of this type provision would have to be determined by the contracting states, who may wish to give further consideration to the types of activities or actions which would be considered in determining whether treaty benefits should be denied.

8.4.5. Limitation on benefits provisions

Some treaties do not allow residents of the contracting states to benefit from treaty reductions in source based taxation unless they also satisfy a limitation on benefits (LOB) provision. If the PE-S treaty contains an LOB, the question arises as to whether the terms of the LOB should be required to be satisfied before a PE can claim treaty benefits, or perhaps more realistically, whether any of the typical provisions of LOBs could be adapted to apply to PEs.

If the terms of an LOB are applied, the first question is whether they should be applied in relation to the PE itself or in relation to the entity to which the PE belongs. Arguably, the LOB should be applied in relation to the PE itself (if at all), since the entity to which the PE belongs is not resident in either of the contracting states. As discussed above, claims for treaty benefits in relation to the income attributable to a PE should not depend on the residence of the entity as a whole. As will be seen below, however, the majority of the tests contained in LOB provisions do not have any relevance or cannot be reasonably applied in the context of a PE.

As discussed in Chapter 4, LOB articles are contained in virtually all the treaties concluded by the United States and the United States is one of the contracting states in the majority of treaties containing an LOB article. The Commentary to the OECD Model Convention also contains suggested wording for an LOB provision, and its provisions are similar to those of the US Model treaty. The discussion in this section will focus on the wording of the LOB provision contained in the OECD Commentary and the ways in which it could be adapted to apply in situations where PEs are entitled to treaty benefits.

Stock exchange listing test

Under the suggested LOB contained in the OECD Model, a company is a "qualified person," and thus not excluded from entitlement to treaty benefits if the principal class of its shares is listed on a recognised stock exchange and is regularly traded on one or more recognised stock exchanges. Clearly,

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985 See Section 8.3.1.
986 With certain notable exceptions, e.g., the treaty between the US and Poland.
987 The US has around 46 treaties in force that contain an LOB. Other states with multiple treaties containing LOBs include, for example, Israel (22 treaties), India (18 treaties), Sweden (11 treaties), Germany (7 treaties), Mexico (7 treaties), Turkey (6 treaties), and Japan (5 treaties) [based on searches of IBFD’s tax treaty database in January 2012].
988 2010 OECD Commentary on Article 1, para 20.
989 2010 OECD Commentary on Article 1, para 20, clause 1, which provides that: "Except as otherwise provided in this Article, a resident of a Contracting State who derives income from sources in the other Contracting state shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a "qualified person" as defined in paragraph 2 and meets the other conditions of this Convention for the obtaining of such benefits."
990 2010 OECD Commentary on Article 1, para 20, clause 2(c)(i). A company will also be a qualified person if at least 50% of its shares are owned by 5 or fewer companies which meet the listing test (see: OECD Commentary on Article 1, para 20, clause 2(c)(ii)). The meaning of the term "recognised stock exchange" is found in para 20, clause 6. Under the equivalent provision of the US Model LOB, a company is a "qualified person," and thus not excluded from entitlement to treaty benefits, if the principal class of its shares is traded on one or more recognized stock exchanges and either (a) its principal class of shares is traded on a recognized stock exchange in its residence state, or (b) its primary place of management and control is in its residence state (see: 2006 US Model Convention, Article 22, para 2).
this cannot be reasonably by applied in relation to a PE claiming treaty benefits since a PE is not a separate legal entity and thus cannot be listed. Further, the listing of the entity to which the PE belongs is arguably not relevant for the application of the PE-S treaty in relation to the income attributable to the PE, since a listed company is also capable of engaging in tax planning.  

Ownership and base erosion test

The ownership and base erosion test was discussed above, in Section 8.4.3., and will not be discussed further here. It was concluded above that while the application of an ownership test is not feasible, PEs could be subject to a base erosion test constructed along the lines of that included in the LOB provision suggested by the OECD Model Commentary.

Active business test

The LOB provision in outlined in the OECD Commentary provides that treaty benefits will be available in relation to a particular item of income derived by a resident of one of the contracting states if the person deriving that income is "actively carrying on business" in their residence state and the income is "derived in connection with, or is incidental to, that business." Unlike the other tests contained in the LOB, this test is applied in relation to particular items of income for which treaty benefits are claimed, rather than the person deriving the income. Thus, if this requirement is satisfied, treaty benefits are available in relation to the item of income in question regardless of whether or not the person deriving it is a "qualified person" under any other paragraph of the LOB.

The active business test could potentially be adapted to apply to PEs by including a provision to the effect that a PE will be entitled to treaty benefits with respect to a particular item of income if the PE is actively carrying on business in the PE state and derives the income in connection with or incidental to the conduct of that business. The basic definition of a PE in Article 5 of the OECD Model is "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and therefore, in order for a PE to exist under this basic definition, there must be business activities carried on in the PE state. Nevertheless, the question may arise in some cases as to whether the PEs activities in the PE state, if considered independently from the activities carried on by the rest of the enterprise, would be sufficient to constitute actively carrying on business. In addition, under Article 5(5), an agency PE will exist where a person is acting on behalf of an enterprise and has and habitually exercises the authority to conclude contracts. This provision does not refer to business activities and the activities of a particular agency PE may not be considered to amount to carrying on business. Depending on the exact nature of their activities, therefore, certain PEs may be considered to be actively carrying on business. The other requirement of the active business test is that the income is "derived in connection with, or is incidental to, that business." Where a PE is considered to be actively carrying on business, it would be difficult to argue that any income which is considered to be attributable to the PE would not be "derived in connection with, or incidental to" the business carried on by the PE.

More broadly, the active business test is intended to allow claims for treaty benefits in situations where the person deriving the income has a sufficient link to their residence state by virtue of conducting business activities there (and where the income has a sufficient link to those business activities). In the case of a PE, however, this type of requirement does not seem to add any particular value. By definition, PEs will usually be carrying on business activities in the PE state, even if they may not amount to a complete business when considered independently of the activities conducted by the entity as a whole.

991 Closely held companies may potentially be subject to less oversight and thus more likely to engage in aggressive tax planning, but clearly tax avoidance concerns would still exist with respect to listed companies.

992 The LOB article of the US Model Convention provides that the benefits under the convention will be available with respect to an item of income derived in connection with (or incidental to) the active conduct of a trade or business in the residence state (referred to herein as the "active trade or business test") (see: 2006 US Model Convention, Article 22, para 3(a)). The active conduct of a trade or business is a detailed US domestic law concept, and the consideration of the circumstances in which there may be a "trade or business" and in which income may be derived in connection with (or incidental to) that trade or business are beyond the scope of this study. For a discussion of these issues in the US context, see: 2006 US Model Technical Explanation, pp. 69-72
Furthermore, the income attributable to a PE clearly has a strong link to the PE state, given the way in which the profit attributable to a PE is determined, and this link should be sufficient to enable the PE to claim treaty benefits (subject to any other specific provisions limiting the availability of treaty benefits to PEs). Taking into account the difficulties in applying an active business test, requiring PEs to meet such a test in order to be entitled to treaty benefits does not seem to be appropriate.

8.4.6. Safe harbour provisions

The OECD Commentary suggests a number of safe harbour provisions which could be included in tax treaties to counteract the potential denial of treaty benefits under a specific anti-avoidance provision in bona fide situations. A number of these provisions could be adapted to allow claims for treaty benefits in relation to the income attributable to a PE 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. The safe harbour provisions suggested in the OECD Commentary, and the way in which they could be adapted to apply to PEs, are outlined below.

General bona fide provision:

A general bona fide provision allows the provisions of the treaty to continue to apply where the circumstances leading to the claim for treaty benefits are motivated by sound business reasons and not driven by the treaty claim. The suggested provision in the OECD Commentary is worded as follows:

"The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other 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."994

This could clearly be adapted to situations where PEs are entitled to treaty benefits. Such a provision could be worded as follows:

"The provision of this Convention shall not apply under this Article995 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."

The LOB provision suggested in the OECD Commentary includes a similar provision which gives the contracting states the discretion to allow treaty benefits in situations where the specific terms of the LOB may not be satisfied. This provision is worded as follows:

"A resident of a Contracting state that is neither a qualified person pursuant to... or entitled to benefits under... shall, nevertheless, be granted benefits of the Convention if the competent authority of the other Contracting State determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention".996

993 For discussion of the separate enterprise approach for determining the profit attributable to a PE, see Chapter 5 (Section 5.2.5).
994 OECD Commentary on Article 1, para 19(a).
995 This provision is designed to be included in the article of the treaty which extends treaty benefits to PEs.
996 OECD Commentary on Article 1, para 20 (5).
A similar provision could be included in tax treaties to allow treaty benefits to be extended to PEs at the source states discretion, even if the PE would otherwise be denied treaty benefits as a result of a specific anti-abuse provision. Such a provision could be worded as follows:

"A person deriving income through a permanent establishment established in one of the Contracting States which would be entitled to benefits paragraph 1 of this Article but is not entitled to benefits as a result of the application of [paragraph X or Y] 997 of this Article, shall, nevertheless, be granted benefits of the Convention under this Article if the competent authority of the other Contracting State determines that the establishment, acquisition or maintenance of the permanent establishment and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention."

There is clearly an overlap between this provision and the general bona fide provision discussed above, and a general provision allowing PEs to claim treaty benefits in bona fide situations could be modelled on either of these two suggested provisions.

Activity provision

An activity provision allows a claim for treaty benefits in circumstances where the person claiming treaty benefits engages in substantial activities in their residence state. The suggested provision in the OECD Commentary is as follows:

"The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed in the other Contracting State is with respect to income that is connected with such operations." 998

This type of provision could also be adapted to apply in the context of PEs. Such a provision could be worded as follows:

"[Paragraphs X and Y] 999 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 connected with such operations."

Typically, where a PE exists under Article 5(1), the PE will exist as a result of business activities carried on through a fixed place of business, which would in most cases presumably amount to substantial business activities.1000 This is the idea behind the PE concept, i.e., the PE state is entitled to impose tax on the income attributable to the PE because the entity carries on a sufficient level of business activities in that state to justify taxation. In this case, the first part of the test would be satisfied, and presumably all the income attributable to the PE would be connected with those business operations, with the result that the safe harbour rule would apply. In the context of PEs, this provision may therefore substantially reduce the situations in which treaty benefits are denied under specific anti-avoidance rules (e.g., it may allow treaty benefits to be claimed even in base erosion situations or in situations where the PE is not taxed in the PE state on foreign source income). This impact on the effectiveness of the anti-abuse rules should be taken into account by the contracting states if they are considering including such a provision in their treaty. However, to the extent that substantial business activities are carried on in the PE state,

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997 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.
998 OECD Commentary on Article 1, para 19(b).
999 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.
1000 In the case of agency PEs, under Article 5(5), this may not necessarily be the case. The different types of PEs are discussed in Chapter 5 (see Section 5.2.4.).
and to the extent that the income in question has a sufficient connection to those business activities to be attributable to the PE, then it seems somewhat unreasonable to deny treaty benefits.

**Amount of tax provision**

An amount of tax provision allows a claim for treaty benefits where the reduction in tax is less than the tax imposed in the residence state. The suggested provision in the OECD Commentary is as follows:

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."[1001]

This provision operates on the premise that if the tax imposed in the residence state is greater than the reduction in tax available in the source state under the treaty, then the company has clearly not been established to take advantage of the treaty since the benefit of applying the treaty is outweighed by the tax imposed in the residence state. This test could also be applied to PEs, substituting the PE state for the residence state. Such a provision could be worded as follows:

"[Paragraphs X and Y][1002] 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."

**Stock exchange provision**

A stock exchange provision allows a claim for treaty benefits by an entity which is listed on a stock exchange in its residence state. The suggested provision in the OECD Commentary is as follows:

"The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned – directly or indirectly through one or more companies each of which is a resident of the first-mentioned state – by a company which is a resident of the first-mentioned state and the principal class of whose shares is so registered."[1003]

This test is clearly not relevant to PEs, since a PE is not a separate legal entity. It would also not make sense to include a safe harbour which is based on the entity to which the PE belongs being a listed company (or a subsidiary of a listed company) since there is no reason to believe that a public company could not establish a PE in order to claim what may be considered improper treaty benefits in the source state.

**Alternative relief provision**

An alternative relief provision allows a claim for treaty benefits

"In cases where an anti-abuse clause refers to non-residents of the Contracting State, it could be provided that the term shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation that is not less than the relief from taxation claimed under this Convention."[1004]

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1001 OECD Commentary on Article 1, para 19(c).
1002 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.
1003 OECD Commentary on Article 1, para 19(d).
1004 OECD Commentary on Article 1, para 19 (c).
This type of safe harbour would be very useful in allowing the PE-S treaty to apply in a PE triangular case in circumstances where the person deriving the income would be entitled to an equivalent reduction in source based taxation under the R-S treaty if the income were not attributable to the PE. Such a provision could be worded as follows:

"[Paragraphs X and Y] 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."

This assumes, of course that the R-S treaty contains specific provisions excluding its application in the source state in PE triangular cases. If this is not the case, i.e., if the source state is subject to the conditions of both the R-S treaty and the PE-S treaty, then the source state can only satisfy its treaty obligations by applying the conditions which are most favourable to the taxpayer. In such cases, this type of safe harbour provision would have no operation, since either the R-S treaty conditions will be less favourable, or the source state will apply those conditions rather than the conditions of the PE-S treaty. It could, nevertheless, be included in the PE-S treaty with no adverse consequences.

8.4.7. Conclusions

The potential risks of treaty shopping if treaty benefits were extended to PEs were discussed in detail Chapter 5 (Section 5.2.6.). This section has not dealt with these general considerations, but has focussed on specific provisions which could be included in tax treaties to prevent improper claims for treaty benefits by PEs. These provisions could be used to address the potentially increased risk of treaty shopping which may exist in relation to PEs due to the non-recognition of notional payments for purposes other than profit attribution, and the potential for favourable taxation of the PEs income in comparison to the income of residents of the PE state.

Where a treaty contains specific anti-avoidance provisions applicable to resident persons, those provisions should be adapted so that an equivalent provision can be applied to PEs claiming treaty benefits. However, where the treaty does not contain any such provisions applicable to resident persons, then arguably, the PE should only be denied treaty benefits in situations where the PEs income is taxed more favourably than that of resident persons, since it is in these situations that the extension of treaty benefits to PEs may facilitate treaty shopping. The treaty could, for example, include a subject-to-tax provision which compares the tax imposed on the income attributable to the PE to the tax that would be imposed on a resident of the PE state deriving the same income. It could also include a base erosion test focussing on notional payments from the PE to the rest of the enterprise.

The exact provisions to be included in the treaty should be a matter for negotiation between the contracting states and should deal with their concerns regarding the potential for improper access to the treaty through PEs. If the treaty does include specific provisions denying treaty benefits in certain circumstances, it should also include savings provisions to prevent denial of treaty benefits in bona fide situations. The specific savings provisions to be included in a particular treaty would depend on the nature of the anti-abuse provisions included in the treaty and would also be a matter for negotiation between the contracting states.

8.5. Conclusions

Clearly, the way in which specific provisions extending treaty benefits to PEs are drafted must be carefully considered, taking into account their impact on the application of the various treaty articles both in PE triangular cases and in other situations involving PEs. This chapter has generally referred to claims for

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1005 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.

1006 Refer to the discussion in Chapter 7 (Section 7.5.).
treaty benefits by PEs, but in practice, such claims should be made by the entity to which the PE belongs, since this is the entity which would generally be taxable in relation to the income attributable to the PE under the domestic laws of the states involved. This would require an exception to Article 1 for non-residents operating through a PE in one of the contracting states in relation to any income attributable to that PE and derived from sources in the other contracting state. In addition, the operation of the provision extending treaty benefits to PEs should depend on the existence of a PE for the purposes of the R-PE treaty. This would require a specific provision to ensure that the PE definition contained in the R-PE treaty applies for determining whether there is a treaty-eligible PE in the PE state for the purposes of the PE-S treaty. In general, neither the PE nor the entity to which the PE belongs should be required to satisfy any conditions with respect to residence or beneficial ownership; rather, the entitlement to treaty benefits should be based on the existence of a PE under the R-PE treaty and the attribution of profit to that PE. However, the availability of treaty benefits may still be subject to the requirements of a specific provision aimed at preventing improper claims for treaty benefits (i.e., treaty shopping).

One of the main concerns with extending treaty benefits to PEs is that doing so would facilitate treaty shopping. As discussed in detail in Chapter 5, and briefly in this chapter, there are some aspects of the taxation of PEs which may result in opportunities for treaty shopping through PEs that would not exist in the case of separate legal entities. However, this may be offset by the fact that the determination of the income attributable to a PE is based on an economic and factual analysis, rather than being based on legal ownership, and thus the income attributable to the PE will always have a significant economic link to the PE state. Nevertheless, the contracting states may which to include specific provisions in the treaty to prevent claims for treaty benefits in certain circumstances where such claims may be considered to be improper. Such provisions could take the form of a subject-to-tax requirement, a base erosion test, or a provision denying treaty benefits where there is a tax avoidance motive. However, where the treaty does not contain equivalent provisions applicable to resident enterprises claiming treaty benefits, the provision applicable to PEs should only deny treaty benefits in situations where, for example, the PE is taxed more favourably than a resident enterprise or makes excessive notional payments to other parts of the enterprise. Any such provision should also be accompanied by safe harbour provisions to prevent the denial of treaty benefits in non-abusive situations.
Chapter 9
Further issues regarding treaty entitlement for PEs

9.1. Introduction
This chapter addresses certain additional issues which may arise if the PE-S treaty is made to apply in PE triangular cases. These are largely issues which arise with respect to the application of certain articles of the PE-S treaty, but special considerations for PEs of insurance companies and in sub-PE triangular cases are also addressed. The second part of this chapter goes on to discuss the scope of the extension of treaty benefits to PEs. It discusses the extent to which the PE should be able to claim treaty benefits under the R-PE treaty, and whether notional payments should be recognised for treaty purposes beyond the determination of attributable income.

While this chapter seeks to identify and deal with some of the more important questions which may arise in extending treaty benefits to PEs, it does not purport to be exhaustive and can only deal briefly with each of the issues identified. If treaty benefits were in fact extended to PEs, there would undoubtedly be many more issues requiring serious consideration and both those issues and the issues identified in this chapter would clearly need to be considered in much greater depth and ideally discussed at a multilateral level.

It should also be remembered that, in accordance with the proposed provisions outlined in Chapter 8, the claim for treaty benefits under the PE-S treaty in relation to the income attributable to the PE would in fact be made by the entity to which the PE belongs, and not the PE itself. Nevertheless, for ease of expression, this chapter will generally refer to treaty benefits being extended to or claimed by PEs.

9.2. Special issues in applying the articles of the PE-S treaty
The application of the PE-S treaty in PE triangular cases would, in most circumstances, give rise to no specific issues in the application of the distributive rules of tax treaties that follow the OECD Model. The source state will simply ensure that the amount of tax it collects in relation to the income is in accordance with the terms of the PE-S treaty and, if necessary, the PE state will grant either exemption or credit relief for the tax imposed in the source state. Nevertheless, issues will arise with the application of certain treaty articles which may need to be specifically addressed.

9.2.1. Disagreements regarding the existence of a PE or attribution of income
It was concluded in Chapter 8 that, for the purposes of determining whether there is a treaty-eligible PE in the PE state under the PE-S treaty, the PE definition contained in the R-PE treaty should apply.\footnote{See Section 8.2.2.} However, even where all three states and the taxpayer are applying the same definition to a given set of facts, there may still be disagreement regarding whether a PE exists or whether certain income is attributable to a PE, particularly in borderline cases. The question arises, therefore, as to how such disagreements should be resolved. Where there is a disagreement as to the application of a treaty a bilateral situation, the taxpayer has the option of commencing the mutual agreement procedure (sometimes referred to as the "MAP"), and this should generally also be the case in multilateral situations. However, as will be seen below, the operation and effectiveness of the MAP may be subject to additional limitations in a multilateral situation.

This section will first briefly discuss the application of the mutual agreement procedure in bilateral situations, before going on to discuss the potential operation of mutual agreement procedures in multilateral situations where PEs are entitled to treaty benefits. This section will not discuss the opportunities which may be available to the taxpayer to raise objections under the domestic laws of the states involved, which would of course depend on the laws of those states.
9.2.1.1. Bilateral mutual agreement procedure

The MAP provision, Article 25, provides for agreements regarding the application of the treaty to specific taxpayers and more general agreements regarding the interpretation of the treaty. The discussion here will focus on the MAP procedure with respect to specific taxpayers under paragraphs 1 and 2 of Article 25.

Article 25(1) provides that:

"Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the State of which he is resident... The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention."

Article 25(2) provides that:

"The competent authority shall endeavour, if the objection appears to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States."

A taxpayer may invoke the mutual agreement procedure under Article 25, where, for example, the two states involved and/or the taxpayer come to different conclusions in a particular case regarding the existence of a PE and/or the attribution of income to a PE.1008 In practice, the taxpayer will only invoke the mutual agreement procedure if one or both of the states' application of the treaty results in an unfavourable tax outcome for the taxpayer, e.g., where one state takes the view that certain income is taxable on the basis that it is attributable to a local PE, while the other state does not consider the income to be attributable to a PE and thus does not provide any relief. The taxpayer may also initiate the mutual agreement procedure in situations where there is no unrelieved double taxation,1009 e.g., where both states consider the income to be attributable to a PE but the taxpayer disagrees, since this could also result in tax being imposed that is not in accordance with the terms of the convention.1010

A taxpayer seeking to invoke the MAP must present their request to the tax authorities of their residence state,1011 regardless of which state has taken the action which has prompted the request.1012 The request to initiate the mutual agreement procedure must be presented to the tax authorities within three years of the earliest notification of the action by the tax authorities,1013 but may also be presented earlier if the taxpayer has reason to believe that the unfavourable outcome will occur, i.e., before any charge to tax.1014

A taxpayer can also initiate the MAP whilst simultaneously pursuing domestic law remedies in relation to the same issue.1015

1008 OECD Commentary on Article 25, para. 9.
1009 OECD Commentary on Article 25, para. 13.
1010 This may also lead to excess tax being imposed than if the treaty were properly applied, e.g., where the PE state's tax rate is higher than the residence state's tax rate, and the residence state uses the exemption method of relief.
1011 Unless the issue arises under Article 24(4), i.e., discrimination on the basis of nationality, in which case they submit their request to the state of which they are a national (Article 25(1)). Note that this proviso is omitted from the quotation set out above.
1012 OECD Commentary on Article 25, para 17. The OECD Commentary on Article 25 also states that the "Contracting States may, if they consider it preferable, give taxpayers the option of presenting their cases to the competent authority of either state" and gives alternative wording which could be included in the treaty to this effect (OECD Commentary on Article 25, para 19).
1013 The OECD Commentary on Article 25 states that the starting point for the time limit, "the 'first notification of the action resulting in taxation not in accordance with the provisions of the Convention' should be interpreted in the way most favourable to the taxpayer" (para 21). See also paras 22-25.
1014 OECD Commentary on Article 25, para 14.
1015 Holmes, K., International Tax Policy and Double Tax Treaties, (Amsterdam: IBFD, 2007), at p. 398 (Chapter 20); OECD Commentary on Article 25, paras 33-35. For the interaction between domestic proceedings and the mutual agreement procedure, see also: OECD Commentary on Article 25, paras 42-45.
Once the MAP is initiated, the competent authorities of the contracting states (generally the tax authorities) must "endeavour" to resolve the issue; there is no requirement that they actually come to a conclusion.\textsuperscript{1016} This aspect of the MAP has been widely criticised, as has the excessive time which it may take for the competent authorities to reach an agreement regarding the application of the treaty. In more recent treaties, however, this deficiency may be counteracted by the inclusion of an arbitration provision, which was introduced to Article 25 in the 2008 update to the OECD Model.\textsuperscript{1017} This provision applies only where the competent authorities are unable to reach an agreement within two years of the mutual agreement procedure being initiated.\textsuperscript{1018} It is intended to limit the potential for issues to remain unresolved, primarily by encouraging the competent authorities to reach a conclusion before the two year period expires.

The other major criticisms of the mutual agreement procedure generally relate to the nature of the procedure itself. That is, the outcome of the MAP is based on an agreement between the two tax administrations, which are likely to be primarily concerned with the revenue which each of them will be able to collect, or with policy considerations, than with the interests of the taxpayer.\textsuperscript{1019} In addition, the taxpayer generally has no involvement in the negotiations and their interests may not be represented.\textsuperscript{1020} The process also lacks transparency, since agreements reached under the mutual agreement procedure are generally kept confidential and, once an agreement has been reached, the taxpayer may not be informed of the reasoning behind the decisions reflected in the agreement.\textsuperscript{1021}

9.2.1.2. Dispute resolution in multilateral situations

If the PE-S treaty applies in relation to income derived through a PE located in one of the contracting states and arising from sources in the other contracting state, then the person deriving the income should clearly be entitled to initiate the mutual agreement procedure under the PE-S treaty. This would not require a specific provision to be included in the treaty, since there is already an exception to Article 1 under the provision making the treaty applicable in this case. The person deriving the income would therefore be entitled to invoke to MAP if tax is imposed that is not in accordance with the terms of the treaty. Nevertheless, the operation of the MAP may still be problematic in such situations, since the correct application of the PE-S treaty will depend on the interpretation and application of the R-PE treaty, i.e., with respect to whether the income is attributable to a PE in the PE state.

Where, in a PE triangular case, there is a disagreement between the residence state and the PE state regarding whether certain income is attributable to a PE in the PE state, or where the taxpayer disagrees

\textsuperscript{1016} OECD Commentary on Article 25, para 37.
\textsuperscript{1017} Article 25(5). See also: OECD Commentary on Article 5, paras 63-85; OECD Committee on Fiscal Affairs, "Improving the Resolution of Tax Treaty Disputes," (Paris: OECD, 2007).
\textsuperscript{1018} OECD Commentary on Article 25, para 63.
\textsuperscript{1019} Holmes states: "...under the mutual agreement procedure, the competent authorities (i.e., the tax authorities are the judges of the propriety of the particular tax impost. We, therefore, have a tax outcome based on an agreement between two tax administrations, the primary focus of each of which is more likely to be budgetary consideration, i.e., revenue protection, or policy driven, rather than the interests of the taxpayer. The result of the mutual agreement procedure is typically arrived at without any involvement of the taxpayer (after it presents its case) or any representation of the taxpayer during the deliberations. By contrast, in judicial proceedings a taxpayer has the opportunity to put its case to the impartial decision maker and be reasonably confident that its arguments will be independently and fairly evaluated against the arguments of the prosecuting tax administration. The mutual agreement procedure therefore lends itself to resolution of disputes involving concessions (or 'horse trading') between the contracting states to ultimately reach a compromise between them (typically concerning revenue sharing) over a particular taxpayer's tax liability. Compare that with the judicial approach of technical analysis of the law (including the provisions of the relevant DTA) to arrive at a tax outcome for the taxpayer based on a judge's statutory interpretation skills and analysis of the facts of the taxpayer's case..." (see: Holmes, K., International Tax Policy... at pp. 398-399 (Chapter 20)).
with both states regarding the correct application of the R-PE treaty, the taxpayer should initiate the mutual agreement procedure under the R-PE treaty. Where a third state, i.e., the source state, is affected by the outcome of the mutual agreement procedure under the R-PE treaty by virtue of the application of the PE-S treaty, then arguably that state should also be involved in the discussions. This could be difficult, however, due to the bilateral nature of the mutual agreement procedure under tax treaties. In the transfer pricing arena, multilateral agreements are sometimes reached in the context of advance pricing agreements ("APAs"), however this requires the taxpayer to initiate the mutual agreement procedure under each relevant bilateral treaty. Consequently, involving the source state in discussions between the PE state and the residence state would require the taxpayer to invoke the mutual agreement procedure under the PE-S treaty, which the taxpayer may not wish to do. The taxpayer may either have no particular interest in involving the source state, or may be concerned that the source state will argue for a position that is unfavourable for the taxpayer, e.g., where the PE-S treaty is more favourable than the R-S treaty, the source state has an incentive to argue that there is no PE. In addition, even if the taxpayer does invoke the MAP under the PE-S treaty, it would presumably be required to present the request to the PE state (which is the state equivalent to the residence state) and the PE state would only be required to approach the source state if it could not otherwise resolve the issue. If the PE state is confident of resolving the issue with the residence state, then it is unlikely to do this. More importantly, at least from the source state’s perspective, the source state has no authority to request to be included in the negotiations and indeed, may not even be aware that they are taking place. Clearly some mechanism should be introduced to allow third states which have an interest in the outcome of a particular agreement to be involved in the negotiations.

Another issue which may arise where an agreement is reached under the terms of the R-PE treaty, without the involvement of the source state, is that the source state may be unable to implement any corresponding changes in its application of the PE-S treaty. The MAP article contains a specific provision to the effect that any agreement reached can be implemented notwithstanding the time limits contained in domestic law, but this is not the case with respect to third states. Where, for example, the taxpayer initiates the mutual agreement procedure under the R-PE treaty, and the residence state and the PE state ultimately agree that certain income arising in the source state is not attributable to the PE, then the source state may be unable to impose any additional tax on the income that should be imposed as a result of the non-application of the PE-S treaty. Clearly this would be an inappropriate outcome and may warrant a specific provision in the PE-S treaty to set aside domestic time limits in situations where the correct application of the treaty changes on the basis of an agreement reached under the mutual agreement procedure of another tax treaty.

A situation may also arise where the PE state, the residence state, and the taxpayer all agree that there is a PE in the PE state and that the income is attributable to that PE for the purposes of the R-PE treaty, while the source state takes a different view and is thus unwilling to grant treaty benefits to the PE. In this case, the source state will presumably impose tax without applying the conditions of the PE-S treaty, and the taxpayer would be entitled to initiate the mutual agreement procedure under the PE-S treaty. The question arises, however, as to whether the source state should simply be required to accept the PE state’s and the residence state’s interpretation and application of the R-PE treaty, and thus accept that there is a PE in the PE state to which the income is attributable. This would clearly be the most straightforward approach, and could be considered reasonable since the interpretation of the R-PE treaty should arguably be a matter for the contracting states; once the two contracting states, and the taxpayer, agree on the interpretation of the treaty and its application to a particular set of facts, it is difficult to see how a third state could legitimately disagree with their interpretation. However, in some cases the PE state and the residence state may be indifferent regarding whether the income is attributable to a PE in the PE state, (e.g., in a situation where the PE state does not seek to impose tax on the income and the residence state

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1022 OECD “Transfer Pricing Guidelines,” Annex to Chapter IV: Advance Pricing Arrangements, at pp. 217-219. The report also notes that, depending on the terms of the MAP articles of the various treaties, confidentiality issues may arise in relation to exchanging information between the various tax administrations.

1023 OECD Commentary on Article 25, paras 31-36.

1024 Article 25(2) provides that "[a]ny agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States." However, this exception to the domestic time limits would not apply in third states, i.e., the source state.
uses the credit method of relief), or the PE state and the residence state may have simply accepted the information included in tax returns filed by the taxpayer and not (yet) conducted an audit or examination. If there is a discussion regarding whether a PE exists and whether certain income is attributable to that PE, initiated under the mutual agreement article of the PE-S treaty, then clearly the residence state should also be involved in these discussions, since the conclusion would effectively relate to the application of the R-PE treaty and would typically impact on the amount of tax that the residence state is entitled to impose. However, again, there no opportunity for the residence state to participate unless the taxpayer also initiates the MAP under the R-PE treaty. This again suggests that some mechanism should be introduced to allow third states which have an interest in the outcome of a particular agreement to be involved in the negotiations.

9.2.2. Application of thresholds contained in the PE-S treaty

In some cases, the provisions of tax treaties proscribe different treatment depending on whether or not a certain threshold is met. The application of these thresholds may be problematic, however, in some cases involving claims for treaty benefits in PE triangular cases. A good example is the ownership thresholds which apply for determining the applicable limitation on the rate of source-based taxation of dividends. Article 10(2) of the OECD Model limits the rate of tax that can be imposed in the state where dividends arise as follows:

"... the tax so charged shall not exceed:

a) 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividends;

b) 15% of the gross amount of the dividends in all other cases."

Thus, the amount of tax that can be imposed in the source state depends upon the ownership interest which the recipient of the dividends has in the company paying the dividends (i.e., whether it is below 25% or whether it is equal to or above 25%). The first point of note is that the 5% rate applies only where the beneficial owner of the dividends is a company; if treaty benefits are extended to PEs, this rate should arguably also be available where dividends are attributable to a PE established by a company. However, focus of this discussion is on how this threshold should be applied if the company receiving the dividends owns more than 25% of the shares in the paying company, but only part of the shareholding is attributable to the PE such that the PE holds less than 25% of the shares in the paying company. Should the PE be entitled to a reduced rate of withholding tax under the PE-S treaty in this situation? It would arguably be unfair to apply the higher rate, since the company as a whole meets the threshold. However, if the shareholding were split between different companies in the same corporate group, there would generally be no aggregation of their shareholdings and, if the aim is to treat the PE in the same way as a separate enterprise for treaty purposes, then the application of the threshold in the case of a PE should be equivalent to its application in the case of a subsidiary. The correct approach for applying the ownership threshold in this case is unclear, and although this is not likely to be a common situation, the contracting states should address the application of this threshold, and any other similar thresholds contained in the treaty when extending treaty benefits to PEs.

1025 Although not likely to be a common occurrence, this could potentially occur, for example, in the case of a global trading enterprise where traders located in different PEs make separate investments in the same company. However, given that such investments would commonly be minority investments (e.g., in listed companies) it is nevertheless likely to be uncommon.

1026 Although certain states may take an economic approach and aggregate shareholdings of related enterprises; in this case a similar approach should clearly also be applied in situations where part of a shareholding is attributable to a PE.

1027 In some treaties, for example, source-based taxation is allowed in relation to capital gains arising from the alienation of shares where the person disposing of those shares has a “substantial participation” (i.e., a shareholding of more than a certain specified percentage) in the company whose shares are being alienated (see, for example the reservations of France, Chile, Sweden and Korea in the OECD Commentary to Article 13 of the OECD Model).
A similar issue may also arise in relation to time thresholds contained in tax treaties. The OECD Commentary suggests, for example, that states which require a minimum holding period in order to qualify for a reduced rate of dividend withholding tax under their domestic law may include a similar holding period requirement in their tax treaties. If PEs were entitled to claim benefits under a treaty containing a holding period requirement for reduced rates of dividend withholding tax, an issue may arise in situations where shares are transferred between a PE and the rest of the enterprise, with the result that the shares are not held by the PE for a sufficient time to qualify for the lower rate of withholding. The question in this case is whether the reduced rate should continue to be available notwithstanding that the PE does not satisfy the time threshold, if the entity as a whole has held the shares for a sufficient period of time. Again, to the extent that treaty articles proscribe different treatment depending on whether or not a certain threshold is met, the contracting states should consider the application of the threshold in situations involving PEs, and should provide guidance regarding how the thresholds should be applied.

9.2.3. Attribution of investment income to insurance PEs

PE triangular cases are likely to occur with relative frequency in the insurance industry, firstly because insurance companies hold substantial investment assets and secondly, because they commonly operate through PEs for regulatory reasons. Clearly the combination of these two factors can lead to PE triangular cases. However, the process of determining the investment income attributable to an insurance PE, which will be discussed below, may make it significantly more difficult to apply the PE-S treaty in relation to the investment income of insurance PEs.

An insurance company accepts risks from customers who, in return, pay insurance premiums. Part of the income from these premiums is set aside in reserves to pay future claims under the insurance policies. Insurance companies must also maintain a "surplus" to absorb any losses in excess of reserves, which essentially reflects the company's equity. The two primary sources of income for insurance companies are therefore premiums received from customers, and investment income from the invested reserves and surplus. Under the AOA, the determination of the profit attributable to a PE of an enterprise carrying on insurance business is determined on the basis of "key entrepreneurial risk taking functions" ("KERT functions"). However, an insurance enterprise will have only one KERT function, being the assumption of insurance risk (i.e., the risk assumed by the insurer under insurance policies). The following section outlined in greater detail the process for determining the income attributable to an insurance PE, while the following section goes on to discuss the unique problems this creates with applying the PE-S treaty in PE triangular cases.

Other thresholds may also be included in treaties as a result of the process of negotiation between the contracting states.

1029 OECD Commentary on Article 10, para 16.
1030 OECD, "2010 Report…," Part IV, Section B-1(i), para 12.
1031 As the OECD Report on the Attribution of Profits states that: "Insurance companies may find it advantageous to operate through PEs in a number of jurisdictions, rather than through subsidiaries, because certain host state regulators rely on regulation by the home state and so may impose a lower capital requirement or none at all." (OECD, "2010 Report…," Part IV, Section A, para 2.)
1032 OECD, "2010 Report…," Part IV, Section B-1(i), para 14.
1033 OECD, "2010 Report…," Part IV, Section B-1(i), para 15.
1034 OECD, "2010 Report…," Part IV, Section B-1(i), para 12. The discussion in this section focuses on PE triangular cases involving investment income; PE triangular cases could also potentially arise in relation to premium income, but in this case the issues regarding the attribution of income discussed below would not be relevant.
1035 OECD, "2010 Report…," Part IV, Section C, para 68.
1036 OECD, "2010 Report…," Part IV, Section B-1, para 7.
1037 OECD, "2010 Report…," Part IV, Section C, para 69. The report also notes (in this paragraph) that various activities will contribute to the process of assuming insurance risk.
9.2.3.1. Attribution of investment assets to insurance PEs

Under the AOA, investment assets must be allocated to PEs operating in the insurance industry on the basis of the insurance risks which are assumed by the PE, since it is the assumption of risk that gives rise to the need to maintain a pool of investment assets. The goal is for the investment assets attributed to the PE to reflect the total amount of assets that the PE would hold if it were a "distinct and separate enterprise operating at arm's length."  

The AOA gives several alternatives for determining the total investment assets attributable to an insurance PE. The first is the "capital allocation approach", under which the total investment assets belonging to the organization are allocated to the different parts of the enterprise in proportion to the insurance risk assumed by each part. Assets could be allocated, for example, on the basis of reserves for insurance risks, premium income, or minimum regulatory asset requirements. The second approach is the "Thin capitalization / adjusted regulatory minimum approach." Under this approach, investment assets are attributed to an insurance PE by reference to "the amount of investment assets of an independent insurance enterprise carrying on the same or similar activities and assuming the same or similar risks under the same or similar conditions." The reserves and surplus included in the PEs regulatory filings are used as a starting point, to be adjusted as necessary. The OECD Report also suggests a "safe harbour – quasi-thin capitalization / regulatory minimum approach", under which the PE would be required to have an amount of investment assets at least equal to its reserves under the host country’s regulatory regime, plus the minimum surplus of an independent enterprise operating in the host country. All of these approaches determine the total amount of investment assets attributable to a PE, but would not generally identify specific assets which are considered to be attributable to the PE. A second step is therefore required to determine the amount of investment income attributable to the PE.

9.2.3.2. Determining the investment income attributable to an insurance PE

Certain assets may be directly identified as being attributable to the PE, in which case the income arising from those assets should also be attributed to the PE. The clearest example is a situation where the host state, i.e., the PE state, requires certain assets to be placed in trust ("trusteed assets") to satisfy insurance claims in that state, in which case it would be appropriate to attribute the income arising from those assets to the PE. The OECD Report on the Attribution of Profits to PEs also states that, in general, the investment return attributed to the PE should closely correspond to the return on the assets held in the host country (including trusteed assets), which seems to suggest that assets located in the PE state may be attributed to the PE in preference to assets located in third states. This would of course minimise the extent to which the income attributable to the PE includes investment income arising in third states, and thus minimise the occurrence of PE triangular cases.

As noted above, however, the process for allocating investment assets to a PE may not result in a direct identification of the specific assets which are considered to be attributable to the PE, in which case the AOA requires the investment income attributable to the PE to be determined indirectly.

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1038 OECD, "2010 Report…," Part IV, Section C, para 81, which states: "The factual starting point for the attribution of investment assets to an insurance PE is that the assets representing surplus and reserves are primarily required to support the risks assumed by the enterprise. These assets must be regarded as following those risks. In other words, investment assets are to be attributed to a PE by reference to the insurance risk arising from its acceptance of insured risks, and not the other way round." See also: OECD, "2010 Report…," Part IV, Section C-1(iii), para 127.
1039 OECD, "2010 Report…," Part IV, Section C-1(iii), para 128.
1040 OECD, "2010 Report…," Part IV, Section C-1(iii), para 131.
1041 OECD, "2010 Report…," Part IV, Section C-1(iii), paras 143-152.
1042 OECD, "2010 Report…," Part IV, Section C-1(iii), para 153.
1043 OECD, "2010 Report…," Part IV, Section C-1(iii), para 154.
1044 OECD, "2010 Report…," Part IV, Section C-1(iii), para 156.
1045 OECD, "2010 Report…," Part IV, Section C-1(iii), paras 137 and 165.
1046 OECD, "2010 Report…," Part IV, Section C-1(iii), para 166.
1047 OECD, "2010 Report…," Part IV, Section C-1(iii), para 166.
1048 OECD, "2010 Report…," Part IV, Section C-1(iii), para 165.
Report suggests two approaches for determining the investment income attributable to an insurance PE; the "top-down approach" and the "bottom-up approach." Under the top-down approach, to the extent that the investment assets attributable to the PE exceed the assets held in the host country, those additional assets should be deemed to earn a rate of return equal to either; (i) that earned on all the "uncommitted" (i.e., non-trusted) assets held by the company as a whole,1049 (ii) the rate of return on all the investment assets held by the company,1050 or (iii) the rate of return on the categories of uncommitted assets which are most appropriate to associate with the PE, e.g., based on the currency in which the assets are denominated.1051 Under the "bottom-up approach," the investment income attributable to the PE is determined on the basis that the return on any investment assets attributable to the PE in excess of the assets held in the host country is the same as the return on the assets held in the host country.1052 The result under either approach necessarily constitutes a proxy for the actual return on the investment assets.1053

9.2.3.3. Implications for application of PE-S treaty to investment income of insurance PEs

The investment income attributable to an insurance PE is likely to include income arising in relation to investments outside the PE state, however, there will generally be no specific identification of the items of income attributable to the PE, and thus no specific identification of the nature or geographical source of the income. This would clearly make it problematic, to say the least, to apply the terms of treaties concluded between the PE state and the third states where investment income arises.

One alternative would be for the income attributable to PEs of insurance companies to be excluded from the application of the PE-S treaty. As a result, source states would continue to apply the conditions of the R-S treaty in relation to all the investment income derived by the company, regardless of the extent to which it is attributable to one or more PEs. However, this means that PE triangular cases remain unresolved in the case of insurance companies, an industry in which, as discussed above, such cases may occur relatively more frequently than in other industries. Like in other industries, a lack of relief in the PE state may result in unrelieved double taxation, since the residence state may not be in a position to provide sufficient relief for the tax imposed in both the source state and the PE state. A specific requirement for the PE state to grant relief, which could be based on, e.g., the average rate of source-based taxation imposed on the company's investment income, may go some way to resolving the issue of double taxation, but this would not resolve the issue of the applicable conditions in the source state and it is likely to be difficult to determine the appropriate amount of relief. Another alternative would be to allow insurance companies to determine which specific investment assets are attributable to each of PEs on some reasonable basis. However, depending upon the basis used to allocate investment assets, this would potentially be open to abuse, i.e., by attributing each asset to a PE located in the state which has the most favourable treaty with the source state. Regardless of the approach taken, special rules would clearly be required to deal with PEs in the insurance industry.

9.2.4. Income and capital gains arising from immovable property

Under tax treaties that follow the OECD Model, the distribution of taxing rights in relation to income from immovable property is not based on the existence of a PE. Instead, Article 6 provides that the state where immovable property is located may impose tax on the income arising from that property without limitation.1054 However, as discussed in Chapter 2 (Section 2.6.), the application of tax treaties to income from immovable property is unclear in situations where the property is situated in a third state. In such cases, Article 6 does not apply because the definition of the term "immovable property" only applies if

1049 OECD, "2010 Report…" Part IV, Section C-1(iii), para 167.
1050 OECD, "2010 Report…" Part IV, Section C-1(iii), para 167.
1051 OECD, "2010 Report…", Part IV, Section C-1(iii), para 168.
1052 OECD, "2010 Report…", Part IV, Section C-1(iii), para 170.
1053 OECD, "2010 Report…", Part IV, Section C-1(iii), para 170.
1054 Article 6 of the OECD Model provides that: "Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other state."
the property in question is situated in one of the contracting states. It is therefore not clear whether the income should fall under Article 7, in which case the PE state would be entitled to impose tax, or Article 21, in which case the PE state may be prevented from imposing tax. For the reasons discussed in Chapter 2, the better view seems to be that Article 7 should generally apply, but the application of treaties to income from immovable property located in third states should be clarified.

This issue may become more pressing if treaty benefits are extended to PEs, because the ability of the PE state to impose tax will influence whether the PE-S treaty should be applied (instead of the R-S treaty) in relation to income from immovable property located in State S. If the R-S treaty and the PE-S treaty both follow the OECD Model with respect to immovable property, then there would generally be no difference in the amount of tax the source state could impose on the income under the conditions of those two treaties. However, a situation could arise where the terms of the two treaties differ, e.g., with respect to the definition of immovable property, and thus where the source state may be entitled to impose tax under the terms of one treaty but would be prevented from imposing tax under the terms of the other. The application of the R-PE treaty in relation to income arising from immovable property situated in a third state should therefore be clarified, and the determination of the applicable treaty conditions (i.e., the R-S treaty or the PE-S Treaty) should follow the distribution of taxing rights under the R-PE treaty. Preferably, the R-PE treaty would provide that the PE state is entitled to impose tax on the income and the PE-S treaty would be applied in both the PE state and the source state in relation to the income.

A similar issue arises in relation to capital gains from the alienation of immovable property. Under existing tax treaties, capital gains arising from the alienation of immovable property located in a third state are not covered by Article 13(1) because that provision refers to the definition of immovable property in Article 6 which is inapplicable where the property is located in a third state. Instead, the gain will fall under Article 13(5), dealing with capital gains from other property (i.e., property not dealt with in other paragraphs of Article 13), which will prevent the PE state from imposing any tax. This is inconsistent with the taxation of income arising from immovable property located in a third state, where the PE state may be entitled to impose tax under Article 7. The distribution of taxing rights in relation to capital gains under Article 13 is intended to correspond to the distribution of taxing rights in relation to the corresponding categories of income under the other articles of the treaty. If the PE state is entitled to impose tax on income from immovable property located in third states, which I believe it should be (particularly if the PE-S treaty applies such that there will be no unrelieved double taxation), then the PE state should also be entitled to impose tax on capital gains from the alienation of immovable property located in third states. This would require a change to the terms of the treaty. It could be achieved by, for example, extending the definition of immovable property to include property located in third states, or amending the treaty to follow the OECD Model with respect to immovable property, which would generally lead to a change in the amount of tax the source state could impose on the income.

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1055 Article 6(2) contains the following definition of immovable property: "The term 'immovable property' shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property." See also: OECD Commentary on Article 6, para 1.

1056 See Section 2.6. It was concluded in Chapter 2 that if income from immovable property situated in a third state is considered to be business income under the domestic law of the PE state, then it should also be considered to be business income for the purposes of the R-PE treaty. The income should not be considered to be "dealt with separately" in Article 6 and thus, Article 7(4) should not apply. As a result, where the income is considered to be business profits the distributive rule of Article 7 should apply; this would allow the PE state to impose tax on the income. If the income is not considered to be business profits or, alternatively, is considered to be business profits but is also considered to be "dealt with" in Article 6, such that Article 7 would not apply directly, the distributive rule of Article 7 should still ultimately apply as a result of the application of Article 21(2). This would again allow the PE state to impose tax on the income. The only situation in which the distributive rule of Article 21(1) should apply for the purposes of the R-PE treaty in a PE triangular case is if (i) the income is not considered to be business income and (ii) the property from which the income arises falls within one of the categories of property which is always considered to be immovable property under Article 6(2), without reference to the domestic laws of the Contracting States, such as livestock and equipment used in agriculture and forestry. In this case, Article 21 will apply and Article 21(2) will not operate to shift the income to Article 7.

1057 This issue will be outlined here, but was also discussed in Chapter 2 (see Section 2.8.1.).

1058 OECD Commentary on Article 13, para 4.
example, amending Article 13(2) dealing with movable property forming part of the business property of a PE in a way that would make it apply also to capital gains from the alienation of immovable property forming part of the business property of the PE. The amended Article 13(2) could read:

"Gains from the alienation of property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other contracting state."

In situations where the immovable property is located in the PE state (i.e., in bilateral cases), the PE state would be entitled to impose tax under Article 13(1) (dealing with capital gains from the alienation of immovable property) or Article 13(2). Article 13(1) would be intended to have priority over Article 13(2), being more specific, but in any case the result would be the same regardless of which of these two articles applied, i.e., the PE state (the state where the immovable property is located) would be entitled to impose tax. In a PE triangular case, where a person derives a capital gain from the alienation of movable property located in a third state and that gain is attributable to a PE, the PE state would be entitled to impose tax on the gain under Article 13(2).

### 9.2.5. Sub-PE triangular cases

Sub-PE triangular cases give rise to specific problems with respect to the application of the PE-S treaty because a PE exists in both the PE state and the source state (i.e., the sub-PE state). This means that in the absence of any specific way of dealing with sub-PE triangular cases, the reductions in source-based taxation available under the PE-S treaty (the PE-SPE treaty) and the relief provisions of that treaty could be claimed both from the perspective of the PE (i.e., in relation to the tax imposed in the sub-PE state) and from the perspective of the sub-PE (i.e., in relation to the tax imposed in the PE state). Clearly this would be an inappropriate outcome and would be particularly problematic in relation to the provision of relief (as discussed in Chapter 4, Section 4.3.6.).

One way of dealing with this would be to include a provision in the article extending treaty benefits to PEs which would exclude sub-PES and thus prevent sub-PES from claiming treaty benefits. However, this increase in the complexity of the provision may not be warranted given that sub-PE triangular cases are likely to be extremely uncommon. Perhaps the best way of dealing with sub-PE triangular cases would be through the attribution of income, by ensuring that income can never be attributable to more than one PE. For example, in the case of a PE arising as a result of a regional headquarters and with a sub-PE arising as a result of local activities carried out in another state (and under the supervision of the regional headquarters), this could be done by providing that the income attributable to the regional headquarters includes only remuneration for its management activities and not any other income earned through the sub-PE. Conversely, the income attributable to the sub-PE would be appropriately reduced by the amount of income attributable to the regional headquarters. The determination of the income attributable to each of the two PEs (the PE and the sub-PE) would of course depend on the circumstances of each particular case. Thus, it is suggested that a general principle be introduced to the effect that a particular item of income cannot be attributable to more than one PE. In situations where there are two PEs, a proper factual and functional analysis should determine which of those two PEs the income is property attributable to or how much of the income is properly attributed to each PE. This could be implemented through changes to the guidelines on the attribution of profit to PEs and any disagreements regarding the attribution of the profit could then be resolved through the mutual agreement process.

### 9.3. Application of the R-PE treaty and recognition of notional dealings

An important limit on the separate enterprise approach is that a PE is treated as a separate enterprise only for the purposes of determining the amount of profit attributable to the PE and the amount of relief to be provided in the residence state. The PE is not considered to be a separate entity for the purposes of

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1059 For an overview of sub-PE triangular cases, refer to Chapter 2 (Section 2.4.1.).
applying other articles of the treaty.\textsuperscript{1060} Baker and Collier, discussing the shift towards greater independence for PEs under the AOA,\textsuperscript{1061} write:

"...it is fair to say that the AOA does not go to the absolute extreme of independence – what one might call the 'full monty' separate enterprise. On that approach, if one were to attribute assets, risks and capital to the FSE [functionally separate enterprise]... there seems no reason why the FSE should not be regarded as a resident of state H [i.e., the PE state], capable of taking the benefit of the DTCs entered into by state H, and, if domestic law requires, operating a withholding of tax on the payment of (notional) royalties, rents, interest (and possibly technical service fees) deemed to be paid to other parts of the enterprise."\textsuperscript{1062}

The focus of this section will be on the extent to which a PE should be considered to be a separate enterprise for treaty purposes, i.e., whether the separate enterprise treatment should go further than allowing the PE to claim benefits under the PE-S treaty. More specifically, it will address the question of whether the PE should be considered a treaty-eligible resident of the PE state for the purposes of the R-PE treaty (i.e., in relation to income arising in the residence state), and whether notional dealings between the PE and the rest of the enterprise should be recognised for treaty purposes beyond the determination of the profit attributable to the PE. This would not be required in order to resolve the issues arising in PE triangular cases, however, if a PE is treated as a separate enterprise for the purposes of the R-PE treaty, then it seems fair to consider how far the approach of treating the PE as a separate enterprise for treaty purposes should be taken. This section can address these issues only briefly and they are largely beyond the scope of this thesis; the following discussion is intended merely to highlight some of the issues that may arise if PEs are treated as separate enterprises for the purposes of the R-PE treaty and for the purposes of applying treaties to notional payments between different parts of an enterprise.

Note that source based taxation of payments which originate in the PE state and are borne by the PE (including payments to residents of State R) will be discussed in Chapter 12, which deals with reverse triangular cases, and will thus not be discussed in detail in this section.

\subsection*{9.3.1. Application of the R-PE treaty to income derived from sources in the residence state}

Treating the PE as a resident of the PE state would involve both the PE state and the residence state imposing tax as though the situation involved a parent company resident in State R with a subsidiary company in the PE state. This would involve requiring the residence state to exempt the profit attributable to the PE, since the income would not be included in the tax base in the residence state (i.e., of the parent company) if it were derived by a subsidiary company.\textsuperscript{1063} It would also involve allowing the residence state to impose source-based taxation on income paid by its residents to foreign PEs of resident enterprises as though it were paid, not to a resident enterprise, but instead to an enterprise resident in the PE state; this implies that the residence state would be entitled to impose "source-based" taxation on such income. In the PE state, the income attributable to the PE may be taxed in the normal way, but the PE state would be required to grant relief for source-based taxation imposed in the residence state in relation to income attributable to the PE. This would clearly be a drastic departure from current principles, and would likely have a much greater impact on the distribution of taxing rights and the application of tax treaties than allowing PEs to claim treaty benefits under treaties with third states, since it would also have an impact in bilateral cases.

One problem with treating the PE as a resident of the PE state for the purposes of the R-PE treaty is that the actual imposition of tax in the residence state would depend on that state’s domestic law and, given

\textsuperscript{1060} 2010 OECD Commentary on Article 7, para 28.
\textsuperscript{1061} The Authorised OECD Approach (AOA) for determining the profit attributable to a PE was discussed in detail in Chapter 5 (see Section 5.2.5.).
\textsuperscript{1063} One possible exception is situations where the income would be taxed in the residence state of the parent entity under controlled foreign companies (CFC) rules. To simplify the discussion in this section, it will be assumed that the residence state either does not have CFC rules or that they would not be applicable if a subsidiary of a resident entity derived the income in question.
the novelty of taxing locally sourced income of a resident taxpayer as though it were derived by a non-
resident, there are likely to be mismatches between the treaty provisions and domestic laws. This may not
be prohibitive, since the treaty simply sets the maximum amount of tax that the residence state can
impose, and does not require that the tax be imposed on the basis of "source" or, for example, by way of
a withholding tax and, in addition, any tax liability would continue to be imposed on the entity resident in
State R from a legal and administrative perspective. Nevertheless, the mismatch between the
characterisation of the situation for domestic law purposes and the characterisation of the situation for
treaty purposes may give rise to significant problems if such an approach were implemented in tax
treaties.

The following sections will discuss the potential application of the R-PE treaty in relation to various
categories of income if the PE were treated as a separate, treaty eligible enterprise for the purposes of the
R-PE treaty. As will be seen below, this would generally require firstly, applying the R-PE treaty from the
perspective of the person resident in State R to determine the existence of the PE and the profit
attributable to the PE, and then, secondly, applying the treaty from the perspective of the PE in relation
to any income arising from sources in State R.

9.3.1.1. Passive income

Under existing tax treaties the treatment of income which is derived by a resident of a contracting state
from sources in its residence state, but which is attributable to a PE in the other contracting state,
depends upon whether the residence state uses the credit method or the exemption method of relief in
relation to the income attributable to the PE. If the residence state uses the credit method, then the
income remains within the taxable income of the person deriving it and the residence state must provide a
credit for any tax imposed on the income in the PE state. However, if the residence state exempts the
income attributable to the PE, then the residence state is effectively required to exempt the income
regardless of the fact that it is locally sourced income of a resident enterprise (this will be demonstrated in
the example below). Under this existing framework, the residence state is not entitled to impose any
withholding tax on such income.

If, however, the PE-S treaty were applied in such a way that income attributable to a PE was considered
to be derived by a resident of the PE state, then the residence state should arguably be entitled to impose
tax on passive income arising from sources in the residence state and attributable to the PE. The treaty
would continue to require the residence state to exempt the income attributable to the PE, but would
effectively contain an exception for situations where the residence state would be entitled to impose tax
on a source basis if the income were derived by a resident of the PE state.

Treating the PE as a resident of the PE state for the purposes of the R-PE treaty would require a multi-
step analysis, as follows:

1. An initial application of the R-PE treaty on the basis that the income is derived by a resident of
   State R. This would involve:
   a. The determination that a PE exists under Article 5 and the application of Article 7.
      Under Article 7, the PE state would be entitled to impose tax on the profit attributable
to the PE.
   b. The application of Article 23A/B, requiring the residence state to grant relief for source-
      based taxation imposed in the PE state, in this case, assumed to be an exemption.

2. A secondary application of the R-PE treaty on the basis that the income is derived by a resident
   of State PE. This would involve:
   a. The application of Article 10, Article 11 or Article 12 (depending on the type of passive
      income involved). For the purposes of applying these articles, the income would be
      considered to arise in the residence state and the residence state would therefore be
      entitled to impose a limited rate of tax on the income in accordance with Article 10, 11
      or 12, as applicable.
b. The application of Article 23A/B, requiring the PE state to grant relief for source-based taxation imposed in the residence state. Given that the income is passive income, the credit method would generally apply, and the PE state would be required to provide a credit for tax imposed on a source basis in the residence state.

This is demonstrated in the following example.

Example

A company resident in State R derives $100 of interest income from sources in State R. The income is attributable to a PE in State PE under the R-PE treaty. Under the R-PE treaty, State R exempts the income attributable to the PE. The R-PE treaty is applied as though the income were derived by a resident of State PE and accordingly, State R is entitled to impose source-based taxation on the income in accordance with the interest article of the treaty (Article 10). Under Article 10, source-based taxation of interest is limited to 10% of the gross amount of the income. The general company tax rate in both State R and State PE is 25%. This situation is illustrated in the following diagram.

Figure 9.1.: Example showing application of R-PE treaty if PE is treated as a resident of the PE state

The table below compares (i) the situation where the R-PE treaty is applied as though the PE were a resident of State PE and (ii) the situation where the PE is not treated as a resident of State PE for the purposes of the R-PE treaty.

<table>
<thead>
<tr>
<th>(i) PE is a resident of State PE for the purposes of the R-PE treaty</th>
<th>(ii) PE not a resident of State PE for the purposes of the R-PE treaty</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Source-based&quot; tax imposed in State R</td>
<td>10(^{1064})</td>
</tr>
<tr>
<td>Tax imposed in State PE</td>
<td>25(^{1065})</td>
</tr>
<tr>
<td>Less: Credit for source-based tax imposed in State R</td>
<td>(10)</td>
</tr>
<tr>
<td>Tax collected in State PE</td>
<td>15</td>
</tr>
<tr>
<td>&quot;Residence-based&quot; tax collected in State R (^{1067})</td>
<td>-</td>
</tr>
<tr>
<td>Total tax collected in State R</td>
<td>10</td>
</tr>
</tbody>
</table>

\(^{1064}\) State R imposes source based tax of 10% on $100 of interest income. The tax imposed is therefore $10.

\(^{1065}\) $100 \times 25\% = $25

\(^{1066}\) $100 \times 25\% = $25

\(^{1067}\) State R exempts the income attributable to the PE and therefore imposes no residence-based taxation.
This demonstrates that if there were a secondary application of the R-PE treaty on the basis that income derived from sources in State R and attributable to the PE were derived by a resident of State PE, the residence state may be entitled to collect more tax in relation to passive income arising in the residence state than it would under the existing framework. The tax collected in State R would reduce the amount of tax collected in State PE as a result of the relief mechanism of the treaty, which the PE state would also be required to apply. This would clearly be very complicated to apply in practice, particularly given that the facts are unlikely to be as straight-forward as those presented in the above example. It also would require a completely separate calculation process to be conducted for the purposes of determining the limit on the amount of tax the residence state could impose under the treaty, which would not necessarily be linked to the calculation required for the purposes of determining the applicable tax liability under the domestic law of the residence state.

9.3.1.2. Passive income where the residence state uses the credit method in relation to PE income

Treating the PE as a resident of the PE state for the purposes of the R-PE treaty would imply that the residence state should exempt the profit attributable to the PE. Allowing the residence state to continue to impose tax on the profit attributable to the PE on a residence basis (and providing relief using the credit method) would arguably be inconsistent with treating the PE as a separate taxable entity for treaty purposes. However, it is likely that requiring an exemption would be unacceptable to states that use the credit method as the exclusive method of relief in their treaties. This may be somewhat offset by the potential ability of the residence state to impose a greater level of tax on locally sourced income attributable to foreign PEs of resident enterprises (as shown in the example in the previous section), but such income is not likely to represent the bulk of the income attributable to foreign PEs, which is most likely to arise from sources in the PE state. The discussion in this section will therefore consider how the R-PE treaty could be applied if the PE is treated as a resident of the PE state and the residence state uses the credit method.

Where the residence state uses the credit method to provide relief in relation to the profit attributable to the PE, the application of the PE-S treaty as though the income were derived by a resident of the PE state would be particularly difficult. It would require a similar multi-step analysis to that discussed above in relation to the exemption method, with the exception that the amount of (credit) relief in the residence would depend on the amount of tax imposed in the PE state, taking into account the availability of relief in the PE state for tax imposed on a source basis in State R. This is demonstrated in the following example.

Example: A company resident in State R derives $100 of interest income from sources in State R. The income is attributable to a PE in State PE under the R-PE treaty. Under the R-PE treaty, both contracting states use the credit method of relief. The R-PE treaty is applied as though the income were derived by a resident of State PE and therefore, State R is entitled to impose source-based taxation on the income in accordance with the interest article (Article 10) of the R-PE treaty. Under Article 10, source-based taxation of interest is limited to 10% of the gross amount of the income. The general company tax rate in both State R and State PE is 25%. This situation is illustrated in the following diagram.

Figure 9.2: Example showing the application of R-PE treaty if PE is treated as a resident of the PE state
The table below compares (i) the situation where the R-PE treaty is applied as though the PE were a resident of State PE and (ii) the situation where the PE is not treated as a resident of State PE for the purposes of the R-PE treaty.

<table>
<thead>
<tr>
<th>Source-based&quot; tax imposed in State R</th>
<th>(i) PE a resident of State PE for the purposes of the R-PE treaty</th>
<th>(ii) PE not a resident of State PE for purposes of R-PE treaty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax imposed in State PE on profit attributable to PE</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Less: Credit for source-based tax imposed in State R</td>
<td>(10)</td>
<td>N/A</td>
</tr>
<tr>
<td>Tax collected in State PE</td>
<td>15</td>
<td>25</td>
</tr>
<tr>
<td>&quot;Residence-based&quot; tax imposed in State R</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Less: Credit for tax imposed in State PE</td>
<td>(15)</td>
<td>(25)</td>
</tr>
<tr>
<td>&quot;Residence-based&quot; tax collected in State R</td>
<td>15</td>
<td>5</td>
</tr>
<tr>
<td>Total tax collected in State R</td>
<td>20</td>
<td>5</td>
</tr>
</tbody>
</table>

In both cases, the total amount of tax collected in relation to the income is $30 and there is no unrelieved double taxation. However, where the income is treated as being derived by a resident of the PE state for the purposes of the R-PE treaty, thus allowing the residence state to impose "source-based" taxation, the share of tax collected by the residence state increases.

9.3.1.3. Business profits and "other income"

The income attributable to the PE may include income from sources in the residence state which would be categorised as either business profits (under Article 7) or "other income" (under Article 21). This is illustrated in the following diagram.

1068 State R imposes source based tax of 10% on $100 of interest income. The tax imposed is therefore $10.
1069 $100 x 25% = $25
1070 $100 x 25% = $25
1071 $100 x 30% = $30.
1072 $100 x 30% = $30.
1073 It is assumed that the residence state is not required to provide a credit for the tax it imposes on the interest paid to the PE, since granting such a credit would not be consistent with treating the PE as a separate entity. If the situation involved a payment from a resident of State R to a company resident in State PE, the residence state would generally not grant such relief (although there may be indirect credits available for underlying taxes in relation to dividends, at least under domestic law). However, granting a credit for the withholding tax imposed on the payment to the PE would be consistent with the treatment of income attributable to the PE and arising in third states, in which case the residence state would have an obligation to provide credit relief under the R-S treaty; this suggests that State R should perhaps have an obligation to grant a credit for the withholding tax it imposes on the payment.
1074 This is the total of the "source-based" taxation imposed on the interest paid to the PE and the "residence-based" tax imposed on the resident enterprise,
If the PE were entitled to treaty benefits under the R-PE treaty then the residence state would not be entitled to impose any source-based taxation on the income under either Article 21 or Article 7. The application of the R-PE treaty as though the PE were a resident of the PE state would therefore have no impact on the taxation of business profits or other income derived from sources in the residence state. The income would simply be taxable in the PE state and in the residence state in accordance with the normal terms of the treaty, with the residence state obliged to grant relief for tax imposed in the PE state (either by exempting the income or by granting a credit).

9.3.1.4. Income from immovable property

Under Article 6, income arising from immovable property may be taxed in the state where the immovable property is located. In so-called "bilateral triangular cases" involving immovable property, i.e., in situations where a person derives income from immovable property situated in their residence state which is attributable to a PE in a second state, it is clear that Article 6 applies. As a result, the PE state is prevented from imposing tax on the income based on the normal application of the R-PE treaty. This is illustrated in the following diagram.

If PEs are eligible for treaty benefits, therefore, the PE should not be considered to derive such income for treaty purposes and the R-PE treaty should not be applied as though the income were derived by a resident of the PE state.

9.3.1.5. Income from shipping, inland waterways transport and air transport

Under Article 8, income from shipping, inland waterways transport and air transport is only taxable in the state where the place of effective management is located (or, under many existing treaties, in the state of residence). In a PE triangular case, the R-PE treaty would therefore not allow the PE state to impose

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1075 This result in relation to income from immovable property arising in the residence state would somewhat inconsistent with the treatment of income arising from immovable property situated in a third state. The application of tax treaties to income from immovable property situated in a third state was discussed in Chapter 2 (Section 2.6.) where it was concluded that such income should be taxable in the PE state under Article 7 of the R-PE treaty, with the result that the PE should be entitled to treaty benefits under the PE-S treaty in relation to such income. This inconsistency will be discussed further in Section 9.2.4., below.

1076 Based on a survey of treaties between OECD member states and between OECD member and non-member states, Maisto identifies that around 47% of treaties follow the wording in the OECD Model (allocating exclusive taxing rights to the state where the place of effective management is located) and around 44-48% of treaties base the allocation of taxing rights on residence. Thus, 85-90% of treaties base the allocation of taxing rights on either the
any tax on such income and the source state would not be obliged to apply the conditions of the PE-S
treaty. Given that the PE-S treaty does not apply in a triangular situation, the R-PE treaty should also not
be applied as through the income were derived by a resident of the PE state. That is, the normal
operation of the R-PE treaty should continue and the PE state should be prevented from imposing any
tax.

9.3.1.6. Capital gains

The distribution of taxing rights in relation to capital gains depends on the type of asset from which the
capital gains arise. The various types of capital gains dealt with in the OECD Model will therefore be
discussed in turn below.

*Immovable property:* Where the income attributable to a PE includes capital gains arising from the alienation
of immovable property situated in the residence state (illustrated in the diagram below), those capital
gains cannot be taxed in the PE state under the terms of the R-PE treaty based on the normal application
of that treaty.\(^{1077}\) The PE should therefore not be entitled to claim treaty benefits in relation to such gains
under the R-PE treaty.

*Figure 9.5.*: Application of the R-PE treaty to capital gains arising from immovable property located in State R

![Diagram showing application of R-PE treaty to capital gains from immovable property]

*Movable property attributable to a PE:* Article 13(2) deals with capital gains arising in relation to movable
property forming part of the business property of a PE in the other contracting state. If there is movable
property located in the residence state which is attributable to the PE in the PE state then, under the
normal application of the R-PE treaty, the PE state would be entitled to impose tax on such income in
accordance with Article 13(2). Therefore, if the PE is entitled to treaty benefits under the R-PE treaty,
then treaty benefits should be available in relation to these types of capital gains. However, Article 13(2)
will not apply for the purposes of this application of the R-PE treaty from the perspective of the PE,
unless the property is attributable to a "sub-PE"\(^{1078}\) in the residence state (and thus attributable to both
that sub-PE and the PE claiming treaty benefits). In general, assuming the gain is not attributable to a
"sub-PE" in the residence state (of the enterprise as a whole; this is illustrated in the diagram below),
Article 13(5) would apply and that state would not be entitled to impose any source-based taxation on the
gain.

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\(^{1077}\) Article 13(1) provides that: "Gains derived by a resident of a Contracting State from the alienation of
immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other
state." Thus, Article 13(1) allows the state where the property is situated to impose tax on any gains from its
alienation. However, Article 13(1) does not apply if the property is situated in the residence state, in which case
Article 13(5) applies. Under Article 13(5) the gains may only be taxed in the residence state.

\(^{1078}\) Refer to Chapter 2 for a discussion of the issues associated with sub-PEs (see Section 2.2.3.1.).
Shipping and air transport: Where the profit attributable to the PE includes capital gains arising from the alienation of assets involved in a shipping or air transport enterprise, the PE state would be prevented from imposing tax on those gains under Article 13(3), based on the normal application of the R-PE treaty. The PE should therefore not be entitled to claim treaty benefits under the R-PE treaty in relation to such capital gains.

Shares in real property companies: Similarly, where capital gains attributable to the PE arise from the disposal of shares in a company holding immovable property in the residence state, the PE state would be prevented from imposing tax under Article 13(4), based on the normal application of the R-PE treaty, and the PE should therefore not be entitled to claim treaty benefits under the R-PE treaty in relation to such capital gains.

Other assets: Similarly, where the profit attributable to the PE includes capital gains arising from the alienation of assets not covered by any other paragraphs of Article 13, the PE state would be prevented from imposing tax on those gains under Article 13(5) of the R-PE treaty. The PE should therefore not be entitled to claim treaty benefits under the R-PE treaty in relation to such capital gains.

9.3.1.7. Conclusions

Allowing the PE to claim treaty benefits under the R-PE treaty would be consistent with treating the PE in the same way as a separate enterprise for treaty purposes. However, this approach is not necessary for resolving the issues that arise in PE triangular cases and the main impact of such an approach would be felt in bilateral cases, which represent the vast majority of situations involving PEs. It would also be extremely complicated to apply in practice, as is evident from the analysis above. If the PE were recognised as a treaty eligible enterprise under the R-PE treaty, the application of the R-PE treaty would require a two step process. First, the R-PE treaty would have to be applied from the perspective of the resident of State R to determine that a PE exists and to distribute taxing rights between State R and State PE in relation to the income attributable to the PE (i.e., under Article 7). The R-PE treaty would then have to be applied again, with the PE being treated as a resident of the PE state, to determine the source based taxation that could be imposed in State R. The provision of relief would also be complicated, since the PE state should be required to provide relief for tax imposed on a source-basis in the residence state. Finally, issues may arise as a result of the mismatch between the characterisation of the situation for treaty purposes and the legal nature of the situation, upon which the characterisation under domestic law is likely to be based. These complications seem to outweigh the benefit of the theoretical consistency of treating the PE as a separate, treaty-eligible enterprise for the purposes of the R-PE treaty.

1079 Article 13(4) provides that "gains derived by a resident of one Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State." Concluded treaties may also allow source based taxation of capital gains arising from the alienation of shares which represent substantial participations, or where the underlying assets of the company are located in the other contracting state (i.e., not the source state); refer to Chapter 2 for further information (Section 2.8.4.).
9.3.2. Treatment of notional dealings

One of the limits which has historically been placed on the separate entity approach for determining the profit attributable to a PE relates to the treatment of dealings between the PE and other parts of the enterprise. With the adoption of the AOA,1080 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 for profit attribution purposes if a "real and identifiable event has occurred."1081 According to the OECD report, "[t]his requires a determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the 'dealing'."1082 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. In some circumstances, it may also be possible to recognise internal interest payments, including a profit margin; namely, where part of the enterprise conducts treasury operations.1083 Thus, the AOA has greatly expanded the situations in which internal dealings may be recognised for profit attribution purposes.

Internal dealings are not, however, recognised for the purposes of applying tax treaties outside the context of determining the profit attributable to the PE.1084 This means, for example, that the PE state is prevented from imposing source-based taxation on notional payments made by the PE to the rest of the enterprise. If treaty benefits are extended to PEs, effectively resulting in PEs being treated more like separate enterprises for treaty purposes, it seems reasonable to re-examine this non-recognition of notional payments.

The discussion below will focus on notional transactions involving interest and royalties to illustrate the main considerations associated with the recognition of notional payments for treaty purposes. It should be kept in mind, however, that notional interest payments can only be recognised for profit attribution purposes in limited circumstances and that such payments should only be recognised for the purposes of applying Article 11 or Article 12 if they are recognised for profit attribution purposes. Notional transactions can of course also involve other categories of income. Notional payments may occur from the PE to the head office, from the head office to the PE, or between PEs located in different states; the discussion below addresses each of these different types of payments in turn.

Note that references to the recognition of notional payments for treaty purposes in this section should be taken to refer to the recognition of such payments for treaty purposes other than profit attribution (i.e., for the application of the treaty after the profit attributable to the PE and to other parts of the enterprise has been determined).

9.3.2.1. Notional payments from the PE to the head office

A PE may be considered to make notional royalty payments to its head office for profit attribution purposes if, for example, the PE utilises intellectual property rights which are attributable to the head office.1085 Similarly, if the head office conducts treasury functions and the funding for the PEs operations includes a notional loan from the head office to the PE, then for profit attribution purposes, the PE may be considered to make notional interest payments to the head office.1086 Recognising such notional

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1080 The AOA is discussed in more detail in Chapter 5 (see Section 5.2.5.).
1081 OECD, "2010 Report…," Part I, Section B-3(v), para 35.
1085 See, for example: OECD, "2010 Report…," Part I, Section D-3(iv), para 241. For discussion regarding the attribution of intangible assets to different parts of an enterprise, see: OECD, "2010 Report …," Part I, Section D-2, paras 105-128. For discussion regarding the determination of the profits attributable to different parts of an enterprise in relation to intangible property, see: OECD, "2010 Report…," Part I, Section D-3(iv), paras 235-250.
1086 It is important to distinguish between the allocation of external interest to the PE and notional payments of interest from the PE to other parts of the enterprise. An allocation of external interest to the PE will not give rise to notional payments, since the PE will effectively be considered to have made the real payment to the third party. This gives rise to reverse PE triangular cases, which will be discussed in Chapter 11. Notional interest payments can only be recognised for profit attribution purposes where part of the entity conducts treasury functions, in this case the head office (see: OECD, "2010 Report…," Part I, Section D-2(v), para 153).
transactions as income received by the head office and paid by the PE for the purposes of applying the other articles of the R-PE treaty would be consistent with treating PEs as separate entities. This implies that the interest and royalties articles (Article 11 and Article 12) would apply to the notional payment and the PE state would be entitled to impose tax on the notional income in accordance with the maximum rates specified in those articles.\textsuperscript{1087} Recognising notional payments for treaty purposes (beyond the attribution of income) and allowing source-based taxation to be imposed may also reduce the potential for treaty shopping though PEs, since it could limit the enterprise’s ability to make base eroding payments out of the PE without triggering a withholding tax liability in the PE state. This would depend, however, on the PE state actually imposing tax on the notional payments under its domestic law.

One of the main objections to allowing the PE state to impose source-based taxation on notional payments is that it would represent double taxation. In the residence state, such notional income is effectively taxed in the hands of the entity as a whole because such payments reduce the profit attributable to the PE and therefore reduce the amount in relation to which the residence state must grant relief (either exemption or credit). This is demonstrated in the following example.

**Example**

A resident of State R derives business profits of $100 which is attributable to a PE in State PE. Under the R-PE treaty, State R uses the exemption method as the primary method of relief. This situation is illustrated in the following diagram.

*Figure 9.7.: Example involving notional payments from PE to the head office*

<table>
<thead>
<tr>
<th></th>
<th>(i) Notional royalty payment $90</th>
<th>(ii) No notional royalty payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit attributable to the PE:</td>
<td>10\textsuperscript{1088}</td>
<td>100</td>
</tr>
<tr>
<td>Taxable income in State R before exemption</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Less: Exemption of PE profit</td>
<td>(10)</td>
<td>(100)</td>
</tr>
<tr>
<td>Taxable income in State R</td>
<td>90</td>
<td>-</td>
</tr>
</tbody>
</table>

As can be seen in the table above, where the residence state uses the exemption method in relation to the income attributable to the PE, the taxable income in the residence state is effectively increased by the amount of any notional payments made by the PE, as a result of the reduction in the profit attributable to

\textsuperscript{1087} Under Article 11 of the OECD Model, interest arising in one contracting state and beneficially owned by a resident of the other contracting state can be taxed in the state where it arises, but the tax that can be imposed is limited to 10% of the gross amount of the interest. Under Article 12 of the OECD Model, the source state is prevented from imposing tax on royalties, however, it is common for concluded treaties to allow the source state to impose tax up to a specified maximum rate based on the gross amount of the royalties (similar to the dividend and interest articles).

\textsuperscript{1088} The profit attributable to the PE is $100 less the notional royalty payment of $90: $100 - $90 = $10.
the PE. A similar effect can also be observed where the residence state uses the credit method, however, in that case the impact on the tax collected in the residence state will be influenced by the relative tax rates in the PE state and the residence state. The residence state could be thought of as exempting the "gross" profit attributable to the PE (i.e., before the notional payment to the head office, but net of other deductions) and then taxing the notional royalty payment. If the PE state is entitled to impose source-based taxation on notional payments, such payments are effectively subject to tax in both the PE state and the residence state. The relief for the tax imposed in the PE state on the profit attributable to the PE (whether it be an exemption or credit) is effectively not available in relation to the notional payments because, rather than being included in the profit attributable to the PE, they actually reduce the profit attributable to the PE. This suggests that if the PE state is entitled to impose withholding tax on notional interest and royalty payments made by the PE to the head office, then the residence state should be required to grant relief for the withholding tax imposed in the PE state.

Since the notional income is categorised as interest or royalties, as the case may be, the residence state should be required to grant relief using the credit method. Thus, although the income derived by the resident entity may be categorised as, e.g., business profits, it should effectively be recharacterized to recognise that the income which is being taxed in the residence state is not the business profits attributable to the PE, but rather, the notional interest or royalty payment received from the PE. This relief should be in addition to any relief available in relation to the profit attributable to the PE (whether exemption or credit), since exempting the profit attributable to the PE, or granting a credit for the tax imposed on the profit attributable to the PE, is not sufficient to prevent unrelieved double taxation where notional interest and royalty payments made by the PE to the head office are taxable on a source basis in the PE state.

The application of the R-PE treaty in a situation where the notional royalty payments from the PE to the head office are recognised for the purposes of applying Article 12 is illustrated in the following example.

Example: A resident of State R derives business profits of $100 which is attributable to a PE in State PE. The PE makes a notional royalty payment of $90 to the head office. Under the R-PE treaty, State R uses the exemption method as the primary method of relief, but uses the credit method for interest, royalties and dividends. Under its domestic law, the PE state imposes a withholding tax on notional royalty payments of 10%. The R-PE treaty limits source based taxation of royalties to 10% of the gross amount. The corporate tax rate in State R is 20% and the corporate tax rate in State PE is 30%. This situation is illustrated in the following diagram.

The following table compares two alternative scenarios: (i) the notional royalty payment of $90 is recognised for the purposes of applying Article 12 of the R-PE treaty or (ii) the notional royalty payment is not recognised for the purposes of applying Article 12.

<table>
<thead>
<tr>
<th></th>
<th>(i) Notional royalty payment recognised for Article 12</th>
<th>(ii) Notional royalty payment not recognised for Article 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit attributable to the PE</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>
State PE: Corporate tax imposed on income attributable to the PE

<table>
<thead>
<tr>
<th>State PE: Corporate tax imposed on income attributable to the PE</th>
<th>31089</th>
<th>31090</th>
</tr>
</thead>
</table>

State PE: Withholding tax imposed on notional royalty payment

<table>
<thead>
<tr>
<th>State PE: Withholding tax imposed on notional royalty payment</th>
<th>91091</th>
<th>1092</th>
</tr>
</thead>
</table>

Total tax imposed in State PE

<table>
<thead>
<tr>
<th>Total tax imposed in State PE</th>
<th>12</th>
<th>3</th>
</tr>
</thead>
</table>

Income derived by resident of State R

<table>
<thead>
<tr>
<th>Income derived by resident of State R</th>
<th>100</th>
<th>100</th>
</tr>
</thead>
</table>

Exemption of the profit attributable to the PE

<table>
<thead>
<tr>
<th>Exemption of the profit attributable to the PE</th>
<th>(10)</th>
<th>(10)</th>
</tr>
</thead>
</table>

Taxable income in State R

<table>
<thead>
<tr>
<th>Taxable income in State R</th>
<th>90</th>
<th>90</th>
</tr>
</thead>
</table>

Tax imposed in State R before relief on notional payment (20%)

<table>
<thead>
<tr>
<th>Tax imposed in State R before relief on notional payment (20%)</th>
<th>181093</th>
<th>181094</th>
</tr>
</thead>
</table>

Credit for tax imposed on notional royalty payment

<table>
<thead>
<tr>
<th>Credit for tax imposed on notional royalty payment</th>
<th>91095</th>
<th>-</th>
</tr>
</thead>
</table>

Total tax imposed in State R

<table>
<thead>
<tr>
<th>Total tax imposed in State R</th>
<th>9</th>
<th>18</th>
</tr>
</thead>
</table>

Total tax imposed in all states

<table>
<thead>
<tr>
<th>Total tax imposed in all states</th>
<th>211096</th>
<th>211097</th>
</tr>
</thead>
</table>

The provision of relief in the residence state in relation to withholding tax imposed on notional payments in the PE state would ensure that there is no unrelieved double taxation in relation to such payments. It would require that, at least for treaty purposes, the income derived by the resident entity is considered to have the character of the notional payment received (e.g., interest or royalties) which may differ from the characterisation of the income initially received by that entity (e.g., business profits). This would result in the R-PE treaty being applied to notional payments between a PE and its head office in the same way as it would be applied to payments by a subsidiary resident in the PE state to its parent company resident in State R. This would be very complicated to apply, however, since it would require the residence state to first exempt the income attributable to the PE, or to provide credit relief for tax imposed on that income in the PE state, and then to grant credit relief in relation to the withholding tax imposed on the notional payment. Essentially, one item of income must be treated as two separate items of income.

9.3.2.2. Notional payments between PEs located in different states

The recognition of notional interest and royalty payments between PEs located in different states could potentially give rise to PE triangular cases in situations where they would not otherwise arise. Currently, a notional interest or royalty payment from one PE to another PE located in a different state

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1089 $100 x 30%. The profit attributable to the PE multiplied by the tax rate in the PE state.
1090 $100 x 30%. The profit attributable to the PE multiplied by the tax rate in the PE state.
1091 $90 x 10%. A withholding tax of 10% is imposed on the notional royalty of $90.
1092 The PE state is prevented from imposing withholding tax on the notional royalty payment by the terms of the R-PE treaty.
1093 $90 x 20% corporate tax rate in State R.
1094 $90 x 20% corporate tax rate in State R.
1095 Where the PE state is entitled to impose tax on the notional interest payment, the residence state should be obliged to grant relief. Since the credit method applies in relation to interest payments, even if the exemption method generally applies (at least under the relief provisions of the OECD Model), State R should be required to provide credit relief. The relief will be limited to the lesser of the withholding tax imposed in State PE (i.e., $9) and the tax imposed in State R (i.e., $90 x 20% = $18) in relation to the income. There is no credit for the other $3 of tax imposed in the PE state because the income attributable to the PE is exempt in the residence state.
1096 $12 in State PE and $9 in State R.
1097 $3 in State PE and $18 in State R.
1098 Notional payments could also potentially occur between two PEs located in a single state, but such payments do not give rise to questions of treaty recognition for notional payments so will not be discussed here.
reduces the profit attributable to the paying PE and increases the profit attributable to the recipient PE. If, however, the state where the paying PE is located is entitled to impose withholding tax on such payments in accordance with the terms of the treaty between the two PE states, then the income attributable to the recipient PE would effectively include income which has been taxed on a source basis in a third state (i.e., not the residence state or the PE state). This effectively gives rise to a typical PE triangular situation. In this case, the recipient PE state should be obliged to provide relief and the state where the paying PE is located should be required to apply the conditions of the treaty between the two PE states (i.e., equivalent to the PE-S treaty).

The following example demonstrates how the recognition of notional payments between PEs located in different states for treaty purposes may operate. In this example, the residence state uses the exemption method in relation to both PEs since, as discussed above, this is the only method which is consistent with treating PEs as separate entities for treaty purposes.

**Example**

A resident of State R derives business profits of $200, $100 of which is attributable to a PE in State S and $100 of which is attributable to a PE in State PE. The PE in state S makes a notional royalty payment of $90 to the PE in State PE. Under both the R-PE treaty and the R-S treaty, State R uses the exemption method as the primary method of relief, but uses the credit method for interest, royalties and dividends. Under its domestic law, State S imposes a withholding tax on notional royalty payments of 20%. The PE-S treaty limits source based taxation of royalties to 10% of the gross amount. The corporate tax rate in State S is 20% and the corporate tax rate in State PE is 30%. This situation is illustrated in the following diagram.

**Figure 9.10.: Example showing notional payments between two PEs**

The following table compares two alternative scenarios: (i) the notional royalty payment of $90 is recognised for the purposes of applying Article 12 of the PE-S treaty or (ii) the notional royalty payment is not recognised other than for profit attribution purposes.

<table>
<thead>
<tr>
<th></th>
<th>(i) Notional royalty payment recognised for Article 12</th>
<th>(ii) Notional royalty payment not recognised for Article 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit attributable to the PE in State S (after deduction for notional royalty)</td>
<td>10(^{1099})</td>
<td>10(^{1000})</td>
</tr>
<tr>
<td>Tax imposed in State S on profit attributable to the PE (20%)</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>State S withholding tax on notional royalty payment</td>
<td>9(^{1101})</td>
<td>-</td>
</tr>
</tbody>
</table>

\(^{1099}\) Business profits of $100, less notional royalty payment of $90: $100 - $90 = $10
\(^{1100}\) Business profits of $100, less notional royalty payment of $90: $100 - $90 = $10
\(^{1101}\) The notional royalty of $90 is subject to withholding tax of 10%: $90 x 10% = $9
As can be seen in the table above, where the residence state uses the exemption method in relation to the profit attributable to both the PEs, the imposition of source-based taxation on notional payments between PEs located in different states does not have any impact on the tax collected in the residence state. This may not be the case if the residence state uses the credit method. More broadly, however, the main impact of recognising notional payments between two PEs for treaty purposes, and thus allowing the state of the paying PE to impose withholding tax, would be on the split of revenue between the two PE states. It would essentially result in the state where the paying PE is located collecting more tax in relation to the activities conducted by the PE.

9.3.2.3. Notional payments from the head office to the PE

Notional payments from the head office to a PE should arguably be treated in the same way for treaty purposes as other income arising in the residence state and attributable to the PE, and should therefore only be recognised for treaty purposes if such other income is also recognised. The potential application of the R-PE treaty to such income was discussed in detail above (see Section 9.3.1.), and similar issues would arise if notional payments from the head office to the PE were recognised.

9.3.2.4. Notional profit distributions by the PE

If notional payments between different parts of the enterprise are recognised for treaty purposes, the question arises as to whether the PE should be considered to make notional profit distributions (i.e., dividends) and whether such distributions should be subject to withholding tax in the PE state. This would give rise to extremely difficult issues regarding the situations in which a PE should be deemed to make a profit distribution and how the amount of such notional distributions should be determined. It would also likely give rise to economic double taxation similar to that which exists where the profits derived by a company are taxed in that company’s residence state when they are received and are then effectively taxed again when the profits are distributed to shareholders in the form of dividends. Further discussion of the potential recognition of notional profit distributions by PEs is beyond the scope of this thesis.

<table>
<thead>
<tr>
<th></th>
<th>1102</th>
<th>1103</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax imposed in State S</td>
<td>11</td>
<td>2</td>
</tr>
<tr>
<td>Profit attributable to the PE in State PE (including notional royalty income)</td>
<td>190$^{1102}$</td>
<td>190$^{1103}$</td>
</tr>
<tr>
<td>Tax on profit in attributable to the PE (before credit relief)</td>
<td>57$^{1104}$</td>
<td>57$^{1105}$</td>
</tr>
<tr>
<td>Credit for withholding tax on notional royalty payment</td>
<td>(9)</td>
<td>-</td>
</tr>
<tr>
<td>Total tax imposed in State PE</td>
<td>48</td>
<td>57</td>
</tr>
<tr>
<td>Total income of resident of State R</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Exemption for profit attributable to PE in State S</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Exemption for profit attributable to PE in State PE</td>
<td>190</td>
<td>190</td>
</tr>
<tr>
<td>Taxable income in State R</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

$^{1102}$ Business profits of $100, plus notional royalty payment of $90: $100 + $90 = $190

$^{1103}$ Business profits of $100, plus notional royalty payment of $90: $100 + $90 = $190

$^{1104}$ $190 \times 30\% = $57$

$^{1105}$ $190 \times 30\% = $57$
9.3.2.5. Conclusions

Recognising notional payments between different parts of an enterprise for treaty purposes beyond determining the profit attributable to a PE would be consistent with treating the PE in the same way as a resident enterprise for treaty purposes. It would result in the state where the income arises (e.g., the PE state) being entitled to impose source-based taxation on notional payment in accordance with the terms of the treaty between that state and the state where the part of the enterprise receiving the income is located (whether that be the residence state or another PE state). In addition, in order to prevent double taxation, the state where the part of the enterprise receiving the notional income is located should be obliged to provide relief (e.g., for withholding tax imposed on the notional payment). Taxation of notional payments made by PEs would tend to limit the opportunities for lowering the overall tax burden through base eroding payments, and thus may tend to limit the opportunities for treaty shopping. The main problem with recognising notional payments for treaty purposes is that it would be extremely complicated to apply in practice. It is also necessary for resolving the issues that arise in PE triangular cases and its main impact would be felt in bilateral cases, which represent the vast majority of situations involving PEs. For these reasons, the recognition of notional payments is something which could be considered further, but it would not be a necessary consequence of applying the PE-S treaty in PE triangular cases.

9.4. Conclusions

This chapter has addressed a number of specific issues which should be addressed if the PE-S treaty is made to apply in PE triangular cases, including the resolution of multilateral disputes through the mutual agreement procedure, the application of threshold requirements in tax treaties, and the extent to which treaty benefits can be extended to PEs of insurance companies, given that investment income is allocated to such PEs on the basis of the insurance risks assumed by the PE. The application of Article 6, in relation to income from immovable property, should also be considered further. In addition, PEs should be prevented from claiming treaty benefits under the PE-S treaty in relation to income which, while it may be attributable to the PE, cannot be taxed in the PE state under the terms of the R-PE treaty. If PEs are effectively treated as separate enterprises for the purposes of claiming benefits under treaties concluded with third states, the question also arises as to how far this separate entity treatment should be taken. That is, whether the PE should be treated as a separate treaty-eligible entity for the purposes of the R-PE treaty and, in addition, whether notional payments between different parts of the enterprise should be recognised for treaty purposes, thus allowing states to impose source-based taxation on such notional payments. For the purposes of resolving the issues arising in PE triangular cases, it would not be necessary to take the separate enterprise treatment of PEs to this logical conclusion and it would be extremely complicated to implement and apply in practice. In addition, the vast majority of cases involving PEs are bilateral cases and it is in these cases, rather than in triangular cases, where the main impact of such an approach would be felt. However, if PEs are treated as separate entities for profit attribution purposes and for the purposes of treaties with third states, the extent to which PEs should be treated as separate entities more generally for treaty purposes is clearly something that should be considered further.
Chapter 10
Dual resident triangular cases

10.1. Introduction
Dual resident triangular cases occur where a person who is considered to be resident in two different states under their respective domestic laws receives income from sources in a third state (the "source state"). Dual residence may occur where the residence rules of the two states differ and take into account different factors for determining residence or, alternatively, where the residence rules of both states are similar, but where the factor upon which residence is based is split between different states. Dual residence can occur, for example, where an individual lives for part of the year in each of two different states or, in the case of a company, where the company is incorporated in one state and is managed in another or has its management split between various locations. Tax treaties contain tie-breaker rules to assign residence for treaty purposes however, as will be seen below, these rules may not be effective for resolving the issues that arise in dual resident triangular cases.

A dual-resident triangular case is illustrated in the following diagram (in this diagram the source state is labelled “State S” and the residence states are each labelled “residence state”).

![Figure 10.1.: Dual resident triangular case.](image)

There are three treaties which are potentially applicable in this situation; the first is the treaty between the two residence states and the other two are the treaties between the two residence states and the source state. 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. In dual-resident triangular cases, therefore, where a person is resident in two states under their respective domestic laws, that person will generally also be resident in both those states for the purposes of the treaties which each of them have concluded with third states. As a result, the source state in a dual resident triangular case may be subject to the provisions of two separate treaties, in which case it will only be able to satisfy its treaty obligations by applying the terms of the treaty that are most favourable to the taxpayer. This gives rise to concerns regarding the potential for tax avoidance.

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1106 The term "persons" is defined in Article 3(1) to include "...an individual, a company and any other body of persons.” The discussion in this chapter will refer only to individuals and companies; it does not address any issues associated with partnerships and/or hybrid entities.


through improper use of treaties. That is, a company could be incorporated in one state and effectively managed from another, making it a dual resident, in order to take advantage of the treaties between those two residence states and a third state (the source state). Of particular concern is the possibility for the dual-resident company to claim a reduction in source based taxation under the treaty between the losing residence state (State B) and the source state (the B-S treaty) in situations where the treaty between the two residence states prevents the losing residence state from imposing any tax on the income.

The OECD Commentary takes the position that a company whose residence has been allocated to one state (i.e., State A) under a tax treaty will not be resident of the losing residence state (State B) for the purposes of treaties with third states (i.e., the B-S treaty), on the basis of the second sentence of Article 4(1). The second sentence of Article 4(1) provides that: "This term [i.e., 'resident of a Contracting State'], however, does not include any person who is liable to tax in that state in respect only of income from sources in that state..." The OECD Commentary takes the view that, as a result of the terms of the treaty between the two residence states, a person whose residence has been assigned to one state (the winning residence state or "State W") under the treaty between those two states will only be subject to tax in the state to which residence is not assigned (the losing residence state or "State L") on income from sources in that state, and will therefore not be resident in that state (State L) under Article 4(1) of treaties with third states (i.e., the L-S treaty). As a result, the dual resident would only be able to claim the benefit of treaties concluded by the winning residence state and would not be able to claim dual treaty benefits in third (source) states. This issue will be discussed in detail in Chapter 11.

This chapter will first give a general overview of the types of residence rules that are commonly found in domestic law and of the residence tie-breaker rules in tax treaties before moving on to consider the application of tax treaties in various types of dual resident triangular cases. Please note that this chapter gives only a brief outline of the issues that can arise in the application of the residence tie-breaker rules of tax treaties. These issues have been discussed at length elsewhere, and are not specific to dual resident triangular cases; they arise equally in bilateral situations involving dual residents.

10.2. Residence under domestic laws

Different states employ different criteria for determining whether a certain person is resident for tax purposes. Where these criteria overlap, a person may be considered to be resident in two states under their respective domestic laws and thus may be a dual resident. This section will give a brief overview of the residence rules that are typically applied in relation to individuals under domestic laws, before turning to the domestic residence rules typically applied to companies.

10.2.1. Individual residence under domestic laws

Various tests are employed by different countries to determine the residence of individuals. The basic idea behind the residence concept is that the person involved has close economic and personal ties to the state. In the case of individuals, therefore, residence is often determined using a "facts and circumstances approach" whereby an individual’s residence is determined on the basis of their personal

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1112 Vann, R., "International Aspects...,” at p. 729.
and economic connections to the state.\footnote{1113}{In applying this type of a approach, various factors may be taken into account, such as whether the person has a permanent home within the jurisdiction, the extent to which they have family or other personal ties, or the extent to which they engage in income-producing activities in the country.\footnote{1114}{In addition to a facts and circumstances approach (or as an alternative), many countries use a more objective residence test. It is common, for example, for domestic legislation to include a residence test based on physical presence, whereby a person is considered to be a resident if they spend more than 183 days in the country in a particular tax year or in any 12 month period.\footnote{1115}{Objective residence tests for individuals may also be based on visa and immigration status, domicile, nationality or citizenship.\footnote{1116}{Clearly the factors used to determine residence in different states can overlap, such that an individual is considered to be resident under the domestic laws of two states. This is most likely to occur in situations where an individual splits their time between two different states, for example, where they live close to an international border and have their home in one state but work in the other.}}}} In applying this type of a approach, various factors may be taken into account, such as whether the person has a permanent home within the jurisdiction, the extent to which they have family or other personal ties, or the extent to which they engage in income-producing activities in the country. In addition to a facts and circumstances approach (or as an alternative), many countries use a more objective residence test. It is common, for example, for domestic legislation to include a residence test based on physical presence, whereby a person is considered to be a resident if they spend more than 183 days in the country in a particular tax year or in any 12 month period. Objective residence tests for individuals may also be based on visa and immigration status, domicile, nationality or citizenship. Clearly the factors used to determine residence in different states can overlap, such that an individual is considered to be resident under the domestic laws of two states. This is most likely to occur in situations where an individual splits their time between two different states, for example, where they live close to an international border and have their home in one state but work in the other.

10.2.2. Corporate residence under domestic laws

The specific criteria for determining whether a corporate entity is resident differ substantially between countries, however they generally fall into two broad categories; formal tests based on legal factors (such as the place of incorporation) and factual tests based on economic or business factors (usually the place of management). In countries that employ both legal and economic factors as residence criteria they are usually alternate tests, such that meeting the conditions of one test makes the company a resident even if the conditions of the other are not satisfied.\footnote{1117}{Formal tests of company residence may refer to the place of incorporation or registration, the domicile of the company, or the location of the company's registered office or legal "seat".\footnote{1118}{The basic principle behind these formal tests is that companies exist only as a result of their formation under the laws of a particular country, and therefore companies formed in a particular country (or having their main legal ties to a particular country) are generally deemed to have a sufficient connection to that country to justify residence-based worldwide taxation.}}

Formal tests of company residence may refer to the place of incorporation or registration, the domicile of the company, or the location of the company's registered office or legal "seat".\footnote{1119}{The factual or business tests applied in different countries use varying criteria to determine residence, however most ultimately refer in some way to the place where management functions are performed. For example, in some common law countries (such as the UK and Canada) a company is resident in the place where its central management and control is located.\footnote{1120}{Central management and control refers to the highest level of management in the company, generally exercised by the board of directors.}} Many other jurisdictions also refer to the highest level of strategic management of the company, while some refer to a lower level of day-to-day management.\footnote{1121}{In general, the place of management is a question of fact and...}
courts tend to apply a substance over form approach, carefully examining who, in reality, manages the company within the meaning of the relevant domestic rules.\textsuperscript{1123}

It is possible for the management of a company to be split between more than one place, which can result in the company being treated as a resident taxpayer under the domestic laws of more than one jurisdiction. For example, board meetings could be held in different locations throughout the year or directors could attend board meetings from different locations using teleconferencing facilities. In a similar vein, dual residence can arise as a result of two countries having overlapping residence rules, for example where they look at different levels of management to determine residence. Clearly, dual residence can also occur if a company is incorporated in one state but has its place of management in another.

10.3. Residence under tax treaties

For treaty purposes, residence is determined in accordance with Article 4(1) (or its equivalent) by reference to residence under domestic laws. Article 4(1) provides as follows:

“For the purposes of this Convention, the term ‘resident of a Contracting State’ means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.”

There are a number of issues associated with applying this provision to determine who is resident for treaty purposes,\textsuperscript{1124} however, the important point to note here is that 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.\textsuperscript{1125} However, as will be seen below, the applicable tie-breaker rule may not always be effective in assigning residence to a particular state and the person involved may continue to be a dual-resident for the purposes of the treaty. This can potentially lead unrelieved double taxation both in bilateral and multilateral situations.

10.3.1. Residence tie-breaker rules for individuals

Where an individual is resident in two states for domestic law purposes and thus for the purposes of the tax treaty between those two states (under Article 4(1)), the residence tie-breaker provision of Article 4(2) applies. Under this provision, the individual's residence for the purposes of the treaty will be determined as follows:

"a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available in both States, he shall be deemed to be a resident only of the state with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either state, he shall be deemed to be a resident only of the State in which he has an habitual abode;

c) if he has a habitual abode in both States, or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;"

\textsuperscript{1123} Couzin, R., \textit{Corporate Residence…}, at p. 44-45 (Section 2.2.2.6.); De Broe, L., “Corporate Tax Residence…,” at p. 109 (Section 4.5.2.).

\textsuperscript{1124} For discussion of these issues see, inter alia: Couzin, R., \textit{Corporate Residence…}; Maisto, G., (Ed.), \textit{Residence of Companies…}.

\textsuperscript{1125} 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).
d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement."

Thus, the residence tie-breaker for individuals contains a hierarchy of tests; if the first test does not settle the question, then the next test should be applied and so on until the person's residence has been settled or until the contracting states are required to determine the individual's residence for treaty purposes by mutual agreement.

The first residence tie-breaker test for individuals assigns residence to the State where the individual "has a permanent home available to him." The existence of a "home" implies some kind of "emotional and family link" to the accommodation.1126 Permanence requires that the home is available continuously or for permanent use, in contrast to being available only temporarily or for occasional short stays,1127 and does not require that the person intends to live there forever.1128 In broad terms, a home will be available if it is owned or rented by the individual and they are able to access it.1129 The application of the permanent home test will often be quite straight-forward and it will effectively assign residence to one state,1130 however difficulties may arise in some cases, for example, in determining whether a holiday home or some other kind of secondary home should be considered a permanent home.1131

If the individual has a permanent home available to them in both contracting states, then the next factor to consider is with which state their personal and economic relations are closer (their "centre of vital interests").1132 This test is a facts and circumstances test, which requires an examination of the individuals connection to each state.1133 In determining a person's the centre of vital interests, the OECD Commentary states that "regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc."1134 Where an individual has closer personal relations with one state and closer economic relations with the other, the personal relations will often be given more weight for the purposes of applying the test, although practice varies between countries1135 and there should in fact be an evaluation of the individuals circumstances as a whole.1136

Where a dual-resident individual does not have a permanent home in either contracting state, or if their centre of vital interests cannot be determined, the habitual abode test will apply. The main question regarding the application of this test is whether it should be applied simply by considering the amount of time spent in each state, or whether something else is required.1137 The OECD Commentary states that where a person has a permanent home in both states (but where the centre of vital interests cannot be
determined), the habitual abode test will "tip the balance to the state where he stays more frequently."\textsuperscript{1138} However, the test should generally not be applied by simply comparing the number of days spent in each state and allocating residence to the state where the individual has spent more time during the period under consideration; this follows from the next paragraph of the tie-breaker which indicates it is possible for an individual to have a habitual place of abode "in both states or in neither of them."\textsuperscript{1139} Where an individual does have a permanent home available in both states, that person's place of habitual abode will should be determined as the place where they normally live.\textsuperscript{1140} Where the individual does not have a permanent home in either state, they may still be considered to have a habitual abode in one of the states on the basis of a number of stays, e.g., in different hotels.\textsuperscript{1141}

If the person's habitual abode cannot be determined, they will be considered to be resident in the state of which they are a national. In relation to individuals, the term "national" is defined in Article 3(2) of the OECD Model to mean "any individual possessing the nationality or citizenship" of the state in question. Ultimately, unlike the other concepts used in the tie breaker rule (permanent home, centre of vital interests, habitual abode), which should generally be given an international meaning,\textsuperscript{1142} nationality must be determined under domestic laws.\textsuperscript{1143} The application of the nationality test should not generally give rise to any difficulties since an individual's nationality will usually be quite clear. If an individual's residence has still not been assigned to one of the contracting states after the application of the nationality test, the contracting states are required to determine that person's residence by mutual agreement. This provision differs from the normal application of the mutual agreement procedure in that it imposes a positive obligation on the states to reach a conclusion ("shall settle the matter" rather than "shall endeavour... to resolve the case")\textsuperscript{1144}. However, there is no time limit imposed on the contracting states and it may take a number of years before they are able to reach an agreement. Furthermore, it is not clear that there is any way of forcing the states to come to an agreement or of solving the situation if they fail to agree,\textsuperscript{1145} although this may be remedied if Article 25 of the treaty contains a binding arbitration provision\textsuperscript{1146} (provided that provision also applies where the mutual agreement procedure is initiated under Article 4\textsuperscript{1147}).

\textbf{10.3.2. Residence tie-breaker rules for companies}

Where a company\textsuperscript{1148} is resident in both contracting states under Article 4(1), the tie-breaker test in Article 4(3) applies to determine the residence of the company for the purposes of the treaty. Article 4(3) deems a dual-resident company to be resident only in "the State in which its place of effective management is situated." However, the interpretation of the term "place of effective management" is not always clear and this test can be extremely difficult to apply in practice. This section will first discuss the

\begin{itemize}
\item \textsuperscript{1138} OECD Commentary on Article 4, para 17.
\item \textsuperscript{1139} See OECD Model, Article 4(1)(c); Sasseville, J., "History and Interpretation...", at p. 166 (Section 7.3).
\item \textsuperscript{1140} Vogel, K., Engelschalk, M., & Görhl, M., \textit{Klaus Vogel on Double Tax Conventions...}, at pp. 252-253, (m.no. 78).
\item \textsuperscript{1141} OECD Commentary on Article 4, para 18; Vogel, K., Engelschalk, M., & Görhl, M., \textit{Klaus Vogel on Double Tax Conventions...}, at p. 253, (m.no. 79).
\item \textsuperscript{1142} See, inter alia: Avery Jones, J.F., et al., "Dual Residence...", at pp. 19-22; Sasseville, J., "History and Interpretation...", at p. 162 (Section 7.3).
\item \textsuperscript{1143} Avery Jones, J.F., et al., "Dual Residence...", at p. 20; Vogel, K., Engelschalk, M., & Görhl, M., \textit{Klaus Vogel on Double Tax Conventions...}, at p. 253, (m.no. 81).
\item \textsuperscript{1144} OECD Model, Article 25(2). Note that an individual could also invoke the mutual agreement procedure directly under Article 25 if the contracting states fail to agree on the application of one of the earlier tie-breaker rules (for further discussion, see: Stuart, E., "Art. 4(2) of the...").
\item \textsuperscript{1145} Avery Jones, J.F., et al., "Dual Residence...", at p. 118.
\item \textsuperscript{1146} A binding arbitration provision was introduced into Article 25 in the 2008 update of the OECD Model (see Article 25(5)).
\item \textsuperscript{1147} Vogel states that mutual agreement under Article 4(2) is "reached by application of the procedural rules of Art. 25" indicating that the arbitration procedure should apply also for the purposes of reaching a mutual agreement under Article 4(2) (provided the treaty contains an arbitration clause). See: Vogel, K., Engelschalk, M., & Görhl, M., \textit{Klaus Vogel on Double Tax Conventions...}, at p. 254, (m.no. 82).
\item \textsuperscript{1148} Article 4(3) applies to a "person other than an individual" but, for ease of expression, the discussion in this section will refer solely to companies.
\end{itemize}
interpretation and application of the tie-breaker provision based on the "place of effective management" and will then go on to discuss alternative tie-breaker provisions which are included in some treaties.

10.3.2.1. Place of effective management

The OECD Commentary to Article 4 states that the place of effective management is "the place where the key management and commercial decisions" are made. However, there is no common agreement on the level of management which the tie-breaker is referring to and different states interpret the term differently, commonly influenced by the tests which are found in their domestic laws. States that have inherited residence concepts based on the UK common law "central management and control" concept, for example, tend to view the place of effective management as referring to management by the board of directors. The other most common interpretation is that the place of effective management is located in the place where senior management operates, however other interpretations are also possible. Differing interpretations of the term "place of effective management" can clearly give rise to significant difficulties in applying it as a residence tie-breaker.

Even if the two contracting states do agree on the interpretation of the term "place of effective management," it may not be possible to determine where the place of effective management of a particular company is located, particularly where the company is managed in a decentralized way and management activities are split between different states. This could occur, for example, if the place of effective management is based on the activities of the board of directors, but board meetings are held in different locations throughout the year or board members attend meetings from different locations using teleconferencing facilities. Senior management activities may also be conducted in a similar way, with senior executives located in different states, travelling frequently and communicating electronically. The OECD Commentary states that an entity "can only have one place of effective management at any one time," but this does not mean that it will always be possible to identify exactly where that place of effective management is.

Where the place of effective management cannot be identified, Article 4(3) of the treaty between the two residence states would not be effective in allocating the residence of the company to one state for the purposes of the treaty. In this case, the person involved may invoke the mutual agreement procedure under Article 25. However, Article 25 requires only that the competent authorities "shall endeavour... to resolve the case"; it is possible that they will not be able to come to an agreement. In addition, it may be that the place of effective management is located in a third state, in which case the tie-breaker rule will not be effective in assigning residence to one of the contracting states. If this is the case, it is difficult...
to see how the question of residence could be resolved under the mutual agreement procedure, since it is not a question of the treaty being improperly applied or of taxation being imposed "other than in accordance with the Convention" but rather, of the terms of the convention failing to resolve the conflict. Ultimately, the place of effective management tie-breaker rule may not be effective in some cases in assigning the company's residence to one state for the purposes of the treaty between the two residence states, and dual residence may persist.

10.3.2.2. Alternative tie-breaker rules

The concerns and issues associated with applying the place of effective management test have led to the development of certain alternative tie-breaker rules. Couzin identifies four broad categories of tie-breaker rules adopted in bilateral tax conventions:

1. Factual tests – based on the place of effective management or some similar criterion.
2. Legal tests – such tests generally refer to the place of incorporation, creation or registration of the company.
3. "Best efforts" rule – where there is no specific tie-breaker as such, but rather, where the contracting states determine the residence of the dual-resident through mutual agreement.
4. Sequential tests – where the tie-breaker includes multiple sequential tests (based on the three categories specified above), similar to the approach used in the tie-breaker for individuals.

The discussion in this section will focus on tie-breaker rules based on mutual agreement between the contracting states and those based on legal tests, and will also briefly address the alternative of including sequential tests.

Mutual agreement

The OECD Commentary suggests an alternative provision to Article 4(3), whereby the residence of dual-resident companies would be determined on the basis of a mutual agreement between the contracting states. The suggested provision reads as follows:

"Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States."

provides that the company is resident in "the State in which its place of effective management is situated" without a specific limitation to the treaty partners.

1156 Couzin, R., Corporate Residence..., at pp. 166-167 (Section 3.2.1.);
1157 Couzin identifies the following alternative expressions: place of general management, centre of its administrative of practical management, actual centre of management, where the company is managed and controlled, and real organ of management (Couzin, R., Corporate Residence..., at p. 160 (Section 3.2.1.)). However, based on key word searches of IBFD's tax treaty database, these terms do not seem to be commonly used.
1158 Couzin notes that it is not clear whether tie-breakers that adopt "head office" or "headquarters" are meant to establish a factual or legal test, and that this could depend on the law of the treaty partners if these terms are used domestically (Couzin, R., Corporate Residence..., at p. 166 (Section 3.2.1.)).
1159 2010 OECD Commentary on Article 4, para 24.1.
1160 2010 OECD Commentary on Article 4, para 24.1.
Similar provisions are included in a number of concluded treaties\textsuperscript{1161} and Sasseville notes that the mutual agreement tie-breaker was not created by the OECD, but "merely reflects provisions that are increasingly included in bilateral tax treaties."\textsuperscript{1162} Under such provisions, the residence of a dual resident company is determined by the contracting states through mutual agreement, taking into account various factors. The main difficulty with this approach is that it relies on the contracting states reaching an agreement in circumstances where both states may be highly reluctant to concede that the company should be treated as a resident of the other contracting state for the purposes of the treaty.\textsuperscript{1163}

In addition, and perhaps more importantly, this provision is based on the premise that the dual resident will initiate the mutual agreement procedure. This is perhaps not an unrealistic assumption in most cases, since unless a mutual agreement is reached the person involved cannot claim treaty benefits in either state (as a result of specific wording included the provision) and may be subject to double taxation.\textsuperscript{1164} In certain situations, however, the dual resident may not have any incentive to initiate the mutual agreement procedure to resolve the question of its residence. In fact, the lack of a resolution may even be beneficial in certain triangular situations provided that double taxation can be avoided in the residence states (e.g., due to the application of domestic relief provisions).\textsuperscript{1165} That is, by not initiating the mutual agreement procedure to resolve the question of its residence, the dual resident may be able to ensure its continued eligibility under treaties concluded by both its residence states with third states from which it derives income.\textsuperscript{1166} This is clearly a weakness of the mutual agreement tie-breaker, particularly since there seems to be no authority for the contracting states to conclude an agreement in the absence of a request from the taxpayer.\textsuperscript{1167}

\textit{Incorporation and other formal criteria}

The OECD Commentary dismisses the approach of resolving the dual-residence of companies by reference to registration on the basis that it is a "purely formal criterion."\textsuperscript{1168} However, a formal criterion such as incorporation or registration does have the distinct advantage that it would be simple to apply, at least in the vast majority of cases,\textsuperscript{1169} and would uniquely attach a company to a single jurisdiction, thus preventing situations where residence would not be assigned to either state for the purposes of the treaty.\textsuperscript{1170} Several states have in fact made reservations on the tie-breaker rule in Article 4(3), whereby they have reserved the right to use an alternative tie-breaker rule for corporate residence in their tax treaties.
based on more formal criteria. Those alternative criteria include the "place of incorporation or organisation" (Canada), the "registered office" (Turkey), and the "place of incorporation" (US).

One specific issue which must be dealt with where the treaty includes a tie-breaker based on incorporation is situations involving companies incorporated in third states. In their reservations to the OECD Commentary, Canada and the US have also reserved the right to deny dual-resident companies certain benefits under tax treaties if the place of incorporation (or organisation) does not result in an effective allocation of residence. As an alternative to the complete denial of treaty benefits, however, it would perhaps be preferable to supplement the main tie-breaker with a provision establishing how residence will be determined where the state of incorporation etc. is not located in either of the contracting states.

Sequential tests

Some treaties contain sequential tests for determining the treaty residence of dual-resident companies. Such provisions may, for example, treat the company as a resident of the state in which it is incorporated and, if it is not incorporated in either state, may treat the company as a resident of the state where it's place of effective management is located (or vice versa, i.e., the first test may refer to place of effective management and the second may refer to incorporation). These two sequential tests may be supplemented by a mutual agreement tie-breaker, or alternatively, there may be only one test (either based on incorporation or management) supported by a mutual agreement provision. Sequential tie-breaker rules significantly reduce the likelihood that a residence conflict will not be resolved.

Conclusions

The difficulties with applying the "place of effective management" tie-breaker rule mean that there are likely to be situations where the residence of a dual-resident company cannot be assigned to one state for the purposes of the treaty between its two residence states. This would clearly be problematic in both bilateral and multilateral situations and indicates that it may be preferable to use an alternative tie-breaker rule. The use of an alternative tie-breaker based on the contracting states determining the residence of a dual resident by mutual agreement, however, may potentially lead to other problems in situations where the dual resident derives income from third states. This will be discussed in more detail below (see Section 10.4.4.).

1171 2010 OECD Commentary on Article 4, paras 27-32. In addition, Korea and Japan reserve the right to use the "head or main office" as the tie-breaker rule for companies in their treaties.

1172 The reservation made by the US is reflected in Article 4(4) of the 2006 US model treaty, which reads as follows: "Where by reason of the provisions of paragraph 1 a company is a resident of both the Contracting States, then if it is created or organized under the laws of one of the Contracting States or a political subdivision thereof, such company shall be deemed to be a resident of the first-mentioned Contracting State. In all other cases involving dual resident companies, the competent authorities of the Contracting States shall endeavour to determine the mode of application of the Convention to such company. If the competent authorities do not reach such an agreement, that company will not be treated as a resident of either Contracting State for purposes of its claiming any benefits provided by the Convention."

1173 Van Weeghel, S., "The Tie-Breaker Revisited..." at p. 967.

1174 Couzin, R., Corporate Residence..., at pp. 177-178 (Section 3.2.5.). A series of sequential tests was also proposed by the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ("TAG") in a draft report published in 2001 (titled "The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule"), however these proposals were not implemented. For discussion, see: Hinnekens, L., "Revised OECD-TAG Definition of Place of Effective Management in Treaty Tie-Breaker Rule," 31 Intertax 10, (2003), pp. 314-319.

1175 Couzin, R., Corporate Residence..., at pp. 177-178 (Section 3.2.5.).

1176 Couzin, R., Corporate Residence..., at pp. 177-178 (Section 3.2.5.).

1177 Couzin, R., Corporate Residence..., at pp. 177-178 (Section 3.2.5.).
10.4. Application of tax treaties in dual resident triangular cases

This section deals with the application of tax treaties in various types of dual resident triangular cases. It deals firstly with situations where there is no effective allocation of residence under the tie-breaker rule of the treaty between the two residence states, before moving on to deal with situations where residence is assigned to one of the residence states (the winning residence state, or “State W”) for the purposes of that treaty. For situations where residence is assigned to one state, the analysis is further split into two parts; the first considering situations where there is no PE in the state to which residence is not assigned (the losing residence state, or “State L”) and the second considering situations where the income is attributable to a PE in the losing residence state.

Scope and assumptions

In a dual-resident triangular case, in the absence of any applicable tax treaties, tax may be imposed on a residence basis in both residence states and on a source basis in the source state. It may not always be the case that tax is imposed in all three states, for example if the source state chooses not to impose tax on the income, if one or both of the residence states operates a territorial system, or if the income is covered by a domestic exemption in one or both of the residence states. In addition, if the residence states do impose tax then they may grant unilateral double taxation relief, either by granting a credit for the foreign tax imposed or by exemptions. Nevertheless, for the purposes of the analysis below, it will be assumed that all three states do seek to impose tax on the income under their domestic laws and that neither of the residence states grants any unilateral relief.

It should be noted that the actual flows of income (e.g., the location of bank accounts) are not relevant for the analysis set out below. It is the derivation of income by a dual resident company, along with the fact that the source state considers the income to be locally sourced under its domestic laws, which gives rise to the multiple taxing claims in dual-resident triangular cases.

The analysis in this section deals only with certain categories of income identified in the OECD Model, namely business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12), income from immovable property (Article 6), income from shipping, inland waterways transport and air transport (Article 8), capital gains (Article 13) and other income (Article 21). It does not discuss income from employment (Article 15), directors’ fees (Article 16), artistes and sportsmen (Article 17), pensions (Article 18), government service (Article 19) or students (Article 20), which are outside the scope of this study.

10.4.1. Situations where tie-breaker does not effectively allocate residence

There are a number of situations, as discussed above, where the tie-breaker provision of the treaty between the two residence states may not be effective in allocating the residence of a dual-resident company to one state for the purposes of the treaty. This may occur, for example, where a company has its management split between two states such that it is not clear where the company’s place of effective management is located. It can also occur in the case of individuals who have strong ties to two states if those states cannot agree on the application of the tie-breaker provisions.

The following diagram illustrates a dual resident triangular situation where there is no effective allocation of residence for the purposes of the treaty between the two residence states. In this diagram the source state is marked “State S” and the two residence states are marked “State A” and “State B.”
The applicable treaties in this case will be:

(i) The treaty between the two residence states (the A-B treaty);
(ii) The treaty between the first residence state and the source state (the A-S treaty); and
(iii) The treaty between the second residence state and the source state (the B-S treaty).

The lack of an effective allocation of residence will have implications for the application of the treaty between the two residence states. For the purposes of the treaties which each of those two states have concluded with the source state, however, the person will simply remain resident in both residence states and will thus be able to claim the benefit of both treaties. This can be contrasted with situations where the tie-breaker rule is effective in allocating residence for the purposes of the treaty between the two residence states, in which case the application of the treaty between the losing residence state and the source state is less certain (as will be seen in Sections 10.4.2. and 10.4.3. below and in Chapter 11).

10.4.1.1. Application of the treaty between the two residence states

If the tie-breaker rule of the treaty between the two residence states does not effectively allocate residence to one state, then it is not clear how the treaty between the two residence states should be applied. One possibility is that the person involved would be able to claim treaty benefits in both states as though they were a resident of the other contracting state. To give an example, Article 7 of the treaty between the two residence states would usually allow business profits to be taxed only in the residence state unless they are attributable to a PE in the other state. If a dual resident derives business profits which are not attributable to a PE in either residence state, and both states apply the treaty as though the person deriving the income is a resident of the other state, then both states may be prevented from imposing tax under Article 7. This would clearly be an undesirable outcome from the perspective of the contracting states and it relies on both contracting states accepting that the person involved is resident in the other contracting state (and is not a local resident) for treaty purposes.

The more likely scenario is that both states would take the view that the tie-breaker provision should resolve the residence of the dual resident in their favour, e.g., in the case of a dual-resident company, both states may consider that the place of effective management of the company is located within their territory. In this case, both residence states are likely to apply the treaty as though the person involved is a local resident for treaty purposes and is not a resident of the other contracting state. As a result, it is likely that neither state would accept any restriction on its taxing rights under the treaty (except to the extent that the treaty imposes restrictions on the residence state\textsuperscript{1178}), and both states may impose tax on the income.

\textsuperscript{1178} This does not commonly occur, however there are certain circumstances in which a residence state may be prevented from imposing tax. This could occur, for example, in the case of certain students deriving income which is dealt with under Article 20. Article 20 provides that: “Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.” Thus, in certain circumstances, Article 20 may prevent a residence state from imposing tax.
The question then arises as to the extent to which one or both of the residence states will grant relief for the tax imposed in the other residence state. Whether a particular state grants relief would generally depend upon whether it considers the tax imposed in the other residence state to be imposed in accordance with the terms of the treaty. Relief may be granted, if, for example, the state deciding whether to grant relief views the income as being attributable to a PE in the other state for the purposes of the treaty. Where one of the residence states grants relief for tax imposed in the other residence state, unrelieved double taxation would generally be prevented (provided that, if it is a triangular case, both residence states grant relief for tax imposed in the source state). However, if neither residence state grants relief for tax imposed in the other residence state then unrelieved double taxation will persist. Issues may also arise where both residence states grant relief using the credit method for the tax imposed in the other residence state. In this case, the calculation of the amount of the credit would become circular, since the credit available in each state would depend upon the tax imposed (and thus on the credit available) in the other state. It is clearly very important, both in bilateral and multilateral situations, that the tie-breaker provision of the treaty between the two residence states allocates the residence of a dual resident to one state for the purposes of that treaty.

10.4.1.2. Application of the treaties between the residence states and the source state

In situations where there is no effective allocation of residence under the treaty between the two residence states then it is quite clear that the source state will be bound by the conditions of two treaties. The dual resident deriving the income is a resident of each of the two residence states under their respective domestic laws and thus, will be considered resident under Article 4(1) of their respective treaties with the source state. The source state will therefore be bound to apply the conditions of both these treaties and will only be able to meet its treaty obligations by applying the terms of the treaty which are most favourable to the dual resident deriving the income. In practice, the application of multiple treaty conditions will only have an impact where the conditions of the two treaties differ, such that the source state would be permitted to impose tax under one of the applicable treaties but is prevented from imposing tax under the other applicable treaty or with respect to passive income where the applicable rates differ.

Where the source state is permitted to impose tax, both residence states will have an obligation to grant relief under their respective treaties with the source state, either by exempting the income or by granting a credit for the tax imposed in the source state. If one of the residence states exempts the income, or imposes no residual tax after the allowance of foreign tax credits (i.e., for the tax imposed in the source state), then there would generally be no unrelieved double taxation regardless of the application of the treaty between the two residence states. If, however, both residence states do impose tax after the provision of relief for tax imposed in the source state, then unrelieved double taxation can still occur despite relief provided for tax imposed in the source state, i.e., where both residence states impose tax and neither state provides relief for the tax imposed in the other residence state. Again, this highlights the

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1179 The relief provisions of the OECD Model (Article 23A and Article 23B) require the residence state to grant relief when tax is imposed in the other state "in accordance with the provisions" of the Convention. Article 23A(1), for example, provides that: “Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.” Similarly, Article 23B(1) provides that: “Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow...”

1180 For example, a dividend of $100 is paid (assuming no source state taxation) and the tax rate in both A and B is 30%. In the absence of any tax credit, $30 tax is due in each state (A and B). If each state then allows a credit for the tax imposed in the other state then no tax will be payable in either state ($30 tax less $30 credit), however if no tax is payable then no credit is available and thus $30 tax is still payable. This is clearly circular and it is not clear what the final outcome should be. This problem is not confined to cases where the tax rates are the same; a similar result occurs if the tax rates in A and B differ.

importance of an effective allocation of residence under the tie-breaker provision of the treaty between the two residence states.

10.4.2. Situations where the tie-breaker effectively allocates residence to one state

In most cases involving dual residents, it is likely that the application of the tie-breaker rules of the treaty between the two residence states will effectively allocate residence to one of those states. This greatly simplifies the application of the treaty between the two residence states, but, as mentioned above, it raises additional issues in relation to the application of treaties between the losing residence state and third states.

The following diagram illustrates a dual resident triangular situation where there is an effective allocation of residence for the purposes of the treaty between the two residence states. In this diagram the source state is marked “State S”, the winning residence state is marked “State W” and the losing residence state is marked “State L.”

Figure 10.3: Dual resident triangular case where tie-breaker provision of the treaty between the two residence states assigns residence to one state

The applicable treaties in this case will be:

(i) The treaty between the two residence states (the W-L treaty);
(ii) The treaty between the winning residence state and the source state (the W-S treaty); and
(iii) Potentially, the treaty between the losing residence state and the source state (the L-S treaty).

The application of these treaties will be discussed in detail below.

10.4.2.1. Application of the treaty between the two residence states

Where there is an effective allocation of residence under the tie-breaker provision of the treaty between the two residence states, that treaty will be applied as though the income is derived by a resident of the winning residence state. The losing residence state’s ability to impose tax will therefore depend on the terms of the treaty and the extent to which it allows source-based taxation. In general, however, the treaty will prevent the losing residence state from imposing tax on income derived by the dual resident from sources in third states (provided there is no PE in the losing residence state). This is illustrated in the following table, which shows the outcome of the application of the treaty between the two residence states in a dual resident triangular case. This table is based on a situation where (i) there is an effective allocation of residence under the tie-breaker provision of the treaty between the two residence states and (ii) the income is not attributable to a PE in the losing residence state for the purposes of the treaty between the two residence states (situations where there is a PE in State L will be discussed in Section 10.4.3., below).
Table 1: Application of the W-L treaty where there is no PE in State L

<table>
<thead>
<tr>
<th>Category of income</th>
<th>Applicable treaty article</th>
<th>Can State L impose tax?</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business profits</td>
<td>Article 7</td>
<td>No</td>
<td>There is no PE in State L and State L is therefore prevented from imposing tax.</td>
</tr>
<tr>
<td>Dividends</td>
<td>Article 7 or Article 21</td>
<td>No</td>
<td>Article 10 does not apply because the dividends are not paid by a resident of State L. Instead, Article 7 or Article 21 applies, depending on whether the income is considered to be business profits, and State L is prevented from imposing tax (since the dividends are not attributable to a PE in State L).</td>
</tr>
<tr>
<td>Interest</td>
<td>Article 7 or Article 21</td>
<td>No</td>
<td>Article 11 does not apply because the interest does not arise in State L. Instead, Article 7 or Article 21 applies, depending on whether the income is considered to be business profits, and State L is prevented from imposing tax (since the interest is not attributable to a PE in State L).</td>
</tr>
<tr>
<td>Royalties</td>
<td>Article 7 or Article 21</td>
<td>No</td>
<td>Article 12 does not apply because the royalties arise in a third state. Instead, Article 7 or Article 21 applies, depending on whether the income is considered to be business profits, and State L is prevented from imposing tax (since the royalties are not attributable to a PE in State L).</td>
</tr>
</tbody>
</table>

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1183 Article 10 applies to: “Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State…” (Article 10(1)).

1184 Article 11 applies to: “Interest arising in a Contracting State and paid to a resident of the other Contracting State…” (Article 11(1)). Article 11(5) provides that: “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 in a Contracting State 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.” In this situation, the interest is not paid by a resident of State L and is not borne by a PE located in that state; the interest therefore does not arise in State L.

1185 Article 12 applies to “Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State…” (Article 12(1)). In this situation, where the royalties arise in a third state, Article 12 will therefore not apply.
<table>
<thead>
<tr>
<th>Income from immovable property (property located in the source state).</th>
<th>Article 7 or Article 21</th>
<th>No</th>
<th>Article 6 does not apply because the immovable property is not located in State L. Instead, Article 7 or Article 21 applies, depending on whether the income is considered to be business profits, and State L is prevented from imposing tax on the income (since it is not attributable to a PE in State L).(^{1186})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from shipping, inland waterways transport and air transport</td>
<td>Article 8</td>
<td>No</td>
<td>Under Article 8, tax can only be imposed in the state where the place of effective management is located. Given that residence is assigned to State W under the tie-breaker provision, it can be assumed that the place of effective management is located in State W. State L will therefore be prevented from imposing any tax on the income.</td>
</tr>
<tr>
<td>Capital gains arising from the alienation immovable property (property located in the source state)</td>
<td>Article 13(5)</td>
<td>No</td>
<td>Article 13(1) does not apply because the immovable property is not located in State L. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) applies. Article 13(5) provides that any capital gains not referred to in other paragraphs of Article 13 can only be taxed in the residence state. For the purpose of applying the treaty between the two residence states, State W is the residence state and therefore, State L is prevented from imposing tax on the gain.</td>
</tr>
</tbody>
</table>

\(^{1186}\) For a detailed analysis of the applicable treaty article in relation to income from immovable property located in a third state, refer to Chapter 2 (Section 2.6.). The discussion in that section was framed in terms of PE triangular cases, but applies equally in dual resident triangular cases. It was concluded there that the income may fall under either Article 7 or Article 21 depending on whether it is considered to be business profits for the purposes of the treaty.
| Capital gains arising from the alienation of movable property which forms part of the business property of a PE (assuming the capital gain is attributable to a PE located in the source state) | Article 13(5) | No | For the purposes of the analysis here, it is assumed that there is no PE in State L. Article 13(2) can therefore not apply. If a dual resident derives a capital gain from the alienation of movable property forming part of the business property of a PE located in the source state, then Article 13(5) would apply for the purposes of the treaty between the two residence states. Under Article 13(5), State L would be prevented from imposing any tax on the gain. |
| Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or associated movable property | Article 13(3) | No | Under Article 13(3), tax can only be imposed in the state where the place of effective management is located. Given that residence is assigned to State W under the tie-breaker provision, it can be assumed that the place of effective management is located in State W. State L will therefore be prevented from imposing any tax on the capital gain. |
| Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (property located in the source state) | Article 13(5) | No | Article 13(4) allows a state to impose tax on a capital gain arising from the alienation of shares if the shares derive more than 50% of their value from immovable property located in that state. Article 13(4) cannot apply because the property is not located in either of the contracting states. Instead, Article 13(5) applies and the losing residence state is prevented from imposing tax |
This table clearly illustrates that, in the absence of a PE in the losing residence state, the treaty between the two residence states will prevent the losing residence state from imposing tax on any income arising in third states. It is for this reason that the application of the treaty between the losing residence state and the source state gives rise to tax avoidance concerns.

To the extent that the losing residence state is prevented from imposing tax under the W-L treaty, dual resident triangular cases would generally not give rise to any unrelieved double taxation. Tax may be imposed in the source state and the winning residence state, but to the extent that tax may be imposed in the source state, the winning residence state would grant relief under the terms of the W-S treaty.

10.4.2.2. Application of the treaties between the residence states and the source state

Where there is an effective allocation of residence, it is quite clear that the dual resident will remain resident in the winning residence state for the purposes of the treaty between that state and the source state. What is less clear is the application of the treaty between the losing residence state and the source state; this will be discussed in detail in Chapter 11.

The result of the application of the W-S treaty in a dual resident triangular case is illustrated in the following table.

<table>
<thead>
<tr>
<th>Other capital gains</th>
<th>Article 13(5)</th>
<th>No</th>
<th>Article 13(5) will apply and State L will be prevented from imposing any tax on the capital gain.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other income</td>
<td>Article 21</td>
<td>No</td>
<td>Article 21 applies and, given that the income is not attributable to a PE in State L, State L is prevented from imposing any tax on the income.</td>
</tr>
<tr>
<td>Category of income</td>
<td>Relevant treaty article</td>
<td>Can State S impose tax?</td>
<td>Relief in State W?</td>
</tr>
<tr>
<td>--------------------</td>
<td>-------------------------</td>
<td>-------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>Business profits</td>
<td>Article 7</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Dividends</td>
<td>Article 10</td>
<td>Yes</td>
<td>Credit</td>
</tr>
<tr>
<td>Interest</td>
<td>Article 11</td>
<td>Yes</td>
<td>Credit</td>
</tr>
<tr>
<td>Royalties</td>
<td>Article 12</td>
<td>No / Yes</td>
<td>No / Credit</td>
</tr>
<tr>
<td>Income from immovable property (property located in the source state)</td>
<td>Article 6</td>
<td>Yes</td>
<td>Credit or Exemption</td>
</tr>
<tr>
<td><strong>Figure 10.20.:</strong> Dual resident triangular case involving income from immovable property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td><strong>Income from shipping, inland waterways transport and air transport</strong></td>
<td><strong>Figure 10.21.:</strong> Dual resident triangular case involving income dealt with under Article 8</td>
<td><strong>Article 8</strong></td>
<td><strong>No</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Article 8 will apply. Under Article 8, tax can only be imposed in the state where the place of effective management is located. Given that residence of the dual resident receiving the income is assigned to State W under the tie-breaker provision, it can be assumed that the place of effective management is located in State W. State S will therefore be prevented from imposing any tax on the income and State W will have no obligation to provide relief.</td>
<td></td>
</tr>
<tr>
<td><strong>Capital gains arising from the alienation of immovable property</strong> (property located in the source state)</td>
<td><strong>Figure 10.22.:</strong> Dual resident triangular case involving capital gains dealt with under Article 13(1)</td>
<td><strong>Article 13(1)</strong></td>
<td><strong>Yes</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Article 13(1) will apply and State S may impose tax on the capital gain. State W will be obliged to provide relief using the method specified in the treaty.</td>
<td></td>
</tr>
<tr>
<td><strong>Capital gains arising from the alienation of movable property which forms part of the business property of a PE</strong></td>
<td><strong>Figure 10.23.:</strong> Dual resident triangular case involving capital gains dealt with under Article 13(2)</td>
<td><strong>Article 13(2)</strong></td>
<td><strong>Yes</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Article 13(2) applies and the source state is entitled to impose tax on the capital gain. State W will be required to provide relief using the method specified in the treaty.</td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated movable property</td>
<td>Article 13(3)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (property located in the source state)</td>
<td>Article 13(4)</td>
<td>Yes</td>
<td>Credit or Exemption</td>
</tr>
<tr>
<td>Other capital gains</td>
<td>Article 13(5)</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
### Other income

**Figure 10.27.: Dual resident triangular case involving other income**

<table>
<thead>
<tr>
<th>Article 21</th>
<th>No</th>
<th>No</th>
<th>Assuming there is no PE in the source state, the source state will be prevented from imposing tax under Article 21. State W will therefore have no obligation to provide relief.</th>
</tr>
</thead>
</table>

The application of the W-S treaty therefore allows the source state to impose tax on a number of types of income arising in that state, including passive income (dividends, interest and possibly royalties), income from immovable property, and certain types of capital gains. If the income were attributable to a PE of the dual-resident located in the source state then the source state would also be able to impose tax on certain other types of income, particularly business profits (under Article 7) and other income (under Article 21), and would not be subject to a maximum tax rate for passive income. Where the source state is entitled to impose tax, State W will have a corresponding obligation to provide relief.

**Impact of the L-S treaty applying in addition to the W-S treaty**

If the L-S treaty applies in addition to the W-S treaty, then the source state will be obliged to apply the conditions of both treaties. As a result, the source state will only be able to meet its treaty obligations by applying the treaty conditions which are most favourable to the person deriving the income. The practical impact of applying the conditions of both treaties is likely to depend on the category of income involved. In relation to dividends, interest and royalties, for example, it is common for the maximum rate of source based taxation to vary between treaties and where this occurs, the source state would be obliged to apply the lower of the two rates. For other categories of income, such as income from immovable property and income from shipping and air transport, variations are less common and therefore, the application of both treaties may give the same result. Differences in the PE definition may also be very important in some cases, i.e., where the dual-resident would have a PE in the source state under the definition contained in the W-S treaty but does not have a PE under the definition contained in the L-S treaty. In such cases the source state would clearly be concerned about the potential for improper use of the L-S treaty; this is discussed further in the following section.

Regardless of the application of the L-S treaty, the losing residence state will generally not provide any relief for tax imposed in the source state (either exemption or credit) since it imposes no tax on the income. This assumes, of course, that the limitation of State L’s taxing rights under the treaty between the two residence states is taken into account for the purposes of applying the L-S treaty. If the treaty limitation is not taken into account, and State L imposes tax on the income under its domestic law, then State L may theoretically have a relief obligation under the L-S treaty (if it applies) despite not being able to impose any tax on the income. This would clearly be an inappropriate outcome. This issue was discussed in detail in Chapter 3 (in the context of PE triangular cases), where it was concluded that the

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treaty limitation should be taken into account1188 and thus, that a state which is prevented from imposing tax under one treaty should not have any relief obligation under another applicable treaty. This applies equally with respect to the losing residence state in a dual resident triangular case.

10.4.2.3. Potential for improper use of treaties

The primary concern of most states in relation to dual-resident triangular cases is the potential for tax avoidance through the improper use of treaties, particularly in order to gain reductions in source based taxation. A company could, for example, be incorporated in one state and effectively managed from another, making it a dual resident, in order to take advantage of the treaties between those two residence states and a third state (the source state). As mentioned above, the source state could only satisfy its treaty obligations in such cases by applying the treaty conditions that are most favourable to the taxpayer.1189 Of particular concern for source states is the possibility that a dual-resident company could claim a reduction in source based taxation under the L-S treaty in situations where the treaty between the two residence states prevents State L from imposing any tax on the income. This is especially concerning in light of the ease with which a company can become resident under domestic laws (e.g., by incorporation or by holding board meetings in a particular state)1190 and thus, under tax treaties.

The source state may therefore wish to deny the benefit of the L-S treaty, particularly in relation to income which the losing residence state is prevented from taxing under the treaty between the two residence states. This may not be easy to accomplish, however, since residence for treaty purposes depends on domestic laws and must be determined independently for each treaty. It is sometimes possible to attack a claim for treaty benefits in relation to dividends, interest or royalties on the basis that the recipient is not the beneficial owner of the income, however there is no particular reason why a dual resident is less likely to be the beneficial owner of its income than any other person.1191 It may also be possible for the source state to rely on anti-avoidance provisions included in its domestic law, but this is likely to raise questions regarding whether the source state has satisfied its obligations under international law.1192

The OECD Commentary takes the position that a company whose residence has been allocated to one state under a tax treaty will not be a resident of the losing residence state for the purposes of treaties between that state and third states on the basis of the second sentence of Article 4(1),1193 which reads as follows:

"This term [resident of a Contracting State], however, does not include any person who is liable to tax in that State in respect only of sources in that State or capital situated therein."

The view expressed in the OECD Commentary is that, as a result of the restrictions imposed on State L under the treaty between the two residence states, the dual resident is taxable in State L only on income from sources in that state and will therefore not be resident in State L for the purposes of the L-S treaty. On the basis of this interpretation, the source state could potentially deny treaty benefits to dual resident

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1188 Refer to Section 3.3. Broadly, it was concluded in that section that for the purposes of determining the amount of tax which the residence state imposes on the income, and thus for determining the amount of credit relief which should be granted, consideration should be given to the actual amount of tax imposed (taking into account any treaty limitations) and should not be limited to the amount of tax imposed under domestic law of the residence state. While tax treaties are bilateral and do not have effect for the purposes of other tax treaties, the impact which tax treaties have on the operation of domestic law cannot be ignored for the purposes of applying other tax treaties. 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.


1190 For a brief overview of domestic residence rules, see Section 10.2.

1191 For a discussion of the beneficial ownership concept, please refer to Chapter 5 (Section 5.2.6.1.).


1193 2010 OECD Commentary on Article 4, para 8.2.
persons under the treaty which it has concluded with the losing residence state. This approach is controversial, however, and will be discussed in detail in Chapter 11.

10.4.3. Situations where there is a PE in the losing residence state

This section deals with dual resident triangular situations where the tie-breaker provision of the treaty between the two residence states effectively allocates the person’s residence to one state (i.e., State W), but where the income arising in a third state is attributable to a PE in the losing residence state (i.e., State L) for the purposes of the treaty between the two residence states. Whether a PE exists in the losing residence state will depend on the activities carried out there. The fact of incorporation alone would not be enough to give rise to a PE in State L, however, where there are also business activities conducted in that state those activities could very well amount to a PE. If so, the situation is very similar to a PE triangular case and many of the issues arising in PE triangular cases become relevant. The main difference between a PE triangular case and a dual resident triangular case with a PE in State L is that, in the dual-resident triangular case, the company may to be entitled to the benefit of treaties between State L (now also the PE state) and third states. This situation is illustrated in the following diagram (in this diagram the source state labelled “State S”, the winning residence state is labelled “State W” and the losing residence state is labelled “State L”).

Figure 10.28.: Dual resident triangular situation where there is a PE in the losing residence state

The applicable treaties in this case will be:

(i) The treaty between the two residence states (the W-L treaty);
(ii) The treaty between the winning residence state and the source state (the W-S treaty); and
(iii) Potentially, the treaty between the losing residence state and the source state (the L-S treaty).

The application of these treaties will be discussed in detail below.

10.4.3.1. Application of the treaty between the two residence states

The following table illustrates the result of the application of the treaty between the two residence states in situations where the income arising in the source state is attributable to a PE in the losing residence state. For categories of income where the result differs due to the existence of the PE, the third column is shaded.

Table 3: Income attributable to a PE in the losing residence state

<table>
<thead>
<tr>
<th>Category of income</th>
<th>Relevant treaty article</th>
<th>Can State L impose tax?</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business profits</td>
<td>Article 7</td>
<td>Yes</td>
<td>Article 7 applies and State L is entitled to impose tax on the profit attributable to the PE.</td>
</tr>
</tbody>
</table>

---

1194 Whether a PE exists must be determined in accordance with the PE definition contained in the treaty (Article 5).
1195 Article 5, OECD Model.

295
<table>
<thead>
<tr>
<th>Case</th>
<th>Article</th>
<th>Applies to</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>Article 7</td>
<td>Yes</td>
<td>Article 10 does not apply because the dividends are not paid by a resident of State L. Article 7 applies, either because the dividends are considered to be business profits or as a result of Article 21(2). Under Article 7, State L may impose tax on the profit attributable to the PE.</td>
</tr>
<tr>
<td>Interest</td>
<td>Article 7</td>
<td>Yes</td>
<td>Article 11 does not apply because the interest does not arise in State L. Instead, Article 7 applies, either because the interest is considered to be business profits or as a result of Article 21(2). Under Article 7, State L may impose tax on the profit attributable to the PE.</td>
</tr>
<tr>
<td>Royalties</td>
<td>Article 7</td>
<td>Yes</td>
<td>Article 12 does not apply because the royalties do not arise in State L. Instead, Article 7 applies, either because the royalties are considered to be business profits or as a result of Article 21(2). Under Article 7, State L may impose tax on the profit attributable to the PE.</td>
</tr>
</tbody>
</table>

---

1196 Article 10 applies to: “Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State…” (Article 10(1)).

1197 Article 21 applies to income not dealt with under the other articles of the treaty, and provides that tax may only be imposed in the residence state (Article 21(1)). Article 12(2) provides that: “The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

1198 Article 11 applies to: “Interest arising in a Contracting State and paid to a resident of the other Contracting State…” (Article 11(1)). Article 11(5) provides that: “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 in a Contracting State 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.” In this situation, the interest is not paid by a resident of State L and is not borne by a PE located in that state; the interest therefore does not arise in State L.

1199 See above, note 92.

1200 Article 12 applies to “Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State…” (Article 12(1)). In this situation, where the royalties arise in a third state, Article 12 will therefore not apply.

1201 See above, note 92.
**Income from immovable property** (property located in the source state)

*Figure 10.33.*: Dual resident triangular case involving income from immovable property

| Article | Yes | Article 6 does not apply because the immovable property is not located in State L. Instead, Article 7 applies, either because the income is considered to be business profits or indirectly under Article 21(2).\(^{1202}\) Under Article 7 State L may impose tax on the profit attributable to the PE. |

**Income from shipping, inland waterways transport and air transport**

*Figure 10.34.*: Dual resident triangular case involving income dealt with under Article 8

| Article | No | Under Article 8, tax can only be imposed in the state where the place of effective management is located. Given that residence is assigned to State W under the tie-breaker provision of the W-L treaty, it can be assumed that the place of effective management is located in State W. State L will therefore be prevented from imposing any tax on the income. The existence of a PE in State L has no impact on this result. |

**Capital gains arising from the alienation immovable property** (property located in the source state)

*Figure 10.35.*: Dual resident triangular case involving capital gains dealt with under Article 13(1)

| Article 13(5) | No | Article 13(1) does not apply because the immovable property is not located in State L. Similarly, Article 13(2) (which applies to movable property forming part of the business property of a PE) is not likely to apply because the property is not “movable property.” Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) applies. Under Article 13(5), State L is prevented from imposing tax on the gain. The existence of a PE in State L has no impact on this result. |

---

\(^{1202}\) See above, note 92. Although Article 21(2) excludes income from immovable property (such that Article 21 would continue to apply), it refers to the definition of immovable property in Article 6, which does not apply where the immovable property is located in a third state. See Chapter 2 for further discussion (Section 2.6.).
<table>
<thead>
<tr>
<th>Capital gains arising from the alienation of movable property which forms part of the business property of a PE (Property attributable to the PE in State L)</th>
<th>Article 13(2)</th>
<th>Yes</th>
<th>Where the dual resident derives a capital gain from the alienation of movable property which forms part of the business property of a PE located in State L, Article 13(2) will apply. State L may impose tax on the gain.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figure 10.36.: Dual resident triangular case involving capital gains dealt with under Article 13(2)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or associated movable property</td>
<td>Article 13(3)</td>
<td>No</td>
<td>Article 13(3) applies. Under Article 13(3), tax can only be imposed in the state where the place of effective management is located. Given that residence is assigned to State W under the tie-breaker provision of the W-L treaty, it can be assumed that the place of effective management is located in State W. State L will therefore be prevented from imposing any tax on the capital gain. The existence of a PE in State L has no impact on this result.</td>
</tr>
<tr>
<td>Figure 10.37.: Dual resident triangular case involving capital gains dealt with under Article 13(3)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (property located in the source state)</td>
<td>Article 13(2)</td>
<td>Yes</td>
<td>Article 13(4) allows a state to impose tax on a capital gain arising from the alienation of shares if the shares derive more than 50% of their value from immovable property located in that state. Article 13(4) does not apply, however, because the property is not located in either of the contracting states. On the basis that the shares are movable property forming part of the business property of the PE in State L, Article 13(2) applies. Under Article 13(2), State L may impose tax on the gain.</td>
</tr>
<tr>
<td>Figure 10.38.: Dual resident triangular case involving capital gains dealt with under Article 13(4)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| **Other capital gains**  
*Figure 10.39.: Dual resident triangular case involving capital gains dealt with under Article 13(5)* | Article 13(5) | No | Article 13(5) applies and State L will be prevented from imposing any tax on the gain. |
|---|---|---|---|

**Other income**  
*Figure 10.40.: Dual resident triangular case involving other income*  
| Article 7 | Yes | As a result of Article 21(2), Article 7 applies. Under Article 7, State L may impose tax on the profit attributable to the PE. |

This table illustrates that the existence of a PE in the losing residence state entitles that state to impose tax on a much wider range of income under the treaty between the two residence states than is the case in the absence of a PE. This would tend to reduce the level of concern about the improper application of the L-S treaty, since these concerns are in large part prompted by the non-taxation of the income in State L. Tax avoidance concerns may still exist, however, as a result of the source state being subject to the terms of multiple treaties in respect of the same income. The application of the treaties between the residence states and the source state is discussed in detail in the following chapter (Chapter 11). It should also be remembered that the existence of a PE in the losing residence state will only entitle that state to impose tax on income arising in a third state if the income is attributable to the PE for the purposes of the treaty between the two residence states.

### 10.4.3.2. Application of the treaties between the residence states and the source state

The existence of a PE in the losing residence state would generally have no impact on the application of the treaties between the two residence states and the source state. It remains quite clear that the dual resident will be resident in the winning residence state for the purposes of the W-S treaty, while also remaining unclear whether the dual resident will be able to claim the benefit of the L-S treaty; this will be discussed in detail in Chapter 11.

The application of the W-S treaty in a dual resident triangular case is illustrated in the following table. This table is largely the same as Table 2, since the existence of a PE in State L will generally have no impact on the application of the W-S treaty. However, this table also contains a column which indicates whether relief is required in the losing residence state, i.e., for those categories of income where the losing residence state is entitled to impose tax under the terms of the treaty between the two residence states (see Table 3). For additional comments regarding the application of the W-S treaty, refer to Table 2, above; the comments included in that table are not repeated here.
Table 4: Application of the W-S treaty (where there is an effective allocation of residence and a PE in State L)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Business profits</td>
<td>Article 7</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>State L may impose tax under Article 7 of the W-L treaty, but State S is prevented from imposing tax under the W-S treaty.</td>
</tr>
<tr>
<td>Dividends</td>
<td>Article 10</td>
<td>Yes</td>
<td>Credit</td>
<td>Credit</td>
<td>State L may impose tax under Article 7 of the W-L treaty and tax may also be imposed in State S. In relation to dividends, the credit method typically applies regardless of the general method of relief used in the treaty.</td>
</tr>
<tr>
<td>Interest</td>
<td>Article 11</td>
<td>Yes</td>
<td>Credit</td>
<td>Credit</td>
<td>State L may impose tax under Article 7 of the W-L treaty and tax may also be imposed in State S. In relation to interest, the credit method typically applies regardless of the general method of relief used in the treaty.</td>
</tr>
<tr>
<td>Royalties</td>
<td>Article 12</td>
<td>No / Yes</td>
<td>No / Credit</td>
<td>No / Credit</td>
<td>Article 12 of the OECD Model does not allow source based taxation of royalties, however in practice many treaties vary from the OECD Model and allow a limited rate of source based taxation. State L may impose tax under Article 7 of the W-L treaty and tax may also be imposed in State S. In relation to royalties, the</td>
</tr>
<tr>
<td><strong>Income from immovable property</strong> (property located in the source state)</td>
<td>Article 6</td>
<td>Yes</td>
<td>Credit or Exemption</td>
<td>Credit or Exemption</td>
<td>State L may impose tax under Article 7 of the W-L treaty (see Table 3) and tax may also be imposed in State L.</td>
</tr>
<tr>
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<td>---</td>
</tr>
<tr>
<td><strong>Income from shipping, inland waterways transport and air transport</strong></td>
<td>Article 8</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Income from shipping and air transport may only be taxed in the state where the place of effective management is located.</td>
</tr>
<tr>
<td><strong>Capital gains arising from the alienation immovable property</strong> (property located in the source state)</td>
<td>Article 13(1)</td>
<td>Yes</td>
<td>Credit or Exemption</td>
<td>No</td>
<td>State L is prevented from imposing tax under the W-L treaty (see Table 3).</td>
</tr>
<tr>
<td>Capital gains arising from the alienation of movable property which forms part of the business property of a PE</td>
<td>Property attributable to PE in State L: Article 13(5)</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No relief is required in State L because State S is prevented from imposing tax under the W-S treaty.</td>
</tr>
<tr>
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<td>---</td>
<td>---</td>
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</tr>
<tr>
<td>Figure 10.48.: Dual resident triangular case involving capital gains dealt with under Article 13(2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated movable property</td>
<td>Article 13(3)</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No relief is required in State L because State S is prevented from imposing tax under the W-S treaty.</td>
</tr>
<tr>
<td>Figure 10.49.: Dual resident triangular case involving capital gains dealt with under Article 13(3)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (property located in the source state)</td>
<td>Article 13(4)</td>
<td>Yes</td>
<td>Credit or Exemption</td>
<td>No</td>
<td>No relief is required in State L because State L is prevented from imposing tax under the W-L treaty (see Table 3).</td>
</tr>
<tr>
<td>Figure 10.50.: Dual resident triangular case involving capital gains dealt with under Article 13(4)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
This table illustrates that, in situations where there is an effective allocation of residence and the income is attributable to a PE in the losing residence state, there are only a few categories of income where tax may be imposed in all three states. These are, namely, dividends, interest, royalties (provided the applicable treaties differ from the OECD Model and allow source-based taxation) and income from immovable property. In relation to other categories of income, either the source state or the losing residence state (or both) will be prevented from imposing tax under their respective treaties with the winning residence state.

10.4.3.3. Potential double taxation where there is a PE in the losing residence state

Where the losing residence state is entitled to impose tax on income arising in third states as a result of that income being attributable to a PE, the situation is effectively the same as a PE triangular case. 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 also provides relief for tax imposed in the source state. If the L-S treaty 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 L-S treaty does not apply (e.g., in accordance with the view expressed in the OECD Commentary on Article 4) then the losing residence state would generally have no explicit obligation to provide relief for tax imposed in the source state.

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1203 Refer to the analysis in Chapter 3 regarding the residence state’s ability to grant sufficient relief in PE triangular cases (see Section 3.2.).

1204 Except perhaps, under the PE non-discrimination article (Article 24(3)) of the treaty between the two residence states (i.e., as in PE triangular cases: refer to the analysis in Chapter 4, where it was argued that a relief obligation
and thus, unrelieved double taxation may arise. The losing residence state may have a relief obligation under the non-discrimination article (Article 24(3)) of the W-L treaty, but the lack of a direct relief obligation nevertheless suggests that it would be preferable for the L-S 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 broadly prevent dual residents from being resident in State L for the purposes of treaties between that state and third states, but to extend treaty benefits to PEs (as proposed, in particular, in Chapters 7, 8 and 9). As a result, dual residents would generally only be entitled to claim the benefits of one treaty in the source state; the applicable treaty would usually be the W-S treaty but, in situations where the income is attributable to a PE in State L, the applicable treaty would be the L-S treaty (i.e., the treaty between the PE state and the source state). Thus, improper access to the L-S treaty could be prevented while still ensuring that unrelieved double taxation would not arise. This will be discussed further in Chapter 11.

Potential dual relief obligation in the winning residence state

Where State L is entitled to impose tax on income arising in third states under the W-L treaty, State W will generally have an obligation to provide relief under both the W-S treaty and the W-L treaty. As a result, State W may potentially have an obligation to grant dual relief (e.g., an exemption and a credit) in relation to the same income. This potential dual relief obligation also arises in PE triangular cases, and was discussed in detail in Chapter 3, where it was concluded that if certain income is exempt under one applicable treaty, then that exemption should be taken into account for the purposes of determining the amount of credit relief required under another applicable treaty. As a result, the residence state should not have any dual relief obligation despite being subject to the relief provisions of two treaties in relation to the same item of income. That analysis applies equally here.

10.4.4. Impact of retroactive determination of residence under tie-breaker rules

The residence of a dual resident company for the purposes of the treaty between its two residence states may be determined under the mutual agreement procedure, either because the application of the tie-breaker in Article 4(3) is not clear and the company initiates the mutual agreement procedure under Article 25, or because the tie-breaker itself provides for residence to be determined by mutual agreement. Where this occurs, the residence of the company may not be determined until a relatively long period of time has elapsed. In such cases, the allocation of residence would generally be implemented retroactively in the two residence states. That is, the company would be treated as a resident of the relevant state for the purposes of the treaty at least back to the time in respect of which it initiated the mutual agreement procedure, but potentially even for earlier periods. As a result of Article 25(2), the contracting states will

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1205 Refer to Chapter 4 (Section 4.3.) for an in-depth discussion of the PE state’s potential relief obligation under Article 24(3) in PE triangular cases; that analysis applies equally here.
1206 Where the L-S treaty applies on the basis that the income is attributable to the PE, the W-S treaty should be excluded in relation to that income in the same way that the R-S treaty should be excluded in PE triangular cases. For this purpose, the provisions suggested in Chapter 7 to exclude the operation of the R-S treaty would apply equally in dual resident situations where there is a PE in the losing residence state (see Section 7.5.).
1207 Refer to Section 3.3. Broadly, it was concluded in that section that for the purposes of determining the amount of tax which the residence state imposes on the income, and thus for determining the amount of credit relief which should be granted, consideration should be given to the actual amount of tax imposed (taking into account any treaty limitations) and should not be limited to the amount of tax imposed under domestic law of the residence state. While tax treaties are bilateral and do not have effect for the purposes of other tax treaties, the impact which tax treaties have on the operation of domestic law cannot be ignored for the purposes of applying other tax treaties. 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.
generally be able to implement the agreement, and apply the treaty as it should have been applied, despite any applicable time limits in domestic law.1208

The situation is not so clear, however, with respect to treaties concluded between the losing residence state and third states. In particular, the question arises as to whether the retroactive determination of residence under the treaty between the two residence states should also be taken into account retroactively for the purposes of treaties with third states.1209 Assume, for example, that the treaty between the two residence states contains a provision along the lines of the mutual agreement tie-breaker contained in the OECD Commentary, which is worded as follows:

"Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting State."1210

Under this provision, the dual resident will not be treated as resident in either contracting state (i.e., for the purposes of the treaty between the two residence states) prior to a mutual agreement being reached. This means that neither state will be restricted by the treaty and consequently, the dual-resident will be taxable in both residence states under their domestic laws. In this situation, there would be nothing to prevent both treaties concluded by the residence states with the source state from applying. This is the case even if the second sentence of Article 4(1) prevents dual residents from being resident in the losing residence state for the purposes of treaties with third states, if there is a specific provision included in the treaties between the residence states and the source states, or if the result of a treaty tie-breaker is incorporated into the domestic law of the residence states. There has been no determination of residence under the treaty between the two residence states, and thus there can be no denial of residence in either state for the purposes of treaties with third states. As was mentioned above, this means that a dual resident company could ensure its continued eligibility under the treaties concluded by both its residence states with the source state by not initiating the mutual agreement procedure.1211 This is clearly a weakness of the mutual agreement tie-breaker, particularly since there seems to be no authority for the contracting states to conclude an agreement in the absence of a request from the taxpayer.1212

Once an agreement has been reached with regard to residence for the purposes of the treaty between the two residence states (with retroactive effect), the question arises as to whether this allocation of residence will also have retroactive effect for the purposes of treaties with third states. Van der Berg and Van der Gulik write:

"We see no basis in the OECD model convention or the commentary for the position that a retroactive determination of residence by mutual agreement between two contracting states should retroactively affect the tax treaty status of the dual resident for the purposes of other treaties."1213

During the period prior to the mutual agreement being reached, the dual resident was taxable on its worldwide income in what is now the losing residence state (without any treaty restriction) and, at that time, would have satisfied the conditions of Article 4 of the treaty between that state and the source

1208 Article 25(2) provides (in part) that: "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States." This clearly applies where the taxpayer initiates the mutual agreement procedure under Article 25, and perhaps less clearly and more indirectly, should also apply where Article 4 provides for the residence of dual-resident persons to be determined by mutual agreement.
1209 Van den Berg, J-P., & Van der Gulik, B., "The Mutual Agreement...."
1210 2010 OECD Commentary on Article 4, para 24.1.
1211 Van den Berg, J-P., & Van der Gulik, B., "The Mutual Agreement...."
1212 Van den Berg, J-P., & Van der Gulik, B., "The Mutual Agreement...."
1213 Van den Berg, J-P., & Van der Gulik, B., "The Mutual Agreement...."
state. It is therefore difficult to see how the retroactive allocation of residence could have an impact on the application of the L-S treaty.

Even if the retroactive residence determination is effective for the purposes of the L-S treaty, with the result that the L-S treaty doesn’t apply for the period for which residence has been determined, difficulties may arise in implementing the results of the non-application of that treaty in the source state. Prior to the allocation of residence for the purposes of the treaty between the two residence states, the source state was required to apply the conditions of two treaties and could only meet its treaty obligations by applying the conditions that were most favourable to the taxpayer. Generally therefore, the non-application of the L-S treaty will only have an impact where the conditions of that treaty are more favourable than the conditions of the W-S treaty and therefore, the source state will generally be seeking to impose more tax as a result of the non-application of that treaty. However, the source state may be prevented from revising the amount of tax imposed (e.g., by issuing and amended assessment and requesting additional payment) as a result of the time limits contained in its domestic law. There is no clear solution for addressing this issue. A specific provision could potentially be included in tax treaties, e.g., as part of a specific provision exclude treaty benefits where residence is assigned to a third state under an applicable treaty. However, determining the wording of such a provision would involve considerable difficulties, since the provision would need to apply to set aside the domestic time limits in circumstances where tax is being imposed because the treaty as a whole does not apply.

10.5. Conclusions

There are a number of factors which will influence the outcome of a dual resident triangular situation. One of the main factors is the application of the residence tie-breaker rule under the treaty between the two residence states. Where residence is not effectively assigned to one state there is a high likelihood of unrelieved double taxation (i.e., of tax being imposed in both residence states with no relief being provided) regardless of the category of income involved, and regardless of whether tax is also imposed in the source state. This highlights the importance of an effective allocation of residence.

Where residence is effectively assigned to one state for the purposes of the W-L treaty, the two most important factors influencing the outcome of triangular dual resident cases are whether the income is attributable to a PE in State L and whether the L-S treaty applies. In the absence of a PE, State L will generally be prevented from imposing tax on any income arising from third states, however if such income is attributable to a PE in State L, then depending on the category of income involved, State L may be entitled to impose tax. If the L-S treaty does not apply and there is a PE in State L, then unrelieved double taxation may occur. If the L-S treaty does apply, however, then there is a significant risk of improper claims for treaty benefits, since the source state will be bound by the conditions of its treaties with both residence states. This is of particular concern in situations where the losing residence state is prevented from imposing tax on the income under the treaty between the two residence states. The application of the L-S treaty is the key issue in dual-resident triangular cases and will be discussed in detail in the following chapter.


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Chapter 11
Residence under tax treaties with third states

11.1. Introduction

The primary issue in dual-resident triangular cases is the dual-resident’s eligibility for treaty benefits under the treaty between their losing residence state and the source state. A consequence of the fact that residence for treaty purposes depends on residence under domestic laws, and due to the bilateral nature of income tax treaties, residence must be determined independently for each treaty. Residence for treaty purposes is determined under Article 4(1) (or its equivalent), which provides that:

"For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of sources in that State or capital situated therein."

Thus, whether a person is resident in a particular state for treaty purposes depends upon whether they are resident in that state under its domestic laws. As a result, an allocation of residence under the tie-breaker provision of one particular treaty will have effect only for the purposes of that treaty and will generally have no impact on the application of other tax treaties. As mentioned above, residence must always be determined independently for each individual treaty that is applied. In dual-resident triangular cases, therefore, where a person is resident in two states under their respective domestic laws, that person will generally also be resident in both those states for the purposes of treaties which each of them have concluded with third states. In a triangular situation, this means that a dual resident may be entitled to claim treaty benefits (including reductions in source based taxation) under the tax treaties concluded by both its residence states with the source state. If both these treaties apply then the source 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. As outlined in Chapter 10, 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 (i.e., the losing residence state) in situations where that state is prevented from imposing tax under the treaty between the two residence states. As a result, source states may seek to deny treaty benefits to dual-residents under the L-S treaty.

The only argument for not applying the L-S treaty, and the argument that is presented in the OECD Commentary, is that the dual-resident is not resident in the losing residence state as a result of the second sentence of Article 4(1). The second sentence of Article 4(1) provides that a person will not be resident in a particular state if they are "liable to tax in that State in respect only of sources in that State". It is argued that a dual resident does not meet this condition for the purposes of the L-S treaty due to the restrictions imposed on the losing residence state’s taxing rights under the treaty between the two

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1215 OECD Model 2010, Article 4(1).
1216 The term "persons" is defined in Article 3(1) to include "...an individual, a company and any other body of persons." The discussion in this chapter will refer only to individuals and companies; it does not address any issues associated with partnerships and/or hybrid entities.
1217 Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems..."; Avery Jones, J.F., "The Interaction Between..." at p. 137 (Chapter 6, Section 6.4.1.);
1218 See, inter alia: Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems..."; Avery Jones, J.F., "The Interaction Between..." at p. 137 (Chapter 6, Section 6.4.1.);
1220 Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems..."
1221 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..."
residence states. This interpretation is controversial however. This chapter assesses this interpretation and considers other ways in which the application of treaties concluded between the losing residence state and third states could be prevented. It also discusses the potential impact that a retrospective determination of residence under a tie-breaker rule may have on the application of treaties with third states.

Scope

It is quite clear that a dual resident person will remain resident in the winning residence state for the purposes of treaties concluded between that state and third states. It is also clear that where the tie-breaker rule of the treaty between the two residence states fails to assign residence to one state for the purposes of that treaty, the dual resident will remain resident in both residence states for the purposes of treaties concluded between those states and third states. The discussion in this chapter therefore deals only with the application (or non-application) of the treaty between the losing residence state and the source state.

Abbreviations

In this chapter, the state to which residence is assigned for the purposes of the treaty between the two residence states is referred to as the "winning residence state" (or "State W"), and the state to which residence is not assigned is referred to as the "losing residence state" (or "State L"). The third state where income arises is referred to as the "source state" or "State S." The treaty between the losing residence state and the source state is referred to as the "L-S treaty" and the treaty between the winning residence state and the source state is referred to as the "W-S treaty."

11.2. The second sentence of Article 4(1)

Under the second sentence of Article 4(1), a person will not be resident in a particular state for treaty purposes if they are only liable to tax in that state in respect of locally sourced income. The purpose of this provision is, in broad terms, to prevent persons who are taxed only on a source basis in a particular state from claiming treaty benefits. It is based the typical distinction between residence and source based taxation, however, as was seen in Chapter 5, this distinction is not always clear and it can be very difficult to apply in practice. This is certainly the case with respect to dual-residents, as will be seen below.

The second sentence of Article 4(1) provides that:

"This term [resident of a Contracting State], however, does not include any person who is liable to tax in that State in respect only of sources in that State or capital situated therein."

Determining whether the second sentence of Article 4(1) excludes dual-residents from eligibility under treaties between the losing residence state and third states requires consideration of three issues:

(i) Whether the treaty limitations on the tax imposed in the losing residence state should be taken into account for the purposes of applying the second sentence of Article 4(1) or whether consideration should be limited to the tax imposed under the domestic law of that state;

(ii) Assuming the treaty limitations are taken into account, whether the applicable treaty limitations will prevent the dual resident from being "liable to tax" in the losing residence state in relation to income which that state is prevented from taxing under the treaty between the two residence states (i.e., income arising in third states); and

(iii) Assuming items (i) and (ii) are answered affirmatively, whether the dual resident is liable to tax in that state "in respect only of income from sources in that State."

These three issues will be discussed in turn below.

### 11.2.1. Whether treaty limitations should be taken into account

One of the key issues in determining whether a dual resident will be denied treaty benefits as a result of Article 4(1) is whether regard should be had only to the domestic law of that state, or also to the impact of the treaty between the two residence states. If consideration is limited to domestic law, then the second sentence of Article 4(1) would generally not prevent a dual resident person from being resident in the losing residence state for the purposes of treaties with third states (given that that person must have a sufficient liability under domestic law to be considered a resident under the treaty between the two residence states). It is only when the restriction under the treaty between the two residence states is taken into account that the dual resident may be denied treaty benefits.\(^{1223}\)

There is no reference in the second sentence of Article 4(1) 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 refer specifically to domestic law and, since the second sentence refers back to (and limits) the first sentence, the better interpretation is therefore that the second sentence also refers only to domestic law.\(^{1224}\) To the extent that this is the case, a dual-resident would simply continue to be resident in the losing residence state for treaty purposes and could not be denied treaty benefits under the second sentence of Article 4(1) of the L-S treaty.

One difficulty with this interpretation is that the distinction between domestic law on the one hand and tax treaties on the other is not always clear from a legal perspective.\(^{1225}\) In some countries tax treaties are given effect by an act of Parliament and once enacted, become part of the domestic law;\(^{1226}\) while in others, treaties become part of domestic law by virtue of specific constitutional provisions.\(^{1227}\) Where tax treaties do form part of the domestic law of the losing residence state, there seems to be little justification for excluding the effect of the treaty between the two residence state when determining the scope of the tax liability in the losing residence state for the purposes of the L-S treaty. Nevertheless, a distinction could perhaps be drawn between domestic law and tax treaties on the basis that the basic rules of domestic law apply generally, whereas the provisions of a tax treaty apply only to residents of the other contracting state and do not have universal effect. In addition, the argument that tax treaties are in many cases part of domestic law could be applied equally to the first sentence of Article 4(1), which would clearly make a nonsense of the specific reference to "the laws of that state" included in that sentence. This direct reference does seem to imply that some distinction can be drawn between internal laws of one hand and tax treaties on the other, even if tax treaties are technically incorporated into the domestic law of the state involved from a legislative or constitutional perspective.

Avery Jones has argued that consideration should be limited to domestic law on the basis that, for the purposes of applying the second sentence of Article 4(1) of the treaty between the two residence states, the provisions of that treaty should not be taken into account (because otherwise one would never get to the tie-breaker) and therefore, the distributive provisions should similarly not be taken into account in applying the second sentence of Article 4(1) of other treaties.\(^{1228}\) The difference, however, is that before the distributive provisions of the treaty between the two residence states can be applied, residence must be determined under Article 4. It would be quite odd to apply the first sentence of Article 4(1) to determine whether an entity is resident in a particular contracting state, then apply the other distributive rules of the treaty on the basis that the person is resident in the other contracting state, before finally

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1224 Van Gennep, C.J.A.M., "Dual-Resident....", at pp. 143-144; Vann, R., "Liable to Tax....", at p. 253.
1225 Sasseville, J., "A Tax Treaty Perspective....", at pp. 38-41 (Chapter 3, Section 3.2.) and (in the context of Article 4(1)) p. 44 (Section 3.3.). See also Vogel, who writes: "Under the theory of 'moderate dualism,' which seems to be generally accepted nowadays, international and domestic law are two spheres which exist separate of each other (save some exceptions). To exercise their intended influence on domestic law, treaties therefore have to be implemented by the domestic legislator. Thus, they receive the force of domestic law." (Vogel, K., "The Domestic Law....", at p. 3, (Chapter 1, Section 1.1.).)
1226 In relation to the UK, see: Avery Jones, J.F., "The Interaction Between....", at p. 135 (Chapter 6, Section 6.3.).
1227 Sasseville, J., "A Tax Treaty Perspective....", at p. 39 (Chapter 3, Section 3.2.).
1228 Avery Jones, J.F., "The Interaction Between....", at p. 138, (Chapter 6, Section 6.4.1.).
returning to apply the second sentence of Article 4(1) for the ultimate determination of residence. It therefore does not seem inconsistent to consider the final result of the treaty between the two residence states (and thus the limitations on the losing residence state’s taxing rights under that treaty) for the purposes of determining residence under other treaties, but to ignore it for the purposes of determining residence under that treaty itself.

One case where a tax treaty limitation was taken into account in determining treaty residence in a dual-resident triangular case was decided in the Netherlands in 2001.1229 This case involved a distribution of dividends1230 by a dual-resident company (i.e., a reverse dual resident triangular case), but the basic question to be decided was whether the dual-resident company was resident in the Netherlands (the losing residence state) under Article 4 of a treaty with a third state (in this case Belgium, the state where the shareholders were resident). It is therefore clearly also relevant to situations where a dual-resident company receives income from a third state.1231 The company involved was incorporated in the Netherlands but had its place of effective management in the Netherlands Antilles. Under the domestic laws of the Netherlands, the company was resident in the Netherlands, however, under the Tax Arrangement for the Kingdom of the Netherlands (which effectively operated as a tax treaty between the Netherlands and the Netherlands Antilles), the company was treated as a resident of the Netherlands Antilles and the Netherlands could only impose tax on certain items of income.1232 The court found that the company was not resident in the Netherlands for the purposes of the Belgium-Netherlands treaty because the company was not fully liable to tax in the Netherlands, i.e., taking into account the limitations imposed under the Tax Arrangement for the Kingdom of the Netherlands.1233 Importantly, however, a Protocol to the Belgium-Netherlands treaty contained a specific provision which stated that: "The expression, 'under the law of that State' used in Article 4 paragraph 1, means the law of that State as amended or supplemented by international agreements."1234 It is therefore not clear whether the limitations under a tax treaty between the two residence states should be taken into account for the purposes of applying treaties with third states that do not include a similar provision.

In summary, it is difficult to determine whether limitation on the losing residence state’s taxing rights under the treaty between the two residence states should be taken into account for the purposes of applying the second sentence of Article 4(1) and thus for determining whether a dual-resident company is entitled to the benefits of a treaty between the losing residence state and a third state, although I tend towards the view that consideration should be limited to domestic law (excluding tax treaties). Taking the treaty limitation into account for the purpose of applying the second sentence of Article 4(1) requires the distributive rules of one treaty (i.e., the W-L treaty) to effectively be read into a definition contained in another treaty (i.e., the L-S treaty), which is difficult to defend. Even if the tax treaty limitation is taken into account, however, it does not follow that treaty residence will be denied, since 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 which the losing residence state is prevented from taxing and on the interpretation of "in respect only of income from sources in that state"; these factors will be discussed in the following sections.

1229 Decision in Case No. 35557, Supreme Court (HR) of 25 February 2001. For discussion of this case, see: Smit, P.M., "Treaty Residence…"; De Kort, J.W.J., "HR 28 February 2001…"; and Damen, S., "Netherlands Supreme Court…".
1230 Actually, it involved a purchase by the company of its own shares, but considered to be a dividend under Dutch tax law. See: De Kort, J.W.J., "HR 28 February 2001…"
1231 Damen, S., "Netherlands Supreme Court…"
1232 Smit, P.M., "Treaty Residence…".
1233 De Kort, J.W.J., "HR 28 February 2001…". This is despite the fact that, under the Belgium-Netherlands treaty which was in force at that time, Article 4(1) did not contain an equivalent to the second sentence of Article 4(1) of the OECD Model treaty. The treaty in force at the relevant time was the Belgium-Netherlands treaty concluded in 1970; Belgium and the Netherlands concluded a new treaty in 2001. This meant that the Netherlands could not impose any dividend withholding tax.
1234 Translation by: Smit, P.M., "Treaty Residence…".
11.2.2. Meaning of 'liable to tax'

The second issue which must be addressed in applying the second sentence of Article 4(1) in the context of a dual resident is whether a treaty limitation which prevents a state from imposing tax on certain income will also prevent the person involved from being considered to be "liable to tax" in relation to that income. 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. Although the context is slightly different, in that for the purposes of the first sentence of Article 4(1), being liable to tax is an attribute of the person whose residence is being determined, whereas in the second sentence the focus is shifted more to the income, the interpretation of the phrase "liable to tax" in the first sentence may still shed some light on its proper interpretation in the second sentence.

As was discussed in Chapter 5, the extent of the liability to tax required in order for a person to be resident in a particular state under the first sentence of Article 4(1) is not always clear and, in particular, there is disagreement as to whether it has to be a full and comprehensive liability. However, it is clear that the requirement that a person be "liable to tax" does not require that the person have an actual tax liability. For example, if the taxpayer has an overall loss, or if the country exempts certain items of income, this should not prevent the recipient of the income from being resident of that state under the relevant treaty. 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 the basis that they are subject to the tax system of the country and are only exempt because they meet certain criteria for exemption. 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 residence 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. It would, however, be a very restrictive interpretation and would mean, for example, that even diplomats (the clear target of the provision) would not be excluded from treaty residence under the second sentence of Article 4(1) in cases where their foreign income was included in the tax base of the host state but was then exempted under a specific provision or an international treaty (i.e., the 1961 Vienna Convention on Diplomatic Relations). Thus, 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).

1235 A brief reminder of the wording of this sentence: "This term ['resident of a Contracting State'], however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."
1236 Couzin, R., Corporate Residence..., at p. 109 (Section 3.1.1.1.).
1237 Vogel, K., Engelschelk, M. & Göl, M., Klaus Vogel on Double Tax Conventions..., at p. 229, (m.no. 24a).
1238 OECD Commentary to Article 4, paras 8.5 and 8.6. This view is not universally accepted.
1239 The second sentence of Article 4(1) was inserted in the 1977 version of the OECD Model in order to deal with the situation of diplomats posted abroad. Under Article 34 of the 1961 Vienna Convention on Diplomatic Relations, diplomats are granted an exemption from taxes in their host state with certain exceptions, including "taxes on private income having its source in the receiving state" (i.e., in the host state) (Article 34). Thus, the second sentence of Article 4(1) is intended to ensure that diplomats posted abroad are treated as resident in the sending state for treaty purposes instead of the receiving state, both for the purposes of the treaty between those two states (without having resort to the tie-breaker rule) and for the purposes of treaties with third states. (See: the 1977 OECD Commentary on Article 4, para 8; Van Raad, K., "2008 OECD Model..."; Van Raad, K., "Dual Residence....")
11.2.3. Source of income

A key question in applying the second sentence of Article 4(1) in the context of dual-residents is the source of income. 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.\footnote{OECD Commentary on Article 4, para 8.2.} The Commentary, referring to the second sentence of Article 4(1), states that:

"It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State’s tax law, are considered to be residents of another State pursuant to a treaty between these two States."

This will clearly depend, however, on the meaning of the phrase "liable to tax in that State in respect only of income from sources in that State" (emphasis added) and in particular, on how the source of income is determined for the purposes of applying this provision. As will be discussed below, the geographical source of income is by no means clear in the majority of cases. In this respect, Vogel writes:

"All this suggests that authors take ‘source’ to be a natural, self-defining concept about which not much dissent or disagreement is possible. However, this is far from the truth. ‘Source’ is unambiguously only in what it excludes: taxation based on ‘source’ is different from taxation based on residence or on citizenship. The only positive statement that can be made on the other hand is that ‘source’ refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good. In contrast, the type of connection that establishes the ‘source’ of income cannot be defined generally."

Most clearly in the present case, there is disagreement regarding whether the taxation of income which arises in a third state but is attributable to a PE in the losing residence state demonstrates that the dual resident is not "liable to tax in [the losing residence state] in respect only of income from sources in that State."\footnote{Van Raad, K., “2008 OECD Model…”; Sasseville, J., "A Tax Treaty Perspective…," at p. 44 (Chapter 3, Section 3.3.). Van Raad argues that such income is sourced outside the losing residence state and thus, the dual-resident should continue to be resident there for the purposes of treaties with third states, while Sasseville argues the opposite, that such income can be considered to be sourced in the losing residence state. This will be discussed further below.}

11.2.3.1. Determining the source of income

The basic interpretive rule of Article 3(2) is that where a term is not defined in the treaty, it will take its meaning from the domestic law of the state applying the treaty, unless the context otherwise requires.\footnote{Article 3(2) reads as follows: "As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."} Since tax treaties based on the OECD Model do not contain a definition of "source," that term should, prima facie, take its meaning from the domestic law of the state applying the treaty. This firstly relies on that state applying the treaty having a definition of source in its domestic law, which may not always be the case, for example, tax may instead be imposed directly on certain types of income derived by non-residents without reference to source.\footnote{Van Raad, K., “Worldwide vs. Source… Part I.” Emphasis in the original.} In addition, domestic law is likely to contain overlapping source rules with the result that a particular item of income may be considered to be sourced in two different...
states under those rules, e.g., where passive income is derived in the context of business activities or where multiple factors are taken into account for the purposes of determining the source of particular types of income. Perhaps the most problematic aspect of relying on a domestic law definition, however, is that reference must be made to the domestic law of the state applying the treaty which, in any given situation, may be either of the two states. Where the source state is applying the treaty, treaty residence would depend on the source rules of that state, which should arguably not be relevant for determining whether an entity is resident in the other contracting state. Furthermore, where the source rules differ between the two states, the person involved may be considered to be a resident for the purposes of the treaty in one of the contracting states but not in the other. This would clearly be an inappropriate outcome.

These problems suggest that the better approach would be to consider this a situation where "the context otherwise requires" and thus where an international fiscal meaning should be applied. Given the wide diversity of source rules in different states, it would be difficult to identify the source rules that should be applied. However, the determination of source could perhaps be based on the implicit source rules contained in the OECD Model, i.e., on the basis that these rules reflect broadly accepted principles for determining the source of income. So, for example, dividends could be considered to be sourced in a particular state if they are paid by a resident of that state. The main difficulty with this approach is that the implicit sourcing rules in tax treaties generally do not identify a unique geographical source for each type of income. Dividends that are attributable to a PE, for example, could be considered to be sourced both in the state where the payor is resident under Article 10 (e.g., the source state) and in the state where the PE is located under Article 7 (e.g., in the losing residence state). Given the inherent difficulty in determining the source of income there will inevitably be some overlap regardless of the principles which are employed, with the result that certain items of income may be considered to be sourced in more than one state. Nevertheless, in most cases the losing residence state will be prevented from imposing tax on income which, in accordance with the implicit source rules in tax treaties, can be considered to be sourced in third states. Dividends, interest, and royalties arising in a third state (and not attributable to a PE in the losing residence state) for example, will fall under the distributive rule of Article 21 of the treaty between the two residence states and the losing residence state will be prevented from imposing tax. This will also be the case in respect of any business profits or "other income" not dealt with in other articles of the treaty, which the losing residence state will be prevented from taxing under Article 7 and Article 21, respectively, unless it is attributable to a PE in that state. Similarly, under Article 13, the losing residence state will generally be prevented from imposing tax on capital gains arising from the alienation of assets connected with third states. Thus, the clearest example of a category of income which can be taxed in the losing residence state 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.

11.2.3.2. Interpretation of the second sentence of Article 4(1)

The taxation of income which arises in a third state but is attributable to a PE in the losing residence state gives rise to particular disagreements with respect to the application of the second sentence of Article 4(1). It also clearly illustrates the problems that arise in interpreting that provision. The main point of contention in the application of the L-S treaty to dual residents is whether the taxation of this type of income demonstrates that the dual resident is not "liable to tax in that State [i.e., the losing residence state] in respect only of income from sources in that State." On one hand, it is argued that such income is

1246 See, for example, Vann, R., "International Aspects…,” at pp. 734-749.
1247 Although the articles of the OECD Model do not contain explicit source rules, they do set out the circumstances under which each contracting state may impose tax on income derived by residents of the other contracting state which, in effect, operate as source rules. See, for example, the Introduction to the 2010 OECD Model, para 19, which describes a contracting state which is entitled to impose tax on income derived by residents of the other contracting state as the "state of source." See also: Vogel, K., "State of Residence"….
1248 Under Article 13 of the treaty between the two residence states, the losing residence state will generally only be able to impose tax on capital gains arising from the alienation of (i) immovable property located in that state, (ii) movable property attributable to a PE located in that state, (iii) gains from the alienation of ships or aircraft operated in international traffic (but only if the place of effective management is located in that state), and (iv) gains from the alienation of shares deriving more than 50% of their value from immovable property located in that state.
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 should be available.\(^{1249}\) 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) and thus, that the taxation of such income should not prevent the denial of treaty benefits under the second sentence of Article 4(1).\(^{1250}\) In this respect, Vann writes:

“In terms of the Model wording in the second sentence, the only way that the OECD view can stand is in effect by preferring the PE sourcing rule over the passive income sourcing rule and so regarding all of the PE income as sourced in the PE country, but no explanation is given for such a preference.”\(^{1251}\)

In reality, this type of income is sourced both in the state where it arises and in the PE state, at least in accordance with the implicit sourcing rules of tax treaties.\(^{1252}\) However, this does not solve the issue of whether the second sentence of Article 4(1) should apply to deny treaty benefits to a dual-resident. In fact, 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;\(^{1253}\) 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 there.\(^{1254}\)

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 and there seems to be no grounds for preferring one interpretation over the other.

11.2.3.3. Conclusion

The case of dual-residents reveals a major flaw of the second sentence of Article 4(1), namely the amorphous nature of the source concept in international tax law and the possibility for a certain item of income to be considered to have its "source" in various geographic locations either under differing conceptions of source or, in some cases, even under the single set of source rules. The wording of the second sentence of Article 4(1) also means that it is open to two differing interpretations. In the context of dual resident triangular cases, the dual resident is, on one hand, taxable only on income that is sourced in State L, since it is not taxed on any income that is not sourced in State L, but equally, the dual resident is not taxable only on income sourced in State L, since it is also taxable on certain income that is sourced in third states. This also assumes that the treaty limitation will be taken into account for the purposes of applying the second sentence of Article 4(1), and that it will prevent the dual resident from being "liable to tax" in the losing residence state in relation to income which that state is prevented from taxing under the treaty between the two residence states. This is by no means certain. Given the lack of clarity in the application of the second sentence of Article 4(1), it does not seem appropriate to take the extraordinary step of denying treaty benefits to an entity that would otherwise be entitled to them (even if the source


\(^{1250}\) Sasseville, J., “A Tax Treaty Perspective…,” at p. 44 (Chapter 3, Section 3.3.)

\(^{1251}\) Vann, R., “Liable to Tax…” at p. 253 (Section 7.4.2.1.).

\(^{1252}\) Refer to the discussion in Chapter 6 (Section 6.2.1.) regarding the overlap in tax treaty sourcing rules in PE triangular cases, where it was concluded that there is an overlap in tax treaty sourcing rules where a PE derives income from a third state; that analysis applies equally here.

\(^{1253}\) This is the interpretation favoured by Van Raad. (Van Raad, K., "Dual Residence and the 1977…"); Van Raad, K., “2008 OECD Model….” See also: Betten, R., "Denial of Certificate….”

\(^{1254}\) This is the interpretation favoured implicitly by the OECD Commentary on Article 4 (para 8.2.) and by Sasseville (Sasseville, J., "A Tax Treaty Perspective…,” at pp. 42-44 (Chapter 3, Section 3.3.))
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), this approach is not a satisfactory way of dealing with (potentially improper) claims for treaty benefits by dual resident persons.

11.3. Preventing dual residents from claiming dual treaty benefits

If dual residents are not denied treaty benefits under the L-S treaty as a result of the second sentence of Article 4(1), the question arises as to the circumstances in which treaty benefits should be specifically denied. There are two main reasons for denying the benefit of the L-S treaty to dual-residents. The first is to prevent the source state from being subject to multiple treaty conditions in respect of the same income, and the second is to deal with the potential for tax avoidance. Clearly, the considerations are different in circumstances where the dual-resident is, for example, simply incorporated in the losing residence state and is not taxed there on any income arising in third states, and situations where the dual resident has a PE in the losing residence state and the income attributable to the PE includes income which arises in a third state (i.e., where there is effectively a PE triangular case). In the first case, real treaty shopping concerns do exist and the application of the L-S treaty is more clearly inappropriate. In the second case, however, there are strong arguments for continuing to apply the PE-S treaty. The ideal solution would therefore be to deny treaty benefits to dual-resident companies (i.e., under the treaty between the losing residence state and the source state) but to effectively extend treaty benefits to PEs (as outlined in Chapters 7 through 9). In this way, the L-S treaty would generally apply only in circumstances where the losing residence state would be entitled to impose tax on the income in accordance with the terms of the treaty between the two residence states.

This section will focus on alternative ways in which treaty benefits could be denied to dual resident companies. However, one option would of course be for states to do nothing and simply continue relying on the second sentence of Article 4(1) as currently worded. The primary advantage of this approach is that the second sentence of Article 4(1), having been included in the OECD Model since 1977, is widely included in existing treaties. Thus, treaty benefits can be denied to dual resident companies through the interpretation of existing treaty provisions with no changes to tax treaties (or domestic law) being required. Given the significant time which it would take to renegotiate an entire treaty network to implement an alternative approach, an approach that can be applied under existing treaty provisions clearly presents an enormous advantage. The disadvantage of this approach is equally clear, however, in light of the difficulties surrounding the interpretation of the second sentence of Article 4(1) and its application in the context of dual residents.

11.3.1. Provisions included in domestic law

One 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. Such provisions are already included in the domestic laws of Canada, the UK and South Africa.

Section 250(5) of Canada's Income Tax Act provides that:

"Notwithstanding any other provision of this Act (other than paragraph 126(1.1)(a)), a person is deemed not to be resident in Canada at a time if, at that time, the person would, but for this subsection and any tax treaty, be resident in Canada for the purposes of this Act but is, under a tax treaty with another country, resident in the other country and not resident in Canada."

1255 Paragraph 126(1.1)(a) deals with authorized foreign banks. It reads as follows: "(1.1) In applying subsections 20(12) and (12.1) and this section in respect of an authorized foreign bank, (a) the bank is deemed, for the purposes of subsections (1), (4) to (5), (6) and (7), to be resident in Canada in respect of its Canadian banking business"
A similar provision in the UK provides as follows:

"(1) A company which—

(a) would (apart from this section) be regarded as resident in the United Kingdom for the purposes of the Taxes Acts, and

(b) is regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the United Kingdom and not resident in the United Kingdom,

shall be treated for the purposes of the Taxes Acts as resident outside the United Kingdom and not resident in the United Kingdom."1256

The provision in South Africa is as follows:

" 'resident' means ... but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic [of South Africa] and that other country for the avoidance of double taxation." 1257

The effect of such provisions is that a person who is resident under domestic law but who has their residence of allocated to another state for treaty purposes under a treaty tie-breaker rule ceases to be a resident under domestic law. Consequently, they will also not be resident in the state concerned (the losing residence state) for the purposes of treaties which that state has concluded with third states (since treaty residence depends on residence under domestic law). This approach is therefore 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. It may also be relatively easy to implement since it does not require any renegotiation of tax treaties. 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.1258

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. Thus the beneficiary of such a provision in a treaty context is not the state that implements it, but rather, other states with which that state has concluded tax treaties. As a result, states may have no particular incentive to implement such a provision purely to resolve the issue of dual residents claiming treaty benefits, and may be reluctant to do so, particularly in light of the amount of work that would need to go into drafting the provision and ensuring that it does not give rise to any adverse consequences under domestic laws.1259 Most states have limited resources and would prefer to direct those resources towards matters that are of concern domestically, rather than towards developing a provision primarily benefiting other states.

Thus, the main difficulty with advocating an approach which prevent dual residents from claiming treaty benefits by incorporating the result of the treaty tie breaker into domestic law is therefore that the main impact in the state implementing the provision will be with respect to the application of its domestic laws. The effects of the provision in a domestic context will depend upon its interaction with other domestic laws of the state where it is enacted and, in light of the complexity of the tax laws of most countries,

1256 Section 249, 1994 Finance Act.
1257 Section 1 of the Income Tax Act, 58 of 1962. This specific paragraph was introduced by amendment by Section 33(1) of Act No. 12 of 2003, with effect from 26 February 2003.
1258 Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems…" (Avery Jones and Bobbett state that "It was generally agreed that the problems caused by two treaties applying to the receipts and payments of a dual resident taxpayer can best be solved by internal law." The members of the panel were: John Avery Jones, Moris Lehner, Kees Van Raad, Jacques Sasseville and David A. Ward.); Avery Jones, J.F., "The Interaction Between…," at pp. 138-140 (Chapter 6, Section 6.4.1.); Sasseville, J., "A Tax Treaty Perspective…," at pp. 46-48 (Chapter 3, Section 3.4.).
1259 Although the wording of the provision could be quite simple, this would depend on the domestic laws of the state involved. It may be necessary to define how the denial of residence will interact with certain other provisions of domestic law ( exceptions and provisos are included in both the Canadian and UK provisions) and it may also be necessary to implement transitional provisions to deal with the sudden change in residency status upon the new law coming into force, dealing with, e.g., exit taxes on unrealised capital gains, changes in administrative obligations.
adverse consequences may potentially arise despite the best efforts of the drafters to identify and prevent them. Couzin, discussing the Canadian provision, writes:

"There are numerous provisions in the Act, both substantive and procedural, that are fundamentally affected by the reclassification of a taxpayer as a non-resident person under Section 250(5)."

Couzin then goes on to identify various issues that may arise in relation to the interaction between the Canadian Section 250(5) and other provisions of Canadian law. One of these is the interaction between Section 250(5) and deemed residence rules for withholding tax purposes. These provisions deem, e.g., a company whose business is carried on principally in Canada to be resident in Canada solely for the purposes of determining whether payments made by that entity should be subject to withholding tax (Subsection 212(13.2)). The question arises as to which of these provisions should take priority; Couzin notes that the administrative position is that Section 250(5) should be considered to operate first, deeming the company not to be resident in Canada, and then subsection 212(13.2) will apply to deem the company to be resident in Canada for limited purposes. He comments that while this seems correct from a policy perspective and "defensible as a matter of statutory construction" it does highlight the difficulty of coordinating various deeming rules.

Another important implication of a provision like Section 250(5), deeming a person who is resident in another state under a treaty to be non-resident for the purposes of domestic law, is that it may trigger an emigration for tax purpose. Like many countries, Canada has rules to the effect that a company which ceases to be a resident is deemed to dispose of all its assets for fair market value, resulting in the taxation of unrealised gains (or losses). Couzin notes that this provision could be triggered and could therefore result in a tax liability where, for example, two states reach an agreement regarding the company's residence under the mutual agreement procedure, i.e., without any intentional change in residence by the taxpayer. Such a charge may be justified where the tax is intended to compensate for the fact that the gains will be outside the taxing net when realised at a later date and where the allocation of residence which prevents tax from being imposed (i.e., under the treaty), however, it does highlight the fact that a provision tying domestic residence to treaty residence is likely to have implications for the application of other provisions of domestic law. These implications should be taken into account in determining whether to implement such a provision and in drafting the provision itself.

States may also be reluctant to include a deemed non-residence provision in their domestic law for fear of relinquishing taxing revenue unnecessarily, given that residents tend to be taxed on a broader range of income than non-residents. However, there are likely to be few items of income which can be taxed in the losing residence state under the treaty between the two residence states but which would not be taxable in that state under domestic law when derived by a non-resident. Sasseville, after discussing the benefits of this type of provision, notes that it might well be "counter-intuitive for a tax administration to prefer that a person (company or individual) be considered a non-resident rather than a resident" particularly in light of the additional reporting obligations usually imposed on resident persons.

It should also be borne in mind, however, that a deemed non-residence provision may in some cases be advantageous for domestic purposes. The Canadian provision, for example, was introduced not to deal with claims for treaty benefits by dual-residents, but to deal with the insertion of dual-resident holding companies between Canadian companies and their US parent companies for the purpose of avoiding

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1260 Couzin, R., Corporate Residence..., at p. 215 (Section 4.2.3.4.).
1261 Couzin, R., Corporate Residence..., at pp. 213-218.
1262 Couzin, R., Corporate Residence..., at pp. 213-214.
1263 Couzin, R., Corporate Residence..., at pp. 213-214.
1264 Couzin, R., Corporate Residence..., at p. 214.
1265 Couzin, R., Corporate Residence..., at p. 214.
1266 Couzin, R., Corporate Residence..., at pp. 216-217. Couzin also discusses a special tax imposed on a company becoming a non-resident by reference to the amount by which the company's net assets exceed its paid up capital. He notes that this special tax is, in effect, a surrogate for the dividend withholding tax that would be imposed if the company had distributed all its assets on liquidation, and is imposed at the same rate.
1267 Couzin, R., Corporate Residence..., at pp. 216-217.
1268 Sasseville, J., "A Tax Treaty Perspective...", at p. 48 (Chapter 3, Section 3.4.).

Canadian withholding tax on dividends. Thus, this type of provision may prevent other types of tax avoidance by preventing dual resident persons who are resident in another state for treaty purposes from claiming certain benefits which would otherwise be available under domestic laws. Resident companies may, for example, be able to obtain benefits under group relief or consolidation provisions, provisions exempting inter-corporate dividends, provisions that restrict withholding taxes to non-residents, provisions that allow residents to claim relief from international double taxation, or under provisions allowing certain deductions or granting allowances exclusively to residents. In relation to individuals, the benefits available to residents may include personal allowances and the application of progressive tax rates.

Ultimately, the decision as to whether a provision deeming a dual resident whose residence is assigned to another state under a treaty to be a non-resident for domestic purposes should be implemented in a particular state will most likely come down to the impact it would have on the application of the domestic laws of that state. While a provision along these lines would certainly be a good way of dealing with (improper) claims for treaty benefits 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. This is particularly evident given that this type of provision does not allow the state implementing it to refuse to apply reductions in source-based taxation to companies which are dual-resident elsewhere. In a treaty context the beneficiary of such a provision is not the state that implements it, but rather, the other states with which that state has concluded tax treaties.

11.3.2. Provisions included in tax treaties

Dual resident entities could be prevented from claiming treaty benefits under treaties concluded by their losing residence state with third states under specific provisions included in tax treaties. Such provisions could either clarify the application of the second sentence of Article 4(1) or, alternatively, could deny treaty benefits on the basis of a direct reference to the allocation of residence to a third state under a treaty with that third state. These two options will be discussed in turn below.

11.3.2.1. Alternative second sentence of Article 4(1)

The second sentence of Article 4(1) of the 2006 US Model Treaty provides as follows:

"This term ["resident of a contracting state"], however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State."

The Technical Explanation indicates that this reference to the profits attributable to a PE is intended to ensure that PEs cannot be considered to be residents for the purposes of the treaty. However, it may also forestall some of the issues discussed above in relation to determining the source of income for the purposes of applying the second sentence of Article 4(1), given that it is in cases where there is a PE in

\[1269\] Couzin, R., Corporate Residence..., at pp. 208-209 (Section 4.2.3.2.).
\[1270\] Sasseville, J., "A Tax Treaty Perspective..." at p. 47 (Chapter 3, Section 3.4.).
\[1271\] Sasseville, J., "A Tax Treaty Perspective..." at p. 47 (Chapter 3, Section 3.4.).
\[1272\] 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. 21-218 (Sections 4.2.3.3. and 4.2.3.4.).
\[1273\] 2006 U.S. Model Technical Explanation, p. 14. The Technical Explanation states that: "A person who is liable to tax in a Contracting State only in respect of income from sources within that State or capital situated therein or of profits attributable to a permanent establishment in that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, a consular official of the other Contracting State who is posted in the United States, who may be subject to U.S. tax on U.S. source investment income, but is not taxable in the United States on non-U.S. source income (see Code section 7701(b)(5)(B)), would not be considered a resident of the United States for purposes of the Convention. Similarly, an enterprise of the other Contracting State with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise generally is subject to U.S. tax only with respect to its income that is attributable to the U.S. permanent establishment, not with respect to its worldwide income, as it would be if it were a U.S. resident."
the losing residence state where the most difficult questions arise. By addressing the most obvious case of income which may be considered to be sourced in a third state, this alternate wording may make it easier to deny treaty benefits under the second sentence of Article 4(1). It does not, however, resolve the issues surrounding the determination of the source of income in a more general sense and, in addition, questions may remain regarding whether treaty limitations should be taken into account or whether consideration should be limited to domestic law. For these reasons, although this wording is an improvement on that of the OECD Model, it is not the preferred approach for preventing dual residents from claiming the benefit of treaties concluded by the losing residence state with third states.

11.3.2.2. Provision referring directly to treaties with third states

As an alternative to altering the wording of Article 4(1), treaties could include a provision which denies treaty benefits by direct reference to the allocation of residence under treaties concluded with third states. Such a provision could be worded as follows:

"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."

This provision is designed to be included in the residence article of the treaty (i.e., Article 4 or its equivalent) and operates where the treaty in which it is included is the treaty between the losing residence state and the source 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. It avoids, for example, the difficult interpretive questions regarding source of income that may arise if states seek to deny treaty benefits under the second sentence of Article 4(1). It is also effective only for treaty purposes, so does not give rise to the issues discussed above with respect to the interaction between a domestic deemed non-residence provision and other provisions of domestic law. 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 a substantial period of time can elapse before a treaty is renegotiated. This makes this approach ineffective as a short-term solution.

One of the issues which may arise if the operation of the L-S treaty is completely excluded is that unrelieved double taxation may arise in situations where the losing residence state is entitled to impose tax on the income in accordance with the terms of the treaty between the two residence states, e.g., where there is a PE in that state. This suggests that either treaty benefits should be available in relation to third state income attributable to PEs (i.e., the application of the PE-S treaty in PE triangular cases) or, otherwise, the L-S treaty should continue to require the losing residence state to grant relief to the extent that that state is entitled to impose tax under the treaty between the two residence states. Such a provision could be worded as follows:

"Where paragraph X [the paragraph denying treaty benefits] applies, the Contracting State where the person would otherwise be resident shall continue to apply [Article 23A / Article 23B] as though that person were a resident of that State, and as though the Convention had been applied as such in both Contracting States."

This provision would require the losing residence state to grant relief for tax imposed in the source state, but would limit that relief in circumstances where the source state would have imposed less (or no) tax if it had applied the L-S treaty. That is, no relief would be required if the source state would have been prevented from imposing tax on the income if it had applied the L-S treaty and, if the credit method applies, the amount of the credit will be limited to the amount of tax that the source state could have imposed in the absence of the L-S treaty.

1274 Note that if the contracting states are concerned about being obliged to grant relief in excess of the tax that the losing residence state would be entitled to impose under the treaty between the two residence states (i.e., because the restriction on that state’s taxing rights under the treaty is not taken into account for the purposes of determining the relief available), then they could include a specific provision to avoid the risk of this occurring. However, on the basis of the analysis conducted in Chapter 3 (where it was concluded that when applying the relief provisions of one treaty, any restriction on the residence state’s taxing rights should be taken into account – see Section 3.3.), such a provision should not be necessary.
imposed if it had applied the conditions of the L-S treaty in relation to the income. The relief will also naturally be limited to the amount of tax imposed in the source state and the amount of tax imposed in relation to the income in the residence state by the provisions of Article 23A or Article 23B, as applicable.

### 11.3.3. Conclusions

States should be encouraged to include provisions in their domestic law to the effect that a person will not be resident in that state if their residence is assigned to another state under a tax treaty. This is a simple and effective approach, but it has the disadvantage that such a provision does not allow the state implementing it to deny treaty benefits to dual residents. It is also important to take into account the interaction between this type of provision and the other provisions of domestic law. From a treaty perspective, its effect is instead felt in that state’s treaty partners. Thus, from the perspective of the state considering whether to implement such a provision, the consequences under domestic law are likely to take precedence over treaty considerations. A better approach, and one which may be much easier to implement in certain states, 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 with a third state. This is a clear and direct approach, and avoids the difficult interpretive questions associated with denying treaty benefits under the second sentence of Article 4(1). It would, however, require the renegotiation of tax treaties (or at least the negotiation of a protocol) and thus its full implementation would likely take decades.

### 11.5. Conclusions

Concern regarding improper access to tax treaties by dual-residents has led to the development of the view, expressed in the OECD Commentary on Article 4, that a dual resident will not be resident in the losing residence state for the purposes of treaties with third states as a result of the second sentence of Article 4(1). However, it is not clear that the treaty limitations should be taken into account for the purposes of applying this provision and its wording is open to two differing interpretations. In the context of a dual resident deriving income arising in a third state and attributable to a PE in the losing residence state, for example, the dual resident is, on one hand, taxable only on income that is sourced in State L, since it is not taxed on any income that is not sourced in State L, but equally, the dual resident is not taxable only on income sourced in State L, since it is also taxable on certain income that is sourced in third states. Given the amorphous nature of the source concept and the uncertainty in applying the second sentence of Article 4(1), it is not a good way of denying treaty benefits to dual-residents, although it does have the practical advantage that it relies on the wording of existing treaties.

One 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. This is a simple and effective approach, but it has the disadvantage that such a provision does not allow the state implementing it to deny treaty benefits to dual residents. From a treaty perspective, its effect is instead felt in that state’s treaty partners who are then able to deny treaty benefits when the state implementing the provision is the losing residence state. States should be encouraged to implement such provisions but, from the perspective of the state considering whether to implement such a provision, the consequences under domestic law are likely to take precedence over treaty considerations.

A better alternative 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 that third state, i.e., by providing that they are not residents for the purposes of the treaty. This is a clear and direct approach, but it would require the renegotiation of tax treaties and thus its full implementation would likely take decades. This makes it problematic as a short term solution but, nevertheless, it would certainly be the best approach in the long term.

One of the issues associated with completely excluding the operation of this treaty is that unrelieved double taxation may arise in situations where the losing residence state is entitled to impose tax on the income in accordance with the terms of the treaty between the two residence states, e.g., where there is a
PE in that state. Such cases are effectively PE triangular cases; an entity resident in one state (the winning residence state) derives income which is attributable to a PE located in another state (the losing residence state) and which arises in a third state. The ideal solution would therefore be to deny treaty benefits to dual-resident companies (i.e., under the treaty between the losing residence state and the source state) but to allow treaty benefits in relation to income attributable to a PE in the losing residence state. In this way, the L-S treaty would generally apply only in circumstances where the losing residence state would be entitled to impose tax on the income in accordance with the terms of the treaty between the two residence states.
Chapter 12

Reverse triangular cases

12.1. Introduction

Reverse triangular cases occur where a person who has a connection to two separate states pays an amount which forms part of the income of a resident of a third state. There are two types of reverse triangular cases, distinguished by the nature of the connection between the payor and the source states, namely, reverse PE triangular cases\(^{1275}\) and reverse dual resident triangular cases.\(^{1276}\) In a reverse PE triangular case, the payor is resident in one state and the payment originates from a PE in another state. In a reverse dual resident triangular case, the payor is resident in two states under their respective domestic laws and for treaty purposes and is therefore a dual resident. These situations stand in contrast to the situations discussed throughout the earlier chapters in that it is the payor, rather than the recipient of income who has a connection to more than one state. They are, in effect, a mirror image.

The main issue in reverse triangular cases is the potential for the income to be subject to source-based taxation in more than one state. In a reverse PE triangular case, both the residence state and the PE state of the payor may seek to impose source-based taxation. Similarly, in a reverse dual resident triangular case, both residence states of the payor may seek to impose tax on payments made by the dual resident. Both these situations may therefore lead to dual source-based taxation, at least in the absence of any applicable treaty limitation. As will be seen below, however, in both types of reverse triangular cases the person deriving the income will be entitled to claim the benefit of the treaties between its residence state and the two source states and consequently, dual source based taxation will generally only occur in relation to passive income, such as dividends, interest and royalties. The discussion in this chapter therefore focuses primarily on situations involving these types of income, although it will also outline the result of the application of tax treaties where other categories of income are involved.

Where source-based taxation is imposed in two states in accordance with the terms of the treaties between those states and the residence state of the recipient, the residence state of the recipient will generally be obliged to provide relief for tax imposed in both those states.\(^{1277}\) This relief could take the form of either a credit or an exemption, but in the case of passive income it would usually be in the form of a credit even if the general method of relief used in the treaty is the exemption method.\(^{1278}\) Where taxation is imposed on a source basis in two different states, however, the residence state of the person receiving the income may not be capable of providing sufficient relief and unrelieved double taxation may arise.\(^{1279}\) The only way of preventing such unrelieved double taxation would be to limit the amount of tax imposed on a source basis. This could be done by limiting the amount of tax imposed in each of the source states to a sufficiently low amount, or by preventing one of the source states from imposing tax so

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\(^{1277}\) In accordance with Article 23A / Article 23B of its treaties with each of the source states.

\(^{1278}\) Article 23A (dealing with the exemption method) requires the residence state to provide a credit in relation to income taxable in the other contracting state under Article 10 (dividends) or Article 11 (interest). In concluded treaties that (unlike the OECD Model) allow source-based taxation of royalties, this provision generally also refers to income taxable under Article 12 (i.e., royalties).

\(^{1279}\) 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.
that source-based taxation is imposed in only one state. If the residence state is capable of providing sufficient relief, then the case for preventing one of the source states from imposing tax may not be as strong and indeed, both states may have a legitimate claim to impose tax based on the link between the payment and their jurisdiction. Nevertheless, the risk of unrelieved double taxation suggests that dual source-based taxation should generally be prevented wherever possible, and this chapter will proceed on that basis.

Scope and assumptions
Reverse triangular cases can also give rise to double taxation if one or both of the source states fails to allow a deduction for business expenses, such as commissions or service fees, paid to a resident of a third state. Where such payments are taxable in the residence state of the recipient this can effectively lead to economic double taxation. This issue is not dealt with in this chapter for two reasons. Firstly, this issue can also arise in bilateral situations, e.g., where a resident of one state makes a payment to a resident of another state. Thus, although the quantum of the economic double taxation may be greater where there are two source states, this is not an issue that is unique to reverse triangular cases. Secondly, the non-deductibility of business expenses gives rise to economic rather than juridical double taxation, which is outside the scope of the OECD Model, and also outside the scope of this study. This chapter therefore focuses solely on the potential unrelieved double taxation that may occur as a result of two states imposing source-based taxation where payments are made by a dual resident or by a person who is resident in one state but has a PE in a second state from which the payment originates.

The analysis in this chapter deals only with certain categories of income identified in the OECD Model, namely, business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12), income from immovable property (Article 6), income from shipping, inland waterways transport and air transport (Article 8), capital gains (Article 13) and other income (Article 21). It does not discuss income from employment (Article 15), directors’ fees (Article 16), income of artists and sportsmen (Article 17, although Article 17 is discussed briefly in relation to business income), pensions (Article 18), government service (Article 19) or students (Article 20), which are outside the scope of this study.

Throughout this chapter it is assumed that bilateral tax treaties have been concluded between all the relevant states. It is further assumed that all these treaties follow the OECD Model except where specifically stated.

Abbreviations
In this chapter, the state where the recipient of the income is resident is referred to as “State R” in both reverse PE triangular cases and reverse dual resident triangular cases. In reverse PE triangular cases, the state where the payor of the income is resident is referred to as the “head office state” or “State HO” and the state where the PE from which the payment originates is located is referred to as the PE state or “State PE.” State HO and State PE are sometimes referred to collectively as the “source states.”

In reverse dual resident triangular cases, the two residence states of the payor are referred to either as “State A” and “State B” or, when discussing situations where the tie-breaker rule of the treaty between the two residence states has assigned residence to one state, as the winning residence state (“State W”) and the losing residence state (“State L”). These two states are also referred to collectively as the “source states” when discussing reverse dual resident triangular cases.

12.2. Reverse PE triangular cases
Reverse PE triangular cases occur where a person who is resident in one state (generally referred to as the "head office state" or "State HO") makes a payment which originates from a PE of the payor located in a second state (the "PE state" or "State PE") and which is received by a resident of a third state (the "recipient state" or "State R"). It is assumed that the recipient of the income does not have a PE in either State HO or State PE. This situation is illustrated in the following diagram.
In this situation it is assumed that both State HO and State PE view the income as locally sourced income under their respective domestic laws and that both states seek to impose tax on the recipient of the income, either by assessment or by withholding at source. It is also assumed that the recipient's residence state will seek to impose tax on the income on a residence basis. Thus, in the absence of any applicable tax treaties, tax could be imposed in State HO, State PE and State R. State R may provide double taxation relief under its domestic law, however for the purposes of the analysis below it will be assumed that no such unilateral relief is available.

**Applicable treaties**

In a reverse PE triangular case, the recipient of the income will be entitled to claim the benefit of the treaties which its residence state has concluded with each of the two source states. The applicable tax treaties in this case will therefore be:

(i) the treaty between the recipient's residence state and the head office state of the payor (the "R-HO treaty"); and

(ii) the treaty between recipient's residence state and the PE state of the payor (the "R-PE treaty").

For the purposes of both these treaties, the person receiving the income will be resident in State R and, as a result, may claim reductions in source based taxation in both State HO and State PE. The treaty between State HO and State PE (the "HO-PE treaty") will generally not apply because for the purposes of this treaty the recipient of the income is not resident in either of the contracting states.

The discussion of reverse PE triangular cases in this chapter deals firstly with situations involving dividends (in Section 12.2.1.), before moving on to deal with situations involving interest and royalties (in Section 12.2.2.) and finally, other categories of income (in Section 12.2.3.).

### 12.2.1. Dividends

In this situation the payor of the dividends, resident in State HO, has derived profits which are attributable to a PE in State PE, and has paid those profits out in the form of dividends to a resident of a third state, State R. A reverse PE triangular case involving dividends is illustrated in the following diagram.

*Figure 12.2.: Reverse PE triangular case involving dividends*
12.2.1.1. Application of tax treaties under the existing treaty framework

As will be seen below, the application of tax treaties will generally prevent dual source-based taxation of dividends in reverse PE triangular cases. Article 10 applies to dividends paid by a resident of one contracting state to a resident of the other contracting state, and allows the state of the payor to impose a limited rate of tax on the gross amount of the dividend.1280 Such tax is typically imposed by way of a withholding tax. In a reverse PE triangular case, therefore, the residence state of the payor will generally be entitled to impose tax on the dividends under Article 10 of its treaty with the residence state of the person receiving the dividends (i.e., the R-HO treaty). Article 10 will not apply, however, for the purposes of the treaty between the recipient’s residence state and the PE state (the R-PE treaty) because the dividend is not paid by a resident of State PE. Instead, the income will fall under either Article 7 or Article 21 of the treaty depending upon whether or not it is considered to be business profits.1281 Regardless of which of these two articles applies, the PE state will be prevented from imposing any tax on the dividends, since that the recipient of the income does not have a PE in the PE state.1282 Thus, source based taxation can only be imposed in State HO. State R may also impose tax but will be obliged to provide relief for tax imposed in State HO (under the R-HO treaty). There will therefore be no unrelieved double taxation.

Article 10 also contains a specific paragraph (Article 10(5)) which prevents a contracting state from imposing tax on dividends paid by a resident of the other contracting state, except in situations where those dividends are received by a resident of the state seeking to impose tax or are attributable to a PE in the first mentioned state.1283 Article 10(5) of the treaty between State HO and State PE may therefore also potentially prevent taxation in the PE state in a reverse PE triangular case.1284 However, given that the PE state will already be prevented from taxing the dividend under Article 7 or Article 21 of the treaty with the recipients residence state, it would generally not be necessary to apply Article 10(5) to prevent the PE state from imposing tax.1285 Article 10(5) will be discussed further in the context of reverse dual resident triangular cases (see Section 12.3.1.), and that discussion would also be relevant in reverse PE triangular cases if, for example, there is no treaty between the PE state and the residence state of the person receiving the income.

12.2.1.2. Policy considerations

One question which deserves to be raised in respect of reverse PE triangular cases involving dividends is whether the taxation of such income in the residence state of the payor, and not in the PE state, is appropriate or whether the PE state should be entitled to impose tax on dividends paid out of the profits attributable to the PE. It could be argued that if the PE is to be treated in the same way as a separate enterprise,1286 then the PE state should be entitled to impose tax on distributions of the PE’s profit.1287

1280 Refer to Article 10(1) and Article 10(2) of the OECD Model.
1281 Avery Jones, J.F., et al., “Tax Treaty Problems….” Article 7, titled “Business Profits,” applies to “Profits of an enterprise of a Contracting State…” (Article 7(1)), and allows source based taxation only in relation to business profits which are attributable to a PE in the source state. Article 21, titled “Other Income,” applies to “Items of income… not dealt with in the foregoing articles of this Convention…” (Article 21(1)). Article 21 does not allow any source-based taxation, however if the income is attributable to a PE in the source state, Article 7 will apply instead of Article 21 as a result of Article 21(2).
1283 Article 10(5) provides that: “Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other Contracting State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State.”
1286 As proposed in earlier chapters. Refer to Chapter 5 for discussion of the similarities between PEs and resident enterprises and for arguments supporting a more residence-like treatment of PEs. Refer also to Chapter 7 and Chapter 8, for discussion of the proposed extension of treaty benefits to PEs.
However, if this approach were accepted it would arguably entitle the PE state to impose tax on notional profit distributions (dividends) from the PE to the rest of the enterprise, rather than dividends paid by the enterprise as a whole. This would raise a number of serious difficulties, particularly in determining the timing and amount of any such notional distributions.1288 Allowing the PE state to impose tax on (part of) the dividends paid by the company as a whole, e.g., as a proxy for imposing tax on notional dividends, would also require a determination of the timing and amount of the dividends which should be considered to be paid from the profit attributable to the PE. This is likely to be very difficult and, in many cases, arbitrary, since dividends are paid from the overall net profit of the company which is likely to have been derived over various periods and from various sources. In addition, the residence state arguably has the stronger claim to imposing source-based taxation on dividends given that, from a company law perspective, the declaration (and payment) of dividends is an integral activity of the company itself and of its management, and thus has a strong connection to the organisation and residence of the company as a whole, whether that be based on incorporation or, for example, on the place of effective management. Thus, it is appropriate that in reverse PE triangular cases involving dividends, source-based taxation may only be imposed in the residence state of the payor. Since this result generally arises under the existing treaty framework, there is no need for any changes to deal with reverse PE triangular cases involving dividends.

12.2.2. Interest and royalties

In a reverse PE triangular case involving interest or royalties, a person who is resident in State HO makes a payment of interest or royalties which originate from a PE in State PE, and the interest or royalties form part of the income of a resident of a third state, State R. A reverse PE triangular case involving interest or royalties is illustrated in the following diagram.

*Figure 12.3.* Reverse PE triangular case involving interest

Article 11 allows interest "arising" in a particular state (and paid to a resident of the other contracting state) to be taxed in the state where it arises.1289 However, the amount of tax that can be imposed in the source state is limited to a certain specified percentage of the gross amount of the income; the rate is 10% in the OECD Model but commonly varies between concluded treaties. Such tax is typically imposed by way of a withholding tax on the gross amount of the income. Whether interest "arises" in a particular state is determined in accordance with Article 11(5). Under Article 11(5), interest will be considered to arise in a particular state if (i) it is paid by a resident of that state or (ii) if the payment originates from a PE located in that state. The interpretation and application of this provision will be the main focus of the discussion below.

Royalties are dealt with in Article 12 of the OECD Model. Under Article 12, a contracting state cannot impose any tax on royalties arising in that state and beneficially owned by a resident of the other contracting state unless those royalties are attributable to a PE of the recipient in the state where the royalties arise (in which case Article 7 applies).1290 In the UN Model treaty, however, as well as in many

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1287 This was discussed in greater detail in Chapter 9 (see Section 9.3.2.4.).
1288 For a more detailed discussion, see Chapter 9 (Section 9.3.2.4.).
1289 Refer to Article 11(1) and Article 11(2) of the OECD Model.
1290 Article 12(1) provides that: “Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.” If, however, the royalties are attributable to a PE of the recipient in the source state, then Article 7 will apply instead of Article 12 as a result of Article 12(3).
concluded treaties, royalties are taxable on a source basis in a similar way to dividends and interest.\textsuperscript{1291} That is, royalties "arising" in a particular state and paid to a resident of the other contracting state may be taxed in the state where they arise with the amount of tax being limited to a certain percentage of the gross amount of the income.

There is no guidance in the OECD Model regarding when royalties will be considered to arise in a particular state. This is not particularly strange since it will generally make no difference whether the royalties arise in the non-residence state (in which case Article 12 applies) or whether they are considered to arise elsewhere (in which case Article 7 or Article 21 will apply).\textsuperscript{1292} In either case the non-residence state will be prevented from imposing tax unless the royalties are attributable to a local PE. Nevertheless, where Article 12 (or its equivalent) does allow source based taxation of royalties, it is important to determine whether royalties arise in a particular state because that will govern whether that state can impose taxation under Article 12, or whether it is prevented from imposing taxation under Article 7 or Article 21.\textsuperscript{1293} The approach taken in the UN Model for determining where royalties arise is similar to that taken by Article 11(5) of the OECD Model in relation to interest. That is, royalties will be considered to arise in a particular state if they are paid by a resident of that state or are connected with a PE of the payor located in that state.\textsuperscript{1294} The discussion below will focus on primarily on interest payments and the interpretation of Article 11(5) in the context of reverse dual resident triangular cases. However, it should be borne in mind that this discussion will apply equally to royalties if the treaties which State R has concluded with State HO and State PE both allow source based taxation of royalties and determine where royalties arise on the basis of a provision similar to Article 11(5).\textsuperscript{1295} For treaties that don't contain a provision equivalent to Article 11(5), similar principles may be applied but it is difficult to generalize and the place where royalties should be considered to arise may need to be determined on a case-by-case basis. For the purposes of the discussion below, it will be assumed that wherever a particular treaty allows source-based taxation of royalties, the determination of where royalties arise will be based on the principles of Article 11(5).

12.2.2.1. Application of Article 11(5)

Article 11(5), which determines whether interest "arises" in a particular state for the purposes of Article 11, provides as follows:

"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 in a Contracting State a permanent establishment in connection with which the indebtedness on 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."

Thus, there are two basic rules for determining where interest income "arises" for the purposes of Article 11. Interest will arise in a particular state if (i) it is paid by a resident of that state or (ii) if it is connected with a PE of the payor which is located in that state (i.e., the payor of the interest has a PE in that state "in connection with which the indebtedness on the interest is paid was incurred, and such interest is borne by such permanent establishment"). In a reverse PE triangular case, this results in the interest being considered to arise in two different states for the purposes of the two applicable treaties. For the

\begin{itemize}
\item \textsuperscript{1291} UN Income and Capital Model Convention (2001), Article 12(2).
\item \textsuperscript{1292} Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 776, (m.no. 20).
\item \textsuperscript{1293} Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 776, (m.no. 20).
\item \textsuperscript{1294} Article 12(5) of the UN Model Treaty (2001) provides that: "Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."
\item \textsuperscript{1295} If one or both of these treaties prevent source based taxation of royalties, then no dual source-based taxation will arise. Thus, the potential for unrelieved double taxation arises only where both the applicable treaties allow source-based taxation of royalties.
\end{itemize}
purposes of the treaty between the residence state of the person receiving the income and the PE state (the R-PE treaty), the interest will be considered to arise in the PE state in accordance with the second sentence of Article 11(5), since it is connected with a PE of the payor located in that state. It is not necessary for the payor to be resident in one of the contracting states in order for this rule to apply ("whether he is a resident of a Contracting State or not"). As a result of the interest arising in the PE state, Article 11 of the R-PE treaty will apply and will allow the PE state to impose tax on the income, albeit at a limited rate.

In the context of the treaty between the residence state of the payor of the interest and the residence state of the recipient (i.e., the R-HO treaty), the interest will be considered to arise in the residence state of the payor in accordance with Article 11(5), because it is paid by a resident of that state. This is the case notwithstanding that the interest payment is connected with a PE of the payor, because the PE is not located in either of the contracting states and thus, the rule deeming the interest to arise in the state where the PE is located does not apply. In this respect, the OECD Commentary provides that:

"Paragraph 5 provides no solution for the case, which it excludes from its provisions, where both the beneficiary and the payer are indeed residents of the Contracting States, but the loan was borrowed for the requirements of a permanent establishment owned by the payer in a third state and the interest is borne by that establishment. As paragraph 5 now stands, therefore, only its first sentence will apply in such a case...

The Contracting State of the payer's residence does not, therefore, have to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne."

Thus, for the purposes of the treaty between the payor's residence state and the recipients residence state, the interest is considered to arise in the payor's residence state (State HO), and that state may impose source based taxation under Article 11 of that treaty. Prior to the 2005 update, the OECD Commentary contained comments suggesting that Article 11(5) of the treaty between the PE state and the residence state of the payor (the HO-PE treaty) could potentially prevent the residence state of the payor (State HO) from imposing tax. The commentary implied that Article 11(5) of the HO-PE treaty would deem the interest to arise in the PE state, and that the residence state of the payor would therefore be prevented from imposing tax. However, the HO-PE treaty does not apply to the income derived in this situation, since the recipient of the income is not resident in either of the contracting states, and it is therefore difficult to see how Article 11(5) of that treaty could apply. Even if the HO-PE treaty did apply, the determination of the place where the interest arises for the purposes of that treaty would have no impact on where the interest should be considered to arise for the purposes of applying other treaties, i.e., the R-HO treaty and the R-PE treaty, which must be determined under Article 11(5) of those other treaties.
The comments contained in the OECD Commentary were therefore clearly wrong and, as indicated above, were removed in the 2005 update.

The overall result in a reverse PE triangular case involving interest is that source-based taxation may be imposed in both the residence state of the payor (State HO) and the PE state (State PE) under Article 11 of their respective treaties with the residence state of the recipient. State R may also impose tax but will be obliged to provide relief for the tax imposed in both State HO and State PE under its treaties with those states. Given that the income is interest income, State R will generally use the credit method of relief regardless of the general method of relief used in the treaty. Depending on the rates of tax imposed in each of the source states relative to the amount of tax imposed in the residence state, the expenses (if any) associated with the interest, and the applicable credit limitations, the residence state may not be able to fully relieve the double taxation.

12.2.2.2. Potential solutions

To resolve reverse PE triangular cases, either the PE state or the residence state of the payor should be prevented from imposing source-based taxation. Of these two states, it seems more appropriate to prevent taxation in the residence state since the interest must have a significant economic connection to the activities of the PE (and thus the PE state) in order to be borne by the PE. This is further supported by the fact that the terms of Article 11(5) give priority to the PE state in bilateral situations. Thus, the potential solutions discussed in this section will focus on ways in which the residence state of the payor could be prevented from imposing source-based taxation on the payment of interest in reverse PE triangular cases.

The best way to prevent the payor's residence state (State HO) from imposing tax would be through provisions included in the treaty between that state and the residence state of the recipient (the R-HO treaty). It may also be possible for State HO to be prevented from imposing tax by including specific provisions in the HO-PE treaty, but this is likely to give rise to uncertainty regarding whether the recipient of the income, a resident of a third state, would be entitled to claim the benefits of those provisions given the limitation of the personal scope of the treaty under Article 1. It would also require anyone trying to determine how much tax can be imposed in the residence state of the payor (State HO) to consult multiple treaties, and gives rise to the possibility that the provisions of the two treaties would somehow fail to interact properly. Given these considerations, the best approach is clearly to deal with reverse PE triangular cases under provisions included in the R-HO treaty.

One way of preventing State HO from imposing tax in reverse PE triangular cases is 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 state is not one of the contracting states. As a result, the interest would not be considered to arise in the PE state even if the PE state is not one of the contracting states. As a result, the interest would not be considered to arise in the PE state even if the PE state is not one of the contracting states. As a result, the interest would not be considered to arise in the PE state even if the PE state is not one of the contracting states. As a result, the interest would not be considered to arise in the PE state even if the PE state is not one of the contracting states. As a result, the interest would not be considered to arise in the PE state even if the PE state is not one of the contracting states.

1304 Avery Jones, J.F., et al., "Tax Treaty Problems…"; Jakobson, C., "Payment of Interest…," at p. 84; Hattingh, P.J., "The Role and Function…".
1305 Refer to: OECD Model, Article 23A(2) and Article 23B.
1306 Refer to: OECD Model, Article 23A(2) and Article 23B.
1307 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.
1308 Refer to the discussion in Chapter 5 regarding the attribution of profits to PEs (see Section 5.2.5.), demonstrating the extent of the economic connection that will be required in order for income (or expenses) to be attributable to a PE.
1309 See: Hattingh, P.J., "The Role and Function…."
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."\(^{1310}\) [Emphasis added.]

This type of provision is routinely included in tax treaties concluded by Australia, and has also been included in some treaties concluded by various other states.\(^{1311}\) The problem with this approach, and the reason why this alternative wording is not included in the OECD Model, is that preventing the payor's residence state from imposing tax may lead to the income escaping source-based taxation altogether (i.e., if the PE state does not impose tax), which could potentially create opportunities for tax avoidance.\(^{1312}\) This issue could be dealt with by limiting the circumstances in which the residence state would be prevented from imposing tax.\(^{1313}\) Avery Jones (et al.) write:

"It seems to us that the alternative wording given by the Commentary provides the best solution, although it could be improved by a variation to the effect that the payor's residence state only gives up its right to tax if the permanent establishment state exercises its right to tax the interest, because otherwise the source state gives up its right to tax in favour of the residence state, which would not have to credit any source tax imposed by either the payor's residence state or the permanent establishment state. This solution could be limited to cases where there are treaties between all three states in order to prevent the problem of permanent establishments in tax havens imposing a small charge to tax. Possibly there could also be a requirement that the permanent establishment state must not charge substantially less than the rate of tax which the payor's residence state would have charged."\(^{1314}\)

These suggested limitations on the situations in which the payor's residence state would be prevented from imposing tax would address the concern that the residence state would give up taxing rights unnecessarily or that tax avoidance opportunities would be created. Another alternative would be for the payor's residence state to reduce the amount of withholding tax that it imposes by the amount imposed in the PE state, although this would perhaps be unnecessarily complicated. Ultimately, the exact wording of the provision would 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. But, more generally, it should be possible to overcome the objections to preventing the residence state of the payor from imposing source-based taxation in reverse PE triangular cases.

12.2.2.3. Applicable PE definition for the purposes of Article 11(5)

For the purposes of Article 11(5), the applicable permanent establishment definition is that contained in Article 5 of the treaty which is currently being applied.\(^{1315}\) As Article 11(5) of the OECD Model is currently worded, the paragraph referring to PEs applies only where the PE is located in one of the contracting states and the existing wording of the PE definition can generally apply without any

\(^{1310}\) 2010 OECD Commentary on Article 11, para 30.

\(^{1311}\) See: Avery Jones, J.F., et al., "Tax Treaty Problems...," who give a detailed history and analysis of the inclusion of such provisions in tax treaties.

\(^{1312}\) 2010 OECD Commentary on Article 11, para 29.

\(^{1313}\) Avery Jones, J.F., et al., "Tax Treaty Problems...".

\(^{1314}\) Avery Jones, J.F., et al., "Tax Treaty Problems...".

\(^{1315}\) This follows from Article 5(1) (or the equivalent provision of the applicable tax treaties) which provides that, "For the purposes of this convention, the term 'permanent establishment' means..." The PE definition contained in Article 5 therefore applies wherever the term "permanent establishment" is used in the treaty. This issue was also addressed in a case in Denmark in a triangular case involving the taxation of employment income under Article 15(2) (Poseidon Personnel Services S.A. v. Ministry of Taxation, 18th Dept., Case No. B 2581/05, published in TT3 2006, 635). For further discussion, see Chapter 8 (Section 8.2.3.).
significant problems.\textsuperscript{1316} If, however, the alternative wording of Article 11(5) (discussed above) is included in a particular treaty then it may require a determination of whether a PE exists in a third state. Where this occurs, it may be problematic to apply the PE definition of Article 5 because that definition is worded to apply bilaterally, and in several places makes reference to the contracting states.\textsuperscript{1317} Article 5(5), for example, dealing with agency PEs, refers to a person acting on behalf of an enterprise who "... has and habitually exercises, in a Contracting State an authority to conclude contracts..." [emphasis added]. Similar references can be found in Article 5(6), dealing with agents of independent status, and Article 5(7), dealing with companies that control or are controlled by a company in the other contracting state. Due to the way in which these paragraphs are worded, they may not be applicable in situations where Article 5 is being applied to determine whether a PE exists in a third state. This issue could be mitigated by a provision along the lines of that included in Article 5 (or its equivalent) of many Australian treaties, which reads as follows:

"The principles set forth in the preceding paragraphs of this Article shall be applied in determining for the purposes of paragraph 7 of Article 11 [equivalent to Article 11(5) of the OECD Model] and paragraph 5 of Article 12 [a similar provision applicable to royalties] whether there is a permanent establishment outside both Contracting States, and whether an enterprise, not being an enterprise of a Contracting State, has a permanent establishment in a Contracting State."\textsuperscript{1318}

This wording allows the PE definition to apply properly in situations where the definition is being applied to determine whether there is a PE in a third state, and thus resolves the difficulty in applying those parts of Article 5 that refer to the contracting states.\textsuperscript{1319} Alternatively, Article 5 could be amended such that the paragraphs referred to above use the phrase "in a State" rather than "in a Contracting State," which would provide an even clearer solution. This should also not give rise to any particular issues in applying the other articles of the treaty, since those that refer to the existence of a PE also generally make reference to the relevant contracting state.\textsuperscript{1320}

A separate issue is whether this is the appropriate PE definition to apply. Arguably, the more appropriate definition would be that contained in the treaty between the residence state of the payor (State HO) and the PE state (the HO-PE treaty), since it is the existence of a PE under this treaty which governs whether the "PE state" is entitled to impose tax on business income under Article 7 (and also whether it can impose tax on certain other categories of income on a net basis under Article 7 rather than under Article 10, Article 11, Article 12 or Article 21). If the PE definitions differ between the HO-PE treaty and either the R-HO treaty or the R-PE treaty, then it would not make sense for the PE state to be entitled to impose tax or for State HO to be prevented from imposing tax in situations where there is no PE for the purposes of the HO-PE treaty. Similarly, situations could arise where the PE state and the residence state of the payor (State HO) are either both prevented from imposing tax or are both entitled to impose tax under Article 11 as a result of inconsistent PE definitions. The better approach would therefore be for the R-HO treaty and the R-PE treaty to refer to the existence of a PE for the purposes of the HO-PE treaty in determining whether income is considered to be connected to a PE outside the payor's residence state.

Taking this into account, it is proposed that Article 11(5) be modified 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, for the purposes of the treaty between the State of which he is resident and that other State, a permanent establishment in connection with which the indebtedness on which the

\textsuperscript{1316} Although if the payment is made by a resident of a third state, the PE definition under the treaty between the PE state and the state where the recipient of the income is resident may differ from that contained in the treaty between the residence state and the PE state of the payor. Thus, a PE could exist for the purposes of one of those treaties but not for the other. This was discussed in more detail in Chapter 8 (Section 8.2.3.) and is also discussed briefly below.

\textsuperscript{1317} Avery Jones, J.F., et al., "Tax Treaty Problems..."

\textsuperscript{1318} This provision is taken from the Australia-New Zealand treaty of 2009 (Article 5(11)). See: Avery Jones, J.F., et al., "Tax Treaty Problems..."

\textsuperscript{1319} Avery Jones, J.F., et al., "Tax Treaty Problems..."

\textsuperscript{1320} See: OECD Model, Article 7(1), (2) and (3), Article 10(4) and (5), Article 11(4) and (5), Article 12(3), Article 13(2), Article 15(2), Article 21(2), Article 22(2), and Article 24(3),
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."

This provision, in combination with provisions preserving the residence state of the payor’s right to impose tax in situations where insufficient tax is imposed in the PE state, would ensure that interest would not be subject to dual source-based taxation in reverse PE triangular cases whilst also guarding against tax avoidance. In addition, it would ensure that the existence of a PE for the purposes of the treaty between the residence state of the payor and the purported PE state would be controlling, preventing possible mismatches between the application of different treaties.

12.2.3. Other categories of income

This section briefly outlines the effect of the application of tax treaties in reverse PE triangular cases involving categories of income other than those discussed above. As will be seen in the table below, dual-source based taxation will generally not occur in these cases and there will be no unrelieved double taxation.

Table 1: Application of tax treaties in reverse PE triangular cases

<table>
<thead>
<tr>
<th>Category of income and diagram</th>
<th>Application of the R-HO treaty</th>
<th>Application of the R-PE treaty</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business profits</strong>&lt;br&gt;Figure 12.1.: Reverse PE triangular case involving business profits</td>
<td>Article 7 applies and State HO is prevented from imposing tax.</td>
<td>Article 7 applies and State PE is prevented from imposing tax.</td>
<td>It is assumed that the recipient of the income does not have a PE in either of the source states. Both those states will therefore be prevented from imposing tax under Article 7 of their respective treaties with State R. There is no need for relief in State R. If the income is attributable to a PE in one of the source states, then the state where the PE is located would be entitled to impose tax on the profit attributable to the PE under Article 7. State R would be obliged to provide relief (either credit or exemption) in accordance with the treaty. There would be no unrelieved double taxation.</td>
</tr>
</tbody>
</table>
| **Income from immovable property**<br>(property located in State PE)<br>Figure 12.2.: Reverse PE triangular case involving income from immovable property | Article 7 or Article 21 applies and State HO will be prevented from imposing tax on the income. | Article 6 applies and State PE may impose tax on the income without limitation. State R will be obliged to grant relief (credit or exemption) in accordance with Article 23A/B. | For the purposes of the R-HO treaty, the immovable property is located in a third state and, as a result, Article 6 will not apply. The income will fall under the distributive rule of either Article 7 or Article 21 (depending on whether it is considered to be business profits); regardless of which article applies, State HO will be prevented from imposing tax. Note that it is assumed that the property is located in State PE; this is the most likely since, for example, the payor of the income may lease the
<table>
<thead>
<tr>
<th>Category of income and diagram</th>
<th>Application of the R-HO treaty</th>
<th>Application of the R-PE treaty</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="image1" alt="Diagram" /></td>
<td>Article 8 applies and State HO is prevented from imposing tax on the income.</td>
<td>Article 8 applies and State PE is prevented from imposing tax on the income.</td>
<td>Under Article 8, tax can only be imposed in the state where the place of effective management (&quot;POEM&quot;) is located. Given that the recipient of the income is resident in State R, it can be assumed that the POEM is located in State R. Both State HO and State PE will therefore be prevented from imposing any tax on the income under their respective treaties with State R and State R will have no obligation to provide relief.</td>
</tr>
<tr>
<td><strong>Income from shipping, inland waterways transport and air transport</strong></td>
<td><img src="image2" alt="Diagram" /></td>
<td>Article 8 applies and State HO is prevented from imposing tax on the income.</td>
<td>Article 13(5) applies and State HO is prevented from imposing tax on the capital gain. State R is obliged to provide relief (credit or exemption) in accordance with Article 23A/B of the treaty. Under Article 13(1) State PE will be entitled to impose tax on any capital gains arising from the alienation of immovable property located in that state.</td>
</tr>
<tr>
<td><strong>Capital gains arising from the alienation immovable property (property located in the PE state)</strong></td>
<td><img src="image3" alt="Diagram" /></td>
<td>Article 13(1) applies and State PE may impose tax on the capital gain.</td>
<td>For the purposes of this analysis it is assumed that the recipient of the income does not have a PE in either State HO or State PE. Article 13(2) will therefore never apply. If the recipient of the income did have a PE in one of those states, the state where the PE was located would be entitled to impose tax on any capital gains arising from the alienation of immovable property located in that state.</td>
</tr>
<tr>
<td><strong>Capital gains arising from the alienation of movable property which forms part of the business property of a PE.</strong></td>
<td>N/A</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Category of income and diagram</td>
<td>Application of the R-HO treaty</td>
<td>Application of the R-PE treaty</td>
<td>Comments</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>------------------------------</td>
<td>------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td>gains derived from the alienation of movable property forming part of the business property of the PE under Article 13(2) of its treaty with State R. State R would be obliged to provide relief in accordance with the terms of the treaty. The other source state would be prevented from imposing tax under Article 13(5) of its treaty with State R.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated movable property</td>
<td>Article 13(3) applies and State HO is prevented from imposing tax.</td>
<td>Article 13(3) applies and State HO is prevented from imposing tax.</td>
<td>Under Article 13(3), tax can only be imposed in the state where the place of effective management is located. Given that the recipient of the income is resident in State R, it can be assumed that the place of effective management is located in State R. State HO and State PE will therefore both be prevented from imposing any tax on the capital gain under their respective treaties with State R.</td>
</tr>
<tr>
<td>Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (underlying property located in State PE)</td>
<td>Article 13(5) applies and State HO is prevented from imposing tax on the capital gain.</td>
<td>Article 13(4) applies and State PE may impose tax on the capital gain. State R is obliged to provide relief (credit or exemption) in accordance with Article 23A/B of the treaty.</td>
<td>The state where the underlying property is located may impose tax in accordance with Article 13(4) of its treaty with State R. If the underlying property were located in State HO, Article 13(4) of the R-HO treaty would apply and State HO would be entitled to impose tax. State R would have a corresponding obligation to provide relief. State PE would be prevented from imposing tax. If the underlying property were located in State R, then both State HO and State PE would be prevented from imposing tax under Article 13(5) of their respective treaties with State R.</td>
</tr>
</tbody>
</table>

Figure 12.5.: Reverse PE triangular case involving capital gains dealt with under Article 13(3)

Figure 12.6.: Reverse PE triangular case involving capital gains dealt with under Article 13(4)
<table>
<thead>
<tr>
<th>Category of income and diagram</th>
<th>Application of the R-HO treaty</th>
<th>Application of the R-PE treaty</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other capital gains</td>
<td>Article 13(5) applies and State HO is prevented from imposing tax.</td>
<td>Article 13(5) applies and State HO is prevented from imposing tax.</td>
<td>Article 13(5) provides that any capital gains not referred to in other paragraphs of Article 13 can only be taxed in the residence state. Both State HO and State PE will therefore be prevented from imposing tax under Article 13(5) of their respective treaties with State R. State R has no obligation to provide relief.</td>
</tr>
<tr>
<td>Other income</td>
<td>Article 21 applies and State HO is prevented from imposing tax.</td>
<td>Article 21 applies and State HO is prevented from imposing tax.</td>
<td>Given that the recipient of the income does not have a PE in either State HO or State PE, both those states are prevented from imposing tax under their respective treaties with State R. State R therefore has no obligation to provide relief.</td>
</tr>
</tbody>
</table>

This table illustrates that there will be no dual source-based taxation in reverse PE triangular cases involving these categories of income. In some cases either the PE state or the HO state is entitled to impose source-based taxation under its treaty with State R, however this will not give rise to unrelieved double taxation because State R will generally be capable of providing sufficient relief (either credit or exemption). No particular issues arise in the scenarios considered in this section.

12.2.4. Conclusions

The issues that arise in reverse PE triangular cases arise because two states assert source-based taxing rights. However, provided that tax treaties have been concluded between all three states involved and that those treaties follow the OECD Model, reverse PE triangular cases will only give rise to potential unrelieved double taxation in the case of interest. For all other categories of income, only one of the source states (i.e., State HO or State PE), or neither of them, is entitled to impose tax on the income or gain under the applicable treaties with the residence state of the recipient of the income. In the case of interest, double taxation will only occur if tax is imposed in both the PE state and the HO state and the recipient’s residence state is unable to provide sufficient relief. This could also occur in relation to
royalties if the applicable treaties differ from the OECD Model and allow source based taxation of royalties, as is the case in many concluded treaties.

Double source-based taxation of interest in reverse PE triangular cases could be prevented by adopting the alternate wording of Article 11(5) contained in the OECD Commentary, which would prevent the interest from being considered to arise in the payor's residence state even where the PE to which the payment is connected is located in a third state. This approach could be improved, however, by limiting the circumstances in which the payor's residence state is prevented from imposing tax to those where the PE state imposes source based taxation on the interest. Additional caveats could also be included if the residence state remains concerned about tax avoidance or about unnecessarily giving up its taxing rights. A similar approach could also be taken to prevent double source-based taxation of royalties. The provision could be improved by altering the wording such that the PE definition contained in the treaty between the residence state and the (potential) PE state would be determinative of whether the amount originates from a PE.

12.3. Reverse dual resident triangular cases

Reverse dual resident triangular cases arise where a person who is resident in two states ("State A" and "State B") pays an amount of income to a resident of a third state ("State R"). In such cases, both residence states of the payor may consider the income to be locally sourced and may thus seek to impose source-based taxation. A reverse dual resident triangular situation is illustrated in the following diagram:

Figure 12.9.: Reverse dual resident triangular case

For the purposes of the analysis below it is assumed that both the payor’s residence states would seek to impose source-based taxation on the income in the absence of any treaty limitation. It is further assumed that the residence state of the recipient of the income would impose tax on a residence basis. The recipient’s residence state may provide unilateral relief in the form of an exemption or a credit for the tax imposed in the residence states of the payor, however for the purposes of the analysis below it will be assumed that this is not the case.

In a reverse dual resident triangular case, the recipient of the income will be entitled to claim the benefit of the treaties concluded between that person’s residence state (State R) and the two residence states of the payor (States A and B). The applicable treaties will therefore be the treaty between State R and State A (the A-R treaty) and the treaty between State R and State B (the B-R treaty). The treaty between the two residence states will not apply because the person receiving the income is not resident in either of the contracting states for the purposes of that treaty.

Note that this section does not deal with situations where the payment originates from a PE located in the losing residence state; such situations are discussed in Section 12.4., below. It is therefore assumed for the purposes of the analysis in this section that there is no PE in either of the residence states of the payor.

12.3.1. Application of tax treaties under the existing treaty framework

For most categories of the income dealt with in this study, the distributive rules of tax treaties do not allow source-based taxation on the basis of the residence of the payor and thus, as will be seen below, one
(or even both) of the payor’s residence states will be prevented from imposing tax in a reverse dual-resident triangular case. In the case of dividends, interest and royalties, however, the distributive rules of tax treaties generally allow source based taxation in a particular state if the income is paid by a resident of that state.\textsuperscript{1321} Thus, as will be seen below, such income may be subject to dual source based taxation when paid by a dual resident. Under its treaties with the two source states the residence state of the recipient will be obliged to provide relief, generally using the credit method where passive income is involved. However, given that source-based taxation has been imposed in two states the residence state of the person receiving the income may be unable to provide sufficient relief and unrelieved double taxation may occur.\textsuperscript{1322}

The following table briefly outlines the effect of the application of tax treaties in reverse dual resident triangular cases involving various categories of income. For the purposes of this analysis, it is assumed that the payor remains resident in both its residence states for the purposes of the treaties between those states and the residence state of the recipient, despite any application of the residence tie-breaker rule of the treaty between the two residence states. It is further assumed that the recipient of the income does not have a PE in either of the residence states of the payor.

\textit{Table 2: Application of tax treaties in reverse dual resident triangular cases}

<table>
<thead>
<tr>
<th>Category of income and diagram</th>
<th>Application of the A-R treaty</th>
<th>Application of the B-R treaty</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business profits</strong>&lt;br&gt;\textit{Figure 12.10.: Reverse dual resident triangular case involving business profits}</td>
<td>Article 7 applies and State A is prevented from imposing tax.</td>
<td>Article 7 applies and State B is prevented from imposing tax</td>
<td>Both the source states are prevented from imposing tax. There is no need for relief in State R. If the income is attributable to a PE of the recipient in one of the source states, then the state where the PE is located would be entitled to impose tax on the profit attributable to the PE under Article 7. State R would be obliged to provide relief (either credit or exemption) in accordance with the treaty. There would be no unrelieved double taxation.</td>
</tr>
<tr>
<td><strong>Dividends</strong>&lt;br&gt;\textit{Figure 12.11.: Reverse dual resident triangular case involving dividends}</td>
<td>Article 10 applies and State A is entitled to impose a limited rate of tax on the dividends. State R is obliged to provide relief using the credit method in accordance with either Article 23A or Article 23B.</td>
<td>Article 10 applies and State B is entitled to impose a limited rate of tax on the dividends.</td>
<td>This analysis ignores the potential effect of the application of the residence tie-breaker rule of the treaty between the two residence states and any consequent application of Article 10(5) of that treaty, both of which will be discussed in detail below. Both the payor’s residence states are entitled to impose tax on the dividends and thus there is dual source-based taxation. State R may therefore not be able to provide sufficient relief to prevent unrelieved double taxation.</td>
</tr>
</tbody>
</table>

\textsuperscript{1321} OECD Model, Article 10 and Article 11. In the UN Model (Article 12) and in many concluded treaties, this is also the case with respect to royalties.

\textsuperscript{1322} 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.
### Interest

**Figure 12.12.: Reverse dual resident triangular case involving interest**

<table>
<thead>
<tr>
<th>Description</th>
<th>Taxation</th>
<th>Relief Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 11 applies and State A is entitled to impose a limited rate of tax on the interest. State R is obliged to provide relief using the credit method in accordance with either Article 23A or Article 23B.</td>
<td>This analysis ignores the potential effect of the application of the residence tie-breaker rule of the treaty between the two residence states, which will be discussed in detail below. Both the payor's residence states are entitled to impose tax on the interest and thus there is dual source-based taxation. State R may therefore not be able to provide sufficient relief to prevent unrelieved double taxation.</td>
<td></td>
</tr>
</tbody>
</table>

### Royalties

**Figure 12.13.: Reverse dual resident triangular case involving royalties**

<table>
<thead>
<tr>
<th>Description</th>
<th>Taxation</th>
<th>Relief Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 12 applies and State A is prevented from imposing tax.</td>
<td>As will be discussed below, many concluded treaties depart from the OECD Model and do allow a limited rate of source based taxation. Where this is the case in both the A-R treaty and the B-R treaty then both those states may be entitled to impose tax and dual source-based taxation may arise. This analysis ignores the potential effect of the application of the residence tie-breaker rule of the treaty between the two residence states, which will be discussed in detail below.</td>
<td></td>
</tr>
</tbody>
</table>

### Income from immovable property

**Figure 12.14.: Reverse dual resident triangular case involving income from immovable property**

<table>
<thead>
<tr>
<th>Description</th>
<th>Taxation</th>
<th>Relief Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 6 applies and State A may impose tax on the income without limitation. State R will be obliged to grant relief (credit or exemption) in accordance with Article 23A/B.</td>
<td>For the purposes of the B-R treaty, the immovable property is located in a third state and, as a result, Article 6 will not apply. The income will fall under the distributive rule of either Article 7 or Article 21 (depending on whether it is considered to be business profits); regardless of which article applies, State B will be prevented from imposing tax. Note that if the property were instead located in State B, State B would be entitled to impose tax and State A would be prevented from imposing tax. If the property were located in State R, then both source states would be prevented from imposing tax.</td>
<td></td>
</tr>
</tbody>
</table>

### Income from shipping, inland waterways transport and air transport

**Figure 12.15.: Reverse dual resident triangular case involving income dealt with under Article 8**

<table>
<thead>
<tr>
<th>Description</th>
<th>Taxation</th>
<th>Relief Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 8 applies and State A is prevented from imposing tax on the income.</td>
<td>Under Article 8, tax can only be imposed in the state where the place of effective management (“POEM”) is located. Given that the recipient of the income is resident in State R, it can be assumed that the POEM is located in State R. Both source states will therefore be prevented from imposing tax.</td>
<td></td>
</tr>
</tbody>
</table>
### Capital gains arising from the alienation of immovable property

**Property located in State A**

**Figure 12.16:** Reverse dual resident triangular case involving capital gains dealt with under Article 13(1)

- Article 13(1) applies and State A may impose tax on the capital gain. State R is obliged to provide relief (credit or exemption) in accordance with Article 23A/B of the treaty.

- Article 13(5) applies and State B is prevented from imposing tax on the capital gain.

Under Article 13(1) State A will be entitled to impose tax on any capital gains arising from the alienation of immovable property located in that state.

Note that if the property were instead located in State B, State B would be entitled to impose tax and State A would be prevented from imposing tax. If the property were located in State R then both source states would be prevented from imposing tax.

### Capital gains arising from the alienation of movable property which forms part of the business property of a PE.

**[No diagram]**

- Article 13(2) will therefore never apply.

If the recipient of the income did have a PE in one of those states, the state where the PE was located would be entitled to impose tax on any capital gains derived from the alienation of movable property forming part of the business property of the PE under Article 13(2) of its treaty with State R. State R would be obliged to provide relief in accordance with the terms of the treaty. The other source state would be prevented from imposing tax under Article 13(5) of its treaty with State R.

### Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated movable property

- Article 13(3) applies and State A is prevented from imposing tax.

- Article 13(3) applies and State B is prevented from imposing tax.

Under Article 13(3), tax can only be imposed in the state where the place of effective management (“POEM”) is located. Given that the recipient of the income is resident in State R, it can be assumed that the POEM is located in State R. Both the source states will therefore be prevented from imposing tax.
<table>
<thead>
<tr>
<th>Figure 12.17.: Reverse dual resident triangular case involving capital gains dealt with under Article 13(3)</th>
<th></th>
<th>Figure 12.20.: Reverse dual resident triangular case involving other income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Residence state</strong></td>
<td><strong>Residence state</strong></td>
<td><strong>Residence state</strong></td>
</tr>
<tr>
<td>A</td>
<td>B</td>
<td>A</td>
</tr>
<tr>
<td><strong>Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property – underlying property located in State A</strong></td>
<td><strong>Article 13(4) applies and State A may impose tax on the capital gain. State R is obliged to provide relief (credit or exemption) in accordance with Article 23A/B of the treaty.</strong></td>
<td><strong>Article 21 applies and State A is prevented from imposing tax.</strong></td>
</tr>
<tr>
<td><strong>Figure 12.18.: Reverse dual resident triangular case involving capital gains dealt with under Article 13(4)</strong></td>
<td><strong>Article 13(5) applies and State B is prevented from imposing tax on the capital gain.</strong></td>
<td><strong>Article 21 applies and State B is prevented from imposing tax.</strong></td>
</tr>
<tr>
<td><strong>Other capital gains</strong></td>
<td><strong>Article 13(5) provides that any capital gains not referred to in other paragraphs of Article 13 can only be taxed in the residence state. Both source states will therefore be prevented from imposing tax under Article 13(5) of their respective treaties with State R. State R has no obligation to provide relief.</strong></td>
<td><strong>Given that the recipient of the income does not have a PE in either of the source states, both those states are prevented from imposing tax under their respective treaties with State R. State R therefore has no obligation to</strong></td>
</tr>
<tr>
<td><strong>Figure 12.19.: Reverse dual resident triangular case involving capital gains dealt with under Article 13(5)</strong></td>
<td><strong>Figure 12.20.: Reverse dual resident triangular case involving other income</strong></td>
<td><strong>Figure 12.20.: Reverse dual resident triangular case involving other income</strong></td>
</tr>
<tr>
<td><strong>Other income</strong></td>
<td><strong>Article 21 applies and State A is prevented from imposing tax.</strong></td>
<td><strong>Article 21 applies and State B is prevented from imposing tax.</strong></td>
</tr>
<tr>
<td><strong>article</strong></td>
<td><strong>Article 21 applies and State A is prevented from imposing tax.</strong></td>
<td><strong>Article 21 applies and State B is prevented from imposing tax.</strong></td>
</tr>
</tbody>
</table>
This table illustrates that although reverse dual-resident triangular cases may give rise to dual source-based taxation in relation to dividends, interest and royalties, this will not occur for other categories of income. This is because the distributive rules of tax treaties in relation to these types of income do not allow source-based taxation to be imposed on the basis of the income being paid by a resident enterprise. In these cases, there will generally be no unrelieved double taxation and no particular issues will ordinarily arise. The remainder of this chapter will provide a more in-depth analysis of reverse dual-resident triangular cases involving dividends, interest and royalties, and will suggest ways in which dual source-based taxation could be prevented in such cases.

**12.3.2. Situations where the tie-breaker rule does not effectively allocate residence**

For treaty purposes, residence is determined by reference to residence under domestic laws in accordance with Article 4 (or its equivalent)\(^{1323}\) and, as a result, a person who is resident in two states under their respective domestic laws will generally also be a dual resident for treaty purposes. Where this occurs, the tie-breaker rules of the treaty between the two residence states will apply and will allocate the residence of the dual resident person to one state for the purposes of that treaty.\(^{1324}\) However, the tie-breaker rules may not always be successful in allocating the residence of a dual resident to one state for treaty purposes, e.g., where a company is managed from multiple states and the "place of effective management" cannot be determined.

In a reverse dual resident triangular case where the residence tie-breaker rule of the treaty between the two residence states of the dual-resident payor (the A-B treaty) does not effectively allocate that person’s residence to one state for the purposes of the treaty, there will be nothing to prevent dual source-based taxation of passive income. The dual resident payor will continue to be resident in both of its residence states (State A and State B) for the purposes of the treaties between each of those states and the residence state of the recipient of the income. As a result, both those states would generally be entitled to impose source-based taxation on passive income paid by the dual resident. In the case of dividends for example, Article 10 allows dividends paid by a resident of one contracting state to a resident of the other contracting state to be taxed in the residence state of the payor. For the purposes of both the A-R treaty and the B-R treaty, any dividends paid by the dual resident would be considered to be paid by a resident of one of the contracting states, and State A or State B, respectively, would be entitled to impose tax in accordance with Article 10 of the treaty (at a limited rate). Similarly, any interest paid by the dual resident would be considered to "arise" in State A for the purposes of the A-R treaty (under Article 11(5)), and would be considered to "arise" in State B for the purposes of the B-R treaty (again, under Article 11(5)). Thus, under both treaties, Article 11 would apply and both State A and State B would both be entitled to impose tax on the income at the rate allowed by their respective treaties with State R. This may also occur in relation to royalties to the extent that both the A-R treaty and the B-R treaty allow source-based taxation of such income under Article 12.

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\(^{1323}\) Article 4(1) provides that: “For the purposes of this Convention, the term ‘resident of a Contracting State’ means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of sources in that State or capital situated therein.”

\(^{1324}\) For a detailed overview of the tax treaty tie-breaker rules and their interpretation, see Chapter 10 (Section 10.3.).
Where both residence states of the dual-resident payor impose tax on the income, the residence state of
the person receiving the income (State R) will generally be obliged to grant relief for tax imposed in both
those states. However, depending on the relative rates of tax imposed, it may be unable to provide
sufficient relief and, as a result, unrelieved double taxation may occur. This issue was discussed in detail in
Chapter 3 in the context of PE triangular cases. The simplest solution would be to prevent one state from
imposing source-based taxation, however, it is not clear in this case which state should be prevented from
imposing tax on the income. The remainder of this section discusses two possible approaches for
ensuring that payments are not subject to dual source based taxation in situations where there is no
allocation of residence of the dual-resident payor.

12.3.2.1. Split the right to tax between the two residence states of the payor

One possibility is that taxing rights could be split equally between the two states. That is, each state could
be entitled to impose only 50% of the tax that it would otherwise impose.1325 This could be achieved by
including a specific provision in the treaty between the two residence states of the payor, or under the
treaty between each of the residence states of the payor and the residence state of the recipient. The main
advantage of having the provision operate under the treaty between the two residence states of the payor
is that the terms of that treaty would then specify the consequences of the contracting states being unable
to determine the residence of a dual resident, e.g., under the mutual agreement procedure. However, the
better approach seems to be for the provision to operate under the treaties with the residence state of the
recipient of the income, since there would be no question of this treaty applying to the income. Such a
provision could be worded as follows:

“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].”

Similar provisions could be included for interest and, if applicable, royalties (i.e., in situations where the
treaty allows source-based taxation of royalties). One essential aspect of this provision is that it must be
applied taking into account the application of the tie-breaker provisions of the treaty between the two
residence states. That is, it should only be applied in situations where the application of the tie-breaker
has been unsuccessful, and not in situations where payor of dividends is simply resident in two states
under Article 4(1). This is achieved by limiting the application of the provision to situations where the
payor is not deemed to be resident in one state for the purposes of the treaty between the two residence
states. It must also be included in the source state’s treaties with both the residence states in order for it
to be effective, although even if it were included in only one of these treaties it would at least reduce the
amount of source-based taxation imposed in one state.

One issue which could arise in relation to such a provision is the potential for tax avoidance. A company
that is resident in a state with relatively high rates of withholding tax could, for example, become resident
in another contracting state which imposed no withholding tax or lower rates of withholding tax, in order
to reduce by half the applicable withholding tax rate in the first residence state. The potential for this type
of abuse is limited, of course, by the fact that the reduced withholding tax rate is only applicable in
situations where the tie-breaker provision of the treaty between the two residence states does not
effectively assign residence to one state for the purposes of the treaty. It is also limited by the potential

1325 This is similar to the approach taken in some early model treaties which, instead of including a residence tie-
breaker provision, split taxing rights between the two residence states of a dual-resident in certain cases. Vann
writes: “ Dual residence of individuals is the subject of special mention in the resolutions [see below], though
perhaps confusingly to modern eyes, one of the solutions during this period [the mid-1920s] was a splitting of taxing
rights between both countries of fiscal domicile on the basis of time spent in each country or by agreement between
the competent authorities rather than a tie-breaker.” Vann, R., “‘Liable to Tax’…,” at p. 214 (Section 7.3.1.2.). See
also: League of Nations, “Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical
Experts to the Financial Committee” (Geneva, League of Nations, 1925), Document F.212.
residence-based tax liability in the second residence state on any income derived. Nevertheless, the potential for abuse should be considered if states are contemplating including a provision such as that outlined above in their treaty.

12.3.2.2. Allow tax in the state to which the payment is more closely connected

Another alternative, at least with respect to interest and royalties, would be to seek to identify the state to which the payment is more closely connected in order to determine which state should be entitled to impose source-based taxation. This would essentially involve trying to identify a PE in one of the two residence states of the payor that bears the payment, which would in turn require a notional application of the treaty between the two residence states of the payor to determine firstly whether a PE could be considered to exist and secondly, whether the payment could be considered to originate from the PE.

As discussed in Chapter 10, where the tie-breaker provision of the treaty between the two residence states does not effectively allocate residence to one state for the purposes of the treaty, both states are likely to apply the treaty as though the person involved is a local resident for treaty purposes and is not resident in the other contracting state. In general, one of the residence states (say, State A) will only grant relief for tax imposed in the other residence state (State B) if it considers the tax imposed in that state to have been imposed in accordance with the provisions of the treaty. In many cases, this will require a consideration of whether the income is attributable to a PE in State B. However, from State B’s perspective, it is not imposing tax because the income is attributable to a local PE but instead, because the income is derived by a resident enterprise. Thus, there will be no agreement between the two residence states of the payor as to the existence of a PE in one of those states.

In some cases, it may be easy to identify one state to which the payment is clearly connected. However, even in this situation, it would be very challenging to draft a provision to prevent the other state from imposing tax on the payment. One possible wording of the provision, for inclusion in the interest article (Article 11), is as follows:

“Where, however, the person paying the interest is resident in a Contracting State and in a third state for the purposes of a convention between those two states, and is not deemed to be resident in one State for the purposes of that convention, the interest will not be considered to arise in the Contracting State of which that person is resident if that person would have had a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest would have been borne by such permanent establishment, if the person had been deemed to be a resident of the Contracting State of which they are resident for the purposes of the treaty between that State and the third State.”

A similar provision could be included in the article applicable to royalties (Article 12) if the treaty differs from the OECD Model in allowing source based taxation of royalties. This provision, applied under the treaty between the residence state of the person receiving the income (State R) and one of the residence states of the payor, State A (i.e., the R-A treaty), would prevent State A from imposing tax if the interest would have been considered to have originated from a PE in the other residence state (State B) if the residence of the payor had been assigned to State A for the purposes of applying the A-B treaty. This would clearly be a very difficult provision to interpret and apply, since it would require a hypothetical determination of whether a PE exists and whether income could be considered to originate from that PE. This may give rise to significant uncertainly even in relatively simple cases and therefore cannot be recommended. In any case, the potential for dual source-based taxation in reverse dual resident triangular cases again highlights the importance of an effective allocation of residence under the treaty between the two residence states (as was discussed in Chapter 101326).

1326 See Section 10.4.1.
12.3.3. Situations where the tie-breaker rule does effectively allocate residence of the payor

In a reverse dual-resident triangular case, where a person is resident in two states under their respective domestic laws, that person will generally also be resident in both those states for the purposes of the treaties which each of them have concluded with the third state where the recipient of the income is resident (State R). This would clearly be undesirable since it will result in dual source based taxation of passive income in the same way as in situations where the tie-breaker rule does not effectively allocate residence. This could be avoided by preventing the dual resident from being resident in the state to which residence is not assigned (the losing residence state or "State L") for the purposes of treaties between that state and third states. This would result in State L generally being prevented from imposing tax on passive income (except where the income originates from a PE of the payor or is attributable to a local PE of the recipient). Note that this section does not deal with situations where the payment originates from a PE located in the losing residence state; such situations are discussed in Section 12.4., below. It is therefore assumed for the purposes of this analysis that there is no PE in the losing residence state.

As discussed in Chapter 11, the only argument for not applying the treaty between the losing residence state and third states is that the dual-resident is not resident in the losing residence state under the second sentence of Article 4(1). The second sentence of Article 4(1) provides that a person will not be resident in a particular state if they are "liable to tax in that State in respect only of sources in that State." It is argued that the effect of the restrictions imposed under the treaty between the two residence states is that the dual resident will be taxable in the losing residence state only on income from sources in that state, and should therefore not be resident in that state for the purposes of treaties it has concluded with third states. This interpretation was discussed in detail in Chapter 11, where it was concluded that it is highly uncertain that a dual resident should be denied residence in the losing residence state on this basis.

If the dual resident continues to be resident in the losing residence state for the purposes of the treaty between State L and the residence state of the recipient of the income (State R) (the L-R treaty), then they will continue to be resident in both residence states for the purposes of the treaties between those states and State R. As a result, both of the payor’s residence states will be entitled to impose tax on interest paid by the dual resident under Article 11 of their respective treaties with State R. This may also be the case with respect to royalties under Article 12. In the case of dividends, however, a solution may potentially be found in Article 10(5) of the treaty between the two residence states, as will be discussed below.

If, on the other hand, the application of the tie-breaker rule of the treaty between the two residence states results in the dual resident being denied residence for the purpose of the R-L treaty, then any passive income paid by the dual resident would not be paid by a resident of State L for the purposes of the R-L treaty. As a result, State L would generally be prevented from imposing tax on the dividends, interest or royalties paid by the dual resident. That is, for the purposes of Article 10, Article 11, or Article 12 (as applicable) the income would not be paid by a resident of one state to a resident of the other contracting state and thus, these articles would not apply. The income would then fall under the distributive rules of Article 7 or Article 21, depending on whether it is considered to be business income, and the losing residence state would be prevented from imposing tax (since it is assumed that the recipient of the income does not have a PE in that state).

For the purposes of the treaty between the winning residence state ("State W") and the residence state of the person receiving the income (the W-R treaty), any amounts paid by the dual resident would be paid by a resident of State W. Therefore, where the dual resident pays a dividend, Article 10 of the R-W treaty would apply and State W would be entitled to impose source-based taxation. Similarly, if the dual resident...
pays interest or royalties, Article 11 or Article 12 of the treaty would apply, and State W may be entitled to impose tax. The residence state of the person receiving the income (State R) would also be entitled to impose tax, but would be obliged to provide relief for the tax imposed in State W. Given that the losing residence state is prevented from imposing tax, source based taxation can be imposed in only one state (the winning residence state) and there would therefore be no unrelieved double taxation. This how the denial of residence under the R-L treaty could resolve reverse PE triangular cases. This will be discussed below (see Section 12.3.4.), however, the following section will first discuss the potential application of Article 10(5) to prevent dual source-based taxation of dividends.

12.3.4. Dividends and the application of Article 10(5)

Article 10(5) generally prevents a contracting state from imposing tax on dividends paid by a resident of the other contracting state, unless the dividend is received by a local resident or is attributable to a local PE of a resident of the other state. Article 10(5) reads as follows:

"Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other Contracting State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State"

In a reverse dual resident triangular case where the tie-breaker rule of the treaty between the two residence states assigns residence to one state for the purposes of that treaty, this provision of the treaty between the two residence states may prevent the losing residence state from imposing source-based taxation on the dividend. For the purposes of applying that treaty, the dividend is indeed paid by a resident of the other state (the winning residence state) and it is not paid to a resident of a losing residence state or attributable to a PE located there. However, the application of this provision in such cases is not so straightforward, as will be discussed below.

The application of Article 10(5) in relation to dividends paid by a dual resident company has been dealt with in two court decisions, one in Canada (Hunter Douglas Ltd. v The Queen1331 and one in the Netherlands (Case 27 252).1332 In both cases it was found that Article 10(5) of the treaty between the two residence states will prevent the losing residence state from imposing tax on dividends distributed to residents of third states. These decisions will be discussed below where relevant.

12.3.4.1. Requirement for profits or income derived in the losing residence state

One of the difficulties in applying Article 10(5) in this reverse dual resident triangular cases is that it is stated to apply only where the company paying the dividends "derives profits or income" from the state which is seeking to impose tax (i.e., the losing residence state). Article 10(5) thus assumes that the state seeking to impose tax on the dividends is doing so because the dividends are paid out of income derived from sources in that state. However, if the company is resident in the losing residence state simply by virtue of being incorporated there, the company may not in fact derive any profit or income from that state. Rather than seeking to impose tax on the dividends as a result of the activities of the company, tax is being imposed because the company is considered to be a local resident under domestic law, e.g., as a result of incorporation. In this case, it would be difficult to apply Article 10(5) to prevent the losing

1332 Case 27 252, BNB 1992/379, 2 September 1992, decided by the Supreme Court of the Netherlands (the Hoge Raad).
residence state from imposing tax on dividends paid by the company unless the company also derives at least some income from that state.\textsuperscript{1333}

\textit{Case 27 252}, decided in the Netherlands, involved a company incorporated in the Netherlands and effectively managed from Ireland, which distributed dividends to its parent company incorporated in the United States.\textsuperscript{1334} For the purposes of the Ireland-Netherlands treaty the company was treated as a resident in Ireland, and it derived no income from the Netherlands. The issue in the case was whether the Netherlands was prevented from imposing dividend withholding tax under Article 8(9) of the Ireland-Netherlands treaty,\textsuperscript{1335} which is the equivalent of Article 10(5) of the OECD Model and is worded in virtually the same way.\textsuperscript{1336} The court decided that this provision did prevent the Netherlands from imposing source based taxation on the dividends, and in particular, that it applied notwithstanding that the company derived no income or profits from the Netherlands.\textsuperscript{1337} In applying the Ireland-Netherlands treaty, the Court considered the OECD Commentaries to be of great importance, and referred particularly to comments that Article 10(5) prohibited "extraterritorial taxation" of dividends.\textsuperscript{1338} The Court argued that if the prohibition on source based taxation of dividends applied in situations where the company derives profit or income from sources in the state seeking to impose tax, then it should apply even more so if the company derives no income or profit from that state.\textsuperscript{1339} The Court referred to the wording of the last line of the provision, which states that taxation will be prevented "...even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other state."\textsuperscript{1340} This wording seems to anticipate that the provision will apply, not only in situations where the tax is imposed on the basis that the profits from which the dividend is paid have a local source, but also where tax is imposed on another basis.

In the \textit{Hunter Douglas} case,\textsuperscript{1341} decided in Canada, a company that was resident in both Canada and the Netherlands under their respective domestic laws paid a dividend to residents of third states.\textsuperscript{1342} Under the Canada-Netherlands treaty\textsuperscript{1343} the company was resident only in the Netherlands and the case concerned the application of withholding tax in Canada (i.e., in the losing residence state). The court found that Canada was prevented from imposing tax on the dividends under Article IV(5) of the Canada-Netherlands treaty, a provision which was equivalent to Article 10(5) of the OECD Model and which was

\begin{footnotes}
\item[1333] Avery Jones, J.F., et al., "Tax Treaty Problems...."
\item[1334] Case 27 252, BNB 1992/379, 2 September 1992. This overview of the facts of the case is drawn from: Smit, P.M., "Taxation of Dividends...."
\item[1335] The treaty in force at the relevant time was the Ireland-Netherlands treaty concluded in 1969. This treaty remains in force today.
\item[1336] Article 8(9) of the Ireland-Netherlands treaty provides that: "Where a company which is a resident of one of the States derives profits or income from the other State, that other State may not impose any tax on the dividends paid by the company to persons who are not residents of that other State, or subject the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising from such other State."
\item[1337] Smit, P.M., "Taxation of Dividends...."
\item[1338] Smit, P.M., "Taxation of Dividends...." The OECD Commentary (of 1963) stated that: "Paragraph 5 [i.e., Article 10(5)] adopts a provision already contained in a number of Conventions. It rules out extraterritorial taxation of dividends and further provides that non-resident companies are not to be subjected to special taxes on undistributed profits." [emphasis added] (at para 42 of the Commentary on Article 10). A similar comment is contained in para 34 of the 2010 OECD Commentary on Article 10, although it refers specifically to situations where tax is imposed because the profits from which the dividend is paid is sourced in the state seeking to impose tax. The Commentary does not contain any discussion of the application of Article 10(5) in situations where a dual-resident pays a dividend to residents of a third state.
\item[1339] Smit, P.M., "Taxation of Dividends...." See also: Avery Jones, J.F., et al., "Tax Treaty Problems...."
\item[1340] Smit, P.M., "Taxation of Dividends...."
\item[1342] For a more detailed overview of the facts of the case, refer to either the IBFD Tax Treaty Case Law database or to: Creus, J., & De Jong, D., "Dividends Paid by...."
\item[1343] The treaty in force at the time was that concluded between Canada and the Netherlands in 1957. This treaty is no longer in force, having been replaced by a new treaty in 1986.
\end{footnotes}
worded along similar lines. However, the court did not directly address the question of whether provisions like Article 10(5) will apply where no profits or income are derived in the state seeking to impose tax, which was not necessary since the company did in fact derive income from Canada during the relevant period.

In general, the prevention of dual source-based taxation of dividends paid by a dual resident company under Article 10(5) in situations where no income is derived from the losing residence state is clearly a reasonable outcome, but it is still somewhat difficult to reconcile with the wording of the provision. This difficulty could be remedied by rewording Article 10(5) to remove this requirement. It is not necessary to the purpose of Article 10(5) for it to apply only where the company derives profit or income from the state seeking to impose tax, and indeed, some concluded treaties already omit this requirement. Article 10(5) could, for example, be reworded as follows:

"A Contracting State may not impose any tax on dividends paid by a resident of the other Contracting State, except insofar as such dividends are paid to a resident of the first-mentioned Contracting State or insofar as the dividends are attributable to a permanent establishment situated in that State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State."

This wording achieves the same aim without the unnecessary requirement that the company derive income or profits from the non-residence state before the provision can apply, and would more clearly apply in cases where a dual resident company pays dividends to residents of third states.

12.3.4.2. Personal scope of the treaty

Another difficulty with applying Article 10(5) of the treaty between the two residence states is that the person upon whom tax is being imposed, the recipient of the dividends, is not resident in either of the contracting states and thus does not fall within the personal scope of the treaty under Article 1. As a result, the company's income is not considered to be derived from the state seeking to impose tax, and therefore the provision does not apply.

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1344 The provision was worded as follows: "Where a company which is resident in one of the States derives profits or income from sources within the other State, that other State shall not impose any form of taxation on dividends paid by the company to persons not resident in that other State, or any tax in the nature of an undistributed profits tax on undistributed profits of the company, by reason of fact that those dividends or undistributed profits represent, in whole or in part, profits or income so derived." This wording is very similar to that of Article 10(5) of the OECD Model, except that it provides that no tax can be imposed "by reason of" the dividends representing profit derived from sources in the state seeking to impose tax. This suggests that the provision, Article IV(5), may only prevent tax which is imposed on the basis that the profits are sourced in that state. However, the court found that there was no such limitation based partly on the wording of other tax treaties concluded by Canada which used the wording "even if" instead of "by reason of" and on testimony from a person involved in the negotiation of Canada's tax treaties to the effect that the different wording did not represent any change in policy by the Government of Canada (see para 34 of the court decision). In any case, this issue will not arise under treaty provisions which follow Article 10(5) of the OECD Model, which provides that no tax can be imposed "... even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State." [emphasis added].

1345 Avery Jones, J.F., et al., "Tax Treaty Problems...."


1347 One of these states is the US. The Article 10(7) of the US model treaty (equivalent to Article 10(5) of the OECD Model) reads as follows: "A Contracting State may not impose any tax on dividends paid by a resident of the other State, except insofar as the dividends are paid to a resident of the first-mentioned State or the dividends are attributable to a permanent establishment, nor may it impose tax on a corporation's undistributed profits, except as provided in paragraph 8, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State." Paragraph 8 of that article preserves the operation of the US branch profits tax. Australia and New Zealand take a different approach, including a specific provision in certain treaties which allows dividends paid by a dual resident to be taxed in the losing residence state if the dividends are derived from profits or income arising in that state. See, for example, Article 10(8) of the Australia-New Zealand treaty (2009). See also: Pereira Ribeiro, R., "Dual Source Situations...." at pp. 183-184.

1348 This is similar to the wording used in Article 10(7) of the US Model treaty, reproduced in the previous note.
result, the recipient of the dividends may potentially be unable to claim the benefit of Article 10(5). However, Article 10(5) is not stated to apply only to dividends paid to residents of the contracting states, but simply to "dividends paid by" a resident of the other contracting state, which indicates that its application may not be constrained by Article 1.1349 Hattingh writes that "... the very terms of Art. 10(5) imply an exception to Art. 1 in the treaty..."1350 In a somewhat similar vein, Vogel writes that:

"The inclusion of residents of third States in the 'protective scope' of Art. 10(5) results from the rule, though merely as a secondary effect. The rule's basic purpose is to draw the line between the taxing powers of the two contracting States in regard to the residents of each of them.

This, on the other hand, does not imply that residents of third States are barred from invoking the rule's more far-reaching protective effect, just because the treaty concerned has effect only in the relationship between the two contracting States and hence only to the benefit of their own taxable entities. The fact is that when concluding the treaty, the contracting States, rather than entering into international commitments as representatives of their residents or nationals, are doing so on their own behalf. The treaty becomes an integral part of their domestic law. Therefore, anyone may invoke it who is subject to such domestic law of account of no matter what point of attachment."1351

Thus, Vogel argues that residents of third states can claim the benefit of Article 10(5) as a result of the treaty becoming part of the domestic law of the contracting states1352 (which commonly occurs through specific domestic legislation or through constitutional law1353). He argues that since any tax imposed contravenes the terms of the treaty and, since the treaty is an "integral part" of domestic law, the imposition of tax also contravenes the domestic law of the state seeking to impose tax and can thus be challenged by the person upon whom tax is being imposed.

The court in Hunter Douglas had no problem applying the Canada-Netherlands treaty in relation to dividends paid to residents of third states. However, in this case the tax was imposed on the company paying the dividend rather than the recipients of the dividends (resident in third states) and thus, the person who was being assessed to tax was clearly within the scope of the treaty. Whether this will be the case in other situations depends on the law of the state seeking to impose tax; that is, whether it will seek to collect the tax from the recipients of the dividend or from a withholding agent who has, for example, failed to withhold tax. In most cases, however, it can be expected that the tax would be imposed on the recipient of the dividends and indeed, this is what is anticipated under the distributive rules of Article 10. In addition, the Canada-Netherlands treaty did not contain any equivalent to Article 1 of the OECD Model, and the personal scope of the treaty was therefore not specifically limited to residents of the contracting states. Nevertheless, the court expressed the view that the wording of the Article IV(5) of the treaty (equivalent to Article 10(5)) made it clear that shareholders resident in third states could benefit from the provision, on the basis that it does not limit the application of the provision to situations where the dividends are received by residents of the contracting states.1354 In support of its decision, the court also referred to the purpose of tax treaties, namely, the avoidance of double taxation.1355

1350 Hattingh, P.J., "The Role and Function...." Hattingh goes on to note that "... since its earliest appearance in bilateral tax treaties, Art. 10(5) has been an implied exception to Art. 1." Also describing Article 10(5) as an implied exception to Article 1, see: Avery Jones, J.F., et al., "Tax Treaty Problems...."
1351 Vogel, K., Engelschak, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at pp. 694-695, (m.no. 258).
1352 Elsewhere, Vogel writes: "Under the theory of 'moderate dualism,' which seems to be generally accepted nowadays, international and domestic law are two spheres which exist separate of each other (save some exceptions). To exercise their intended influence on domestic law, treaties therefore have to be implemented by the domestic legislator. Thus, they receive the force of domestic law." (Vogel, K., "The Domestic Law Perspective," at p. 3, (Chapter 1, section 1.1.))
1353 Sasseville, J., "A Tax Treaty Perspective....," at pp. 39-40 (Chapter 3, Section 3.2.).
1354 Hunter Douglas Ltd. v. Her Majesty the Queen, 1979, at para. 33.
1355 Hunter Douglas Ltd. v. Her Majesty the Queen, 1979, at para. 28.
In the case decided in the Netherlands, *Case 27 252*, the relevant treaty (the Ireland-Netherlands treaty) also contained no equivalent to Article 1 of the OECD Model, and the decision therefore does not specifically address this issue. Nevertheless, Smit writes that "...from the wording used by the Supreme Court, it appears justified to assume that its decision is also valid for treaties which do not have such a provision" (i.e., Article 1).

In general, it seems that Article 10(5) of the treaty between the two residence states should apply to prevent the losing residence state from imposing tax on dividends paid to residents of third states by dual resident companies. Nevertheless, various authors have suggested that the application of Article 10(5) in this situation should be put beyond doubt by making it an express exception to Article 1. This could be achieved by specific wording included at the end of Article 10(5).

12.3.4.3. Conclusions

As it is currently worded, the issues associated with applying Article 10(5) in relation to dividends paid by a dual resident to a person resident in a third state mean that it is difficult for taxpayers to achieve certainty that, on the basis of this provision, they will not be subject to dual source-based taxation. It is also difficult for a withholding agent who does not withhold tax in reliance on Article 10(5) to be confident that they have met their withholding obligations. These issues could be alleviated by rewording Article 10(5) to clarify its application in the case of dividends paid by dual resident companies to residents of third states. However, it would be better to establish a more comprehensive approach which would prevent dual source based taxation in reverse dual resident triangular cases not only in relation to dividends, but also in relation to interest and royalties. This will be discussed in the following section.

12.3.5. Potential solutions

The best way of resolving reverse dual resident triangular cases would be to make the allocation of residence under the treaty between the two residence states effective for the purposes of treaties with third states, i.e., by preventing the dual resident from being resident in the losing residence state for the purposes of such treaties. In this case, the dividends, interest or royalties would be paid by a person who is not resident of that state (State L) for the purposes of the R-L treaty and, as a result, State L would be prevented from imposing source-based taxation. As discussed in Chapter 11, there are two main ways of achieving this outcome: the first is for states to incorporate a provision in their domestic law which prevents a dual resident from being resident for domestic purposes when that state is the losing residence state, and the second is for specific provisions to be included in tax treaties. These two options will be discussed in turn below.

12.3.5.1. Domestic law

States could incorporate a provision into domestic law to the effect that a person whose residence is assigned to another state under a tax treaty tie-breaker provision ceases to be a resident under domestic law. If incorporated into the domestic law of the losing residence state, such a provision would prevent the dual-resident payor being resident in that state for the purposes of its treaty with the state where the person receiving the income is resident. As a result, the losing residence state would generally be prevented from imposing source based taxation on passive income paid by the dual resident to residents of third states. As discussed in Chapter 11, this is a simple and effective approach for dealing with dual residence under tax treaties, but it has the disadvantage that it does not resolve the treaty issues in the

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1356 Smit, P.M., "Taxation of Dividends...."
1357 Smit, P.M., "Taxation of Dividends...."
1358 Avery Jones, J.F., et al., "Tax Treaty Problems...."; Hattingh, P.J., "The Role and Function...."
1359 Avery Jones, J.F., & Bobbett, C. "Triangular Treaty Problems...."
1360 Again, this assumes that the payment does not originate from a PE located in the losing residence state. Situations where the payment does originate from a PE in the losing residence state are discussed in Section 12.4., below.
1361 Refer to Section 11.3. for a more in depth discussion of these options.
state implementing the provision.\textsuperscript{1362} In the context of reverse dual resident triangular cases, for example, residents of the state implementing the provision may still be subject to dual source-based taxation when they receive passive income from persons who are dual resident in other states. In fact, reverse dual resident triangular cases clearly provide a disincentive for states to implement this type of provision in their domestic law, since it would effectively result in the state unilaterally giving up its source-based taxing rights when it is in the position of the losing residence state. Perhaps more importantly, the impact of such a provision a domestic context would likely be far greater than its impact in a treaty context and thus, domestic considerations are likely to take precedence over treaty considerations in deciding whether to implement such a provision.\textsuperscript{1363}

\subsection{12.3.5.2. Treaty provisions}

A specific provision included in tax treaties could deny treaty benefits by direct reference to the allocation of residence under treaties concluded with third states. This was also discussed in Chapter 11, in the context of denying treaty benefits to dual residents receiving income from a third state, but would be equally effective in preventing dual source-based taxation in reverse dual resident triangular cases. In Chapter 11 it was proposed that such a provision could be worded as follows (for inclusion in Article 4):

"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."

This provision operates where the treaty in which it is included is the treaty between the losing residence state and the source state, and would be a clear and direct approach for excluding dual residents from treaty benefits. There would be no need to adapt the wording of the 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.

\subsection{12.3.5.3. Conclusions}

States should be encouraged to include provisions in their domestic law to the effect that a person will not be resident in that state if their residence is assigned to another state under a tax treaty. A better approach, however, 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 that third state. This would resolve both situations where a dual resident receives income from a third state and those where a dual resident makes a payment that forms part of the income of a resident of a third state. If, however, there is no effective allocation of residence for the purposes of the treaty between the two residence states then neither of these approaches can be effective and the best alternative would be to split the source based taxing rights evenly between the two residence states of the payor.

\subsection{12.4. Interaction between reverse dual resident and reverse PE triangular cases}

There may be situations where a dual resident will be considered to have a PE in the losing residence state for the purposes of the treaty between the two residence states. Where the dual resident in this scenario pays dividends, interest or royalties to a resident of a third state, the result is a combination of a reverse dual resident triangular case and a reverse PE triangular case. This is illustrated in the following diagram.

\textsuperscript{1362} Refer to Section 11.3.1. for a more in depth discussion of this point.
\textsuperscript{1363} Refer to Section 11.3.1. for a more in depth discussion of this point.
Figure 12.21.: Reverse dual resident case with a PE in the losing residence state

This discussion below addresses such cases involving dividends, interest and royalties since these are the categories of income for which issues have been identified. It first sets out the result in such cases under the existing treaty framework, before going on to discuss the application of the proposals outlined above. As will be seen below, no changes to these proposals are required to deal with such situations.

12.4.1. Dividends

Existing treaty framework

Under the existing treaty framework, both State W and State L would generally be entitled to impose tax on the dividends under their respective treaties with State R. The existence of a PE in State L has no particular impact here, since the existence of a PE does not have any impact on whether a particular state is entitled to impose source-based taxation on dividends. State L may, however, be prevented from imposing any tax either (i) because the dual-resident is not considered to be resident in State L for the purposes of the L-R treaty as a result of the second sentence of Article 4(1), or (ii) as a result of Article 10(5) of the W-L treaty. If the dual-resident is not treated as a resident of State L for the purposes of the R-L treaty, the dividends would not fall under the distributive rule of Article 10 (since they are not paid by a resident) and would instead fall under either Article 7 or Article 21, depending on whether they are considered to be business profits. As a result, State L would be prevented from imposing tax on the dividends (assuming that the recipient of the dividends does not have a PE in that state). Alternatively, if the dual-resident continues to be resident in State L for the purposes of the R-L treaty, State L may nevertheless still be prevented from imposing tax under Article 10(5) of the W-L treaty. This may be difficult to apply, however, since the person benefiting from the reduction in tax is not resident in either of the contracting states (as discussed above).

Proposed solutions

Under the solutions proposed above, the L-R treaty would contain a specific provision having the effect that the dual-resident would no longer be considered a resident of State L for the purposes of that treaty, i.e., as a result of the allocation of residence to State W under the W-L treaty. As a result, State L would be prevented from imposing tax on the dividends under the same analysis as that outlined above. The dividends would remain taxable in State W under Article 10 of the W-R treaty, and State R would continue to have an obligation to provide relief. The advantage of the proposed solution in this case is the increased certainty that State L will be prevented from imposing tax on the dividends.

12.4.2. Interest

Existing treaty framework

Under the existing treaty framework, both State W and State L are likely to be entitled to impose tax on interest paid by the dual resident to a resident of a third state under their respective treaties with that state. Unlike in the case of dividends, the losing residence state would generally be entitled to impose source-based taxation under Article 11 even if the dual-resident is not considered to be a resident for the purposes of the L-R treaty, since the interest will originate from a PE of the payor located in that state.
Thus, there will be dual source-based taxation and the residence state of the recipient of the income may not be capable of providing sufficient relief to prevent unrelieved double taxation.

Proposed solutions

Under the proposed solution, the dual-resident payor would not be considered to be a resident of State L for the purposes of the R-L treaty as a result of a specific treaty provision. However, State L would still be entitled to impose source-based taxation on the interest under Article 11 as a result of the interest originating from a PE in State L. State W, on the other hand, would be prevented from imposing tax on the interest as a result of the amended wording of Article 11(5). Under the proposed alternative wording of Article 11(5), any interest which originates from a PE can only be taxed on a source basis in the PE state, even if that state is not one of the two contracting states. Therefore, as a result of Article 11 of the W-R treaty, State W would be prevented from imposing any tax on the interest. Thus, the interest would only be taxable on a source basis in State L. The residence state of the recipient of the income will be obliged to provide relief and no unrelieved double taxation will arise.

12.4.2. Royalties

As mentioned above, Article 12 of the OECD Model does not allow any source-based taxation of royalties, but many treaties differ from the OECD Model and allow source-based taxation of royalties where they arise in a contracting state. If both the W-R treaty and the L-R treaty follow this approach, then the analysis of the application of the treaties to royalties will be the same as that outlined above for interest. If, on the other hand, both these treaties follow the OECD Model, then both State W and State L will be prevented from imposing any tax under Article 12 of their respective treaties with State R.

Interestingly, if the W-R treaty would generally allow source-based taxation of royalties but prevents State W from imposing tax on royalties which originate from a PE located in a third state, a situation may arise where State W is prevented from imposing tax in circumstances where State L is prevented from imposing tax under the R-L treaty, i.e., where the R-L treaty follows the OECD Model. This may not be acceptable to State W, given that it is presumably agreeing to refrain from taxing the royalties in order to prevent dual source-based taxation. This illustrates one situation where the contracting states (i.e., State W and State R) may want to introduce some limitation on the circumstances in which the residence state of the payor would be prevented from imposing tax as a result of the royalties arising from a PE located in a third state (as discussed above).

12.5. Summary and conclusions

Reverse triangular cases can potentially result in dual source-based taxation of passive income. 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 interest and royalties under their respective treaties with the residence state of the person receiving the income. 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. This risk of unrelieved double taxation be resolved by preventing one of the source states from imposing tax on the income.

Reverse PE triangular cases

In reverse PE triangular cases, 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. 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 the payor's residence state and the recipient's residence state (the R-HO 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 alternative wording for the second sentence of Article 11(5), similar to that suggested in the OECD Commentary. The proposed provision is 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, for the purposes of the treaty between the State of which he is resident and that other State, 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."

Concerns 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), could be dealt with 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. 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.

Reverse dual resident triangular cases

In reverse dual resident triangular cases, dual source based taxation of passive income may occur if the income is considered to be paid by a resident of each of the dual resident's residence states for the purposes of their respective treaties with the residence state of the recipient of the income. This can potentially give rise to unrelieved double taxation in situations where the residence state of the recipient of the income cannot grant sufficient relief. Where the tie-breaker provision of the treaty between the two residence states does not effectively allocate residence to one state, taxing rights should be split between the two residences states of the payor, such that each state may impose only 50% of the tax that it may otherwise have imposed under its treaty with the residence state of the person deriving the income. In situations where residence is assigned to one state under the treaty between the two residence states, however, the losing residence state should be prevented from imposing any source-based taxation. 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. 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 the case of a dual resident paying dividends to residents of third states 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. 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. 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 not considered a resident of the losing residence state for the purposes of treaties which that state has concluded with third states. This 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. Instead of relying on the second sentence of Article 4(1), however, the dual resident should 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. States should be encouraged to implement such
provisions. However, the impact of this type of provision 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 over treaty considerations in deciding whether to implement such a provision.

An alternative 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 that third state. This would resolve both situations where a dual resident receives income from a third state and those where a dual resident makes a payment that forms part of the income of a resident of a third state. In Chapter 11 it was proposed that such a provision could be worded as follows (for inclusion in Article 4):

"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."

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, making it more appropriate as a long term rather than short term solution.
Chapter 13
Conclusions

13.1. Introduction
The purpose of this concluding chapter is to give an overview of the proposed solutions for the issues arising in triangular cases, as discussed in earlier chapters, and to draw the various aspects of the thesis together. To this end, it will discuss the proposed solutions for each of the various triangular cases in turn before briefly drawing some more general conclusions regarding the application of bilateral tax treaties in multilateral situations. An overview of the suggested provisions for dealing with triangular cases is included at the end of the chapter.

13.2. PE triangular cases
The majority of this thesis has focussed on PE triangular cases, situations where a person resident in one state (State R) derives income which is attributable to a PE in a second state (State PE) and which arises from sources in a third state (the source state, or State S). PE triangular cases give rise to a number of issues as a result of the overlapping taxing claims of the three states involved. One of the main issues is the potential for unrelieved double taxation, given that both the source state and the PE state may be entitled to impose tax under their respective treaties with the residence state and that the residence state may not be in a position to provide sufficient relief. The potential for unrelieved double taxation could be mitigated, however, by the provision of relief in the PE state for tax imposed in the source state. The PE state does not have any direct obligation to provide relief but may have a relief obligation under the PE non-discrimination article (Article 24(3)) of its treaty with the residence state (the R-PE treaty). Nevertheless, the existence and scope of this obligation is subject to debate and it would be preferable for the PE state to have an explicit obligation to provide relief.

There is also the important issue of the applicable treaty conditions in the source state. Under the existing treaty framework, the source state will generally be required to apply the conditions of its treaty with the residence state (the R-S treaty) and not those of its treaty with the PE state (the PE-S treaty). Given the transfer of taxing rights to the PE state under the R-PE treaty, however, and a number of other factors discussed in detail in Chapter 5, the source state is arguably applying the wrong treaty conditions and should instead be required to apply the conditions of its treaty with the PE state. The application of the treaty between the residence state and the source state can also give rise to opportunities for treaty shopping, since the source state may be required to apply the conditions of the treaty in situations where the residence state is prevented from imposing tax on the income and where little or no tax is imposed in the PE state.

13.2.1. Extension of treaty benefits to PEs
It is proposed that the issues arising in PE triangular cases be 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:

For an overview of the application of tax treaties in PE triangular cases involving different types of income, refer to the analysis in Chapter 2.
Refer particularly to the discussion in Chapter 3 (Section 3.2.).
Refer to the analysis in Chapter 3 (Section 3.2.2.2.) demonstrating that relief in the PE state will prevent unrelieved double taxation.
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.
See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases," at para 40.
For a detailed analysis of the appropriate treaty conditions for the source state to apply, refer to Chapter 5.
This section provides an overview of the discussion in Chapters 7, 8 and 9 and certain parts of Chapter 5 (namely, Section 5.2.6. regarding the potential for treaty shopping through PEs).
4. 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;

5. 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

6. 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.1372

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 potential for treaty shopping through PEs (which is discussed further below).1373 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.

13.2.1.1. Approaches to extending treaty benefits to PEs1374

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:

3. 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.

4. 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

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1372 Refer to Chapter 6 for a detailed discussion of these potential solutions for PE triangular cases.
1373 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,” at para 39).
1374 For further discussion of the possible approaches to extending treaty benefits to PEs, refer to Chapter 7 (Section 7.3).
options were discussed in detail in Chapter 7. 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.

13.2.2. Proposed treaty provisions

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

"(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 is located."

1375 Refer to Section 7.3.
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.1376 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,1377 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.

13.2.2.1. 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.1378 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.1379 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...").1380

13.2.2.2. Income must be attributable to a PE for the purposes of the R-PE treaty

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.1381 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

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1376 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.

1377 Refer to Chapter 8 (Section 8.2.5.) for a brief overview of the various terms used the OECD Model.

1378 See, for example: Yong, S., "Triangular Treaty Cases..."; Langoth, B. "Treaty Entitlement...."

1379 For further discussion, see Chapter 8 (Section 8.2.1.).

1380 For further discussion, see Chapter 8 (Section 8.2.2.).

1381 For further discussion refer to Chapter 8 (Section 8.2.3.).
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.

13.2.2.3. 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.

13.2.2.4. Residence and beneficial ownership

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 and, in relation to dividends, interest and royalties, it must be the beneficial owner of the income. 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. 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.

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, and thus, the existence of a PE and the attribution of income to that PE should 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. 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.

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1382 This section gives an overview of the discussion in Chapter 8, Section 8.3.
1383 In accordance with the residence definition contained in the treaty (in the OECD Model, Article 4).
1384 See: OECD Model, Article 10 (2), Article 11(2) and Article 12(1).
1385 Refer to the discussion in Chapter 8, Section 8.3.1.1.
1386 Refer to the discussion in Chapter 8, Section 8.3.2.1.
1387 This was discussed in Chapter 5, see Section 5.2.4.
13.2.2.5. Certification procedure

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. Where a PE is claiming treaty benefits, the PE state should clearly be involved in this process, 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.

13.2.3. Potential for improper access to treaties through PEs

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 shopping under existing principles 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. 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.

13.2.3.1. 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, 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: 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

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1389 This section gives an overview of the discussion in Chapter 8, Section 8.3.3.
1390 Russo, R., "Administrative Aspects...."
1391 OECD Committee on Fiscal Affairs, "Triangular Cases," at paras 51 and 52.
1392 This was discussed in Chapter 5 (see Section 5.2.6.)
1393 Refer to the discussion of the ways in which states currently combat treaty shopping in Chapter 5 (Section 5.2.6.1.).
1394 Refer to the discussion in Chapter 5 (Section 5.2.6.2.)
1395 Refer to the discussion in Chapter 8 (Section 8.4.1.1.).
1396 Refer to the discussion in Chapter 8, Section 8.4.2.
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")**\(^{1397}\) 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**\(^{1398}\) 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 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**\(^{1399}\) 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.

### 13.2.4. Excluding the operation of the R-S treaty\(^{1400}\)

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.\(^{1401}\)

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.\(^{1402}\) 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.\(^{1403}\) Specific provisions also give taxpayers greater certainty as to the way in which the treaty will apply in their particular circumstances.

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\(^{1397}\) 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(c)).

\(^{1398}\) Refer to the discussion in Chapter 8 (Section 8.4.4.).

\(^{1399}\) Refer to the discussion in Chapter 8 (Section 8.4.6.). See also: OECD Commentary on Article 1, para 19.

\(^{1400}\) This section gives an overview of the discussion in Chapter 7, Section 7.5.


\(^{1402}\) For a detailed discussion of these provisions, refer to Chapter 7 (Section 7.5.1.1.).

\(^{1403}\) 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…."
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. 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:

3. The source state applies the conditions of the PE-S treaty in relation to that income; or
4. 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."
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.

13.2.4.1. 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.

13.2.5. 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 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.

13.3. Dual resident triangular cases

Dual resident triangular cases occur where a dual resident person receives income from sources in a third state (the "source state"). 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. 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. 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. 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.

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. 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. 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. If both these treaties apply then the source state will only be able to satisfy its treaty obligations by applying the

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1405 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, which deals primarily with the application of treaties between the losing residence state of the dual-resident and third states.

1406 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 (Section 10.3).

1407 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 10.4.1.).

1408 The place of effective management tie-breaker is discussed in Chapter 10, Section 10.3.2.1.

1409 Refer to Chapter 10 (Section 10.4.1.).

1410 Refer to the discussion in Chapter 10 (Section 10.4.2.2.) and in Chapter 11.

1411 Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems…"; Avery Jones, J.F., "The Interaction Between…", at p. 137 (Chapter 6, Section 6.4.1.).

treaty conditions that are more favourable to the person deriving the income. 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 losing residence state will generally only be entitled to impose tax in situations where the income is attributable to a PE of the dual resident located in that state. It is therefore proposed that dual residents should be excluded from claiming the benefit of treaties between their losing residence state and third states, but that treaty benefits be extended to PEs located in the losing residence state as outlined above. The next section deals with preventing the application of treaties between the losing residence state and third states, while the following section deals with the interaction between dual resident triangular cases and the extension of treaty benefits to PEs.

13.3.1. Preventing application of treaties between the losing residence state and third states

The OECD Commentary expresses the view that a dual resident will not be resident in the losing residence state for the purposes of treaties concluded between that state and third states as a result of the application of the second sentence of Article 4(1). This is based on the view that, as a result of the limitations contained in the treaty between the two residence states, the dual-resident will only be taxable in the losing residence state on income which is sourced in that state. This view is controversial, however, and given the lack of clarity in the application of the second sentence of Article 4(1), it does not seem appropriate deny treaty benefits on this basis. In light of the difficulties with the interpretation of the second sentence of Article 4(1), discussed in depth in Chapter 11, it is not a satisfactory way of dealing with (potentially improper) claims for treaty benefits by dual residents.

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. 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. However, in other cases it may potentially give rise to

1414 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…"
1415 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., & Bobbett, C., "Triangular Treaty Problems..."; Avery Jones, J.F., "The Interaction Between…," at pp. 138-140 (Chapter 6, Section 6.4.1); Sasseville, J., "A Tax Treaty Perspective…," at pp. 45-48 (Chapter 3, Section 3.4.).
1416 Sasseville, J., "A Tax Treaty Perspective…," at p. 47 (Chapter 3, Section 3.4.).
problems with the interaction between different provisions 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 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.

A better approach would be to include a specific provision in tax treaties, which could deny treaty benefits by direct reference to the allocation of residence under 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, 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.

### 13.3.2. Interaction with extension of treaty benefits to PEs

Under the treaty between the two residence states of a dual resident, 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.

### 13.4. Reverse PE triangular cases

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 potentially also royalties) under their respective treaties with the residence state of the person receiving the income. This dual source-based

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1417 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 (Sections 4.2.3.3. and 4.2.3.4.)).

1418 Reverse triangular cases are discussed in Chapter 11.
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.\footnote{This risk of unrelieved double taxation
can generally only be resolved by preventing one of the source states, preferably the residence state of the
payor, from imposing tax on the interest. This could be achieved by altering the wording of Article 11(5)
to the effect that interest which originates from a PE would be considered to arise in the PE state even if
the PE is located in a third state.\footnote{Avery Jones, J.F., et al., "Tax Treaty Problems…”; Avery Jones, J.F., & Bobbett, C., "Triangular Treaty
Problems…”; Lombardi, M., "Triangular Situations…”; Pereira Ribeiro, R., "Dual Source Situations…”} 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 HO-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 an
alternative wording of Article 11(5) along the lines of that included in the OECD Commentary\footnote{2010 OECD Commentary on Article 11, para 30.}
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, for the
purposes of the treaty between the State of which he is resident and that Other State, 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."

Any concerns that this may create opportunities for tax avoidance could be dealt with 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.\footnote{Avery Jones, J.F., et al., "Tax Treaty Problems…”}
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.

13.5. Reverse dual resident triangular cases\footnote{This section gives an overview of the discussion in Chapter 12, Section 12.3.}

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.\footnote{Refer to the analysis of reverse dual resident triangular cases in Chapter 12, Section 12.3.}
This can result in unrelieved double taxation because the residence state of the recipient may not be in a position to provide sufficient relief.

Provided the residence of the dual resident payor is assigned to one state for the purposes of the treaty
between the two residence states, the best approach would be to prevent the losing residence state from
imposing tax on the payments (except where they originate from a PE located in that state). This could be
achieved by a specific treaty provision preventing the dual-resident from being considered a resident of
the losing residence state for the purposes of treaties which that state has concluded with third states.\footnote{Refer to the discussion in Chapter 12 (Section 12.3.5.).}

Thus, the solutions to dual resident triangular cases discussed above (i.e., situations where income is
received by a dual resident) would equally resolve the issues arising in reverse dual resident triangular
cases. Briefly, it is proposed that a provision would be included 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.\textsuperscript{1426} 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.

Where the treaty between the two residence states is not effective in assigning residence to one state this approach is not practical, however, and a better approach would be to limit the residence states of the payor to imposing 50% of the tax they would otherwise be entitled to impose on the income. This could be achieved by including specific wording in tax treaties as follows:

\begin{quote}
"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]."
\end{quote}

Similar provisions could be included for interest and, if applicable, royalties (i.e., in situations where the treaty allows source-based taxation of royalties).

\subsection*{13.6. 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 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

\begin{footnotesize}
\textsuperscript{1426} Refer to the discussion in Chapter 12 (Section 12.3.5.2.)
\end{footnotesize}
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 chapter. 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.

13.7. Overview of proposed treaty provisions

13.7.1. 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.

<table>
<thead>
<tr>
<th>Aim of the provision</th>
<th>Suggested text</th>
</tr>
</thead>
</table>
| **Preventing application of the R-S treaty:** | "(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.

(3) This article shall apply to capital gains and profits in the same way as it applies to income.

(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."

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<table>
<thead>
<tr>
<th>Ensuring the residence state continues to have a relief obligation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>To ensure that the residence state continues to provide relief for tax imposed in the source state where necessary.</td>
</tr>
</tbody>
</table>

"(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."

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<table>
<thead>
<tr>
<th>Extending treaty benefits to PEs:</th>
</tr>
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<tbody>
<tr>
<td>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. 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. Paragraph 2 ensures that treaty benefits are also available with respect to profits and capital gains attributable to the PE.</td>
</tr>
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</table>

"(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
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. See Chapter 8 (Section 8.2.) for discussion.

<table>
<thead>
<tr>
<th>Preventing improper claims for treaty benefits by PEs:</th>
<th>Subject to tax provision: &quot;Where this Convention applies under this article to income arising in a Contracting State and included in the income 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.&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examples of provisions which could be included in tax treaties to prevent improper claims for treaty benefits by PEs, along with examples of safe harbour provisions to prevent the unreasonable denial of benefits. See Chapter 8 (Section 8.4.) for discussion.</td>
<td>Anti-base erosion provision: &quot;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.&quot;</td>
</tr>
<tr>
<td>Denial of treaty benefits where there is a tax avoidance motive: &quot;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.&quot;</td>
<td>Safe harbour provisions: &quot;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</td>
</tr>
</tbody>
</table>

(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."


13.7.2. 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.

<table>
<thead>
<tr>
<th>Aim of the provision</th>
<th>Suggested text</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Relief in the PE state:</strong></td>
<td></td>
</tr>
<tr>
<td>To require the PE state to provide relief for tax imposed in the source state.</td>
<td>&quot;(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. (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 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</td>
</tr>
</tbody>
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1427 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.

1428 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.

1429 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.
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.

(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."

Preventing improper access to the R-S treaty:

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.

The suggested text is based on the wording of provisions included in many US treaties.

See Chapter 7 (Section 7.5.1.) for discussion.

"(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) This article shall apply to capital gains and profits in the same way as it applies to income."

13.7.3. 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.

<table>
<thead>
<tr>
<th>Aim of the provision</th>
<th>Suggested text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dual-resident triangular cases and reverse dual-resident triangular cases:</td>
<td>&quot;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.&quot;</td>
</tr>
</tbody>
</table>

See Chapter 7 (Section 7.5.1.) for discussion.
OECD Model).

See Chapter 11 (Section 11.3.2.) and Chapter 12 (Section 12.3.5.2.) for discussion.

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.

<table>
<thead>
<tr>
<th><strong>Reverse dual resident triangular cases where there is no effective allocation of residence</strong></th>
</tr>
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<tbody>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td>See Chapter 11 (Section 11.3.2.) for discussion.</td>
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<table>
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<tr>
<th><strong>Reverse PE triangular cases:</strong></th>
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<tr>
<td>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.</td>
</tr>
<tr>
<td>&quot;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 in a State other than that of which he is a resident, for the purposes of the treaty between the State of which he is resident and that other State, 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.&quot;</td>
</tr>
</tbody>
</table>

“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].”
Appendix 1:  
Variations on the basic triangular cases

1.1. Introduction

This part of the thesis expands upon the analysis of the basic triangular cases\(^{1430}\) conducted in earlier chapters and addresses the application of bilateral income tax treaties in other multilateral situations. The cases discussed are variations on the basic triangular cases, each of which essentially combines two of those basic cases.\(^{1431}\) In general, the issues that arise in these more complicated multilateral cases (sometimes referred to as “quadrilateral cases”\(^{1432}\)) are the same as those that arise in the basic cases, although there is sometimes an additional layer of complexity or an additional layer of taxation.

In addition to an analysis based on the existing treaty framework, this chapter discusses the solutions proposed throughout earlier chapters to test their application in quadrilateral cases and in doing so, also tests their application in the basic triangular cases. The beginning of each section of this appendix includes an overview of the proposed changes which are relevant for the particular situation under consideration; these overviews are necessarily brief and reference should be made to the more detailed discussion of the proposed solutions in earlier chapters.\(^{1433}\) This appendix also draws heavily on the analysis of the basic triangular cases conducted throughout the thesis and should be understood in light of that analysis. It does not contain a detailed discussion of all the issues arising in triangular cases.

Scope

There are an almost endless number of variations on the basic triangular cases that could be imagined and it is necessary to limit the situations being considered. This part therefore deals primarily with situations where four states are involved and does not deal with situations where fewer states are involved, e.g., where the payor and the recipient both have a presence in the same state. It also does not address situations where a person is resident in more than two states, situations combining a sub-PE triangular case with a reverse triangular case, or situations involving reverse sub-PE triangular cases.

The four cases discussed in this appendix are:

(i) A combination of a PE triangular case and a reverse PE triangular case (Section 1);
(ii) A combination of a PE triangular case and a reverse dual resident triangular case (Section 2);
(iii) A combination of a dual resident triangular case and a reverse PE triangular case (Section 3); and
(iv) A combination of a dual resident triangular case and a reverse dual resident triangular case (Section 4).

\(^{1430}\) The basic triangular cases referred to here are PE triangular cases, dual resident triangular cases, reverse PE triangular cases and reverse dual resident triangular cases. Chapter 1 contains a brief introduction to these cases (see Section 1.2.). For an analysis of PE triangular cases involving different categories of income, refer to Chapter 2. PE triangular cases are also discussed in Chapters 3 through 8. For discussion of dual resident triangular cases refer to Chapters 10 and 11; Chapter 10 contains an introduction and discussion of dual resident triangular cases involving various categories of income and Chapter 11 focusses on the application of treaties with third states. For discussion of reverse PE triangular cases and reverse dual resident triangular cases, see Chapter 12.

\(^{1431}\) Certain variations on the basic triangular cases have been dealt with previously by Gusmeroli, M. “Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1” 45 European Taxation 1, (2005), pp. 2-13. Gusmeroli discusses situations where a typical PE triangular case is combined with a reverse PE triangular case, including situations where both three and four states are involved; more detail will be given below. Gusmeroli also identifies other authors who have made passing reference to situations involving more than three states.


\(^{1433}\) Proposed solutions for triangular cases have been identified throughout this thesis; reference will be made to those chapters in this appendix where relevant. A more detailed overview of the proposed solutions can be found in Chapter 13.
Each of these situations will be described in more detail in the relevant section. For the purposes of the analysis in this appendix, it is assumed that all the states involved seek to impose tax under their respective domestic laws and that there are treaties in effect between all the relevant states. It is further assumed (except where specifically noted) that those treaties follow the 2010 OECD Model.

The analysis in this part is structured around the categories of income identified in the OECD Model, namely business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12), income from immovable property (Article 6), income from shipping, inland waterways transport and air transport (Article 8), capital gains (Article 13) and other income (Article 21). It does not discuss income from employment (Article 15), directors’ fees (Article 16), artistes and sportsmen (Article 17), pensions (Article 18), government service (Article 19) or students (Article 20), which are outside the scope of this study.

Note that this part of the thesis may seem to contain some repetition but this has been done to ensure that each section can be easily understood without reading the entirety of this part of the thesis. To give an example, the treaty provision applicable to business profits (Article 7) is repeated for each of the four situations being addressed (in the sections dealing with business profits).
Section I

PE triangular cases combined with reverse PE triangular cases

1.1. Introduction

The case discussed in this section is a combination of a typical PE triangular case\textsuperscript{1434} and a reverse PE triangular case.\textsuperscript{1435} It involves a person who is resident in one state ("State R1") and has a PE in a second state ("State PE1") who derives income from outside those two states. The income is paid by a resident of a third state ("State R2") and the payment originates from a PE which the payor has in a fourth state ("State PE2"); State R2 and State PE2 are referred to collectively as the “source states”. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram showing the relationship between the states R1, PE1, R2, and PE2.]

1.1.1. The existing treaty framework

Under the existing treaty framework, the applicable treaties in this case will be:

(i) the treaty between the recipient’s residence state and the payor’s residence state (the R1-R2 treaty);

(ii) the treaty between the recipient’s residence state and payor’s PE state (the R1-PE2 treaty); and

(iii) the treaty between the recipient’s residence state and the recipient’s PE state (the R1-PE1 treaty).

Neither the treaty between the payor’s residence state and the payor’s PE state (the R2-PE2 treaty) nor the treaty between the two PE states (the PE1-PE2 treaty) will apply because, for the purposes both of these treaties, the income is not received by a resident of one of the contracting states.

In relation to virtually all categories of income, this situation gives rise to the same result as that which occurs in a typical PE triangular case under the existing treaty framework (as outlined in Chapter 2). This is because in most cases source-based taxation may only be imposed in one state, i.e., either the payor’s residence state or the payor’s PE state but not both.\textsuperscript{1436} The main exception is interest, where both those states would generally be entitled to impose tax under Article 11 of their respective treaties with the residence state of the recipient of the income, giving rise to dual source-based taxation.\textsuperscript{1437} Dual source-based taxation may also occur in relation to royalties if, as is commonly the case, Article 12 of the relevant treaties differs from the OECD Model and allows some limited rate of source-based taxation.\textsuperscript{1438} Where there is dual source-based taxation, tax may be imposed in four separate states, which would result in a high likelihood of unrelieved double taxation. In addition, even where dual source-based taxation does not arise, this situation will give rise to the same issues as typical PE triangular cases; i.e., the application of the less appropriate treaty conditions in the source state and the potential for unrelieved double taxation if no relief is provided in the PE state. In addition, tax avoidance concerns may arise in

\textsuperscript{1434} For a detailed overview of the application of tax treaties in typical PE triangular cases, refer to Chapter 2.

\textsuperscript{1435} For a detailed discussion of reverse PE triangular cases, refer to Chapter 12 (Section 12.2.).

\textsuperscript{1436} Refer to the analysis of reverse PE triangular cases in Chapter 12 (particularly Section 12.2.3.).

\textsuperscript{1437} Refer to the analysis of reverse PE triangular cases involving interest in Chapter 12 (Section 12.2.2.).

\textsuperscript{1438} The UN Model also allows source-based taxation of royalties. See: UN Income and Capital Model Convention (2001), Article 12(2). This is discussed in somewhat more detail in Chapter 12 (see Section 12.2.2.).
relation to claims for reduced source-based taxation under the treaties concluded by the recipient’s residence state with the two source states.\textsuperscript{1439}

\textbf{1.1.2. Application of proposed solutions}

The relevant proposals for the situation discussed in this section are those which are aimed at dealing with typical PE triangular cases and reverse PE triangular cases.

\textit{Application of treaties between the PE state and third states}\textsuperscript{1440}

It is proposed that where a resident of one state derives income which is attributable to a PE in a second state (for the purposes of the treaty between those two states), the person deriving the income should be entitled to claim the benefits of treaties concluded between the PE state and third states in relation to the income attributable to the PE. As a result, the state where the income arises (the source state) would be obliged to apply the conditions of its treaty with the PE state, and the PE state would be obliged to grant relief in accordance with the terms of that treaty. The proposed treaty provision to achieve this is as follows:

\begin{quote}
"(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.

(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 the preceding paragraphs 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 ... is located for the purposes of the application of this Convention under those paragraphs."
\end{quote}

Note that paragraphs 1(b) and 1(c) of this proposed provision (which are not reproduced above) are intended to deal with situations where treaties do not exist between all the contracting states. They are thus not relevant for the analysis conducted in this appendix, since it is assumed that there are treaties in place between all the states involved.

If this provision were included in all the relevant treaties, then in the situation discussed in this section the person deriving the income would generally be entitled to claim the benefit of the treaties concluded

\textsuperscript{1439} In PE triangular cases, the primary tax avoidance concern is that a company resident in State R will claim a reduction in source-based taxation under the R-S treaty in relation to income which is exempt in State R (as a result of being attributable to a PE), and which is also not subject to tax in the PE state (which may be a tax haven). See, inter alia: Van Weeghel, S. "The Improper Use of Tax Treaties", (London, Kluwer Law International, 1998), pp. 124-126.

\textsuperscript{1440} This proposal is discussed in detail throughout Chapter 7 and Chapter 8.

\textsuperscript{1441} This provision is extracted from Chapter 8 (see Section 8.2.5.).
between State PE1 and the source states (State R2 and State PE2) in relation to the income attributable to the PE. The exclusion for situations where the PE state of the recipient of the income is prevented from imposing tax is also relevant for certain categories of income.

Limited application of treaties between the residence state and third states

It is proposed that in PE triangular cases, the application of tax treaties between the residence state of the person deriving the income and third states where income arises (source states) be restricted. It is proposed that a source state will not be required to apply the conditions of its treaty with the residence state in relation to income attributable to a PE in a third state if either:

3. The source state applies the conditions its treaty with the PE state in relation to that income; or
4. The source state does not apply the conditions of its treaty with the PE state, but the situation is one where the application of the conditions of the treaty with the residence state would be considered improper (in accordance with certain specified criteria).

The proposed provision is as follows:

"(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 the 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.

(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 of which the person deriving the income is resident shall continue to apply [Article 23A(2) / 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.

1442 This aspect of the proposed solutions is discussed in depth in Chapter 7 (see in particular Section 7.5.).
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."¹⁴⁴³

In the situation discussed in this section, the effect of this provision would be to exclude the operation of the treaties between the residence state (State R1) and the two source states (State R2 and State PE2). However, these treaties will continue to require State R1 to provide relief under the terms of the treaty (under paragraph 3 of the provision set out above) in some circumstances. In accordance with the wording of this provision, no relief would be required in State R1 to the extent that the source states are prevented from imposing tax under their respective treaties with State PE1. Furthermore, where State R1 uses the credit method of relief (either under Article 23A(2) or under Article 23B), the credit in State R1 is specifically limited to the rate of tax that the source state could have imposed if it applied the terms of its treaty with State R1. State R1 will also not be required to provide any additional relief if it exempts the income under its treaty with the PE state. This is based on the general principles discussed in Chapter 3 but, if the residence state remains concerned about having to both exempt the income and grant a credit, then there are also certain measures (discussed in Chapter 3) which that state could take to ensure that it does not have a dual relief obligation.¹⁴⁴⁴

Limits on source-based taxation where payments originate from a PE

It is proposed that interest (and, where applicable, royalties) which originate from a PE located in a third state should not be considered to arise in the payor’s residence state for the purposes of treaties concluded between that state and third states. This would be achieved by changing the wording of Article 11(5) and, where applicable, the corresponding provision of Article 12. The proposed wording of Article 11(5) is 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."¹⁴⁴⁵

As a result, interest or royalties paid in a reverse PE triangular situation (or in the situation discussed in this section) would not be considered to arise in the residence state of the payor for the purposes of the treaty between that state and the residence state of the recipient. As a result, the residence state of the payor would be prevented from imposing tax (this will be discussed in further detail below). This may be subject to certain conditions, for example that the PE state imposes source-based tax on the interest,¹⁴⁴⁶ but it is assumed that any such conditions are satisfied for the purposes of the discussion below.

Applicable treaties

If these proposed provisions are incorporated into all the relevant treaties, the applicable treaties in the situation discussed in this section would be:

(i) the treaty between the recipient’s residence state and the payor’s residence state (the R1-R2 treaty) – State R2 will not be bound by the conditions of this treaty, but State R1 may have a relief obligation;

¹⁴⁴³ This provision is extracted from Chapter 7 (Section 7.5.4.) where it is discussed in much greater depth.
¹⁴⁴⁴ Please refer to Chapter 3 for a detailed discussion of the possibility of a dual relief obligation arising in the residence state in PE triangular cases (Section 3.3.). It was concluded in that chapter that a treaty exemption should be taken into account when determining the amount of tax imposed in the residence state in respect of certain income for the purposes of applying the credit relief provisions of the other applicable treaty. As a result, there will be no tax imposed on the income in the residence state for the purposes of those relief provisions and no credit will be required (in accordance with the terms of Article 23A(2) or Article 23B, as applicable).
¹⁴⁴⁵ This provision has been taken from the 2010 OECD Commentary on Article 11, para. 30. It is discussed in much greater depth in Chapter 12 (Section 12.2.2.).
¹⁴⁴⁶ Refer to Chapter 12 (Section 12.2.2.2.) for discussion of the reasons for imposing such limitations and the type of limitations that may be imposed.
(ii) the treaty between the recipient’s residence state and the payor’s PE state (the R1-PE2 treaty) – State PE2 will not be bound by the conditions of this treaty, but State R1 may have a relief obligation;

(iii) the treaty between the recipient’s PE state and the payor’s residence state (the PE1-R2 treaty) – State R2 must apply the conditions of this treaty in relation to the income attributable to the PE and State PE1 may be obliged to provide relief;

(iv) the treaty between the recipient’s PE state and the payor’s PE state (the PE1-PE2 treaty) – State PE2 must apply the conditions of this treaty in relation to the income attributable to the PE and State PE1 may be obliged to provide relief; and

(v) the treaty between the recipient’s residence state and recipient’s PE state (the R1-PE1 treaty) – there will be no change in the way this treaty applies.

The only treaty which will not apply in this case is the treaty between the payor’s residence state and the payor’s PE state. This treaty will not apply because the income is not received by a resident of either of the contracting states.

The following sections discuss the application of tax treaties in this situation, one where a PE triangular case is combined with a reverse PE triangular case, where different categories of income are involved. Each section deals firstly with the application of tax treaties under the existing framework, before going on to discuss the application of tax treaties on the basis that all the relevant treaties include the proposed provisions outlined above.

1.2. Business profits

Article 7 deals with business profits and allows the residence state of the person deriving the income to impose tax. It also allows the other contracting state to impose tax, but only in relation to profits which are attributable to a PE in that other state.\textsuperscript{1447} Article 7 (in paragraphs 1 and 2) provides as follows:

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.\textsuperscript{1448}

Thus, the source state may not impose any tax on business profits except to the extent they are attributable to a PE. For further discussion of the PE concept and the attribution of profit to PEs, refer to the discussion in Chapter 5 (Sections 5.2.3. and 5.2.4.).

This section deals with a situation where a person resident in State R1 derives income which is attributable to a PE in State PE1. The income is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. It is assumed that the recipient of the income does not have a PE in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

\textsuperscript{1447} The term “permanent establishment” is defined in Article 5.

\textsuperscript{1448} Article 7, paragraphs 1 and 2.
For a more detailed discussion of PE triangular cases involving business profits, refer to Chapter 2 (Section 2.4). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving business profits, refer to Chapter 11 (Section 11.2).

1.2.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 7 will apply and, given that the income is not attributable to a PE in State R2, State R2 will be prevented from imposing tax.

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 7 will apply and, given that the income is not attributable to a PE in State PE2, State PE2 will be prevented from imposing tax on the income.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 7 will apply and State PE1 will be entitled to impose tax on the profit attributable to the PE.

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax, but will be obliged to provide relief (either exemption or credit) in accordance with Article 23A/23B of the R1-PE1 treaty.

Overview: Under the existing treaty framework, tax may only be imposed in State R1 and State PE1 and State R1 will be obliged to provide relief. There will be no unrelieved double taxation. This situation is effectively the same as a typical PE triangular case involving business profits, since both source states are prevented from imposing tax. In applying their treaties with State R1, however, the source states (State R2 and State PE2) are arguably not applying the appropriate treaty provisions and should instead apply the provisions of their treaties with State PE1.  

1.2.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of being bound by the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty in relation to the income attributable to the PE. For the purposes of this treaty, Article 7 will apply and, given that the income is not attributable to a PE in State R2, State R2 would be prevented from imposing tax on the income. This outcome is the same as where the R1-R2 treaty applies. The outcome may differ, however, if the PE definitions differ between the two treaties. For example, if the PE threshold is lower in the PE1-R2 treaty than in the R1-R2 treaty, then a PE may exist for the purposes of the first treaty but not the second. Nevertheless, in most cases the application of the PE2-R2 treaty instead of the R1-R2 treaty will have no impact on State R2’s ability to impose tax on the income.

The payor’s PE state (State PE2): Instead of being bound by the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. In relation to business profits, Article 7 applies and given that the income is not attributable to a PE in State PE2, State PE2 would be prevented from imposing tax on the income. The application of the treaty with the PE state instead of the treaty with the

1449 The reasons for considering the conditions of the treaty between the source state and the PE state the appropriate treaty conditions for the source state to apply in PE triangular cases are discussed in depth in Chapter 5.
The residence state will generally have no impact in State PE2 in relation to business profits, however, it may have an impact if the PE definitions differ between the two treaties.

The recipient’s PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 7 will apply and State PE1 will be entitled to impose tax on the profit attributable to the PE. State PE1 is also obliged to apply the conditions of its treaties with State R2 and State PE2, in particular the relief provisions. In relation to business profits, however, both of the source states are prevented from imposing tax and State PE1 therefore has no obligation to provide relief.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax on the income, but will have an obligation to provide relief (either exemption or credit) under the R1-PE1 treaty. State R1 does not have any obligation to provide relief under either the R1-R2 treaty or the R1-PE2 treaty, since both State R2 and State PE2 are prevented from imposing tax under their respective treaties with State PE1.

Overview: The proposed solutions would usually have little practical impact in this situation, since the distributive rules for business profits do not generally differ between treaties. Furthermore, because no tax can be imposed in the source states, no relief is required in the recipient’s PE state. One situation where a different outcome may arise is where the PE definition contained in one of the source states’ treaties with State R1 differs from that contained in its treaty with State PE1. As a result, the source state may be entitled to impose tax if it applies the conditions of its treaty with State R1 but not if it applies the conditions of its treaty with State PE1 or vice versa. In order for this to fit within the scenario discussed in this section, however, the PE in the source state would have to be a sub-PE of the PE in State PE1, which is unlikely to occur in practice; sub-PE triangular cases are discussed in Chapter 2 (Section 2.4.1.) and in Chapter 8 (Section 8.6.6.). Note that the proposals relating to reverse PE triangular cases are not relevant here, since those proposals deal only with situations involving interest and royalties.

1.3. Dividends

Dividends are dealt with in Article 10. Article 10 allows the state where the payor of dividends is resident (the source state) to impose tax, but limits the amount of the tax to a certain percentage of the gross amount of the dividends. Article 10 provides as follows (in paragraphs 1 and 2):

“1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

b) 15 per cent of the gross amount of the dividends in all other cases.”

Thus, the rate of tax that may be imposed in the source state depends on recipient’s interest in the company paying the dividends.\textsuperscript{1450} The exact rates are a common point of negotiation, however, and often vary between treaties. The ownership thresholds also vary in many concluded treaties and some treaties may provide only a single maximum tax rate. Furthermore, if the dividends are attributable to a PE of the recipient which is located in the source state, then as a result of Article 10(3), Article 7 will apply instead of Article 10 and the source state may impose tax on the basis of the profit attributable to the PE.

\textsuperscript{1450} The application of this threshold (and other treaty thresholds) in situations where treaty benefits are claimed in relation to the income attributable to a PE are discussed in Chapter 8 (Section 8.6.2.).
This section deals with a situation where a person resident in State R1 receives dividends which are attributable to a PE located in State PE1. The dividends are paid by a resident of State R2 and the profits from which the dividends are paid originate in a PE located in State PE2. It is assumed that the recipient of the dividends does not have a PE in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a detailed discussion of PE triangular cases involving dividends, refer to Chapter 2 (Section 2.5.1.). For a detailed discussion of reverse PE triangular cases involving dividends, refer to Chapter 11 (Section 11.2.1.).

### 1.3.1. Existing treaty framework

**The payor’s residence state (State R2):** State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 10 will apply and State R2 will be entitled to impose tax on the dividends at a limited rate.

**The payor’s PE state (State PE2):** State PE2 must apply the conditions of the R1-PE2 treaty. Article 10 of the treaty will not apply because the dividends are not paid by a resident of State PE2. Instead, Article 7 or Article 21 will apply (depending on whether the income is considered to be business profits) and State PE2 will be prevented from imposing tax on the dividends. State PE2 may also be prevented from imposing tax under Article 10(5) of the R2-PE2 treaty.1451

**The recipient’s PE state (State PE1):** State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty the dividends are attributable to a PE in State PE1 and therefore, as a result of Article 10(3), will fall under the distributive rule of Article 7 of the purpose of this treaty. Under Article 7, State PE1 will be entitled to impose tax on the basis of the profit attributable to the PE. State PE1 may also have an obligation to provide relief for the tax imposed in State R2 under the PE non-discrimination provision (Article 24(3)) of its treaty with State R1, however, the scope of this obligation is not completely clear.1452

**The recipient’s residence state (State R1):** State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will be obliged to provide relief under both the R1-R2 treaty (using the credit method, regardless of the general relief method specified in the

1451 Article 10(5) provides that: “Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.” Thus, this provision should prevent the PE state from imposing tax on the dividends. The main problem with applying this provision is that it applies under the treaty between the residence state and the PE state of the payor and, for the purposes of this treaty, the recipient of the dividends is not a resident of either of the contracting states. Article 10(5) is discussed in detail in Chapter 12 (see Section 12.2.1. and Section 12.3.4.).

1452 The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).
treaty\textsuperscript{1453} and the R1-PE1 treaty (either credit or exemption). Unless relief is also provided in State PE1, State R1 may be unable to provide sufficient relief to prevent double taxation. Where State R1 provides relief using the exemption method under the R1-PE1 treaty, it should not be obliged to grant any additional credit relief under the R1-R2 treaty.\textsuperscript{1454}

Overview: In this situation, tax may be imposed in State R2, State PE1 and State R1. State R1 will have an obligation to provide relief under its treaties with State R2 and State PE1, and State PE1 may also have an obligation to provide relief for tax imposed in State R2 (under Article 24(3) of the R1-PE2 treaty). This situation is effectively the same as a typical PE triangular case, since State PE2 is prevented from imposing tax, and gives rise to the same issues. These are namely, the application of the “wrong” treaty conditions in the source state (particularly State R2, but also State PE2) \textsuperscript{1455} and the potential for unrelieved double taxation if no relief is provided in State PE1.\textsuperscript{1456}

1.3.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of being bound by the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of the PE1-R2 treaty, Article 10 applies and State R2 may impose tax on the dividends at a limited rate. This rate may differ from that specified in the R1-R2 treaty.

The payor’s PE state (State PE2): Instead of being bound by the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of applying this treaty, Article 10 does not apply because the dividends are not paid by a resident of State PE2. Instead, if the dividends are considered to be business profits, Article 7 will apply. If the dividends are not considered to be business profits, then Article 21 will apply. Regardless of whether Article 7 or Article 21 applies, however, State PE2 will be prevented from imposing tax on the dividends. If State PE2 is prevented from imposing tax as a result of Article 10(5) of the R2-PE2 treaty under the existing treaty framework, then the outcome in this case will not be any different (and Article 10(5) may also continue to prevent State PE2 from imposing tax). However, there is some uncertainty regarding the application of Article 10(5) in this situation and preventing State PE2 from imposing tax under the terms of the PE1-PE2 treaty makes the outcome clearer and more certain.

The recipient’s PE state (State PE1): State PE1 must continue to apply the R1-PE1 treaty. For the purposes of this treaty, Article 7 applies and State PE1 may impose tax on the profit attributable to the PE. State PE1 is also obliged to provide relief for tax imposed in State R2 under the relief provisions of the PE1-R2 treaty. Given that dividends are involved this would typically be credit relief regardless of the general

\textsuperscript{1453} Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).

\textsuperscript{1454} This was discussed in Chapter 3 (Section 3.3.), where it was concluded that the exemption under one treaty should be taken into account when determining the amount of tax imposed in the residence state in respect of the income for the purposes of applying the relief provisions of the treaty requiring credit relief. As a result, there will be no tax imposed on the income in the residence state for the purposes of that provision and no credit will be required (in accordance with the terms of Article 23A(2) or Article 23B, as applicable). Please see Chapter 3 for an in-depth discussion of this issue.

\textsuperscript{1455} That is, the source states apply the conditions of their treaties with the residence state of the recipient of the income (State R1) rather than the conditions of their treaties with the PE state (State PE1), despite the allocation of primary (or even exclusive) taxing rights to State PE1 under the R1-PE1 treaty. The reasons for considering this the “wrong” treaty are discussed in depth in Chapter 5.

\textsuperscript{1456} Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.
method of relief specified in the treaty.\textsuperscript{1457} State PE1 does not have to provide relief under the PE1-PE2 treaty because State PE2 is prevented from imposing tax on the income under the terms of that treaty.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but is obliged to provide relief under the R1-PE1 treaty (either exemption or credit). To the extent that State R1 exempts the income under this treaty, no further relief would be required. If, however, State R1 uses the credit method of relief with respect to the income attributable to the PE, it will also have to provide a credit\textsuperscript{1458} for tax imposed in State R2 under the terms of the R1-R2 treaty.\textsuperscript{1459} State R1 will not be obliged to provide relief under the R1-PE2 treaty, since State PE2 is prevented from imposing tax under the terms of the PE1-PE2 treaty.

Overview: In this situation, the source states (State R2 and State PE2) no longer have to apply the conditions of their treaties with the residence state of the person receiving the dividends (State R1) and will instead be subject to the conditions of their respective treaties with the recipient’s PE state (State PE1). This means that they are now applying the more appropriate treaty conditions. In State PE2 this will generally have no impact since State PE2 will generally be prevented from imposing tax regardless of which treaty it applies. In State R2, however, the treaty with State PE1 may provide a different maximum rate of source-based taxation of dividends and this would have an impact on the amount of tax that State R2 could impose. In addition, State PE1 now has an explicit obligation to provide relief for tax imposed in State R2 under the terms of the PE1-R2 treaty. Relief will also be required in State R1. If State R1 uses the exemption method under the R1-PE1 treaty then it will simply exempt the income, however, if State R1 uses the credit method in relation to the income attributable to the PE then it will also be obliged to provide a credit for tax imposed in State R2. The combination of the relief in State PE1 and in State R1 will generally ensure that no unrelieved double taxation arises. Note that the proposals relating to reverse PE triangular cases are not relevant here, since those proposals deal only with situations involving interest and royalties.

1.4. Interest

Interest is dealt with in Article 11, which allows the state where interest arises to impose a limited rate of tax. Article 11 reads as follows (paragraphs 1 and 2):

“1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.”

Thus, where Article 11 applies, the source state is limited to imposing an amount of tax equal to 10% of the gross amount of the interest. This rate is a common point of negotiation, however, and often varies between concluded treaties. Furthermore, if the interest is attributable to a PE of the recipient which is located in the source state then, as a result of Article 11(4), Article 7 will apply instead of Article 11 and the source state may impose tax on the basis of the profit attributable to the PE.\textsuperscript{1460}

\textsuperscript{1457} Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).

\textsuperscript{1458} Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).

\textsuperscript{1459} It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).

\textsuperscript{1460} Article 11(4) provides that: “The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the
Whether interest arises in a particular state is determined in accordance with Article 11(5) which provides that:

“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 in a Contracting State 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.”

Thus, interest arises in a particular state if it is paid by a resident of that state or, in broad terms, is borne by a PE located in that state. It should be noted that where interest is paid by a resident of a contracting state for the purposes of a particular treaty and is borne by a PE, but that PE is not located in either of the contracting states, then the interest will continue to arise in the residence state of the payor for the purposes of Article 11.1461 Thus, the interest will arise in the residence state of the payor for the purposes of the treaty between that state and the residence state of the recipient, and will arise in the PE state of the payor for the purposes of the treaty between that state and the residence state of the recipient. As will be seen below, this may give rise to dual source-based taxation in reverse PE triangular cases.1462

This section deals with a situation where a resident of State R1 derives interest income which is attributable to a PE in State PE1. The interest is paid by a resident of State R2 and is borne by a PE located in State PE2. It is assumed that the recipient of the income does not have a PE in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a detailed discussion of PE triangular cases involving interest, refer to Chapter 2 (Section 2.5.2.). For a detailed discussion of reverse PE triangular cases involving interest, refer to Chapter 11 (Section 11.2.2.).

1.4.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. Under Article 11(5) of this treaty, the interest will be considered to arise in State R2 since it is paid by a resident of that state.1463 This is the case notwithstanding the fact that the interest is borne by a PE of the payor located in a third state.1464 Article 11 of the treaty will therefore apply and State R2 will be entitled to impose a limited rate of tax on the interest.

1461 See, inter alia, the 2010 OECD Commentary on Article 11, paras. 28 and 29. This is discussed in much greater depth in Chapter 12 (Section 12.2.2.1.).
1462 This is discussed in much greater depth in Chapter 12 (Section 12.2.2.1.).
1463 Article 11(5) provides that: “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 in a Contracting State 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.”
1464 The application of Article 11(5) in reverse PE triangular cases is discussed in detail in Chapter 12 (see Section 12.2.2.1.).
The payor's PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. Under Article 11(5) of this treaty, the interest will be considered to arise in State PE2 since it is borne by a PE located in that state. For the purposes of the R1-PE2 treaty, Article 11 will therefore apply and State PE2 will be entitled to impose a limited rate of tax on the interest.

The recipient's PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of the R1-PE1 treaty, Article 7 will apply (since the interest is attributable to a PE located in State PE1) and State PE1 will be entitled to impose tax on the profit attributable to the PE. State PE1 may also have an obligation to provide relief for the tax imposed in the source states (State R2 and State PE2) under the non-discrimination article (Article 24(3)) of its treaty with State R1, however, the scope of this obligation is not completely clear. If State PE1 does grant relief under this provision, it would typically be credit relief given that the income involved is interest income. However, State PE1 may not be able to fully credit the tax imposed in both State R2 and State PE2.

The recipient's residence state (State R1): State R1 must apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax, but must provide relief under each of the three applicable treaties. Under the R1-R2 treaty and the R1-PE2 treaty this is likely to be credit relief (regardless of the general method of relief specified in the treaty) and under the R1-PE1 treaty it may be either exemption relief or credit relief. Given that State R1 has an obligation to provide relief for tax imposed in three states it is unlikely to be able to provide sufficient relief to prevent unrelieved double taxation.

Overview: In this situation, tax may be imposed in all four states. For the purposes of the R1-R2 treaty the interest is considered to arise in State R2 and for the purposes of the R1-PE2 treaty the interest is considered to arise in State PE2. Both State R2 and State PE2 may therefore impose tax on the interest under Article 11 of their respective treaties with State R1. State PE1 may also impose tax on the basis of the profit attributable to the PE. Given that tax is imposed in four states, the relief granted in the residence state (and possibly in the PE state) is unlikely to be sufficient to prevent double taxation. In addition, the source states (State R2 and State PE2) should arguably apply the conditions of their treaties with the PE state of the recipient (State PE1) rather than the conditions of their treaties with the residence state of the recipient of the income (State R1) in relation to the income attributable to the PE.

1.4.2. Application of proposed solutions

The payor's residence state (State R2): Under the proposed solution, State R2 must apply the conditions of the PE1-R2 treaty instead of the conditions of the R1-R2 treaty in relation to the income attributable to the PE in State PE1. Furthermore, Article 11(5) would be modified such that where interest income is borne by a PE in a third state (in this case, State PE2), the interest would not be considered to arise in the residence state of the payor. As a result, the interest would not be considered to arise in State R2 and Article 11 would not apply for the purposes of the PE2-R1 treaty. Instead Article 7 or Article 21 would apply.

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1465 The PE state's potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

1466 Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.

1467 The reasons for considering the conditions of the treaty between the source state and the PE state the appropriate treaty conditions for the source state to apply in PE triangular cases are discussed in depth in Chapter 5.

1468 As mentioned above, it is proposed that interest (and, where applicable, royalties) which originate from a PE located in a third state should not be considered to arise in the payor's residence state for the purposes of treaties concluded between that state and third states. This would generally result in the PE state (but not the residence state) of the payor being entitled to impose source based taxation on such payments. It would be achieved by changing the wording of Article 11(5) and, where applicable, the corresponding provision of Article 12. Refer to Section A1.2.1.2., above, and to Chapter 12 (Section 12.2.2.) for an in-depth discussion of this proposal.
apply, depending on whether the income is considered business profits, and State R2 would be prevented from imposing tax on the income (since it is not attributable to a PE of the recipient located in that state). Note that it is assumed that any conditions attached to the limitation on State R2’s taxing rights are satisfied, e.g., there may be a provision to the effect that the income continues to arise in the residence state of the payor for the purposes of Article 11 if the PE state does not impose any tax on the interest.1469

The payor’s PE state (State PE2): State PE2 must now apply the conditions of the PE1-PE2 treaty instead of the conditions of the R1-PE2 treaty. Under the modified version of Article 11(5) (as under the current version) the interest would arise in State PE2 for the purposes of the PE1-PE2 treaty. Article 11 of the treaty would therefore apply and State PE2 would be entitled to impose a limited rate of tax on the gross amount of the interest. This rate may differ from the rate that previously applied under Article 11 of the R1-PE2 treaty.

The recipient’s PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty and must now also apply the PE1-R2 treaty and the PE1-PE2 treaty. For the purposes of the R1-PE1 treaty the interest income is attributable to a PE located in State PE1 and therefore, as a result of Article 11(3), the income will fall under the distributive rule of Article 7. Under Article 7, State PE1 is entitled to impose tax on the basis of the profit attributable to the PE. Under the PE1-PE2 treaty, State PE1 will be obliged to grant relief for tax imposed in State PE2. Given that the income is interest income, the credit method would generally apply irrespective of the general method of relief specified in the treaty.1470 State PE1 is not required to provide any relief under the PE1-R2 treaty because the terms of that treaty prevent State R2 from imposing any tax on the income.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax on the income, but will have an obligation to grant relief under both the R1-PE1 treaty (using either the credit or exemption method) and the R1-PE2 treaty (using the credit method).1471 However, no relief will be required for tax imposed in State PE2 if State R1 exempts the income under the R1-PE1 treaty. State R1 will have no obligation to provide relief under the terms of the R1-R2 treaty, since R2 is prevented from imposing tax under the PE1-R2 treaty.

Overview: The proposed modifications to Article 11(5) ensure that interest income which is borne by a PE is only considered to arise in one state for treaty purposes (i.e., the PE state of the payor, State PE2) and thus may not be subject to dual source-based taxation. Furthermore, the application of State PE1’s treaties with the source states (State R2 and State PE2) ensures that the source states are applying the appropriate treaty conditions to the income attributable to the PE. It also ensure that State PE1 provides relief for tax imposed on a source basis in State PE2; in relation to interest income this would typically be credit relief regardless of the general method of relief specified in the treaty. State R1 will also provide relief, either by exempting the income or by providing a credit for tax imposed in both State PE1 (as reduced by the credit for tax imposed in State PE2) and for the tax imposed in State PE2. The combination of the relief in State PE1 and State R1 should ensure that there is no unrelieved double taxation.

1.5. Royalties

Royalties are dealt with in Article 12, which allows tax to be imposed only in the residence state. Article 12 (paragraph 1) reads as follows:

1469 For further discussion of the conditions that may be attached, refer to Chapter 12 (Section 12.2.2.2.).
1470 Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 11 (or Article 10).
1471 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
“Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.”

If, however, the royalties are attributable to a PE of the recipient which is located in the source state, then as a result of Article 12(2), Article 7 will apply instead of Article 12 and the source state may impose tax on the basis of the profit attributable to the PE. Thus, the OECD Model does not allow any source-based taxation of royalties except where they are attributable to a PE in the source state.

As outlined in Chapter 11 (see Section 11.2.2.), the UN Model and many concluded treaties do allow states to impose a limited rate of source based taxation on royalties which arise in one contracting state and are paid to a resident of the other contracting state. In general, the rules for determining whether royalties arise in a particular state mirror the rules of Article 11(5) which apply in relation to interest.1472 To the extent that the applicable treaties do allow source-based taxation of royalties and determine where royalties arise under a provision equivalent to Article 11(5), the analysis in relation to royalties would be exactly the same as that outlined for interest above. The analysis below briefly considers both situations where the applicable treaties do allow source based taxation of royalties under Article 12 and situations where they do not. Where source-based taxation of royalties is allowed, it is assumed that the relevant treaty contains a provision mirroring Article 11(5) for determining whether royalties arise in a particular state. Where Article 12 does not allow source based taxation of royalties, the place where royalties arise becomes less important because if the royalties are not considered to arise in a particular state, then that state will nevertheless generally be prevented from imposing tax under either Article 7 or Article 21 of the treaty (depending on whether the income is considered to be business profits).1473 The result will therefore be the same regardless of whether the royalties are or are not considered to arise in the state applying the treaty.

This section deals with a situation where a person resident in State R1 derives royalties which are attributable to a PE located in State PE1. The royalties are paid by a resident of State R2 and originate in a PE of the payor located in State PE2. It is assumed that the royalties are not attributable to a PE of the recipient in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a detailed discussion of PE triangular cases involving royalties, refer to Chapter 2 (Section 2.5.3.). For a discussion of reverse PE triangular cases involving royalties, refer to Chapter 11 (Section 11.2.2.).

1.5.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State R2

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1472 See, for example, Article 12(5) of the UN Model Treaty (2001), which provides that: "Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."

will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.1474

The payor's PE state (State PE2): State PE2 must apply the R1-PE2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State PE2 will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.1475

The recipient's PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 7 will apply and State PE1 may impose tax on the basis of the profit attributable to the PE. To the extent that either State R2 or State PE2 has imposed source-based taxation on the royalties, State PE1 may be required to provide relief in accordance with the non-discrimination provision (Article 24(3)) of the R1-PE1 treaty. However, the scope of the PE state's obligation to provide relief under Article 24(3) is not completely clear.1476 If State PE1 does grant relief under this provision in relation to royalty income, it would typically be credit relief.

The recipient's residence state (State R1): State R1 must apply the conditions of the R1-PE1 treaty, the R1-R2 treaty and the R1-PE2 treaty. State R1 may impose tax on the income. To the extent that State R2 and/or State PE2 is entitled to impose tax under their respective treaties with State R1, State R1 will be obliged to provide relief (generally using the credit method). State R2 will also be obliged to provide relief (credit or exemption) under the R1-PE1 treaty. To the extent that tax is imposed in State R2 and/or State PE2 as well as State PE1, State R1 will have an obligation to provide relief for tax imposed in more than one state and is unlikely to be able to provide sufficient relief to prevent unrelieved double taxation.1477

Overview: The existence of dual source-based taxation of royalties in this situation will depend on the terms of the applicable treaties; it may be that neither of the source states (State R2 and State PE2) is entitled to impose tax, that only one of those states is entitled to impose tax or it may be that both those states are entitled to impose tax. Tax may also be imposed in State PE1 and State PE1 may have an obligation to provide relief for tax imposed in the source states (if applicable) under the non-discrimination provision of its treaty with State R1. State R1 may also impose tax and will have a clear obligation to provide relief for tax imposed in any of the other three states. Nevertheless, unrelieved double taxation may persist, particularly if tax is imposed in both of the source states. In addition, State R2 and State PE2 are arguably applying the wrong treaty conditions (i.e., the conditions of their treaties

1474 This assumes that the royalties are considered to arise in State R2 for the purposes of the treaty, i.e., as a result of being paid by a resident of State R2. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State R2, State R2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).

1475 This assumes that the royalties are considered to arise in State PE2 for the purposes of the treaty, i.e., as a result of originating from the PE. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State PE2, State PE2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).

1476 The PE state's potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

1477 Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.
with State R1) and should instead apply the conditions of their respective treaties with State PE1 in relation to the income attributable to the PE located in that state.1478

1.5.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State R2 will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.1479

The payor’s PE state (State PE2): Similarly, instead of applying the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State PE2 will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.1480

The recipient’s PE state (State PE1): State PE1 will continue to apply the conditions of the R1-PE1 treaty and will continue to be entitled to impose tax on the profit attributable to the PE in accordance with Article 7. However, State PE1 must now also apply the conditions of the PE1-R2 treaty and the PE1-PE2 treaty. To the extent that State PE2 is entitled to impose tax on the income in accordance with the PE1-PE2 treaty, State PE1 will now have an explicit obligation to grant relief. State R2 will be prevented from imposing tax under the PE1-R2 treaty and therefore, State PE1 will not have any relief obligation under that treaty.

The recipient’s residence state (State R1): State R1 will continue to apply the conditions of the R1-PE1 treaty, the R1-R2 treaty and the R1-PE2 treaty. Under the R1-PE2 treaty, State R1 will continue to have an obligation to provide relief using either the exemption or credit method in relation to the profit attributable to the PE. If State R1 uses the credit method of relief under the R1-PE1 treaty, and if State PE2 is entitled to impose tax under the PE1-PE2 treaty, then State R1 may also have an obligation to provide relief for tax imposed in State PE2 under the R1-PE2 treaty.1481 State R1 will not have any relief obligation under the R1-R2 treaty because State R2 will be prevented from imposing tax under the terms of the PE1-R2 treaty.

Overview: The proposed modification to Article 12 will ensure that the royalties will only be considered to arise, and thus may only be taxable, in one of the source states (State PE2). Depending on the terms of Article 12 of the PE1-PE2 treaty, State PE2 may be prevented from imposing tax or may be entitled to impose tax at a limited rate. State R2 will be prevented from imposing any source-based taxation on the royalties. Thus, there will be no dual source-based taxation of the royalties. In addition, due to the

1478 For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.
1479 This assumes that the royalties are considered to arise in State R2 for the purposes of the treaty, i.e., as a result of being paid by a resident of State R2. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State R2, State R2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).
1480 This assumes that the royalties are considered to arise in State PE2 for the purposes of the treaty, i.e., as a result of originating from the PE in State PE2. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State PE2, State PE2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).
1481 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
application of the treaties between the recipient’s PE state (State PE1) and the source states, the source states are now applying the more appropriate treaty provisions and State PE1 will have an explicit relief obligation in situations where State PE2 is entitled to impose tax. State R1 will also have an obligation to provide relief for tax imposed on the profit attributable to the PE in State PE1 and, where it uses the credit method with respect to the profit attributable to the PE, will also have an obligation to provide relief for tax imposed in State PE2 to the extent that it imposes source-based taxation on the royalty. This ensures that double taxation can generally be prevented.

1.6. Income from immovable property

Income from immovable property is dealt with in Article 6, which allows the state where the property is located to impose tax on the income. Article 6 (paragraph 1) provides as follows:

“Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

Immovable property is defined in Article 6(2) by reference to the domestic law of the state where the property is located.\(^{1482}\) The definition in Article 6(2) also lists certain things, such as property accessory to immovable property and livestock, which are always considered to be immovable property for the purposes of the treaty.

Where immovable property is located in a third state for the purposes of a particular treaty, there is some debate regarding the appropriate treaty article to apply.\(^{1483}\) This was discussed in detail in Chapter 2 (Section 2.6.) where it was concluded that the income may fall under the distributive rule of either Article 7 or Article 21. Article 7 may apply either because the income is considered to be business profits or because is attributable to a PE (i.e., as a result of Article 21(2)). The income will generally fall under Article 21 only if it is not considered to be business profits and is not attributable to a PE. For a detailed discussion, please refer to Chapter 2 (Section 2.6.).

This section deals with a situation where a person resident in State R1 derives income from immovable property which is attributable to a PE located in State PE1. The income is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. It is assumed that the recipient of the income does not have a PE in either State R2 or State PE2. As mentioned above, the application of tax treaties in relation to income from immovable property depends on the location of the property. For the purposes of the analysis below, it is assumed that the immovable property is located in the PE state of the payor (i.e., State PE2); this may occur, for example, where the payor leases business premises in that state through which it carries on its enterprise, thus giving rise to the PE in that state. This situation is illustrated in the following diagram (in which “HO” denotes head office):

\(^{1482}\) Article 6(2) provides that: “The term ‘immovable property’ shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.”

For a detailed discussion of PE triangular cases involving income from immovable property, refer to Chapter 2 (Section 2.6.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving income from immovable property, refer to Chapter 11 (particularly Section 11.2.3).

1.6.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. Article 6 does not apply because the immovable property is not located in State R2; instead, Article 7 or Article 21 applies (depending on whether the income is considered to be business profits)\(^\text{1484}\) and State R2 is prevented from imposing tax on the income.

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 6 will apply and, given that the immovable property is located in State PE2, State PE2 will be entitled to impose tax on the income.

The recipient’s PE state (State PE1): State PE1 will be subject to the conditions of the R1-PE1 treaty. The income will fall under Article 7 of the treaty (either directly because it is considered to be business profits, or indirectly as a result of Article 21(2)) and State PE1 will be entitled to impose tax on the profit attributable to the PE. State PE1 may also have an obligation to provide relief for tax imposed in State PE2 (i.e., the state where the property is located) under the non-discrimination provision (Article 24(3)) of its treaty with State R1.\(^\text{1485}\)

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will have an obligation to provide relief (either exemption or credit) under both the R1-PE2 treaty and the R1-PE1 treaty.\(^\text{1486}\) State R1 will not have a relief obligation under the R1-R2 treaty because the terms of the treaty do not allow State R2 to impose any tax on the income.

Overview: In this situation, tax is imposed in the state where the property is located (State PE2), State PE1 and State R1. State R1 will have a clear obligation to provide relief for tax imposed in both State PE1 and State PE2, but is unlikely to be able to provide sufficient relief in the absence of relief in the PE state (refer to discussion in Chapter 3). State PE1 may have an obligation to provide relief under Article 24(3), but the scope of this relief obligation is subject to debate. Unless State PE1 does provide relief, unrelieved double taxation is likely to arise. In addition, the source states (State R2 and State PE2) are

\(^{1484}\) Please refer to Chapter 2 for an in-depth discussion of the application of the tax treaties to income from immovable property located in a third state (Section 2.6.).

\(^{1485}\) The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

\(^{1486}\) Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations. Chapter 3 also discusses the residence state’s potential option to grant dual relief (see Section 3.3.).
arguably applying the wrong treaty conditions, given the allocation of primary taxing rights to State PE1 under the R1-PE1 treaty.

Note that if the immovable property were instead located in State R2 (rather than in State PE2) then State R2 would be entitled to impose tax under Article 6 of its treaty with State R1 and State PE2 would be prevented from imposing tax under Article 7 or Article 21 of its treaty with State R1. If the immovable property were located in either State PE1 or State R1, then both State R2 and State PE2 would be prevented from imposing tax under their respective treaties with State R1.

1.6.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty, however this is unlikely to have any practical impact in State R2. State R2 will still be prevented from imposing tax, now under either Article 7 or Article 21 of the PE1-R2 treaty (instead of the R1-R2 treaty).

The payor’s PE state (State PE2): Instead of applying the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. Again, Article 6 will apply and State PE2 will be entitled to impose tax on the income. The definition of immovable property in Article 6 refers to the domestic law of the state where the property is located and thus, there is unlikely to be any difference in the results of the application of the two treaties. As a result the application of the PE1-PE2 treaty instead of the R1-PE2 treaty is unlikely to have any practical impact in State PE2.

The recipient’s PE state (State PE1): State PE1 will continue to apply the R1-PE1 treaty and will continue to be entitled to impose tax on the profits attributable to the PE under Article 7. However, State PE1 will now have an explicit obligation to provide relief (either exemption or credit) under the terms of the PE1-PE2 treaty.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will continue to have an obligation to provide relief under the R1-PE1 treaty. If State R1 provides relief using the credit method, it will also have an obligation to provide relief under the R1-PE2 treaty (using either the credit or exemption method).

Overview: The main impact of the proposed solution in this case is the explicit obligation imposed on the PE state to provide relief for tax imposed in the state where the property is located. Although the source states (State R2 and State PE2) are now applying the more appropriate treaty conditions, this is likely to have little practical impact since the terms of Article 6 are less likely to differ between treaties than, for example, the maximum rates of tax that can be imposed on passive income. There is also no concern with dual source-based taxation in this case, since tax cannot be imposed in a state other than the state where the immovable property is located in the absence of a PE. As a result, the proposals relating to reverse PE triangular cases are not relevant here.

1.7. Income from shipping and air transport

Article 8 deals with income from shipping, inland waterways transport and air transport and provides (in paragraphs 1 and 2) that:

“1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

1487 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).

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2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

Thus, under Article 8, income from shipping, inland waterways transport and air transport may only be taxed in the state where the enterprise’s place of effective management is located.1488

This section deals with a situation where a person resident in State R1 derives income from shipping, inland waterways transport and/or air transport which is attributable to a PE in State PE1. The place of effective management of the person deriving the income is located in that person’s residence state, State R1. The income is paid by a resident of State R2 and originates from a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the recipient of the income):

For a more detailed discussion of typical PE triangular cases involving income from shipping, inland waterways transport and air transport, refer to Chapter 2 (Section 2.7.). For further discussion of reverse PE triangular cases, including a brief overview of the outcome of reverse PE triangular cases involving income covered by Article 8, refer to Chapter 11 (Section 11.2.3.).

1.7.1. Existing treaty framework

The payor’s residence state (State R2): State R2 will apply the conditions of the R1-R2 treaty. Article 8 will apply and, given that the place of effective management is located in State R1, State R2 will not be entitled to impose any tax on the income.

The payor’s PE state (State PE2): State PE2 will apply the conditions of the R1-PE2 treaty. Again, Article 8 of the treaty will apply and State PE2 will be prevented from imposing any tax on the income.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. Article 8 will also apply for the purposes of this treaty and State PE1 will not be entitled to impose any tax on the income.

The recipient’s residence state (State R1): State R1 must apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. There will be no limitation on State R1’s ability to impose tax, and since no other state may impose tax on the income, State R1 will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State R1; all the other states involved will be prevented from imposing tax under Article 8 of their respective treaties with State R1. For this category of income, the fact that income is paid by a resident of a particular state or is attributable to a PE located in that state does not have any impact on the allocation of taxing rights under tax treaties.

1.7.2. Application of proposed solutions

1488 The place of effective management will generally be in the residence state of the enterprise, and this is assumed to be the case for the purposes of the discussion below. For further discussion of the location of the place of effective management in the context of applying tax treaties in PE triangular cases involving income from shipping, inland waterways transport and air transport, please refer to Chapter 2 (Section 2.7.).
It is not proposed that the benefits of treaties concluded between the PE state and third states should be available in situations where the PE state is prevented from imposing tax under the conditions of the R-PE treaty, as is the case with respect to income from shipping, inland waterways transport and air transport under Article 8. This is discussed in Chapter 8 (Section 8.6.5.). Furthermore, no changes are proposed with respect to reverse PE triangular cases involving this category of income, since no dual source-based taxation arises under the existing treaty framework. There are therefore no changes proposed in relation to the situation discussed above.

1.8. Capital gains from the alienation of immovable property

Capital gains derived from the alienation of immovable property are dealt with in Article 13(1), which provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.”

Thus, Article 13(1) applies where a resident of one state derives capital gains from the alienation of immovable property located in the other contracting state, and allows the state where the property is located to impose tax on the gain. The reference to Article 6 in Article 13(1) is a reference to the definition of immovable property, which in turn refers to the domestic law of the state where the property is located, as well as containing a list of certain property which is always considered to be immovable property for the purposes of the treaty.\footnote{For further discussion of the definition of immovable property and the application of tax treaties in PE triangular cases involving capital gains from immovable property, please refer to Chapter 2 (particularly Section 2.8.1.).}

This section deals with a situation where a person resident in State R1 derives a capital gain from the alienation of immovable property and that capital gain is attributable to a PE of the recipient located in State PE1. The amount giving rise to the gain is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. It is further assumed for the immovable property from which the gain arises is located in State PE2. This situation is illustrated in the diagram below (in which “HO” denotes head office):

For further discussion of Article 13(1) and of typical PE triangular cases involving capital gains from the alienation of immovable property, refer to Chapter 2 (Section 2.8.1.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains from the alienation of immovable property, refer to Chapter 11 (Section 11.2.3.).

1.8.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State R2 will be prevented from imposing tax on the capital gain.\footnote{Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other}
The payor's PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(1) applies and state PE2 will be entitled to impose tax on the capital gain.

The recipient's PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State PE1 will be prevented from imposing tax on the capital gain.

The recipient's residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will be required to provide relief (either exemption or credit) under the R1-PE2 treaty. State R1 will have no relief obligation under the R1-R2 treaty or the R1-PE1 treaty, since both State R2 and State PE1 are prevented from imposing any tax on the gain under their treaties with State R1.

Overview: In this situation, tax may be imposed in the state where the immovable property is located and in the residence state of the person deriving the capital gain, and the residence state is obliged to provide relief (either exemption or credit, depending on the terms of the treaty). There is therefore no unrelieved double taxation; this is to be expected since the existence of a PE in a particular state does not have any influence on that state’s ability to impose tax, either on the basis of the profit attributable to the PE or on a source basis. The residence of the payor also gives no source-based taxing rights under tax treaties.

Note that if the property were instead located in State R2 or State PE1, then a similar result would arise. The state where the property is located would be entitled to impose tax, as would State R1, but the other two states would be prevented from imposing any tax.

1.8.2. Application of proposed solutions

There are no changes proposed in relation to the situation discussed in this section. As mentioned above, it is not proposed that treaties concluded between the PE state and third states in PE triangular cases should apply in situations where the PE state is prevented from imposing tax under the terms of the treaty between that state and the residence state. Furthermore, no dual source-based taxation arises in relation to this category of capital gains and there are consequently no applicable changes proposed with respect to reverse PE triangular cases involving capital gains from the alienation of immovable property.

1.9. Capital gains from the alienation of movable property of a PE

Article 13(2) deals with capital gains from the alienation of movable property forming part of the business property of a PE. It provides that:

“Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.”

This section discusses a situation where a person resident in State R1 derives a capital gain from the alienation of movable property which forms part of the business property of a PE located in State PE1. The amount giving rise to the gain is paid by a resident of State R2 and the payment originates from a PE.
in State PE2. Note that for the purposes of the analysis below it is not relevant where the property is actually located, only that it is attributable to the PE located in State PE1. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For further discussion of Article 13(2) and of typical PE triangular cases involving capital gains from the alienation of movable property forming part of the business property of a PE, refer to Chapter 2 (Section 2.8.2.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with under Article 13(2), refer to Chapter 11 (Section 11.2.3.).

1.9.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(2) will not apply because the gain does not arise from the alienation of movable property of a PE located in state R2. Since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State R2 will be prevented from imposing any tax on the gain.\(^{1492}\)

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(2) will not apply because the gain does not arise from the alienation of movable property of a PE located in state PE2. Since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State PE2 will be prevented from imposing any tax on the gain.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty Article 13(2) will apply and State PE1 will be entitled to impose tax on the gain.

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty, and the R1-PE1 treaty. State R1 may impose tax on the gain but will be obliged to provide relief (either exemption or credit) under the R1-PE1 treaty. State R1 will have no obligation to provide relief under either the R1-R2 treaty or the R1-PE2 treaty, since both State R2 and State PE2 are prevented from imposing tax on the gain.

Overview: Tax may be imposed in State R1 and in State PE1, and State R1 must provide relief. There is no dual source-based taxation and no unrelieved double taxation, however State R2 and State PE2 are nevertheless still applying the wrong treaty conditions.\(^{1493}\)

1.9.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty, Article 13(2) will not apply because the capital gain does not arise from the alienation of movable property forming part of the business property

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\(^{1492}\) Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4).

\(^{1493}\) For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.
of a PE located in State R2. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State R2 will be prevented from imposing any tax on the gain.

The payor's PE state (State PE2): Instead of applying the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty, Article 13(2) will not apply. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State PE2 will continue to be prevented from imposing any tax on the gain.

The recipient's PE state (State PE1): State PE1 will continue to be bound by the conditions of the R1-PE1 treaty and will continue to be entitled to impose tax under Article 13(2) of that treaty. State PE1 must also apply the conditions of the PE1-R2 treaty and the PE1-PE2 treaty. Given that both State R2 and State PE2 are prevented from imposing tax under these treaties, however, State PE1 will have no relief obligation.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax and will continue to have an obligation to provide relief under the R1-PE2 treaty (using either the exemption or credit method). State R1 will not have any obligation to provide relief under the R1-R2 treaty or the R1-PE2 treaty because both State R2 and State PE2 are prevented from imposing tax under their respective treaties with State PE1.1494

Overview: In this situation, the application of the treaties between the PE state of the person deriving the capital gain and third states has no practical impact on the ability of each state to impose tax, and no impact on the overall outcome. This is because there is no difference between the conditions of those states’ treaties with State R1 and their treaties with State PE1. In practice, there could potentially be differences between the terms of these treaties, in which case the application of the latter treaties may have an impact on the source state’s ability to impose tax in this situation. Note that the proposals relating to reverse PE triangular cases are not relevant here, since those proposals deal only with situations involving interest and royalties.

1.10. Capital gains from the alienation of ships and aircraft in international traffic

Article 13(3) deals with capital gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated assets. It provides that:

"Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated."

This section deals with a situation where a person resident in State R1 derives a capital gain from the alienation of ships or aircraft operated in international traffic, and that capital gain is attributable to a PE located in State PE1. The place of effective management of the person deriving the capital gain is located in State R1. The amount giving rise to the capital gain is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the person deriving the capital gain):

1494 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4).
For further discussion of Article 13(3) and of typical PE triangular cases involving capital gains from the alienation of ships or aircraft operated in international traffic, refer to Chapter 2 (Section 2.8.3.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with in Article 13(3), refer to Chapter 11 (Section 11.2.3).

1.10.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R1, State R2 will be prevented from imposing any tax on the capital gain.

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R1, State PE2 will be prevented from imposing any tax on the gain.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R1, State PE1 will be prevented from imposing any tax on the gain. The fact that the gain is attributable to a PE in State PE1 has no impact on the application of the treaty.

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. None of these treaties will impose any restriction on State R1’s ability to impose tax and State R1 will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State R1. State R2, State PE2 and State PE1 will all be prevented from imposing tax under their respective treaties with State R1.

1.10.2. Application of proposed solutions

There are no proposed changes that would have any impact on the situation discussed in this section. As mentioned above, it is not proposed that treaties concluded between the PE state and third states should apply in situations where the PE state is prevented from imposing tax under its treaty with the residence state. Furthermore, no dual source-based taxation arises in relation to this category of capital gains and there are no applicable changes proposed with respect to reverse PE triangular cases involving capital gains of the type dealt with in Article 13(3).

1.11. Capital gains from the alienation of shares in a real estate company

Article 13(4) deals with capital gains from the alienation of shares which derive their value from immovable property. It provides as follows:

1495 Refer to Section A1.2.1.2. above and, for a more in-depth discussion of the application of the PE state’s treaties with third states in PE triangular cases, refer to Chapter 8 (Section 8.2.3.).
“Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.”

Such gains may therefore be taxed in the state where the underlying immovable property is located. The OECD Model does not contain any other specific provision dealing with shares, but some concluded treaties also allow source-based taxation of gains arising from:

3. The alienation of shares in a company having more than 50% of its assets located in the source state;\(^{1496}\) and/or

4. The alienation of shares where the person disposing of those shares has a "substantial participation" (i.e., a shareholding of more than a certain specified percentage) in the company whose shares are being alienated.\(^{1497}\)

In general, these provisions allow the source state (i.e., the state where the underlying property is located) to impose tax on the gains in the same way as Article 13(4) allows taxation of gains arising from shares in a real estate company. For the purposes of the discussion below, however, it will be assumed that all the relevant treaties follow the OECD Model.

This section deals with a situation where a person resident in State R1 derives a capital gain from the alienation of shares which derive more than 50% of their value from immovable property, and that capital gain is attributable to a PE located in State PE1. The amount giving rise to the capital gain is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. For the purposes of the discussion below, it is assumed that the underlying immovable property is located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram](https://example.com/diagram.jpg)

Note that the place where the shares are registered is not relevant for the purposes of the discussion below.

For additional discussion of PE triangular cases involving capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (and similar cases), refer to Chapter 2 (Section 2.8.4.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with under Article 13(4), refer to Chapter 11 (Section 11.2.3.).

### 1.11.1. Existing treaty framework

The payor's residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. Article 13(4) of the treaty will not apply because the underlying property is not located in State R2. Instead, since none of the other paragraphs of Article 13 apply, the capital gain will fall under Article 13(5) and State R2 will be prevented from imposing tax.\(^{1498}\) Note that if the underlying property were instead located in State R2, then Article 13(4) would apply and State R2 would be entitled to impose tax.

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\(^{1497}\) See, for example the reservations of France, Chile, Sweden and Korea in the OECD Commentary to Article 13 of the OECD Model.

\(^{1498}\) Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other
The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(4) will apply and State PE2 will be entitled to impose tax. Note that if the property were located in another state, such as State R2, then Article 13(5) would apply instead of Article 13(4) and State PE2 would be prevented from imposing tax.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 13(4) will apply and State PE1 will be entitled to impose tax on the gain. State PE1 may have an obligation to provide relief for tax imposed in State PE2 (i.e., the state where the underlying property is located) under the non-discrimination article (Article 24(3)) of the R1-PE1 treaty.1499

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will be obliged to provide relief (either exemption or credit) under both the R1-PE2 treaty and the R1-PE1 treaty.

Overview: In this situation, tax may be imposed in State PE2, State PE1 and State R1. State R1 will be obliged to provide relief under both the R1-PE2 treaty and the R1-PE1 treaty but may not be able to provide sufficient relief to prevent unrelieved double taxation in the absence of relief in State PE1. State PE1 may have an obligation to provide relief under the non-discrimination article (Article 24(3)) of the R1-PE1 treaty. Furthermore, State R2 and State PE2 are arguably applying the wrong treaty conditions and should instead apply the conditions of their respective treaties with State PE1.1500

1.11.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty, Article 13(5) will apply and State R2 will continue to be prevented from imposing tax.

The payor’s PE state (State PE2): Instead of applying the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty, Article 13(4) will apply and State PE2 will continue to be entitled to impose tax on the gain.

The recipient’s PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty and must now also apply the conditions of the PE1-PE2 treaty. As under the existing framework, Article 13(2) of the R1-PE2 treaty is likely to apply and State PE1 is likely to be entitled to impose tax on the gain. However, State PE1 will have a direct obligation to provide relief (exemption or credit) under the terms of the PE1-PE2 treaty. State PE1 will not have any relief obligation under the R1-PE2 treaty since State R2 is prevented from imposing tax.

The recipient’s residence state (State R1): State R1 must continue to apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 will continue to have a relief obligation under the R1-PE1 treaty (either exemption or credit) but now, will only have a relief obligation under the R1-PE2 treaty if it uses the credit method under the R1-PE1 treaty.1501 State R1 will not have any relief obligation

paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of movable property forming part of the business property of a PE (para 2), and capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3).

1499 The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

1500 For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.

1501 It is proposed that the residence state will have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE
under the R1-R2 treaty because State R2 is prevented from imposing tax under the terms of the PE1-R2 treaty.

Overview: In this situation, tax may be imposed in State PE2 (the state where the underlying property is located), State PE1 and State R1. Both State R1 and State PE1 will have an obligation to provide relief, with State PE1 now having an explicit relief obligation under the terms of the PE1-PE2 treaty. The application of the terms of the treaties concluded between State PE1 and the source states (State R2 and State PE2) has little impact on the ability of each of the states to impose tax provided all the relevant treaties follow the OECD Model. It is possible, however, that the terms of the treaties between State PE1 and the source states differ from the terms of the treaties concluded between State R1 and the source states, in which case the application of the State PE1’s treaties could have a significant impact. The explicit obligation for the PE state to provide relief may also have a significant impact if that state does not consider itself bound to provide relief under Article 24(3) of the R1-PE1 treaty. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

1.12. Capital gains from the alienation of other property

Article 13(5) deals with capital gains arising from the alienation of property not dealt with in the other paragraphs of Article 13 (referred to herein as “other property”). It provides that:

“Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.”

Thus, capital gains from the alienation of other property may only be taxed in the residence state of the person deriving the gain.

This section deals with a situation where a person who is resident in State R1 derives a capital gain from the alienation of other property, and that gain is attributable to a PE in State PE1. The amount giving rise to the capital gain is paid by a person resident in State R2 and originates in a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

Note that in most cases, capital gains attributable to the PE in State PE1 (and not arising from the alienation of immovable property) would fall under Article 13(2), which deals with capital gains from the alienation of movable property forming part of the business property of a PE. Thus, it is unlikely that Article 13(5) would ever apply for the purposes of the R1-PE1 treaty in a PE triangular case. Nevertheless, for completeness, this section discusses a situation where that is the case.

For discussion of typical PE triangular cases involving capital gains from the alienation of other property, refer to Chapter 2 (Section 2.8.5.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with under Article 13(5), refer to Chapter 11 (Section 11.2.3.).

1.12.1. Existing treaty framework

state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(5) applies and State R2 will be prevented from imposing tax on the gain.

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(5) applies and State PE2 will be prevented from imposing tax on the gain.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this discussion in this section it is assumed that Article 13(5) applies, in which case State PE1 will be prevented from imposing tax on the gain. However, it should be recognised that in many cases where the capital gain is attributable to the PE, the capital gain will have arisen from the alienation of movable property forming part of the business property of the PE, in which case Article 13(2) would apply and State PE1 would be entitled to impose tax (refer to Section 1.9, above).

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax and will have no obligation to provide relief since State R2, State PE2 and State PE1 are each prevented from imposing tax under their respective treaties with State R1.

Overview: In this situation, tax may only be imposed in State R1. There will be no need for relief in State PE1 and no unrelieved double taxation.

1.12.2. Application of proposed solutions

None of the proposed changes would have any impact on the application of tax treaties in this situation. Since the PE state (State PE1) is prevented from imposing tax on the capital gain under its treaty with State R1, the treaties between State PE1 and the source states (State R2 and State PE2) would not apply. In addition, dual source-based taxation of capital gains falling under Article 13(5) is prevented under the existing framework and thus no changes are proposed in relation to reverse PE triangular cases involving such gains.

1.13. Other income

Article 21, titled “other income,” applies to any income not dealt with elsewhere in the treaty. It provides that:

“1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

Thus, Article 21 does not allow any taxation of other income outside the residence state unless the income is attributable to a local PE, in which case Article 7 applies.

This section deals with a situation where a resident of State R1 derives “other income” which is attributable to a PE in State PE1. The income is paid by a resident of State R1 and originates in a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):
For a discussion of typical PE triangular cases involving other income, refer to Chapter 2 (Section 2.9). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving other income, refer to Chapter 11 (Section 11.2.3).

1.13.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the R1-R2 treaty. For the purposes of this treaty Article 21 applies and, since the income is not attributable to a PE of the recipient in State R2, State R2 is prevented from imposing any tax on the income.

The payor’s PE state (State PE2): State PE2 must apply the R1-PE2 treaty. For the purposes of this treaty Article 21 applies and, since the income is not attributable to a PE of the recipient in State PE2, State PE2 is prevented from imposing any tax on the income.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, the income is attributable to a PE located in State PE1 and therefore, as a result of Article 21(2), the income will fall under the distributive rule of Article 7. Under Article 7, State PE1 will be entitled to impose tax on the profit attributable to the PE.

The recipient’s residence state (State R1): State R1 must apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will have an obligation to provide relief (either exemption or credit) under the R1-PE1 treaty. State R1 will not have any relief obligation under the R1-R2 treaty or the R1-PE2 treaty, since these treaties prevent State R2 and State PE2, respectively, from imposing any tax on the income.

Overview: The outcome in this case is that tax may be imposed in State R1 and in State PE1, and State R1 will be obliged to provide relief. Both State R2 and State PE2 will be prevented from imposing tax on the income.

1.13.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty, Article 21 will apply and, given that the income is not attributable to a PE of the recipient in State R2, State R2 will be prevented from imposing any tax on the income.

The payor’s PE state (State PE2): Instead of applying the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty, Article 21 will apply and, given that the income is not attributable to a PE in State PE2, State PE2 will be prevented from imposing any tax on the income.

The recipient’s PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty and will still be entitled to impose tax on the profit attributable to the PE in accordance with Article 7 of the treaty. State PE1 must also apply the PE1-R2 treaty and the PE1-PE2 treaty, however since these treaties prevent State R2 and State PE2 (respectively) from imposing any tax on the income, State PE2 will not have any relief obligation.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R2 may impose tax but will be obliged to provide relief in accordance with the terms of the R1-PE1 treaty (either exemption or credit). State R1 will not have any relief obligation.
under either the R1-R2 treaty or the R1-PE2 treaty, since both State R2 and State PE2 are prevented from imposing any tax under their treaties with State PE1.

Overview: In practical terms, the final outcome in this situation is no different after the application of the proposed solution. That is, State R1 and State PE1 may impose tax, with State R1 obliged to provide relief, and both of the source states are prevented from imposing tax. However, this is a consequence of the assumption that all the relevant treaties follow the OECD Model. The source states are now applying the more appropriate treaty conditions and if terms of the relevant treaties did differ (for example, if one or both of these treaties did not contain Article 21), then a very different result could occur. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

1.14. Conclusions

This section has discussed a situation where a typical PE triangular case is combined with a reverse PE triangular case. The analysis above illustrates that the issues arising in this situation are generally the same as those arising in the basic triangular cases which it comprises. Reverse PE triangular cases only give rise to dual source-based taxation in relation to interest income (and royalties where the applicable treaties differ from the OECD Model) and thus, dual source based taxation may only occur here where interest and royalties are involved. In all other cases, the outcome in this situation is essentially the same as the outcome in a typical PE triangular case (outlined in detail in Chapter 2).

The application of the proposed solutions in this situation ensures that the source states apply the appropriate treaty conditions, and ensure that both the PE state and the residence state of the person receiving the income provide appropriate relief to prevent unrelieved double taxation. Importantly, the provisions of the treaties concluded between the PE state and the source states do not apply in situations where the PE state is prevented from imposing tax on the income under its treaty with the residence state. In such cases, the source states should continue to apply the conditions of their respective treaties with the residence state. In addition, although the source states are no longer bound by the conditions of their treaties with the residence state of the person deriving the income, the residence state may still have an obligation to grant relief in accordance with these treaties. The residence state will not have any relief obligation in situations where it exempts the income under its treaty with the PE state or where the source state in question is prevented from imposing tax under its treaty with the PE state. In other cases, however, the provision of relief in the residence state is important for preventing unrelieved double taxation.

This situation has also demonstrated the application of the proposed solution for reverse PE triangular cases involving interest. Under this proposed solution, interest which originates in a PE in a third state is not considered to arise in the residence state of the payor (subject to certain conditions) under Article 11(5). As a result, the residence state of the payor is not entitled to impose tax under Article 11 and is prevented from imposing tax under either Article 7 or Article 21. Source based taxation may therefore only be imposed in the PE state of the payor and there will no longer be any dual source based taxation.

One of the key points of the discussion in this section is to test the interaction of these two solutions and, as can be seen above, this presents no special problems. The residence state of the payor of the interest simply applies the modified Article 11(5) of its treaty with the PE state and is prevented from imposing tax under the terms of that treaty.
Section II: PE triangular cases combined with reverse dual resident triangular cases

2.1. Introduction

The situation discussed in this section is a combination of a typical PE triangular case\textsuperscript{1502} and a reverse dual resident triangular case.\textsuperscript{1503} It involves a person who is resident in one state ("State R") and has a PE in a second state ("State PE") who derives income from outside those two states which is attributable to the PE. The income is paid by a person who is resident in two (other) states for both domestic law and treaty purposes, i.e., a dual resident. The tie-breaker provision of the treaty between the payor's residence states assigns the dual resident person's residence to one state for the purposes of that treaty; the state to which residence is assigned is referred to as the winning residence state ("State W") and the other state is referred to as the losing residence state ("State L"). State W and State L are referred to collectively as the “source states.” Finally, it is assumed that the payor does not have a PE in the losing residence state or that if it does, the payment is not connected with and does not originate from that PE. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram showing the relationships between State R, State PE, State W, State L, and the flow of income](image)

2.1.1. The existing treaty framework

Under the existing treaty framework, the applicable treaties in this case will be:

(i) the treaty between the residence state of the recipient and the winning residence state of the payor (the R-W treaty);

(ii) the treaty between the residence state of the recipient and the losing residence state of the payor (the R-L treaty); and

(iii) the treaty between the residence state of the recipient and the PE state of the recipient (the R-PE treaty).

The treaty between the two residence states of the payor will apply to determine the taxation that those two states may impose on the income derived by the dual resident. It will not apply, however, in relation to income paid by the dual-resident person to a person resident in a third state. The treaties between the recipient’s PE state and the source states (the PE-W treaty and the PE-L treaty) will not apply because, for the purposes of both these treaties, the income is not received by a resident of one of the contracting states.

For the purposes of the analysis in this appendix, it is assumed that the allocation of residence under the tie-breaker provision of the treaty between the two residence states of the payor has no effect on the application of treaties concluded between State L and third states. That is, residence must be determined independently for each treaty. This means that any amount paid by the dual resident will continue to be considered to be paid by a resident of State L for the purposes of treaties between that state and third states. This assumption is not free from doubt; for further discussion of the application of treaties between the losing residence state and third states, please refer to Chapter 11.\textsuperscript{1504}

\textsuperscript{1502} For a detailed overview of the application of tax treaties in typical PE triangular cases, refer to Chapter 2.

\textsuperscript{1503} For a detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

\textsuperscript{1504} Chapter 11 deals with the application of treaties between the losing residence state and third states in dual resident triangular cases, but is equally relevant in reverse dual resident triangular cases. The OECD Commentary takes the position that a dual resident will not be considered a resident of the losing residence state for the purposes of treaties concluded between that state as a result of the second sentence of Article 4(1). The second sentence of
The outcome in this case will depend upon the category of income involved and the extent to which source-based taxation is allowed in the absence of a PE. In situations involving dividends and interest (and potentially royalties), where source based taxation is allowed in the residence state of the payor, tax may potentially be imposed in all four states. That is, both the source states may impose tax based on the residence of the payor, the PE state may impose tax on the basis of the profit attributable to the PE, and the residence state may impose tax on the basis of the residence of the person receiving the income. In the case of income from immovable property, the outcome in this case is effectively the same as the outcome in a typical PE triangular case; State W and State L are both prevented from imposing any tax on the income except to the extent that the property is located in one of those states, and thus, the dual-resident nature of the payor does not have any impact on the outcome. For those categories of income where no source-based taxation is allowed unless the income is attributable to a local PE of the recipient (such as income from shipping and air transport and other income, as well as some types of capital gains), there will be no taxation in either of the source states. Overall, the outcome in this situation will generally be the same as the outcome of a typical PE triangular case, with the exception of cases involving dividends and interest (and potentially royalties) where both source states may impose tax in addition to the tax imposed in the PE state and the residence state of the person deriving the income. This additional layer of taxation means that unrelieved double taxation is more likely to occur and that where it does occur, the quantum of unrelieved double taxation is likely to be greater.

2.1.2. Application of proposed solutions

The relevant proposals for the situation discussed in this section are those which are aimed at dealing with typical PE triangular cases and reverse dual-resident triangular cases.

Application of treaties between the PE state and third states\textsuperscript{1905}

It is proposed that where a resident of one state derives income which is attributable to a PE in a second state (for the purposes of the treaty between those two states), the person deriving the income should be entitled to claim the benefits of treaties concluded between the PE state and third states in relation to the income attributable to the PE. As a result, the state where the income arises (the source state) would be obliged to apply the conditions of its treaty with the PE state, and the PE state would be obliged to grant relief in accordance with the terms of that treaty. The proposed treaty provision is as follows:

"(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.

…

\textsuperscript{1905} This proposal is discussed in detail throughout Chapter 7 and Chapter 8.
(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 the preceding paragraphs 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 ... is located for the purposes of the application of this Convention under those paragraphs.\(^{1506}\)

Note that paragraphs 1(b) and 1(c) of this proposed provision (which are not reproduced above) are intended to deal with situations where treaties do not exist between all the contracting states. They are thus not relevant for the analysis conducted in this appendix, since it is assumed that there are treaties in place between all the states involved.

In the situation discussed in this section, the application of this proposed provision would mean that the person deriving the income would be entitled to claim the benefit of the treaties concluded between State PE\(_1\) and the source states (State W and State L). The exclusion for situations where the PE state of the recipient of the income is prevented from imposing tax will also be relevant in some cases.

**Limited application of treaties between the residence state and third states\(^{1507}\)**

It is proposed that in PE triangular cases, the application of tax treaties between the residence state of the person deriving the income and third states where income arises (source states) be restricted. It is proposed that a source state will not be required to apply the conditions of its treaty with the residence state in relation to income attributable to a PE in a third state if either:

5. The source state applies the conditions its treaty with the PE state in relation to that income; or

6. The source state does not apply the conditions of its treaty with the PE state, but the situation is one where the application of the conditions of the treaty with the residence state would be considered improper (in accordance with certain specified criteria).

The proposed provision is as follows:

"(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 the 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.

(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(2) / 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.1508

In the situation discussed in this section, the effect of this provision would be to exclude the operation of the treaties between the residence state (State R) and the two source states (State W and State L). However, these treaties will continue to require State R to provide relief (under paragraph 3 of the provision set out above). In accordance with the wording of this provision, no relief would be required in State R to the extent that the source states are prevented from imposing tax under their respective treaties with State PE. Furthermore, where State R uses the credit method of relief (either under Article 23A(2) or under Article 23B), the credit in State R is specifically limited to the rate of tax that the source state could have imposed if it applied the terms of its treaty with State R.

Making the allocation of residence effective for the purposes of treaties with third states

It is proposed that dual-resident persons be specifically excluded from being resident in their losing residence state for the purposes of treaties between that state and third states. This would essentially make the allocation of residence under the treaty between the two residence states of a dual resident person effective for the purposes of other tax treaties.1509 It is proposed that this be achieved by including a specific provision in tax treaties, which could be worded along the following lines (for inclusion in Article 4, i.e., the residence article):

"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."1510

In the case of a dual-resident making payments of passive income to residents of a third state, this would mean that the dividends, interest or royalties would be paid by a person who is not resident of the losing residence state for the purposes of the treaty between that state and the state where the person receiving the income is resident (i.e., the R-L treaty). As a result, and as will be seen below, State L would be prevented from imposing source-based taxation.

Applicable treaties

If these proposed provisions are incorporated into all the relevant treaties, the applicable treaties in the situation discussed in this section would be:

(i) the treaty between the residence state of the recipient and the winning residence state of the payor (the R-W treaty) – State W will not be bound by the conditions of this treaty, but State R may have a relief obligation;

1508 This provision is extracted from Chapter 7 (Section 7.5.4.) where it is discussed in much greater depth.

1509 This proposal is discussed in detail in Chapter 11 (Section 11.3.2.) and, in the context of reverse dual resident triangular cases, in Chapter 12 (Section 12.3.5.).

1510 This proposed provision is extracted from Chapter 11 (Section 11.3.2.) where it is discussed in-depth.
The only treaty which will not apply in this situation is the treaty between the two residence states of the payor of the income (the W-L treaty), since the income is not derived by a resident of either of these two states. This treaty will apply, however, to determine the taxation that those two states may impose on the income derived by the dual resident.

The following sections will discuss the application of tax treaties in this situation where different categories of income are involved, firstly under the existing framework and secondly where the relevant treaties include the proposed provisions outlined above.

2.2. Business profits

Article 7 deals with business profits and allows the residence state of the person deriving the income to impose tax. It also allows the other contracting state to impose tax, but only in relation to profits which are attributable to a PE in that other state.\textsuperscript{1511} Article 7 (in paragraphs 1 and 2) provides as follows:

\begin{quote}
“1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article \[23A] \[23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”\textsuperscript{1512}
\end{quote}

Thus, the source state may not impose any tax on business profits except to the extent they are attributable to a PE. For further discussion of the PE concept and the attribution of profit to PEs, refer to the discussion in Chapter 5 (Sections 5.2.3. and 5.2.4.).

This section deals with a situation where a person resident in State R derives income which is attributable to a PE in State PE. The income is paid by a dual-resident, a person who is resident in both State W and State L for treaty purposes. It is assumed that the payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office):

\textsuperscript{1511} The term “permanent establishment” is defined in Article 5.

\textsuperscript{1512} Article 7, paragraphs 1 and 2.
For a more detailed discussion of PE triangular cases involving business profits, refer to Chapter 2 (Section 2.4.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving business profits, refer to Chapter 12 (Section 12.3.).

2.2.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of that treaty, Article 7 will apply and, given that the income is not attributable to a PE in State W, State W will be prevented from imposing tax.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. For the purposes of that treaty, Article 7 will apply and, given that the income is not attributable to a PE in State L, State L will be prevented from imposing tax on the income.

The recipient's PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of that treaty, Article 7 will apply and State PE will be entitled to impose tax on the profit attributable to the PE.

The recipient's residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. None of those treaties will restrict State R's ability to impose tax on the income, however State R will be obliged to provide relief (either exemption or credit) under the R-PE treaty.

Overview: Under the existing treaty framework, tax may only be imposed in State R and State PE, and State R will be obliged to provide relief. There will be no unrelieved double taxation. This situation is effectively the same as a typical PE triangular case involving business profits, since both source states are prevented from imposing tax, and gives rise to the same issue; namely, the application of the “wrong” treaty conditions in the source states (State W and State L).

2.2.2. Application of proposed solutions

The winning residence state of the payor (State W): Instead of being bound by the conditions of the R-W treaty, State W must now apply the conditions of the PE-W treaty. In relation to business profits, Article 7 applies and given that the income is not attributable to a PE in State W, State W would be prevented from imposing tax on the income. This outcome is the same as where the R-W treaty applies. The outcome may differ, however, if the PE definitions differ between the two treaties. For example, if the PE threshold is lower in the PE-W treaty than in the R-W treaty, then a PE may exist for the purposes of the first treaty but not the second. Nevertheless, in most cases the application of the L-W treaty instead of the R-W treaty will have no impact on State W’s ability to impose tax on the income.

The losing residence state of the payor (State L): Instead of being bound by the conditions of the R-L treaty, State L must now apply the conditions of the PE-L treaty. In relation to business profits, Article 7 applies and given that the income is not attributable to a PE in State L, State L would be prevented from imposing tax. The application of the treaty with the PE state instead of the treaty with the residence state

1513 That is, the source states apply the conditions of their treaties with the residence state of the recipient of the income (State R1) rather than the conditions of their treaties with the PE state (State PE1), despite the allocation of primary (or even exclusive) taxing rights to State PE1 under the R1-PE1 treaty. The reasons for considering this the “wrong” treaty are discussed in depth in Chapter 6.
will generally have no impact in State L in relation to business profits, however, it may have an impact if the PE definitions differ between the two treaties.

*The recipient’s PE state (State PE)*: State PE must continue to apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 7 will apply and State PE will be entitled to impose tax on the profit attributable to the PE. State PE is also obliged to apply the conditions of its treaties with State W and State L, in particular the relief provisions. In relation to business profits, however, both of the source states are prevented from imposing tax and State PE therefore has no relief obligation.

*The recipient’s residence state (State R)*: State R must continue to apply the R-W treaty, the R-L treaty and the R-PE treaty. There is no restriction on State R’s ability to impose tax on the income, however, State R does have an obligation to provide relief (either exemption or credit) under the R-PE treaty. State R does not have any obligation to provide relief under either the R-W treaty or the R-L treaty, since both State W and State L are prevented from imposing tax under their respective treaties with State PE.

**Overview:** The proposed solutions would generally have little practical impact in this situation, since the distributive rules for business profits do not usually differ between treaties. Furthermore, because no tax can be imposed in the source states, no relief is required in the recipient’s PE state. One situation where a different outcome may arise is where the PE definition contained in a source state’s treaty with State R differs from that contained in its treaty with State PE. Where this occurs, the source state may be entitled to impose tax if it applies the conditions of its treaty with State R but not if it applies the conditions of its treaty with State PE or vice versa. In order for this to fit within the scenario discussed in this section, however, the PE in the source state would have to be a sub-PE of the PE in State PE (sub-PE triangular cases are discussed in Chapter 2 (Section 2.4.1.) and in Chapter 8 (Section 8.6.6.). In addition, the residence of the payor has no impact on the distribution of taxing rights with respect to income dealt with under Article 7 and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State L for the purposes of the R-L treaty will have no impact on the outcome in this case.

### 2.3. Dividends

Dividends are dealt with in Article 10. Article 10 allows the state where the payor of dividends is resident (the source state) to impose tax, but limits the amount of the tax to a certain percentage of the gross amount of the dividends. Article 10 provides as follows (in paragraphs 1 and 2):

> “1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

> a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

> b) 15 per cent of the gross amount of the dividends in all other cases.”

Thus, the rate of tax that may be imposed in the source state depends on recipient’s interest in the company paying the dividends. The exact rates are a common point of negotiation, however, and often vary between treaties. The ownership thresholds also vary in many concluded treaties and some treaties may provide only a single maximum tax rate. Furthermore, if the dividends are attributable to a PE of the recipient which is located in the source state, then as a result of Article 10(3), Article 7 will apply instead of Article 10 and the source state may impose tax on the basis of the profit attributable to the PE.

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1514 The application of this threshold (and other treaty thresholds) in situations where treaty benefits are claimed in relation to the income attributable to a PE are discussed in Chapter 8 (Section 8.6.2.).
This section deals with a situation where a person resident in State R receives dividends which are attributable to a PE located in State PE. The dividends are paid by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a detailed discussion of PE triangular cases involving dividends, refer to Chapter 2 (Section 2.5.1.). For a detailed discussion of reverse dual resident triangular cases involving dividends, refer to Chapter 12 (Section 12.3. and in particular, Section 12.3.4.).

2.3.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty, the dividends are paid by a resident of State W. Article 10 will therefore apply and State W will be entitled to impose a limited rate of tax on the dividends.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. For the purposes of this treaty, the dividends are paid by a resident of State L. Article 10 will therefore apply and State L will be entitled to impose a limited rate of tax on the dividends. State L may be prevented from imposing tax, however, under Article 10(5) of the W-L treaty.1515

The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. The dividends are attributable to a PE in State PE and therefore, as a result of Article 10(3), will fall under the distributive rule of Article 7 of the purpose of this treaty. Under Article 7, State PE will be entitled to impose tax on the profit attributable to the PE. State PE may also have an obligation to provide relief for the tax imposed in State W and State L under the PE non-discrimination provision (Article 24(3)) of its treaty with State R, however, the scope of this obligation is not completely clear.1516

The recipient’s residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. State R may impose tax but will be obliged to provide relief under the R-W treaty.

1515 Article 10(5) provides that: "Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.” Thus, this provision should prevent the losing residence state from imposing tax on the dividends. The main problem with applying this provision is that it applies under the treaty between the two residence states of the payor and, for the purposes of this treaty, the recipient of the dividends is not a resident of either of the contracting states. In addition, it may apply only where the company derives profits or income from the state seeking to impose tax on the dividends. Article 10(5) is discussed in detail in Chapter 12 (see Section 12.2.1. and Section 12.3.4.).

1516 The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).
(using the credit method, regardless of the general relief method specified in the treaty\textsuperscript{1517}) and the R-PE treaty (using either the credit or exemption method). If State L is not prevented from imposing tax under Article 10(5) of the W-L treaty, State R will also be obliged to provide relief (using the credit method) for tax imposed in State L. Where State R provides relief using the exemption method under the R-PE treaty, it should not be obliged to grant any additional credit relief under the R-W treaty (or the R-L treaty).\textsuperscript{1518}

**Overview:** In this situation, tax may be imposed in State W, State L, State PE and State R. State R will have an obligation to provide relief under its treaties with State W, State L and State PE, and State PE may also have an obligation to provide relief for tax imposed in State W and State L (under Article 24(3) of the R-L treaty). In this situation, there is both dual source-based taxation as a result of the dividends being paid by a dual resident, and tax imposed in both State PE and State R. Given that tax is imposed in four separate states, it is highly likely that there will be unrelieved double taxation despite the relief provided in State R, even if relief is also provided in State PE. In this situation the source states (State W and State L) are also applying the “wrong” treaty conditions.\textsuperscript{1519}

### 2.3.2. Application of proposed solutions

**The winning residence state of the payor (State W):** Instead of being bound by the conditions of the R-W treaty, State W must now apply the conditions of the PE-W treaty in relation to the income attributable to the PE in State PE. For the purposes of the PE-W treaty, the dividends are paid by a resident of State W and Article 10 applies. Under Article 10, State W may impose a limited rate of tax on the dividends. This rate may differ from that specified in the R-W treaty.

**The losing residence state of the payor (State L):** Instead of being bound by the conditions of the R-L treaty, State L must now apply the conditions of the PE-L treaty in relation to the income attributable to the PE in State PE. For the purposes of applying this treaty, however, the payor of the dividends will no longer be considered to be resident in State L and, as a result, Article 10 will not apply. Instead, if the dividends are considered to be business profits, Article 7 will apply. If the dividends are not considered to be business profits, then Article 21 will apply. Regardless of whether Article 7 or Article 21 applies, however, State L will be prevented from imposing tax. If State L is prevented from imposing tax as a result of Article 10(5) of the W-L treaty under the existing treaty framework, then the outcome in this case will not be any different (and Article 10(5) may also continue to prevent State L from imposing tax). However, there is some uncertainty regarding the application of Article 10(5) in this situation and preventing State L from imposing tax under the terms of the PE-L treaty makes the outcome clearer and more certain.

**The recipient's PE state (State PE):** State PE must continue to apply the R-PE treaty. For the purposes of this treaty, Article 7 applies and State PE may impose tax on the profit attributable to the PE. State PE must also apply the conditions of the PE-W treaty and the PE-L treaty. State PE is obliged to provide relief for tax imposed in State W under the relief provisions of the PE-W treaty; given that dividends are involved this would typically be credit relief regardless of the general method of relief specified in the

\textsuperscript{1517} Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).

\textsuperscript{1518} This was discussed in Chapter 3 (Section 3.3.), where it was concluded that the exemption under one treaty should be taken into account when determining the amount of tax imposed in the residence state in respect of the income for the purposes of applying the relief provisions of the treaty requiring credit relief. As a result, there will be no tax imposed on the income in the residence state for the purposes of that provision and no credit will be required (in accordance with the terms of Article 23A(2) or Article 23B, as applicable). Please see Chapter 3 for an in-depth discussion of this issue.

\textsuperscript{1519} That is, the source states apply the conditions of their treaties with the residence state of the recipient of the income (State R) rather than the conditions of their treaties with the PE state (State PE), despite the allocation of primary (or even exclusive) taxing rights to State PE under the R-PE treaty. The reasons for considering this the “wrong” treaty are discussed in depth in Chapter 5.
treaty. State PE does not have to provide relief under the PE-L treaty because State L is prevented from imposing tax on the income.

The recipient’s residence state (State R): State R must continue to apply the R-W treaty, the R-L treaty and the R-PE treaty. State R is obliged to provide relief under the R-PE treaty (either exemption or credit). To the extent that State R exempts the income under this treaty, no further relief would be required. If, however, State R uses the credit method of relief with respect to the income attributable to the PE, it will also have to provide a credit for tax imposed in State W under the terms of the R-W treaty. State R will not be obliged to provide relief under the R-L treaty, since State L is prevented from imposing tax under the terms of the PE-L treaty.

Overview: In this situation, the source states (State W and State L) will be subject to the conditions of their respective treaties with the recipient’s PE state (State PE) rather than their treaties with the recipients residence state (State R), which means that they are now applying the more appropriate treaty conditions. In State W, the treaty with State PE may provide a different maximum level of source-based taxation of dividends than the R-W treaty, and this would have an impact on the amount of tax that State W could impose. In addition, the dual-resident payor of the dividends will no longer be considered a resident of State L for the purposes of the R-L or PE-L treaties. As a result, State L will be prevented from imposing tax under the PE-L treaty and there will be no dual source-based taxation. Furthermore, State PE now has an explicit obligation to provide relief for tax imposed in State W under the terms of the PE-W treaty. State R will also be obliged to provide relief; if it uses the exemption method under the R-PE treaty then it will simply exempt the income, however, if State R uses the credit method under that treaty then it will also be obliged to provide a credit for tax imposed in State W. The combination of the relief in State PE and in State R will generally ensure that no unrelieved double taxation arises.

2.4. Interest

Interest is dealt with in Article 11, which allows the state where interest arises to impose a limited rate of tax. Article 11 reads as follows (paragraphs 1 and 2):

“1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.”

Thus, where Article 11 applies, the source state is limited to imposing an amount of tax equal to 10% of the gross amount of the interest. This rate is a common point of negotiation, however, and often varies between concluded treaties. Furthermore, if the interest is attributable to a PE of the recipient which is located in the source state then, as a result of Article 11(4), Article 7 will apply instead of Article 11 and the source state may impose tax on the basis of the profit attributable to the PE.1523

1520 Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).

1521 Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).

1522 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).

1523 Article 11(4) provides that: “The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest
Whether interest arises in a particular state is determined in accordance with Article 11(5) which provides that:

“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 in a Contracting State 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.”

Thus, interest arises in a particular state if it is paid by a resident of that state or, in broad terms, is borne by a PE located in that state.

This section deals with a situation where a resident of State R derives interest income which is attributable to a PE in State PE. The interest is paid by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes; the payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a detailed discussion of PE triangular cases involving interest, refer to Chapter 2 (Section 2.5.2.). For a detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving interest, refer to Chapter 12 (Section 12.3.).

2.4.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. Under Article 11(5) of this treaty, the interest will be considered to arise in State W since it is paid by a resident of that state. Article 11 of the treaty will therefore apply and State W will be entitled to impose a limited rate of tax on the interest.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. Under Article 11(5) of this treaty, the interest will be considered to arise in State L since it is paid by a resident of that state. Article 11 of the treaty will therefore apply and State L will be entitled to impose a limited rate of tax on the interest.

The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of the R-PE treaty, Article 7 will apply (since the interest is attributable to a PE located in State PE) and State PE will be entitled to impose tax on the profit attributable to the PE. State PE may also have an

is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

1524 Article 11(5) provides that: “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 in a Contracting State 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.”

1525 Article 11(5) provides that: “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 in a Contracting State 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.”
obligation to provide relief for the tax imposed in the source states (State W and State L) under the non-discrimination article (Article 24(3)) of its treaty with State R, however, the scope of this obligation is not completely clear.\footnote{1526}{The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).} If State PE does grant relief under this provision, it would typically be credit relief given that the income involved is interest income. However, State PE may not be able to fully credit the tax imposed in both State W and State L.

The recipient’s residence state (State R): State R must apply the R-W treaty, the R-L treaty and the R-PE treaty. State R may impose tax, but each of these three treaties will require State R to provide relief. Under the R-W treaty and the R-L treaty this is likely to be credit relief (regardless of the general method of relief specified in the treaty) and under the R-PE treaty it may be either exemption or credit relief. Given that State R has an obligation to provide relief for tax imposed in three states it is unlikely to be able to provide sufficient relief to prevent unrelieved double taxation.\footnote{1527}{Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.}

Overview: In this situation, tax may be imposed in all four states. For the purposes of the R-W treaty the interest is considered to arise in State W and for the purposes of the R-L treaty the interest is considered to arise in State L; both State W and State L may therefore impose tax on the interest under Article 11 of their respective treaties with State R. State PE may also impose tax on the basis of the profit attributable to the PE. Given that tax is imposed in four states, the relief granted in the residence state (and possibly the PE state) is unlikely to be sufficient to prevent double taxation. Furthermore, the source states (State W and State L) are arguably applying the conditions of the wrong treaty and should instead apply the conditions of their treaty with State PE.\footnote{1528}{That is, the source states apply the conditions of their treaties with the residence state of the recipient of the income (State R) rather than the conditions of their treaties with the PE state (State PE), despite the allocation of primary (or even exclusive) taxing rights to State PE under the R-PE treaty. The reasons for considering this the “wrong” treaty are discussed in depth in Chapter 5.}

2.4.2. Application of proposed solutions

The winning residence state of the payor (State W): Instead of applying the conditions of the R-W treaty, State W must now apply the conditions of the PE-W treaty. For the purposes of this treaty, the interest is paid by a resident of State W and therefore, Article 11 will apply. Under Article 11, State W will be entitled to impose a limited rate of tax on the interest.

The losing residence state of the payor (State L): Instead of applying the conditions of the R-L treaty, State L must now apply the conditions of the PE-L treaty. For treaty purposes the dual-resident of payor of the interest is no longer considered to be resident in State L for the purposes of treaties with third states (i.e., states other than State W). Therefore, for the purposes of the PE-L treaty, the interest will not be considered to be paid by a resident of State L and Article 11 will not apply. Instead, Article 7 or Article 21 will apply (depending on whether the interest is considered to be business profits) and State L will be prevented from imposing any tax.

The recipient’s PE state (State PE): State PE must continue to apply the conditions of the R-PE treaty. For the purposes of this treaty, the interest income is attributable to a PE located in State PE and therefore, as a result of Article 11(3), Article 7 will apply. Under Article 7, State PE will be entitled to impose tax on the profit attributable to the PE. State PE must now also apply the conditions of the PE-W treaty and the
PE-L treaty. State PE will be obliged to grant relief under the PE-W treaty (using the credit method) but, because State L is prevented from imposing tax, will not have any obligation to provide relief under the PE=L treaty.

The recipient’s residence state (State R): State R must continue to apply the R-W treaty, the R-I treaty and the R-PE treaty. State R may impose tax on the income, but will have an obligation to grant relief under both the R-PE treaty (credit or exemption) and the R-W treaty (using the credit method). However, no relief will be required for tax imposed in State W if State R exempts the income under the R-PE treaty. State R will also have no obligation to provide relief under the terms of the R-I treaty, since State L is prevented from imposing tax under the terms of the PE-I treaty.

Overview: The source states (State W and State L) will now be subject to the conditions of their respective treaties with the recipient’s PE state (State PE) rather than their treaties with the recipients residence state (State R) and are therefore applying the more appropriate treaty conditions. In State W, the treaty with State PE may provide a different maximum level of source-based taxation of interest than the R-W treaty and this would have an impact on the amount of tax that State W could impose. In addition, the dual-resident payor of the interest will no longer be considered a resident of State L for the purposes of the R-L or PE-L treaties. As a result, State L will be prevented from imposing tax under the PE-L treaty and there will be no dual source-based taxation. Furthermore, State PE now has an explicit obligation to provide relief for tax imposed in State W under the terms of the PE-W treaty. State R will also be obliged to provide relief; if it uses the exemption method under the R-PE treaty then it will simply exempt the income, however, if State R uses the credit method under that treaty then it will also be obliged to provide a credit for tax imposed in State W. The combination of the relief in State PE and in State R will generally ensure that no unrelieved double taxation arises.

2.5. Royalties

Royalties are dealt with in Article 12, which allows tax to be imposed only in the residence state. Article 12 (paragraph 1) reads as follows:

“Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.”

If, however, the royalties are attributable to a PE of the recipient which is located in the source state, then as a result of Article 12(2), Article 7 will apply instead of Article 12 and the source state may impose tax on the basis of the profit attributable to the PE. Thus, the OECD Model does not allow any source-based taxation of royalties except where they are attributable to a PE in the source state.

As outlined in Chapter 12 (see Section 12.2.2.), the UN Model and many concluded treaties do allow states to impose a limited rate of source based taxation on royalties which arise in one contracting state and are paid to a resident of the other contracting state. In general, the rules for determining whether royalties arise in a particular state mirror the rules of Article 11(5) which apply in relation to interest. To the extent that the applicable treaties do allow source-based taxation of royalties and determine where royalties arise under a provision equivalent to Article 11(5), the analysis in relation to royalties would be

1529 Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 11 (or Article 10).

1530 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).

1531 See, for example, Article 12(5) of the UN Model Treaty (2001), which provides that: “Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.”
exactly the same as that outlined for interest above. The analysis below briefly considers both situations where the applicable treaties do allow source based taxation of royalties under Article 12 and situations where they do not. Where source-based taxation of royalties is allowed, it is assumed that the relevant treaty contains a provision mirroring Article 11(5) for determining whether royalties arise in a particular state. Where Article 12 does not allow source based taxation of royalties, the place where royalties arise becomes less important because if the royalties are not considered to arise in a particular state, then that state will nevertheless generally be prevented from imposing tax under either Article 7 or Article 21 of the treaty (depending on whether the income is considered to be business profits). The result will therefore be the same regardless of whether the royalties are or are not considered to arise in the state applying the treaty.

This section deals with a situation where a person resident in State R derives royalties which are attributable to a PE located in State PE. The royalties are paid by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor's residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a detailed discussion of PE triangular cases involving royalties, refer to Chapter 2 (Section 2.5.3.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving royalties, refer to Chapter 12 (Section 12.3.).

2.5.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State W will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State L will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.

1533 This assumes that the royalties are considered to arise in State W for the purposes of the treaty, i.e., as a result of being paid by a resident of State W. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State W, State W would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).
1534 This assumes that the royalties are considered to arise in State L for the purposes of the treaty, i.e., as a result of being paid by a resident of State L. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State L, State L would still be prevented from imposing tax either under
The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 7 will apply and State PE may impose tax on the basis of the profit attributable to the PE. To the extent that State W and/or State L has imposed source-based taxation on the royalties, State PE may be required to provide relief in accordance with the non-discrimination provision (Article 24(3)) of the R-PE treaty (typically credit relief). However, the scope of the PE state’s obligation to provide relief under Article 24(3) is not completely clear.\(^{1535}\)

The recipient’s residence state (State R): State R must apply the conditions of the R-PE treaty, the R-W treaty and the R-L treaty. To the extent that State W and/or State L is entitled to impose tax under their respective treaties with State R, State R will be obliged to provide relief (generally using the credit method). State W will also be obliged to provide relief (credit or exemption) under the R-PE treaty. To the extent that tax is imposed in State W and/or State L and in State PE, State R will have an obligation to provide relief under more than one treaty and is unlikely to be able to provide sufficient relief to prevent double taxation.\(^{1536}\)

Overview: The existence of dual source-based taxation of royalties in this situation will depend on the terms of the applicable treaties; it may be that neither of the source states (State W and State L) is entitled to impose tax, that only one of those states is entitled to impose tax or that both those states are entitled to impose tax. Tax may also be imposed in State R and in State PE; State R will have a clear obligation to provide relief for tax imposed in any of the other three states, and State PE may have an obligation to provide relief for tax imposed in State W and/or State L under the non-discrimination provision of the R-PE treaty. However, in many cases unrelieved double taxation may persist. In addition, State W and State L are arguably applying the wrong treaty conditions (i.e., the conditions of their treaties with State R) and should instead apply the conditions of their respective treaties with State PE in relation to the income attributable to the PE located in that state.\(^{1537}\)

2.5.2. Application of proposed solutions

The winning residence state of the payor (State W): Instead of applying the R-W treaty, State W will now apply the conditions of the PE-W treaty. For the purposes of the PE-W treaty, Article 12 will generally apply and, depending on the terms of Article 12, State W will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.\(^{1538}\)

The losing residence state of the payor (State L): Similarly, instead of applying the R-L treaty, State L will now apply the conditions of the PE-L treaty. However, the dual-resident payor will no longer be considered a resident of State L for the purposes of State L’s tax treaties, including the PE-L treaty. As a result, the

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\(^{1535}\) The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

\(^{1536}\) Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.

\(^{1537}\) For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.

\(^{1538}\) This assumes that the royalties are considered to arise in State W for the purposes of the treaty, i.e., as a result of being paid by a resident of State W. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State W, State W would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).
royalties may not be considered to arise in State L, and Article 12 will generally not apply. Instead, the income may fall under either Article 7 or Article 21 depending on whether it is considered to be business profits. Irrespective of which of these two provisions applies, State L will be prevented from imposing tax.

The recipient’s PE state (State PE): State PE will continue to apply the conditions of the R-PE treaty and will continue to be entitled to impose tax on the profit attributable to the PE in accordance with Article 7. However, to the extent that State W is entitled to impose tax on the income in accordance with the PE-W treaty, State PE will now have an explicit obligation to grant relief under the terms of that treaty.

The recipient’s residence state (State R): State R will continue to apply the conditions of the R-PE treaty, the R-W treaty and the R-L treaty. State R will continue to have an obligation to provide relief using either the exemption or credit method under the R-PE treaty. If State R uses the credit method of relief in relation to the profit attributable to the PE, and if State W is entitled to impose tax under the PE-S treaty, State R will also have an obligation to provide relief for tax imposed in State W.

Overview: Ensuring that a dual-resident is not resident in its losing residence state for the purposes of treaties between that state and third states prevents dual source-based taxation in situations where royalties are paid by a dual-resident to a resident of a third state. In the situation discussed in this section, this means that State L is prevented from imposing tax. State W may or may not be entitled to impose tax depending on whether the PE-W treaty allows source-based taxation of royalties. Depending on the terms of the applicable treaties, tax may therefore be imposed in only one of the source states (State W) or they may both be prevented from imposing tax. Furthermore, due to the application of the treaties between the recipient’s PE state (State PE) and the source states, the source states are now applying the more appropriate treaty provisions. State PE will also have an explicit relief obligation in situations where State W is entitled to impose tax. State R will have an obligation to provide relief for tax imposed in the PE state (State PE) and, if it uses the credit method with respect to the profit attributable to the PE and State W is not prevented from imposing tax under the PE-W treaty, will also have an obligation to provide relief for tax imposed in State W. This relief, combined with the relief in the PE state, ensures that double taxation can be prevented.

2.6. Income from immovable property

Income from immovable property is dealt with in Article 6, which allows the state where the property is located to impose tax on the income. Article 6 (paragraph 1) provides as follows:

“Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

Immovable property is defined in Article 6(2) by reference to the domestic law of the state where the property is located. Article 6(2) also lists certain things, such as property accessory to immovable property and livestock, which are always considered to be immovable property for the purposes of the treaty.

1539 Assuming that royalties are only considered to arise in a particular state for treaty purposes if they are either paid by a resident of that state or originate in a PE of the payor located in that state, i.e., mirroring the provisions of Article 11(5) which determines where interest arises.

1540 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state (in this case, State W) is prevented from imposing tax under its treaty with the PE state. This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).

1541 Article 6(2) provides that: “The term ‘immovable property’ shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.”
Where immovable property is located in a third state for the purposes of a particular treaty, there is some debate regarding the appropriate treaty article to apply. This was discussed in detail in Chapter 2 (see Section 2.6.), where it was concluded that the income may fall under the distributive rule of either Article 7 or Article 21. Article 7 may apply either because the income is considered to be business profits or because it is attributable to a PE (i.e., as a result of Article 21(2)). It will generally fall under Article 21 only if it is not considered to be business profits and is not attributable to a PE. For a detailed discussion, please refer to Chapter 2 (Section 2.6.).

This section deals with a situation where a person resident in State R derives income from immovable property which is attributable to a PE located in State PE. The income is paid by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. As mentioned above, the application of tax treaties in relation to income from immovable property depends on the location of the property. For the purposes of the analysis below, it is assumed that the immovable property is located in State W. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram showing the location of income and the PE]

For a detailed discussion of PE triangular cases involving income from immovable property, refer to Chapter 2 (Section 2.6.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving income from immovable property, refer to Chapter 12 (Section 12.3.).

2.6.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty, Article 6 applies and State W may impose tax on the income. Note that if the property were instead located in another state, e.g., State L, then Article 6 would not apply. Instead, Article 7 or Article 21 applies (depending on whether the income is considered to be business profits) and State W would be prevented from imposing tax on the income.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. Article 6 will not apply for the purposes of this treaty because the immovable property is not located in State L.

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1543 For a discussion of the appropriate treaty article to apply in relation to income from immovable property where the immovable property is located in a third state, please refer to Chapter 2 (Section 2.6.). As mentioned above, Article 6 will not apply because the definition of immovable property only applies where the property is located in one of the contracting states. Where the income is attributable to a PE (i.e., for the purposes of the R-PE treaty), the income will fall under the distributive rule of Article 7 (either directly because it is considered to be business profits, or indirectly as a result of Article 21(2)). Please refer to Chapter 2 for an in-depth discussion of the application of tax treaties in PE triangular cases involving immovable property (Section 2.6.).
Instead, Article 7 or Article 21 applies, depending on whether the income is considered to be business profits,\textsuperscript{1544} and because the income is not attributable to a PE in State L, State L would be prevented from imposing tax. Note that if the property were instead located in State L, then State L would be entitled to impose tax on the income under Article 6.

\textit{The recipient's PE state (State PE):} State PE must apply the conditions of the R-PE treaty. For the purpose of this treaty, the income will fall under Article 7 (either directly because it is considered to be business profits, or indirectly as a result of Article 21(2)) and State PE will be entitled to impose tax on the profit attributable to the PE. State PE may also have an obligation to provide relief for tax imposed in State W (i.e., the state where the property is located) under the non-discrimination provision (Article 24(3)) of its treaty with State R.\textsuperscript{1545}

\textit{The recipient's residence state (State R):} State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. State R may impose tax but will have an obligation to provide relief (either exemption or credit) under both the R-W treaty and the R-PE treaty.\textsuperscript{1546} State R will not have a relief obligation under the R-L treaty because the terms of that treaty do not allow State L to impose any tax on the income.

\textit{Overview:} In this situation, tax is imposed in the state where the property is located (State W), State PE and State R. The fact that the payment is made by a dual resident does not give rise to dual source-based taxation. State R will have a clear obligation to provide relief for tax imposed in both State PE and State W, but is unlikely to be able to provide sufficient relief in the absence of relief in the PE state (refer to discussion in Chapter 3). State PE may have an obligation to provide relief under Article 24(3), but the scope of this relief obligation is subject to debate. Thus, unrelieved double taxation may arise. In addition, State W and State L are arguably applying the wrong treaty conditions (i.e., the conditions of their treaties with State R) and should instead apply the conditions of their respective treaties with State PE.\textsuperscript{1547}

\subsection*{2.6.2. Application of proposed solutions}

\textit{The winning residence state of the payor (State W):} Instead of applying the conditions of the R-W treaty, State W will now apply the conditions of the PE-W treaty. For the purposes of the PE-W treaty, Article 6 will apply and State W will continue to be entitled to impose tax on the income. The application of the PE-W treaty instead of the R-W treaty is unlikely to have any practical impact in State W, particularly given that the definition of immovable property in Article 6 refers to the domestic law of the state where the property is located.

\textsuperscript{1544} For a discussion of the appropriate treaty article to apply in relation to income from immovable property where the immovable property is located in a third state, please refer to Chapter 2 (Section 2.6.). As mentioned above, Article 6 will not apply because the definition of immovable property only applies where the property is located in one of the contracting states. Where the income is attributable to a PE (i.e., for the purposes of the R-PE treaty), the income will fall under the distributive rule of Article 7 (either directly because it is considered to be business profits, or indirectly as a result of Article 21(2)). Please refer to Chapter 2 for an in-depth discussion of the application of tax treaties in PE triangular cases involving immovable property (Section 2.6.).

\textsuperscript{1545} The PE state's potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

\textsuperscript{1546} Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations. Chapter 3 also discusses the residence state's potential option to grant dual relief (see Section 3.3.).

\textsuperscript{1547} For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.
The losing residence state of the payor (State L): Instead of applying the conditions of the R-L treaty, State L must now apply the conditions of the PE-L treaty. For the purposes of this treaty, Article 7 or Article 21 will apply (depending on whether the income is considered to be business profits) and State L will continue to be prevented from imposing any tax on the income.

The recipient’s PE state (State PE): State PE will continue to apply the R-PE treaty and will continue to be entitled to impose tax on the profits attributable to the PE under Article 7. However, State PE will now have an explicit obligation to provide relief (either exemption or credit) under the terms of the PE-W treaty (i.e., its treaty with the state where the immovable property is located).

The recipient’s residence state (State R): State R must continue to apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. State R will therefore continue to have an obligation to provide relief under the R-PE treaty. If State R provides relief under the R-PE treaty using the credit method, it will also have an obligation to provide relief under the R-W treaty (using either the credit or exemption method).1548

Overview: The main impact of the proposed solution in this case is the explicit obligation imposed on the PE state to provide relief for tax imposed in the state where the property is located. Although the source states (State W and State L) are now applying the more appropriate treaty conditions, this is likely to have little practical impact since the terms of Article 6 are less likely to differ between treaties than, for example, the maximum rates of tax that can be imposed on passive income. In addition, the residence of the payor has no impact on the distribution of taxing rights with respect to income dealt with under Article 6 and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State L for the purposes of the R-L treaty will have no impact on the outcome in this case.

2.7. Income from shipping and air transport

Article 8 deals with income from shipping, inland waterways transport and air transport and provides (in paragraphs 1 and 2) that:

“1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

Thus, under Article 8, income from shipping, inland waterways transport and air transport may only be taxed in the state where the enterprise’s place of effective management is located. This will generally be the state where the person deriving the income is resident.1549

This section deals with a situation where a person resident in State R derives income from shipping, inland waterways transport and/or air transport which is attributable to a PE in State PE. The place of effective management of the person deriving the income is located in that person’s residence state, State R. The income is paid by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the person deriving the income):

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1548 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4).

1549 The place of effective management is assumed to be located in the residence state for the purposes of the discussion below. For further discussion of the location of the place of effective management in the context of applying tax treaties in PE triangular cases involving income from shipping, inland waterways transport and air transport, please refer to Chapter 2 (Section 2.7.).
For a more detailed discussion of typical PE triangular cases involving income from shipping, inland waterways transport and air transport, refer to Chapter 2 (Section 2.7.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving income dealt with under Article 8, refer to Chapter 12 (Section 12.3.).

2.7.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty Article 8 will apply and, since the place of effective management is located in State R, State W will be prevented from imposing any tax on the income.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. Again, Article 8 of the treaty will apply and, since the place of effective management is located in State R, State L will be prevented from imposing any tax on the income.

The recipient's PE state (State PE): State PE must apply the conditions of the R-PE treaty. Article 8 will also apply for the purposes of this treaty and, since the place of effective management is located in State R, State PE will be prevented from imposing any tax on the income.

The recipient's residence state (State R): State R must apply the R-W treaty, the R-L treaty and the R-PE treaty. There will be no limitation on State R's ability to impose tax and, since no other state may impose tax on the income, State R will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State R; all the other states involved will be prevented from imposing tax under Article 8 of their respective treaties with State R.

2.7.2. Application of proposed solutions

It is not proposed that the benefits of treaties concluded between the PE state and third states should be available in situations where the PE state is prevented from imposing tax under the conditions of the R-PE treaty, as is the case with respect to income from shipping, inland waterways transport and air transport under Article 8.1550 The following discussion is therefore intended to deal only with the impact of the proposed solution for reverse dual-resident triangular cases.

The winning residence state of the payor (State W): State W must continue to apply the conditions of the R-W treaty. For the purposes of this treaty Article 8 will apply and, since the place of effective management of the person deriving the income is located in State R, State W will be prevented from imposing any tax on the income.

The losing residence state of the payor (State L): State L must continue apply the conditions of the R-L treaty. Again, Article 8 of the treaty will apply and, since the place of effective management is located in State R, State L will be prevented from imposing any tax on the income. The fact that the person paying the amount in question is no longer considered to be a resident of State L for the purpose of the R-L treaty has no impact on this outcome.

1550 Refer to Chapter 8 (Section 8.6.5.) for further discussion.
The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. Article 8 will also apply for the purposes of this treaty and, since the place of effective management is located in State R, State PE will be prevented from imposing any tax on the income.

The recipient’s residence state (State R): State R must apply the R-W treaty, the R-L treaty and the R-PE treaty. There will be no limitation on State R’s ability to impose tax and, since no other state may impose tax on the income, State R will have no obligation to provide relief.

Overview: In this situation, as under the existing treaty framework, tax may only be imposed in State R; all the other states involved will be prevented from imposing tax under Article 8 of their respective treaties with State R. Furthermore, the residence of the payor has no impact on the distribution of taxing rights with respect to income dealt with under Article 8 and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State L for the purposes of the R-L treaty will have no impact on the outcome in this case.

2.8. Capital gains from the alienation of immovable property

Capital gains derived from the alienation of immovable property are dealt with in Article 13(1), which provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.”

Thus, Article 13(1) applies where a resident of one state derives capital gains from the alienation of immovable property located in the other contracting state, and allows the state where the property is located to impose tax on the gain. The reference to Article 6 in Article 13(1) is a reference to the definition of immovable property, which in turn refers to the domestic law of the state where the property is located, as well as containing a list of certain property which is always considered to be immovable property for the purposes of the treaty.1551

This section deals with a situation where a person resident in State R derives a capital gain from the alienation of immovable property and that capital gain is attributable to a PE of the recipient located in State PE. The property is purchased by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. It is assumed that the immovable property from which the gain arises is located in State W. This situation is illustrated in the diagram below (in which “HO” denotes head office):

![Diagram of capital gains from the alienation of immovable property]

For further discussion of Article 13(1) and of typical PE triangular cases involving capital gains from the alienation of immovable property, refer to Chapter 2 (Section 2.8.1.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving this type of capital gains, refer to Chapter 12 (Section 12.3.).

2.8.1. Existing treaty framework

1551 For further discussion of the definition of immovable property and the application of tax treaties in PE triangular cases involving capital gains from immovable property, please refer to Chapter 2 (particularly Section 2.8.1.).
The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(1) applies and State W will be entitled to impose tax on the capital gain.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State L will be prevented from imposing tax on the capital gain.

The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State PE will be prevented from imposing tax on the capital gain.

The recipient’s residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. There will be no restrictions on State R’s ability to impose tax, but State R will be required to provide relief (either exemption or credit) under the R-W treaty.

Overview: In this situation, tax may be imposed in the state where the immovable property is located and in the residence state of the person deriving the capital gain, and the residence state is obliged to provide relief (either exemption or credit, depending on the terms of the treaty). There is therefore no unrelieved double taxation; this is to be expected since the existence of a PE or the fact that the payment giving rise to the capital gain is made by a resident person, does not have any influence on a state’s ability to impose tax.

2.8.2. Application of proposed solutions

It is not proposed that the benefits of treaties concluded between the PE state and third states should be available in situations where the PE state is prevented from imposing tax under the conditions of the R-PE treaty, as is the case with respect to capital gains from the alienation of immovable property located in third states. The following discussion is therefore intended to deal only with the impact of the proposed solution for reverse dual-resident triangular cases.

The winning residence state of the payor (State W): State W must continue to apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(1) applies and (since the property is located in State W) State W will be entitled to impose tax on the gain.

The losing residence state of the payor (State L): State L must continue to apply the conditions of the R-L treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State L will be prevented from imposing tax on the capital gain. Note that the person paying the amount in question will no longer be a resident of State L for the purposes of the R-L treaty, but this will have no impact on the application of that treaty.

The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State PE will be prevented from imposing tax on the capital gain.

The recipient’s residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. There will be no restrictions on State R’s ability to impose tax, but State R will be required to provide relief (either exemption or credit) under the R-W treaty.

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1552 Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of movable property forming part of the business property of a PE (para 2), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4).

1553 Refer to Chapter 8 (Section 8.6.5.) for further discussion.
Overview: The proposed changes have no impact in this situation, partly because the source states will continue applying their treaties with the residence state (rather than the PE state) and partly because the residence of the payor has no impact on the distribution of taxing rights with respect to this category of capital gains. As under the existing treaty framework, tax may be imposed in the state where the property is located (State W) and in the residence state of the recipient (State R), and State R will have an obligation to provide relief. There will be no unrelieved double taxation. It should also be noted that the residence of the payor has no impact on the distribution of taxing rights with respect to capital gains dealt with under Article 13(1) and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State L for the purposes of the R-L treaty will have no impact on the outcome in this case.

2.9. Capital gains from the alienation of movable property of a PE

Article 13(2) deals with capital gains from the alienation of movable property forming part of the business property of a PE. It provides that:

“Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.”

This section discusses a situation where a person resident in State R derives a capital gain from the alienation of movable property which forms part of the business property of a PE located in State PE. The property is purchased by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For further discussion of Article 13(2) and of typical PE triangular cases involving capital gains from the alienation of movable property forming part of the business property of a PE, refer to Chapter 2 (Section 2.8.2.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving capital gains dealt with under Article 13(2), refer to Chapter 12 (Section 12.3.).

2.9.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(2) will not apply because the gain does not arise from the alienation of movable property of a PE located in State W. Since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State W will be prevented from imposing any tax on the gain.\textsuperscript{1554}

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. For the purposes of this treaty, Article 13(2) will not apply because the gain does not arise from the alienation of movable property of a PE located in State L. Since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State L will be prevented from imposing any tax on the gain.

\textsuperscript{1554} Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4).
The recipient's PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of this treaty Article 13(2) will apply and State PE will be entitled to impose tax on the gain.

The recipient's residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty, and the R-PE treaty. State R may impose tax on the gain but will be obliged to provide relief (either exemption or credit) under the R-PE treaty. State R will have no obligation to provide relief under either the R-W treaty or the R-L treaty, since both State W and State L are prevented from imposing tax under their respective treaties with State R.

Overview: Tax may be imposed in State R and in State PE, and State R must provide relief. There is no dual source-based taxation and no unrelieved double taxation, however State W and State L are nevertheless still applying the wrong treaty conditions. 1555

2.9.2. Application of proposed solutions

The winning residence state of the payor (State W): Instead of applying the R-W treaty, State W must now apply the conditions of the PE-W treaty. For the purposes of this treaty, Article 13(2) will not apply because the capital gain does not arise from the alienation of movable property forming part of the business property of a PE located in State W. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State W will be prevented from imposing any tax on the gain. Thus, the application of the PE-W treaty instead of the R-W treaty would generally have no practical impact in State W.

The losing residence state of the payor (State L): Instead of applying the conditions of the R-L treaty, State L must now apply the conditions of the PE-L treaty. For the purposes of this treaty, Article 13(2) will not apply because the capital gain does not arise from the alienation of movable property forming part of the business property of a PE located in State L. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State L will be prevented from imposing any tax on the gain. Thus, the application of the PE-L treaty instead of the R-L treaty would generally have no practical impact in State L. In addition, the payor will no longer be resident in State L for the purposes of that state's treaties, including the PE-L treaty, however this will have no impact on the application of that treaty in this case.

The recipient's PE state (State PE): State PE will continue to be bound by the conditions of the R-PE treaty and may continue to impose tax under Article 13(2) of that treaty. State PE must also apply the conditions of the PE-W treaty and the PE-L treaty, however, given that both State W and State L are prevented from imposing tax under these treaties, State PE will have no obligation to provide relief.

The recipient's residence state (State R): State R must apply the R-W treaty, the R-L treaty and the R-PE treaty. State R will continue to have an obligation to provide relief under the R-L treaty, using either the exemption or credit method depending on the treaty. State R will not have any obligation to provide relief under the R-W treaty or the R-L treaty because both State W and State L are prevented from imposing tax under their respective treaties with State PE. 1556

Overview: In this situation, the application of the treaties between the PE state of the person receiving the capital gain and the source states states has no practical impact on the ability of each state to impose tax, and no impact on the overall outcome. This is because there is no difference between the conditions of those states' treaties with State R and their treaties with State PE. In practice, there could potentially be differences between the terms of these treaties, in which case the application of the latter treaties may have an impact on the source state's ability to impose tax in this situation. In addition, the fact that the dual resident payor is no longer resident in State L for the purposes of the R-L treaty or the PE-L treaty

1555 For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.

1556 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
will have no impact on the application of these treaties, since the residence of the payor has no impact on the distribution of taxing rights in relation to capital gains dealt with under Article 13(2).

2.10. Capital gains from the alienation of ships and aircraft in international traffic

Article 13(3) deals with capital gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated assets. It provides that:

“Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

This section deals with a situation where a person resident in State R derives a capital gain from the alienation of ships or aircraft operated in international traffic (or similar assets), and that capital gain is attributable to a PE located in State PE. The place of effective management of the person deriving the capital gain is located in State R. The property is purchased by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the person deriving the capital gain):

For further discussion of Article 13(3) and of typical PE triangular cases involving capital gains from the alienation of ships or aircraft operated in international traffic, refer to Chapter 2 (Section 2.8.3.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving capital gains dealt with under Article 13(3), refer to Chapter 12 (Section 12.3.).

2.10.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R, State W will be prevented from imposing any tax.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. For the purposes of this treaty, Article 13(3) will apply and State L will be prevented from imposing any tax.

The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 13(3) will apply and State PE will be prevented from imposing any tax. The fact that the gain is attributable to a PE in State PE has no impact on the application of the treaty.

The recipient’s residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. None of these treaties will impose any restriction on State R’s ability to impose tax and State R will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State R. State W, State L and State PE will all be prevented from imposing tax under Article 13(3) of their respective treaties with State R.
2.10.2. Application of proposed solutions

It is not proposed that the benefits of treaties concluded between the PE state and third states should be available in situations where the PE state is prevented from imposing tax under the conditions of the R-PE treaty, as is the case with respect to capital gains from the alienation of ships, aircraft and associated assets. The following discussion is therefore intended to deal only with the impact of the proposed solution for reverse dual-resident triangular cases.

The winning residence state of the payor (State L): State W must continue to apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R, State W will be prevented from imposing any tax on the capital gain.

The losing residence state of the payor (State L): State L must continue to apply the conditions of the R-L treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R, State L will be prevented from imposing any tax on the capital gain. Note that the fact that the payor is no longer resident in State L for the purpose of the R-L treaty will have no impact on the application of the treaty in this case.

The recipient’s PE state (State PE): State PE must continue to apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 13(3) will apply and State PE will be prevented from imposing any tax on the gain. The fact that the gain is attributable to a PE in State PE has no impact on the application of the treaty.

The recipient’s residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. None of these treaties will impose any restriction on State R’s ability to impose tax and State R will have no obligation to provide relief.

Overview: The proposed changes have no impact in this situation, partly because the source states will continue applying their treaties with the residence state (rather than their treaties with the PE state) and partly because the residence of the payor has no impact on the distribution of taxing rights with respect to this type of capital gains. As under the existing treaty framework, tax may be only be imposed in the state where the place of effective management of the person deriving the capital gain is located (State R). It should also be noted that the residence of the payor has no impact on the distribution of taxing rights with respect to capital gains dealt with under Article 13(3) and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State L for the purposes of the R-L treaty will have no impact on the outcome in this case.

2.11. Capital gains from the alienation of shares in a real estate company

Article 13(4) deals with capital gains from the alienation of shares which derive their value from immovable property. It provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.”

Such gains may therefore be taxed in the state where the underlying immovable property is located. The OECD Model does not contain any other specific provision dealing with shares, but some concluded treaties also allow source based taxation of gains arising from:

5. The alienation of shares in a company having more than 50% of its assets located in the source state; and/or

6. The alienation of shares where the person disposing of those shares has a "substantial participation" (i.e., a shareholding of more than a certain specified percentage) in the company whose shares are being alienated.

1557 Refer to Chapter 8 (Section 8.6.5.) for further discussion.
In general, these provisions allow the source state (i.e., the state where the underlying property is located) to impose tax on the gains in the same way as Article 13(4) allows taxation of gains arising from shares in a real estate company. For the purposes of the discussion below, however, it will be assumed that all the applicable treaties follow the OECD Model.

This section deals with a situation where a person resident in State R derives a capital gain from the alienation of shares which derive more than 50% of their value from immovable property, and that capital gain is attributable to a PE located in State PE. The amount giving rise to the capital gain is paid by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. For the purposes of the discussion below, it is assumed that the underlying immovable property is located in State W. This situation is illustrated in the following diagram (in which “HO” denotes head office):

Note that the place where the shares are registered is not relevant for the purposes of the discussion below.

For additional discussion of PE triangular cases involving capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (and similar cases), refer to Chapter 2 (Section 2.8.4.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving capital gains dealt with under Article 13(4), refer to Chapter 12 (Section 12.3.).

2.11.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(4) will apply and State W will be entitled to impose tax on the gain.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. Article 13(4) of the treaty will not apply because the underlying property is not located in State L. Instead, since none of the other paragraphs of Article 13 apply, the capital gain will fall under Article 13(5) and State L will be prevented from imposing tax.1560

The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of this treaty, Article 13(4) will not apply because the underlying property is not located in State PE. However, the shares are likely to be considered movable property and, since the gain is attributable to the PE, is likely to form part of the business property of the PE. As a result, Article 13(2) is likely to apply and State PE may therefore be entitled to impose tax on the gain. State PE may also have an obligation to provide relief for tax imposed in State W under the non-discrimination article (Article 24(3)) of the R-PE treaty.1561

1559 See, for example the reservations of France, Chile, Sweden and Korea in the OECD Commentary to Article 13 of the OECD Model.
1560 Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of movable property forming part of the business property of a PE (para 2), and capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3).
1561 The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a
The recipient's residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. State R may impose tax but will be obliged to provide relief (either exemption or credit) under both the R-W treaty and the R-PE treaty.

Overview: In this situation, tax may be imposed in State W, State PE and State R. State R will be obliged to provide relief under both the R-W treaty and the R-PE treaty, however may not be able to provide sufficient relief to prevent unrelied double taxation in the absence of relief in State PE. State PE may also have an obligation to provide relief for tax imposed in State W under the non-discrimination article (Article 24(3)) of the R-PE treaty. In addition, State W and State L are arguably applying the wrong treaty conditions (i.e., the conditions of their treaties with State R) and should instead apply the conditions of their respective treaties with State PE.1562

2.11.2. Application of proposed solutions

The winning residence state of the payor (State W): Instead of applying the R-W treaty, State W must now apply the conditions of the PE-W treaty. However, provided both treaties follow the OECD Model, the application of the two treaties will be the same. That is, for the purposes of this treaty, Article 13(4) will apply and State W will be entitled to impose tax on the gain.

The losing residence state of the payor (State L): Instead of applying the R-L treaty, State L must now apply the conditions of the PE-L treaty. Again, Article 13(4) of the treaty will not apply because the underlying property is not located in State L. Instead, since none of the other paragraphs of Article 13 apply, the capital gain will fall under Article 13(5) and State L will be prevented from imposing tax.

The recipient’s PE state (State PE): State PE must apply the conditions of the R-PE treaty and, as under the existing framework, Article 13(2) is likely to apply and State PE is likely to be entitled to impose tax on the gain. Now, however, State PE must also apply the PE-W treaty and the PE-L treaty and will have a direct obligation to provide relief (exemption or credit) under the terms of the PE-W treaty. State PE will not have any obligation under the PE-L treaty since State L is prevented from imposing tax.

The recipient’s residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. State R will continue to have a relief obligation under the R-PE treaty (either exemption or credit) but now, will only have a relief obligation under the R-W treaty if it uses the credit method under the R-PE treaty.1563 State R will not have any relief obligation under the R-L treaty because State L is prevented from imposing tax under the terms of the PE-L treaty.

Overview: In this situation, tax may be imposed in the state where the underlying property is located (e.g., State W), the PE state (State PE) and in the residence state of the person deriving the capital gain (State R). Both State R and State PE will have an obligation to provide relief, with State PE now having an explicit relief obligation under the terms of the PE-W treaty. The application of the terms of the treaties concluded between the PE state (State PE) and the source states (State W and State L) has little impact on the ability of each of the states to impose tax provided all the relevant treaties follow the OECD Model. It is possible, however, that the terms of the treaties between the PE state and the source states differ from the terms of the treaties concluded between the residence state (State R) and the source states, in which case the application of the PE states treaties could have a significant impact. The explicit obligation for the PE state to provide relief may also have a significant impact if that state does not provide relief under Article 24(3) of the R-PE treaty. It should also be noted that the residence of the resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

1562 For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.

1563 It is proposed that the residence state will have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
payor has no impact on the distribution of taxing rights with respect to capital gains dealt with under Article 13(4) and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State L for the purposes of the R-L treaty will have no impact on the outcome in this case.

2.12. Capital gains from the alienation of other property

Article 13(5) deals with capital gains arising from the alienation of property not dealt with in the other paragraphs of Article 13 (referred to herein as “other property”). It provides that:

“Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.”

Thus, capital gains from the alienation of other property may only be taxed in the residence state of the person deriving the gain.

This section deals with a situation where a person who is resident in State R derives a capital gain from the alienation of other property, and that gain is attributable to a PE in State PE. The property is purchased by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes; the payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For discussion of typical PE triangular cases involving capital gains from the alienation of other property, refer to Chapter 2 (Section 2.8.5.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving this type of capital gains, refer to Chapter 12 (Section 12.3.).

2.12.1. Existing treaty framework

The winning residence state of the payor (State W): State W must apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(5) applies and State W will be prevented from imposing tax on the gain.

The losing residence state of the payor (State L): State L must apply the conditions of the R-L treaty. For the purposes of this treaty, Article 13(5) applies and State L will be prevented from imposing tax on the gain.

The recipient's PE state (State PE): State PE must apply the conditions of the R-PE treaty. For the purposes of the discussion in this section it is assumed that Article 13(5) applies, in which case State PE will be prevented from imposing tax on the capital gain. However, it should be recognised that in many cases where the capital gain is attributable to the PE (and does not arise from the alienation of immovable property), the capital gain will have arisen from the alienation of movable property forming part of the business property of the PE, in which case Article 13(2) would apply and State PE would be entitled to impose tax (refer to Section 2.9, above).

The recipient's residence state (State R): State R must apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. State R may impose tax and will have no obligation to provide relief since State W, State L and State PE are each prevented from imposing tax under their respective treaties with State R.

Overview: In this situation, tax may only be imposed in State R. There will be no need for relief in State PE and no unrelieved double taxation.

2.12.2. Application of proposed solutions
It is not proposed that the benefits of treaties concluded between the PE state and third states should be available in situations where the PE state is prevented from imposing tax under the conditions of the R-PE treaty, as is the case with respect to capital gains from the alienation of ships, aircraft and associated assets. The following discussion is therefore intended to deal only with the impact of the proposed solution for reverse dual-resident triangular cases.

The winning residence state of the payor (State W): State W must continue to apply the conditions of the R-W treaty. For the purposes of this treaty, Article 13(5) applies and State W will be prevented from imposing tax on the gain.

The losing residence state of the payor (State L): State L must continue to apply the conditions of the R-L treaty. For the purposes of this treaty, Article 13(5) applies and State L will be prevented from imposing tax on the gain. Note that the fact that the payor is no longer considered resident in State L for the purposes of the R-L treaty has no impact on the application of that treaty in this case.

The recipient’s PE state (State PE): State PE must continue to apply the conditions of the R-PE treaty. For the purposes of the discussion in this section it is assumed that Article 13(5) applies, in which case State PE will be prevented from imposing tax on the capital gain. However, it should be recognised that in many cases where the capital gain is attributable to the PE, the capital gain will have arisen from the alienation of movable property forming part of the business property of the PE, in which case Article 13(2) would apply and State PE would be entitled to impose tax (refer to Section 2.9, above).

The recipient’s residence state (State R): State R must continue to apply the conditions of the R-W treaty, the R-L treaty and the R-PE treaty. State R may impose tax and will have no obligation to provide relief since State W, State L and State PE are each prevented from imposing tax under their respective treaties with State R.

Overview: The outcome in this situation is the same as under the existing treaty framework. That is, tax may be imposed only in State R (assuming the property is not movable property forming part of the business property of the PE, as mentioned above) and no relief will be required. It should also be noted that the residence of the payor has no impact on the distribution of taxing rights with respect to capital gains dealt with under Article 13(5) and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State L for the purposes of the R-L treaty will have no impact on the outcome in this case.

2.13. Other income

Article 21, titled “other income,” applies to any income not dealt with elsewhere in the treaty. It provides that:

“1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

Thus, Article 21 does not allow any taxation of other income outside the residence state unless the income is attributable to a local PE, in which case Article 7 applies.

This section deals with a situation where a resident of State R derives “other income” which is attributable to a PE in State PE. The income is paid by a dual-resident, a person who is resident in two states (State W and State L) for treaty purposes. The payor’s residence is assigned to State W for the purposes of the W-L treaty. This situation is illustrated in the following diagram (in which “HO” denotes head office):

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1564 Refer to Chapter 8 (Section 8.6.5.) for further discussion.
For a discussion of typical PE triangular cases involving other income, refer to Chapter 2 (Section 2.9.). For more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome in reverse dual-resident triangular cases involving other income, refer to Chapter 12 (Section 12.3.).

### 2.13.1. Existing treaty framework

**The winning residence state of the payor (State W):** State W must apply the R-W treaty. For the purposes of this treaty Article 21 applies and, since the income is not attributable to a PE in State W, State W is prevented from imposing any tax on the income.

**The losing residence state of the payor (State L):** State L must apply the R-L treaty. For the purposes of this treaty Article 21 applies and, since the income is not attributable to a PE of the recipient in State L, State L is prevented from imposing any tax on the income.

**The recipient’s PE state (State PE):** State PE must apply the conditions of the R-PE treaty. For the purposes of this treaty, the income is attributable to a PE located in State PE and therefore, as a result of Article 21(2), the income will fall under the distributive rule of Article 7. Under Article 7, State PE will be entitled to impose tax on the profit attributable to the PE.

**The recipient’s residence state (State R):** State R must apply the R-W treaty, the R-L treaty and the R-PE treaty. State R may impose tax but will have an obligation to provide relief (either exemption or credit) under the R-PE treaty. State R will not have any relief obligation under the R-W treaty or the R-L treaty since both State W and State L are prevented from imposing any tax on the income.

**Overview:** Tax may be imposed in State R and in State PE, and State R will be obliged to provide relief. Both State W and State L will be prevented from imposing tax on the income. However, State W and State L are nevertheless applying the wrong treaty conditions (i.e., the conditions of their treaties with State R) and should instead apply the conditions of their respective treaties with State PE.\(^{1565}\)

### 2.13.2. Application of proposed solutions

**The winning residence state of the payor (State W):** Instead of applying the conditions of the R-W treaty, State W must now apply the conditions of the PE-W treaty. For the purposes of this treaty, Article 21 will apply and, given that the income is not attributable to a PE in State W, State W will continue to be prevented from imposing any tax on the income.

**The losing residence state of the payor (State L):** Instead of applying the conditions of the R-L treaty, State L must now apply the conditions of the PE-L treaty. For the purposes of this treaty, Article 21 will apply and, given that the income is not attributable to a PE in State L, State L will continue to be prevented from imposing any tax on the income.

**The recipient’s PE state (State PE):** State PE must still apply the conditions of the R-PE treaty, and will still be entitled to impose tax on the profit attributable to the PE in accordance with Article 7 of the treaty. State PE must also apply the PE-W treaty and the PE-L treaty, however since these treaties prevent State

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\(^{1565}\) For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.
W and State L (respectively) from imposing any tax on the income, State I will not have any relief obligation.

The recipient’s residence state (State R): State R must continue to apply the R-W treaty, the R-L treaty and the R-PE treaty. State W may impose tax but will be obliged to provide relief in accordance with the terms of the R-PE treaty (either exemption or credit). State R will not have any relief obligation under either the R-W treaty or the R-L treaty, since both State W and State I are prevented from imposing any tax under respective their treaties with State PE.

Overview: In practical terms, the final outcome in this situation is no different after the application of the proposed solutions. That is, State R and State PE may impose tax, with State R obliged to provide relief, and both of the source states are prevented from imposing tax. However, this is a consequence of the assumption that all the relevant treaties follow the OECD Model. The source states are now applying the more appropriate treaty conditions and if terms of the relevant treaties did differ (for example, by not including Article 21), then a very different result could occur. It should also be noted that the residence of the payor has no impact on the distribution of taxing rights with respect to income dealt with under Article 21 and, as a result, the fact that the dual-resident payor is no longer considered to be resident in State I for the purposes of the R-L treaty will have no impact on the outcome in this case.

2.14. Conclusions

This section has discussed a situation where a typical PE triangular case is combined with a reverse dual resident triangular case. The analysis above illustrates that the issues arising in this situation are generally the same as those arising in the basic triangular cases which it comprises. Reverse dual resident triangular cases only give rise to dual source-based taxation in relation to dividends and interest income (and royalties where the applicable treaties differ from the OECD Model) and thus, dual source based taxation may only occur where dividends, interest and royalties are involved. In all other cases, the outcome in this situation under the existing treaty framework is essentially the same as the outcome in a typical dual resident triangular case (outlined in detail in Chapter 2).

The application of the proposed solutions in this case ensures that the source states apply the appropriate treaty conditions, and ensures that both the PE state and the residence state of the person receiving the income provide appropriate relief to prevent unrelieved double taxation. Importantly, the provisions of the treaties concluded between the PE state and the source states do not apply in situations where the PE state is prevented from imposing tax on the income under its treaty with the residence state. In such cases, the source states continue to apply the conditions of their respective treaties with the residence state.

This situation has also demonstrated the application of the proposed solution for reverse dual resident triangular cases. Under this proposed solution, a dual resident person would not be considered resident in the “losing” residence state for the purpose of treaties between that state and third states. As a result, any payments made by the dual resident are not considered to be paid by a resident of the losing residence state for the purposes of those treaties. This will only have an impact, however, in relation to categories of income for which there are distributive rules based on the residence of the payor, i.e., dividends, interest and royalties. With respect to other categories of income the residence (or non-residence) of the payor is generally irrelevant for the purposes of determining whether a particular state can impose source-based taxation. Thus, in most reverse dual resident triangular cases, the modification of the residence rules will have no impact on the application of the relevant treaties.

The analysis in this section has also demonstrated the interaction between the proposed solutions for PE triangular cases and for reverse dual resident triangular cases. As can be seen above, this causes no special issues. The source states (the residence states of the dual resident) will apply the conditions of their respective treaties with the PE state of the recipient and the dual resident will simply not be considered resident in the losing residence state for the purposes of applying the treaty between that state and the PE state.
Section III: Dual resident triangular cases combined with reverse PE triangular cases

3.1. Introduction

The case discussed in this section is a combination of a dual resident triangular case and a reverse PE triangular case. It involves a person who is resident in two states ("State W" and "State L") under their respective domestic laws and for treaty purposes who derives income from outside those two states. The income is paid by a resident of a third state ("State R") and the payment originates from a PE which the payor has in a fourth state ("State PE"); these two states are collectively referred to as the “source states.” This case is illustrated in the following diagram (in which “HO” denotes head office):

For the purposes of the analysis in this section, it is assumed that the tie-breaker rule of the treaty between the two residence states of the person deriving the income assigns that person’s residence to one state for the purposes of that treaty. The state to which residence is assigned is referred to as the winning residence state ("State W") and the state to which residence is not assigned is referred to as the losing residence state ("State L"). It is also assumed that the dual-resident person does not have a PE in the losing residence state.

For the purposes of this analysis, it is also assumed that the allocation of residence under the tie-breaker provision of the treaty between the two residence states of the person deriving the income is not effective for the purposes of treaties concluded between State L and third states. This means that any amount received by the dual resident will continue to be considered to be received by a resident of State L for the purposes of such treaties. This position is not free from doubt; for further discussion of the application of treaties between the losing residence state and third states, please refer to Chapter 11.

3.1.1. The existing treaty framework

Under the existing treaty framework, the applicable treaties in this case will be:

(i) the treaty between the winning residence state of the recipient and the residence state of the payor (the W-R treaty);

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1566 For a detailed overview of the application of tax treaties in dual resident triangular cases, refer to Chapter 9.
1567 For a detailed discussion of reverse PE triangular cases, refer to Chapter 12 (Section 12.2.).
1568 For discussion of the impact of a dual resident having a PE in the losing residence state in a dual resident triangular case, refer to Chapter 9 (Section 9.4.3.).
1569 Chapter 11 deals with the application of treaties between the losing residence state and third states in dual resident triangular cases, but is equally relevant in reverse dual resident triangular cases. The OECD Commentary takes the position that a dual resident will not be considered a resident of the losing residence state for the purposes of treaties concluded between that state as a result of the second sentence of Article 4(1). The second sentence of Article 4(1) provides that a person will not be resident in a particular state if they are "liable to tax in that State in respect only of sources in that State." It is argued that a dual resident does not meet this condition for the purposes of treaties concluded between their losing residence state and third states as a result of the restrictions imposed on the losing residence state’s taxing rights under the treaty between the two residence states. This position is controversial, however, and is discussed in detail in Chapter 11 (Section 11.2.).
(ii) the treaty between the losing residence state of the recipient and the residence state of the payor (the L-R treaty);

(iii) the treaty between the winning residence state of the recipient and the PE state of the payor (the W-PE treaty);

(iv) the treaty between the losing residence state of the recipient and the PE state of the payor (the L-PE treaty); and

(v) the treaty between the winning and losing residence states of the recipient (the W-L treaty).

The treaty between the payor's residence state and the payor's PE state (the R-PE treaty) will not apply because for the purposes this treaty, the income is not received by a resident of one of the contracting states.

3.1.2. Application of proposed solutions

The relevant proposals for the situation discussed in this section are those which are aimed at dealing with dual-resident triangular cases and reverse PE triangular cases.

Making the allocation of residence effective for the purposes of treaties with third states

It is proposed that dual-resident persons be specifically excluded from being resident in their losing residence state for the purposes of treaties between that state and third states. This would essentially make the allocation of residence under the treaty between the two residence states of a dual resident person effective for the purposes of other tax treaties.\(^\text{1570}\) It is proposed that this be achieved by including a specific provision in tax treaties, which could be worded along the following lines (for inclusion in Article 4, i.e., the residence article):

"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."\(^\text{1571}\)

In the case of a dual-resident receiving income from third states, this would mean that the dual-resident could no longer claim the benefit of treaties concluded between its losing residence state and the state (or states) where income arises. As a result, source states would no longer be subject to multiple treaty conditions in respect of income derived by a dual-resident.

For the purposes of the discussion in this appendix, it is assumed that the dual-resident does not have a PE in the losing residence state. One consequence of this is that the losing residence state will generally be prevented from imposing tax on the income.\(^\text{1572}\) If there is a PE in the losing residence state then that state would be entitled to impose tax on a number of categories of income to the extent that they are attributable to the PE; in this case relief would be required in that state.\(^\text{1573}\) This could be achieved by implementing the extension of treaty benefits to PEs as outlined briefly above.\(^\text{1574}\) For the purposes of the discussion below, however, there will generally be no relief required in the losing residence state.

Limits on source-based taxation where payments originate from a PE

It is proposed that interest (and, where applicable, royalties) which originate from a PE located in a third state should not be considered to arise in the payor's residence state for the purposes of treaties concluded between that state and third states. This would be achieved by changing the wording of Article

\(^{1570}\) This proposal is discussed in detail in Chapter 11 (Section 11.3.2.) and, in the context of reverse dual resident triangular cases, in Chapter 12 (Section 12.3.5.).

\(^{1571}\) This proposed provision is extracted from Chapter 11 (Section 11.3.2.) where it is discussed in-depth.

\(^{1572}\) For an analysis of the outcome of dual resident triangular cases involving various categories of income (in situations where there is no PE in the losing residence state) refer to Chapter 9 (Sections 9.4.1. and 9.4.2.).

\(^{1573}\) For a discussion of situations where the dual resident does have a PE in the losing residence state, refer to Chapter 9 (Section 9.4.3.). In such cases, the losing state may impose tax on certain categories of income attributable to the PE and the situation becomes similar to a typical PE triangular case.

\(^{1574}\) For a brief overview of this proposal, see Section A1.2.1. above. This proposal is discussed in detail throughout Chapter 7 and Chapter 8.
11(5) and, where applicable, the corresponding provision of Article 12. The proposed wording of Article 11(5) is 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."

As a result the residence state of the payor in a reverse PE triangular case would be prevented from imposing tax. This may be subject to certain conditions, for example that the PE state imposes source-based tax on the interest, but it is assumed that any such conditions are satisfied for the purposes of the discussion below.

Applicable treaties

Under the existing treaty framework, the applicable treaties in this case will be:

(i) the treaty between the winning residence state of the recipient and the residence state of the payor (the W-R treaty);
(ii) the treaty between the winning residence state of the recipient and the PE state of the payor (the W-PE treaty); and
(iii) the treaty between the winning and losing residence states of the recipient (the W-L treaty).

The treaty between the payor's residence state and the payor's PE state (the R-PE treaty) will not apply because for the purposes this treaty, the income is not received by a resident of one of the contracting states. In addition, as a result of the person receiving the income no longer being resident in State L for treaty purposes, the L-R treaty and the L-PE treaty will no longer apply.

The following sections will discuss the application of tax treaties in this situation where different categories of income are involved, firstly under the existing framework and secondly where the relevant treaties include the proposed provisions outlined above.

3.2. Business profits

Article 7 deals with business profits and allows the residence state of the person deriving the income to impose tax. It also allows the other contracting state to impose tax, but only in relation to profits which are attributable to a PE in that other state. Article 7 (in paragraphs 1 and 2) provides as follows:

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account

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1575 This provision has been taken from the 2010 OECD Commentary on Article 11, para. 30. It is discussed in much greater depth in Chapter 12 (Section 12.2.2.).
1576 Refer to Chapter 12 (Section 12.2.2.2.) for discussion of the reasons for imposing such limitations and the type of limitations that may be imposed.
1577 The term “permanent establishment” is defined in Article 5.
the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.\textsuperscript{1578}

Thus, the source state may not impose any tax on business profits except to the extent they are attributable to a PE. Further discussion of the PE concept and the attribution of profit to PEs, refer to the discussion in Chapter 5 (Sections 5.2.3. and 5.2.4.).

This section deals with a situation where a dual resident person, resident in State W and in State L, derives business profits from outside those two states. The income is paid by a resident of State R and originates from a PE of the payor located in State PE. The residence of the dual resident person is assigned to State W for the purposes of the treaty between the two residence states. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram of tax jurisdiction]

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (in particular, Section 9.4.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving business profits, refer to Chapter 12 (Section 12.2.).

3.2.1. Existing treaty framework

The payor's residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R treaty. For the purposes of both these treaties, Article 7 will apply and, given that the income is not attributable to a PE of the recipient in State R, State R will be prevented from imposing tax.

The payor's PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties, Article 7 will apply and, given that the income is not attributable to a PE of the recipient in State PE, State PE will be prevented from imposing tax.

The losing residence state (State L): State L must apply the conditions of the W-L treaty. For the purposes of this treaty, Article 7 will apply and State L will be prevented from imposing any tax on the income (since it is assumed that the income is not attributable to a PE in State L).

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the income and, since State R, State PE and State L are all prevented from imposing tax, State W will have no obligation to provide relief.

Overview: Under the existing treaty framework, tax may only be imposed in State W and there will be no unrelieved double taxation. This situation is effectively the same as a dual-resident triangular case involving business profits, since both source states are prevented from imposing tax. The main concern in this situation is the application of multiple treaty conditions in the source states. This does not have any practical impact in situations where both applicable treaties follow the OECD Model, but in some cases it could influence whether State R is entitled to impose tax, e.g., if the PE definitions differ between the two treaties and the person deriving the income would have a PE in the source state for the purposes of one of the applicable treaties but not for the purposes of the other.

3.2.2. Application of proposed solutions

The payor's residence state (State R): State R must continue to apply the conditions of the W-R treaty but does not have to apply the L-R treaty. For the purposes of the W-R treaty, Article 7 will apply and State R will be prevented from imposing tax on the income. This is the same outcome as under the existing treaty.

\textsuperscript{1578} Article 7, paragraphs 1 and 2.
framework, however, the outcome could be different if there is a difference between the terms of the W-R treaty and the L-R treaty.

**The payor's PE state (State PE):** State PE must continue to apply the conditions of the W-PE treaty but does not have to apply the L-PE treaty. For the purposes of the W-PE treaty, Article 7 will apply and State PE will be prevented from imposing tax on the income. This is the same outcome as under the existing treaty framework, however, the outcome could be different if there is a difference between the terms of the W-PE treaty and the L-PE treaty.

**The losing residence state (State L):** State L must continue to apply the conditions of the W-L treaty. For the purposes of this treaty, Article 7 will apply and State L will be prevented from imposing tax on the income.

**The winning residence state (State W):** State W must continue to apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the income and, since all the other states are prevented from imposing tax, State W will have no obligation to provide relief.

**Overview:** The proposed solutions would generally have little practical impact in this situation, since the distributive rules for business profits do not generally differ between treaties. One situation where a different outcome may arise is where the PE definition contained in a source state's (State R and State PE) treaties with State W differ from those contained in their treaties with State L. If this occurs, one of the source states may be entitled to impose tax if it applies the conditions of its treaty with State W but not if it applies the conditions of its treaty with State L or vice versa. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

### 3.3. Dividends

Dividends are dealt with in Article 10. Article 10 allows the state where the payor of dividends is resident (the source state) to impose tax, but limits the amount of the tax to a certain percentage of the gross amount of the dividends. Article 10 provides as follows (in paragraphs 1 and 2):

> 1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

   b) 15 per cent of the gross amount of the dividends in all other cases.”

Thus, the rate of tax that may be imposed in the source state depends on recipient's interest in the company paying the dividends. The exact rates are a common point of negotiation, however, and often vary between treaties. The ownership thresholds also vary in many concluded treaties and some treaties may provide only a single maximum tax rate. Furthermore, if the dividends are attributable to a PE of the recipient which is located in the source state, then as a result of Article 10(3), Article 7 will apply instead of Article 10 and the source state may impose tax on the basis of the profit attributable to the PE.

This section deals with a situation where a dual resident person, resident in State W and in State L, receives dividends from outside those two states. The dividends are paid by a resident of State R and are

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1579 The application of this threshold (and other treaty thresholds) in situations where treaty benefits are claimed in relation to the income attributable to a PE are discussed in Chapter 8 (Section 8.6.2.).
paid out of profits which are attributable to a PE of the payor located in State PE. The residence of the
dual resident person is assigned to State W for the purposes of the treaty between the two residence
states. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (in particular, Section
9.4.). For a detailed discussion of reverse PE triangular cases involving dividends, refer to Chapter 12
(Section 12.2.1.).

3.3.1. Existing treaty framework

The payor’s residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R
treaty. For the purposes of both these treaties, Article 10 will apply and State R will be entitled to impose
a limited rate of tax on the dividends. If the applicable rate differs between the two treaties, State R can
only satisfy its treaty obligations by applying the lower of the two rates.1580

The payor’s PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE
treaty. For the purposes of both these treaties, Article 10 will not apply because the dividends are not
paid by a resident of State PE. Instead, Article 7 or Article 21 will apply (depending on whether the
income is considered to be business profits) and State PE will be prevented from imposing tax on the
dividends. State PE may also be prevented from imposing tax under Article 10(5) of the R-PE treaty.1581

The losing residence state (State L): State L must apply the conditions of the W-L treaty. Article 10 will not
apply because the dividends are not paid by a resident of State L. Instead, Article 7 or Article 21 will
apply, depending on whether the dividends are considered to be business profits, and regardless of which
of these two articles applies State L will be prevented from imposing any tax on the dividends.

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty
and the W-L treaty. State W may impose tax but will be obliged to provide relief (using the credit

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pp. 298-301; Avery Jones, J.F., and Bobbett, C., "Triangular Treaty Problems: A Summary of the Discussion in
European Taxation 1, (2005), pp. 2-13;

1581 Article 10(5) provides that: "Where a company which is a resident of a Contracting State derives profits or
income from the other Contracting State, that other State may not impose any tax on the dividends paid by the
company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in
respect of which the dividends are paid is effectively connected with a permanent establishment situated in that
other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if
the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other
State." Thus, this provision should prevent the PE state from imposing tax on the dividends. The main problem
with applying this provision is that it applies under the treaty between the residence state and the PE state of the
payor and, for the purposes of this treaty, the recipient of the dividends is not a resident of either of the contracting
states. Article 10(5) is discussed in detail in Chapter 12 (see Section 12.2.1. and Section 12.3.4.).
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method) for tax imposed in State R. State W will not be obliged to provide any relief under the W-PE treaty or the W-L treaty, since both State PE and State L are prevented from imposing tax. There will be no unrelieved double taxation.

Overview: In this situation, tax may be imposed in State R and State W, and State W will have an obligation to provide relief (using the credit method) for tax imposed in State R. The main issue in this situation is the application of multiple treaty conditions in State R and the potential for improper use of the L-R treaty, particularly given that State L is prevented from imposing any tax on the dividends under the W-L treaty.

3.3.2. Application of proposed solutions

The payor's residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. For the purposes of the W-R treaty, Article 10 will apply and State R will be entitled to impose a limited rate of tax on the dividends. State R is no longer required to apply multiple treaty conditions in relation to the dividends.

The payor's PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Article 10 of the W-PE treaty will not apply because the dividends are not paid by a resident of State PE. Instead, either Article 7 or Article 21 will apply and State PE will be prevented from imposing any tax on the dividends. If State PE is prevented from imposing tax as a result of Article 10(5) of the R-PE treaty under the existing treaty framework, then the outcome in this case will not be any different (and Article 10(5) may also continue to prevent State PE from imposing tax). However, there is some uncertainty regarding the application of Article 10(5) in this situation and preventing State PE from imposing tax under the terms of the W-PE treaty makes the outcome clearer and more certain.

The losing residence state (State L): State L must continue to apply the W-L treaty. For the purposes of this treaty, Article 10 does not apply since the dividends are not paid by a resident of State L. Instead, Article 7 or Article 10 will apply, depending on whether the income is considered to be business profits, and State L will be prevented from imposing tax on the income.

The winning residence state (State W): State W must continue to apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax but is obliged to provide relief (using the credit method) for tax imposed in State R. State W will not be obliged to provide relief under the W-PE treaty or the W-L treaty, since both State PE and State L are prevented from imposing tax.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same income and addresses the risk of improper use of the treaties between the losing residence state and the source states. State PE will generally be prevented from imposing tax regardless of which treaty it applies. In State R, however, the treaty with State L may provide a lower maximum level of source-based taxation of dividends than the treaty with State W, in which case the application of the L-R treaty would have an impact on the amount of tax that State R could impose. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.4. Interest

Interest is dealt with in Article 11, which allows the state where interest arises to impose a tax at a limited rate. Article 11 reads as follows (paragraphs 1 and 2):

“1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.”
Thus, where Article 11 applies, the source state is limited to imposing an amount of tax equal to 10% of the gross amount of the interest. This rate is a common point of negotiation, however, and often varies between concluded treaties. Furthermore, if the interest is attributable to a PE of the recipient which is located in the source state then, as a result of Article 11(4), Article 7 will apply instead of Article 11 and the source state may impose tax on the basis of the profit attributable to the PE.\textsuperscript{1582}

Whether interest arises in a particular state is determined in accordance with Article 11(5) which provides that:

“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 in a Contracting State 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.”

Thus, interest arises in a particular state if it is paid by a resident of that state or, in broad terms, is borne by a PE located in that state. It should be noted that where interest is paid by a resident of a contracting state for the purposes of a particular treaty and is borne by a PE, but that PE is not located in either of the contracting states, then the interest will continue to arise in the residence state of the payor for the purposes of Article 11.\textsuperscript{1583} Thus, the interest will arise in the residence state of the payor for the purposes of the treaty between that state and the residence state of the recipient, and will arise in the PE state of the payor for the purposes of the treaty between that state and the residence state of the recipient. As will be seen below, this may give rise to dual source-based taxation in reverse PE triangular cases.\textsuperscript{1584}

This section deals with a situation where a dual resident person, resident in State W and in State L, receives interest income from outside those two states. The interest is paid by a resident of State R and is borne by a PE of the payor located in State PE. The residence of the dual resident person is assigned to State W for the purposes of the treaty between the two residence states. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For a detailed discussion of reverse PE triangular cases involving interest, refer to Chapter 12 (Section 12.2.2.).

### 3.4.1. Existing treaty framework

**The payor’s residence state (State R):** State R must apply the conditions of the W-R treaty and the L-R treaty. Under Article 11(5) of both these treaties, the interest will be considered to arise in State R since it is paid by a resident of that state, despite the fact that the interest is borne by a PE of the payor located in a third state (i.e., State PE). Article 11 will therefore apply for the purposes of both treaties and State R will be

\textsuperscript{1582} Article 11(4) provides that: “The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

\textsuperscript{1583} See, inter alia, the 2010 OECD Commentary on Article 11, paras. 28 and 29. This is discussed in much greater depth in Chapter 12 (Section 12.2.2.1.).

\textsuperscript{1584} This is discussed in much greater depth in Chapter 12 (Section 12.2.2.1.).
entitled to impose a limited rate of tax on the interest. If the applicable rates differ between the two treaties, State R can only satisfy its treaty obligations by applying the lower of the two rates.\textsuperscript{1585}

The payor’s PE state (State PE): State PE must apply the conditions of the W-PE treaty and the L-PE treaty. Under Article 11(5) of both these treaties, the interest will be considered to arise in State PE since it is borne by a PE of the payor located in that state. Article 11 will therefore apply and State PE will be entitled to impose a limited rate of tax on the interest. If the applicable rate differs between the two treaties, State PE can only satisfy its treaty obligations by applying the lower of the two rates.\textsuperscript{1586}

The losing residence state (State L): State L must apply the conditions of the W-L treaty. Article 11 will not apply for the purposes of the W-L treaty since the interest is not paid by a resident of State L. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits, and since the income is not attributable to a PE in State L, State L will be prevented from imposing tax.

The winning residence state (State W): State W must apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax, but will be required to grant relief under both the W-R treaty and the W-PE treaty. This would generally be credit relief regardless of the general method of relief under those treaties. Given that State W has an obligation to provide relief for tax imposed in two states, it may not be able to provide sufficient relief to prevent unrelieved double taxation.\textsuperscript{1587}

Overview: In this situation, source-based taxation may be imposed in both State R and State PE. For the purposes of State R’s treaties with State W and State L, the interest is considered to arise in State R and for the purposes of State PE’s treaties with State W and State L, the interest is considered to arise in State PE. Both State R and State PE may therefore impose tax on the interest under Article 11 of their respective treaties with the two residence states of the person deriving the income. State W will be obliged to provide relief, but may not be able to provide sufficient relief to prevent double taxation. In addition, both State R and State PE are subject to multiple treaty conditions in respect of the same income. This may give rise to concerns about the potential for improper use of the treaties concluded between State L and the source states (e.g., where the rate of tax allowed under a particular state’s treaty with State L is lower than the rate allowed under its treaty with State W). This is of particular concern in situations (like the current one) where State L is prevented from imposing any tax on the interest by the conditions of the W-L treaty.

3.4.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. In addition, Article 11(5) would be modified such that where interest income is borne by a PE in a third state (in this case, State PE), the interest would not be considered to


\textsuperscript{1587} Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation where source based taxation has been imposed in more than one state; Chapter 3 discusses this in the context of PE triangular cases, but it is equally relevant in dual resident triangular cases. Broadly, the ability to grant sufficient relief will depend on the relative tax rates in the states involved and, where the state granting relief uses the credit method, will also depend on the applicable credit limitations.
arise in the residence state of the payor. As a result, the interest would not be considered to arise in State R for the purposes of the W-R treaty and Article 11 would not apply. Instead Article 7 or Article 21 would apply, depending on whether the income is considered to be business profits, and State R would be prevented from imposing tax on the income.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Under the modified version of Article 11(5) (as under the current version) the interest would be considered to arise in State PE for the purposes of the W-PE treaty. Article 11 of the treaty would therefore apply and State PE would be entitled to impose a limited rate of tax on the gross amount of the interest.

The losing residence state (State L): State L must continue to apply the W-L treaty. Article 11 will not apply for the purposes of the W-L treaty since the interest is not paid by a resident of State L. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits, and since the income is not attributable to a PE in State L, State L will be prevented from imposing tax.

The winning residence state (State W): State W must continue to apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax but is obliged to provide relief (using the credit method) for tax imposed in State PE. State W will not be obliged to provide relief under the W-R treaty or the W-L treaty, since both State R and State L are prevented from imposing tax.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same income and addresses the risk of improper use of the treaties between the losing residence state and the source states. In addition, the proposed modifications to Article 11(5) ensures that the interest is only considered to arise in one state for treaty purposes (i.e., State PE) and thus is no longer subject to dual source-based taxation.

3.5. Royalties

Royalties are dealt with in Article 12, which allows tax to be imposed only in the residence state. Article 12 (paragraph 1) reads as follows:

“Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.”

If, however, the royalties are attributable to a PE of the recipient which is located in the source state, then as a result of Article 12(2), Article 7 will apply instead of Article 12 and the source state may impose tax on the basis of the profit attributable to the PE. Thus, the OECD Model does not allow any source-based taxation of royalties except where they are attributable to a PE in the source state.

As outlined in Chapter 12 (see Section 12.2.2.), the UN Model and many concluded treaties do allow states to impose a limited rate of source based taxation on royalties which arise in one contracting state and are paid to a resident of the other contracting state. In general, the rules for determining whether royalties arise in a particular state mirror the rules of Article 11(5) which apply in relation to interest.

1588 As mentioned above, it is proposed that interest (and, where applicable, royalties) which originate from a PE located in a third state should not be considered to arise in the payor’s residence state for the purposes of treaties concluded between that state and third states. This would generally result in the PE state (but not the residence state) of the payor being entitled to impose source based taxation on such payments. It would be achieved by changing the wording of Article 11(5) and, where applicable, the corresponding provision of Article 12. Refer to Section 3.1.2., above, and to Chapter 12 (Section 12.2.2.) for an in-depth discussion of this proposal.

1589 Note that it is assumed that any conditions attached to the limitation on State R’s taxing rights are satisfied, e.g., there may be a provision to the effect that the income continues to arise in the residence state of the payor for the purposes of Article 11 if the PE state does not impose any tax on the payment. For further discussion of the conditions that may be attached, refer to Chapter 12 (Section 12.2.2.).

1590 See, for example, Article 12(5) of the UN Model Treaty (2001), which provides that: "Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such
To the extent that the applicable treaties do allow source-based taxation of royalties and determine where royalties arise under a provision equivalent to Article 11(5), the analysis in relation to royalties would be exactly the same as that outlined for interest above. The analysis below briefly considers both situations where the applicable treaties do allow source-based taxation of royalties under Article 12 and situations where they do not. Where source-based taxation of royalties is allowed, it is assumed that the relevant treaty contains a provision mirroring Article 11(5) for determining whether royalties arise in a particular state. Where Article 12 does not allow source-based taxation of royalties, the place where royalties arise becomes less important because if the royalties are not considered to arise in a particular state, then that state will nevertheless generally be prevented from imposing tax under either Article 7 or Article 21 of the treaty (depending on whether the income is considered to be business profits). The result will therefore be the same regardless of whether the royalties are or are not considered to arise in the state applying the treaty.

This section deals with a situation where a dual resident person, resident in State W and in State L, receives royalties from outside those two states. The royalties are paid by a resident of State R and originate from a PE of the payor located in State PE. The residence of the dual resident person is assigned to State W for the purposes of the treaty between the two residence states. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram](image)

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For discussion of reverse PE triangular cases involving royalties, refer to Chapter 12 (Section 12.2.2.).

### 3.5.1. Existing treaty framework

The payor’s residence state (State R): State R must apply the conditions of the W-R treaty and the L-R treaty. For the purposes of applying these treaties the income would generally be considered to arise in State R, in which case Article 12 would apply. Depending on the terms of Article 12, State R will either be prevented from imposing tax (if one or both of the treaties follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate. If the applicable rates differ between the two treaties, State R can only satisfy its treaty obligations by applying the lower of the two rates.

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royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.”


1592 This assumes that the royalties are considered to arise in State R for the purposes of the treaty, i.e., as a result of being paid by a resident of State R. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State R, State R would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).

The payor’s PE state (State PE): State PE must apply the conditions of the W-PE treaty and the L-PE treaty. For the purposes of applying these treaties, the income would generally be considered to arise in State PE, in which case Article 12 would apply. If Article 12 of either of the two treaties does not allow any source-based taxation, State PE will be prevented from imposing tax. If both treaties do allow source-based taxation under Article 12 then State PE would be entitled to impose tax at a limited rate. If the applicable rates differ between the two treaties, State PE can only satisfy its treaty obligations by applying the lower of the two rates.

The losing residence state (State L): State L must apply the conditions of the W-L treaty. Article 12 will not apply for the purposes of the W-L treaty since the royalties would not generally be considered to arise in State L. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits, and since the income is not attributable to a PE in State L, State L will be prevented from imposing tax.

The winning residence state (State W): State W must apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax, but to the extent that State R or State PE or both of these states may also impose tax, State W will be required to grant relief. This would generally be credit relief, regardless of the general method of relief under those treaties. Given that State W has an obligation to provide relief for tax imposed in two states, it may not be able to provide sufficient relief to prevent unrelieved double taxation.

Overview: The existence of dual source-based taxation of royalties in this situation will depend on the terms of the applicable treaties; it may be that tax is imposed in State R, in State PE, in both of these states or in neither of them. State W will be obliged to provide relief, but may not be able to provide sufficient relief to prevent double taxation. An important issue in this situation is that both State R and State PE are subject to multiple treaty conditions in respect of the same income. This may give rise to concerns about the potential for improper use of the L-R treaty, particularly given that State L is prevented from imposing any tax on the royalties by the conditions of the W-L treaty.

3.5.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. In general, Article 12 could be expected to apply for the purposes of the W-R treaty on the basis that they royalties arise in State R. However, if Article 12 of the W-R treaty allows source-based taxation, it would be modified to the effect that where royalties are borne by a PE in a third state (in this case, State PE), those royalties would not be considered to arise in the residence state of the payor (State R). As a result, the royalties would not be considered to arise in State R for the...
purposes of the W-R treaty and Article 12 would not apply. Instead Article 7 or Article 21 would apply, depending on whether the income is considered to be business profits, and State R would be prevented from imposing tax. If Article 12 does not allow source based taxation of royalties, then the royalties may still be considered to arise in State R (i.e., Article 12 may not be modified), but in that case Article 12 would prevent State R from imposing tax and thus the overall result would be the same.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. For the purposes of this treaty, the royalties would generally be considered to arise in State PE and Article 12 would apply. Depending on the terms of the treaty, State PE may be either prevented from imposing tax or may be entitled to impose tax at a limited rate.

The losing residence state (State L): State L must continue to apply the W-L treaty. Article 12 would not apply for the purposes of the W-L treaty since the royalties do not arise in State L. Instead, Article 7 or Article 21 would apply, depending on whether the income is considered to be business profits, and since the income is not attributable to a PE in State L, State L will be prevented from imposing tax.

The winning residence state (State W): State W must continue to apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax but if State PE may also impose tax (under the W-PE treaty), then State W will be obliged to provide relief (using the credit method) for tax imposed in State PE. State W will not be obliged to provide relief under the W-R treaty or the W-L treaty, since both State R and State L are prevented from imposing tax.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same income and addresses the risk of improper use of the treaties between the losing residence state and the source states. In addition, the proposed modification to Article 12 will ensure that the royalties will only be considered to arise, and thus may only be taxable, in one of the source states (State PE). Depending on the terms of Article 12 of the W-PE treaty, State PE may be prevented from imposing tax or may be entitled to impose tax at a limited rate. State R will be prevented from imposing any source-based taxation on the royalties.

3.6. Income from immovable property

Income from immovable property is dealt with in Article 6, which allows the state where the property is located to impose tax on the income. Article 6 (paragraph 1) provides as follows:

“Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

Immovable property is defined in Article 6(2) by reference to the domestic law of the state where the property is located. Article 6(2) also lists certain things, such as property accessory to immovable property and livestock, which are always considered to be immovable property for the purposes of the treaty.

concluded between that state and third states. This would generally result in the PE state (but not the residence state) of the payor being entitled to impose source based taxation on such payments. Refer to Chapter 12 (Section 12.2.2.) for an in-depth discussion of this proposal.

1598 Note that it is assumed that any conditions attached to the limitation on State R’s taxing rights are satisfied, e.g., there may be a provision to the effect that the income continues to arise in the residence state of the payor for the purposes of Article 12 if the PE state does not impose any tax on the payment. For further discussion of the conditions that may be attached, refer to Chapter 12 (Section 12.2.2.2.).

1599 Article 6(2) provides that: “The term ‘immovable property’ shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.”
Where immovable property is located in a third state for the purposes of a particular treaty, there is some debate regarding the appropriate treaty article to apply. This was discussed in detail in Chapter 2 (see Section 2.6.), where it was concluded that the income may fall under the distributive rule of either Article 7 or Article 21. Article 7 may apply either because the income is considered to be business profits or because is attributable to a PE (i.e., as a result of Article 21(2)). It will generally fall under Article 21 only if it is not considered to be business profits and is not attributable to a PE. For a detailed discussion, please refer to Chapter 2 (Section 2.6.).

This section deals with a situation where a dual resident person, resident in State W and in State L, receives income from immovable property located outside those two states. That person’s residence is assigned to State W for the purposes of the treaty between the two residence states. The income is paid by a resident of State R and originates from a PE of the payor located in State PE. As mentioned above, the application of tax treaties in relation to income from immovable property depends on the location of the property. For the purposes of the analysis below, it is assumed that the immovable property is located in the PE state of the payor (State PE); this may occur, for example, where the payor leases business premises in that state through which it carries on its enterprise, thus giving rise to the PE in that state. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For discussion of reverse PE triangular cases and an overview of the outcome of cases involving income from immovable property, refer to Chapter 12 (particularly Section 12.2.3.).

### 3.6.1. Existing treaty framework

**The payor’s residence state (State R):** State R must apply the conditions of both the W-R treaty and the L-R treaty. For the purposes of both these treaties, Article 6 will not apply because the immovable property is not located in State R. Instead, Article 7 or Article 21 applies (depending on whether the income is considered to be business profits) and State R is prevented from imposing tax on the income.

**The payor’s PE state (State PE):** State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties, Article 6 will apply and, given that the immovable property is located in State PE, State PE will be entitled to impose tax on the income.

**The losing residence state (State L):** State L must apply the conditions of the W-L treaty. For the purposes of this treaty Article 6 will not apply because the immovable property is not located in State L. Instead, Article 7 or Article 21 applies (depending on whether the income is considered to be business profits) and State L will be prevented from imposing tax on the income.

**The winning residence state (State W):** State W must apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax but will have an obligation to provide relief (either exemption or credit)

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under the W-PE treaty. State W will not have a relief obligation under either the W-R treaty or the W-L treaty because the terms of those treaties do not allow State R or State L, respectively, to impose any tax on the income.

Overview: In this situation, tax is imposed in the state where the property is located (State PE) and in State W and State W will have an obligation to provide relief. State R and State PE are both subject to multiple treaty conditions in respect of the same income, however this is unlikely to have any practical impact in relation to income from immovable property; State R (the state where the property is located) would generally be entitled to impose tax under both treaties and State PE would generally be prevented from imposing tax under both treaties. This is particularly so given that the definition of immovable property in Article 6 primarily refers to the domestic law of the state where the property is located. Nevertheless, there may be situations where the terms of the two applicable treaties differ in a way that impacts on one of the source states’ taxing rights.

3.6.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since State R will continue to be prevented from imposing tax under either Article 7 or Article 21 of the W-R treaty. Article 6 will not apply because the immovable property is not located in State R.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Article 6 will continue to apply for the purposes of the W-PE treaty and State PE will be entitled to impose tax on the income.

The losing residence state (State L): State L will continue to apply the W-L treaty. Article 6 of the treaty will not apply because the immovable property is not located in State L. Instead, Article 7 or Article 21 will apply (depending on whether the income is considered to be business profits) and State L will be prevented from imposing tax on the income.

The winning residence state (State W): State W must continue to apply the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax but will be obliged to provide relief (either credit or exemption) under the W-PE treaty. State W will not be obliged to provide relief under the W-R treaty or the W-L treaty, since both State R and State L are prevented from imposing tax.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same income and addresses the risk of improper use of the treaties between the losing residence state and the source states. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.7. Income from shipping and air transport

Article 8 deals with income from shipping, inland waterways transport and air transport and provides (in paragraphs 1 and 2) that:

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”
Thus, under Article 8, income from shipping, inland waterways transport and air transport may only be taxed in the state where the enterprise’s place of effective management is located.\footnote{The place of effective management will generally be in the residence state of the enterprise, and this is assumed to be the case for the purposes of the discussion below. For further discussion of the location of the place of effective management in the context of applying tax treaties in PE triangular cases involving income from shipping, inland waterways transport and air transport, please refer to Chapter 2 (Section 2.7.).}

This section deals with a situation where a dual resident person, resident in State W and in State L, receives income from shipping, inland waterways transport and/or air transport from outside those two states. The income is paid by a resident of State R and originates from a PE of the payor located in State PE. The place of effective management of the person deriving the income is located in State W, and that person’s residence is assigned to State W for the purposes of the treaty between the two residence states. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the person deriving the income):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For further discussion of reverse PE triangular cases and a brief overview of a reverse PE triangular situation involving income covered by Article 8, refer to Chapter 12 (Section 12.2.3.).

\subsection*{3.7.1. Existing treaty framework}

\textbf{The payor’s residence state (State R):} State R must apply the conditions of both the W-R treaty and the L-R treaty. For the purposes of both these treaties, Article 8 will apply and the income may only be taxed in the state where the place of effective management is located. For the purposes of the W-R treaty, it is quite clear that, since the place of effective management is located in State W, State R will be prevented from imposing tax on the income. For the purposes of the L-R treaty, however, the place of effective management is located in a third state and it is thus unclear how Article 8 should be applied. In any case, this will not have any practical impact since State R is already prevented from imposing tax under the W-R treaty.

\textbf{The payor’s PE state (State PE):} State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties, Article 8 will apply and the income may only be taxed in the state where the place of effective management is located. For the purposes of the W-PE treaty, it is quite clear that, since the place of effective management is located in State W, State PE will be prevented from imposing tax on the income. For the purposes of the L-PE treaty, however, the place of effective management is located in a third state and it is thus unclear how Article 8 should be applied.\footnote{This is discussed further in Chapter 2 (see Section 2.7.).} In any case, this will not have any practical impact since State PE is already prevented from imposing tax under the W-PE treaty.

\textbf{The losing residence state (State L):} State L must apply the conditions of the W-L treaty. For the purposes of this treaty Article 8 will apply and, since the place of effective management is located in State W, State L will be prevented from imposing any tax on the income.

\textbf{The winning residence state (State W):} State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the income and, since all the other states are prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.
Overview: In this situation, tax may only be imposed in State W. All the other states involved will be prevented from imposing tax under Article 8 of their respective treaties with State W. One issue which arises in this situation is that the source states, State R and State PE, will be bound by multiple treaty conditions in respect of the income (i.e., their respective treaties with both State W and State L). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ. It is also unclear how Article 8 of the treaties between State L and the source states should be applied, given that the place of effective management of the person deriving the income is located outside the contracting states.

3.7.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since Article 8 of the W-R treaty will continue to prevent State R from imposing any tax.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Again, this is unlikely to have any practical impact since Article 8 of the W-PE treaty will continue to prevent State PE from imposing any tax.

The losing residence state (State L): State L will continue to apply the W-L treaty. For the purposes of this treaty, Article 8 will apply and State L will be prevented from imposing any tax on the income.

The winning residence state (State W): State W must continue to apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the income and, since all the other states are prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same income. In relation to income from shipping and air transport, however, this is unlikely to have any practical impact since State R and State PE will continue to be prevented from imposing tax under their respective treaties with State W. Nevertheless, this does resolve the uncertain application of Article 8 of the treaties between State L and the source states, since these treaties no longer apply, and could have an impact where the relevant terms of the treaties differ. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.8. Capital gains from the alienation of immovable property

Capital gains derived from the alienation of immovable property are dealt with in Article 13(1), which provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.”

Thus, Article 13(1) applies where a resident of one state derives capital gains from the alienation of immovable property located in the other contracting state, and it allows the state where the property is located to impose tax on the gain. The reference to Article 6 in Article 13(1) is a reference to the definition of immovable property, which in turn refers to the domestic law of the state where the property is located, as well as containing a list of certain property which is always considered to be immovable property for the purposes of the treaty.1603

This section deals with a situation where a dual resident person, resident in State W and in State L, derives a capital gain from the alienation of immovable property located outside those two states. The

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1603 For further discussion of the definition of immovable property and the application of tax treaties in PE triangular cases involving capital gains from immovable property, please refer to Chapter 2 (particularly Section 2.8.1.).
amount giving rise to the gain is paid by a resident of State R and originate from a PE of the payor located in State PE. The residence of the dual resident person is assigned to State W for the purposes of the treaty between the two residence states. For the purposes of the discussion below, it will generally be assumed that the immovable property from which the gain arises is located in State PE. This situation is illustrated in the diagram below (in which “HO” denotes head office):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For a brief overview of the application of tax treaties in reverse PE triangular cases involving such gains, refer to Chapter 12 (Section 12.2.3.).

### 3.8.1. Existing treaty framework

The payor’s residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R treaty. Article 13(1) will not apply for the purposes of either of these treaties because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State R will be prevented from imposing tax on the capital gain.\(^{1604}\) Note that if the property were instead located in State R, then State R would be entitled to impose tax in accordance with Article 13(1).

The payor’s PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties, Article 13(1) applies and State PE will be entitled to impose tax on the capital gain. Note that if the property were instead located outside State PE, e.g., in State R, then Article 13(5) would apply and State PE would be prevented from imposing any tax on the gain.

The losing residence state (State L): State L must apply the conditions of the W-L treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State L will be prevented from imposing tax on the capital gain.

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax, but will be required to provide relief (either exemption or credit) under the W-PE treaty (i.e., under its treaty with the state where the property is located).

**Overview:** In this situation, tax may be imposed in the state where the immovable property is located (State PE) and in State W, and State W is obliged to provide relief (either exemption or credit, depending on the terms of the treaty). One issue which arises in this situation is that the source states, State R and State PE, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W and State L). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ, since the source states can only satisfy their treaty obligations by applying the terms of the treaty that are most favourable to the taxpayer.

\(^{1604}\) Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of movable property forming part of the business property of a PE (para 2), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4).
3.8.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since State R will continue to be prevented from imposing tax under Article 13(5) of the W-R treaty.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Again, this is unlikely to have any practical impact since State PE will simply continue to apply Article 13(1) of the W-PE treaty, under which it may impose tax on the gain.

The losing residence state (State L): State L will continue to apply the W-L treaty. For the purposes of this treaty, Article 13(5) will apply and State L will continue to be prevented from imposing any tax on the gain.

The winning residence state (State W): State W must continue to apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the capital gain and, since all the other states are prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L, which means they are no longer subject to multiple treaty conditions in respect of the same capital gain. This is unlikely to have any practical impact, however, unless there is some difference between the terms of the two treaties that has an impact on the source state’s ability to impose tax. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.9. Capital gains from the alienation of movable property of a PE

Article 13(2) deals with capital gains from the alienation of movable property forming part of the business property of a PE. It provides that:

“Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.”

This section deals with a situation where a dual resident person, resident in State W and in State L, derives a capital gain from the alienation of movable property that forms part of the business property of a PE. The residence of the dual resident person deriving the gain is assigned to State W for the purposes of the treaty between the two residence states. The amount giving rise to the gain is paid by a resident of State R and originates from a PE of the payor located in State PE. The discussion in this appendix generally assumes that the dual-resident does not have a PE in either of the source states, however for the purposes of discussing this category of capital gains, it will be assumed that the movable property forms part of the business property of a PE located in State PE (i.e., the PE state of the payor). This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For a brief overview of the application of tax treaties in reverse PE triangular cases involving such gains, refer to Chapter 12 (Section 12.2.3.).
3.9.1. Existing treaty framework

The payor’s residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R treaty. Article 13(2) will not apply for the purposes of either of these treaties because the capital gain does not arise from the alienation of movable property of a PE located in State R. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State R will be prevented from imposing tax on the capital gain.\textsuperscript{1605}

The payor’s PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. Article 13(2) applies for the purposes of both these treaties and state PE will be entitled to impose tax on the capital gain.

The losing residence state (State L): State L must apply the conditions of the W-L treaty. Article 13(2) will not apply for the purposes of this treaty because the capital gain does not arise from the alienation of movable property of a PE located in State L. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State L will be prevented from imposing tax on the capital gain.\textsuperscript{1606}

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax, but will be required to provide relief (either exemption or credit) under the W-PE treaty.

Overview: In this situation, tax may be imposed in the state where the PE to which the property belongs is located (State PE) and in State W, and State W is obliged to provide relief (either exemption or credit). State R and State L are both prevented from imposing tax under their respective treaties with State W. One issue which arises in this situation is that the source states, State R and State PE, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W and State L). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

3.9.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since Article 13(5) of the W-R treaty will continue to apply and will continue to prevent State R from imposing any tax on the gain.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Again, this is unlikely to have any practical impact since State PE will simply continue to apply Article 13(2) of the W-PE treaty, under which it may impose tax on the gain.

The losing residence state (State L): State L will continue to apply the W-L treaty. For the purposes of this treaty, Article 13(5) will apply and State L will continue to be prevented from imposing any tax on the gain.

The winning residence state (State W): State W must continue to apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the capital gain and, since all the other states are prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.

\textsuperscript{1605} Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4).

\textsuperscript{1606} Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4).
Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. This is unlikely to have any practical impact, however, unless there is some difference between the terms of the two treaties. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.10. Capital gains from the alienation of ships and aircraft in international traffic

Article 13(3) deals with capital gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated assets. It provides that:

“Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

This section deals with a situation where a dual resident person, resident in State W and in State L, derives a capital gain from the alienation of ships, aircraft and/or associated assets. The place of effective management of the person deriving the capital gain is located in State W and consequently, the residence of the dual resident person is assigned to State W for the purposes of the treaty between the two residence states. The amount giving rise to the gain is paid by a resident of State R and originate from a PE of the payor located in State PE. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the person deriving the capital gain):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For a brief overview of the application of tax treaties in reverse PE triangular cases involving such gains, refer to Chapter 12 (Section 12.2.3.).

3.10.1. Existing treaty framework

The payor’s residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R treaty. For the purposes of both these treaties, Article 13(3) will apply and the gain may only be taxed in the state where the place of effective management is located. For the purposes of the W-R treaty, it is quite clear that, since the place of effective management is located in State W, State R will be prevented from imposing tax on the gain. For the purposes of the L-R treaty, however, the place of effective management is located in a third state and it is thus unclear how Article 13(3) should be applied. In any case, this will not have any practical impact since State R is already prevented from imposing tax under the W-R treaty.

The payor’s PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties, Article 13(3) will apply and the gain may only be taxed in the state where the place of effective management is located. For the purposes of the W-PE treaty, it is quite clear that, since the place of effective management is located in State W, State PE will be prevented from imposing tax on the gain. For the purposes of the L-PE treaty, however, the place of effective management is located in a third state and it is thus unclear how Article 13(3) should be applied. In

1607 This is discussed further in Chapter 2 (see Section 2.7.).
any case, this will not have any practical impact since State PE is already prevented from imposing tax under the W-PE treaty.

The losing residence state (State L): State L must apply the conditions of the W-L treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management is located in State W, State L will be prevented from imposing any tax on the gain.

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the gain and, since all the other states are prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State W. All the other states involved will be prevented from imposing tax under Article 13(3) of their respective treaties with State W. One issue which arises in this situation is that the source states, State R and State PE, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W and State L). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ. It is also unclear how Article 13(3) of the treaties between State L and the source states should be applied, given that the place of effective management of the person deriving the gain is located outside the contracting states.

3.10.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since State R will continue to be prevented from imposing tax under Article 13(3) of the W-R treaty.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Again, this is unlikely to have any practical impact since State PE will continue to be prevented from imposing tax under Article 13(3) of the W-PE treaty.

The losing residence state (State L): State L will continue to apply the W-L treaty. For the purposes of this treaty, Article 13(3) will apply and State L will be prevented from imposing any tax on the gain.

The winning residence state (State W): State W must continue to apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the gain and, since all the other states are prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. In relation to capital gains from the alienation of ships, aircraft and similar assets, however, this is unlikely to have any practical impact since State R and State PE will continue to be prevented from imposing tax under their respective treaties with State W. Nevertheless, this does resolve the uncertainty regarding the application of Article 13(3) of the treaties between State L and the source states, since these treaties no longer apply. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.11. Capital gains from the alienation of shares in a real estate company

Article 13(4) deals with capital gains from the alienation of shares which derive their value from immovable property. It provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.”

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Such gains may therefore be taxed in the state where the underlying immovable property is located. The OECD Model does not contain any other specific provision dealing with shares, but some concluded treaties also allow source based taxation of gains arising from:

1. The alienation of shares in a company having more than 50% of its assets located in the source state;\textsuperscript{1608} and/or
2. The alienation of shares where the person disposing of those shares has a "substantial participation" (i.e., a shareholding of more than a certain specified percentage) in the company whose shares are being alienated.\textsuperscript{1609}

In general, these provisions allow the source state (i.e., the state where the underlying property is located) to impose tax on the gains in the same way as Article 13(4) allows taxation of gains arising from shares in a real estate company. For the purposes of the discussion below, however, it will be assumed that all the applicable treaties follow the OECD Model.

This section deals with a situation where a dual resident person, resident in State W and in State L, derives a capital gain from the alienation of shares which derive more than 50% of their value from immovable property located outside those two states. The residence of the dual resident person deriving the gain is assigned to State W for the purposes of the treaty between the two residence states. The amount giving rise to the capital gain is paid by a resident of State R and originates from a PE of the payor located in State PE. For the purposes of the discussion below, it is generally assumed that the underlying immovable property is located in State PE. This situation is illustrated in the following diagram (in which “HO” denotes head office):

Note that the place where the shares are registered is not relevant for the purposes of the discussion below.

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For a brief overview of the application of tax treaties in reverse PE triangular cases involving such gains, refer to Chapter 12 (Section 12.2.3.).

### 3.11.1. Existing treaty framework

The payor’s residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R treaty. Article 13(4) will not apply for the purposes of either of these treaties because the underlying property is not located in State R. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State R will be prevented from imposing any tax on the gain.\textsuperscript{1610}

The payor’s PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties Article 13(4) will apply, since the underlying immovable property is located in State PE, and State PE may impose tax on the gain.


\textsuperscript{1609} See, for example the reservations of France, Chile, Sweden and Korea in the OECD Commentary to Article 13 of the OECD Model.

\textsuperscript{1610} Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of movable property forming part of the business property of a PE (para 2), and capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3).
The losing residence state (State L): State L must apply the conditions of the W-L treaty. For the purposes of this treaty, Article 13(4) will not apply because the underlying property is not located in State L. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State L will be prevented from imposing any tax on the gain.\footnote{Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of movable property forming part of the business property of a PE (para 2), and capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3).}

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the gain, but will be obliged to provide relief for tax imposed in State PE under the W-PE treaty (either credit or exemption). State W will not have any relief obligation under the W-R treaty or the W-L treaty because both State R and State L are prevented from imposing tax under their respective treaties with State W.

Overview: In this situation, tax may be imposed in State W and in State PE and State W will be obliged to provide relief. One issue which arises in this situation is that the source states, State R and State PE, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W and State L). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

3.11.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since State R will continue to be prevented from imposing tax under Article 13(5) of the W-R treaty. Article 13(4) will not apply because the underlying immovable property is not located in State R.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Again, this is unlikely to have any practical impact since State PE will continue to apply Article 13(4) of the W-PE treaty and may still impose tax on the gain.

The losing residence state (State L): State L must continue to apply the W-L treaty. For the purposes of this treaty, Article 13(4) will not apply because the underlying property is not located in State L. Instead, Article 13(5) will apply and State L will be prevented from imposing any tax on the gain.

The winning residence state (State W): State W must continue to apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the gain and must provide relief in accordance with the W-PE treaty (either exemption or credit). State W will have no obligation to provide relief under either the W-R treaty or the W-L treaty since both State R and State L are prevented from imposing any tax under their respective treaties with State W.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. In relation to capital gains from the alienation of shares deriving their value from immovable property, however, this is unlikely to have any practical impact since State R will continue to be entitled to impose tax under its treaty with State W and State PE will continue to be prevented from imposing tax under its treaty with State W. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.12. Capital gains from the alienation of other property

Article 13(5) deals with capital gains arising from the alienation of property not dealt with in the other paragraphs of Article 13 (referred to herein as “other property”). It provides that:
“Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.”

Thus, capital gains from the alienation of other property may only be taxed in the residence state of the person deriving the gain.

This section deals with a situation where a dual resident person, resident in State W and in State L, derives a capital gain from the alienation of other property located outside those two states. The residence of the dual resident person deriving the gain is assigned to State W for the purposes of the treaty between the two residence states. The amount giving rise to the capital gain is paid by a resident of State R and originates from a PE of the payor located in State PE. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For a brief overview of the outcome of reverse PE triangular cases involving capital gains dealt with under Article 13(5), refer to Chapter 12 (Section 12.2.3.).

3.12.1. Existing treaty framework

The payor’s residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R treaty. For the purposes of both these treaties, Article 13(5) will apply and State R will be prevented from imposing tax on the gain.

The payor’s PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties, Article 13(5) will apply and State PE will be prevented from imposing tax on the gain.

The losing residence state (State L): State L must apply the conditions of the W-L treaty. For the purposes of this treaty, Article 13(5) will apply and State L will be prevented from imposing tax on the gain.

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the gain. Since State R, State PE and State L are all prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State W. One issue which arises in this situation is that the source states, State R and State PE, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W and State L). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

3.11.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since State R will continue to be prevented from imposing tax under Article 13(5) of the W-R treaty.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Again, this is unlikely to have any practical impact since State PE will continue to be prevented from imposing any tax under Article 13(5) of the W-PE treaty.
The losing residence state (State L): State L will continue to apply the W-L treaty. For the purposes of this treaty, Article 13(5) will apply and State L will be prevented from imposing any tax on the gain.

The winning residence state (State W): State W must continue to apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the gain and will have no obligation to provide relief since State R, State PE and State L are all prevented from imposing any tax under their respective treaties with State W.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. This is unlikely to have any practical impact, however, since they will both continue to be prevented from imposing tax under their respective treaties with State W. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.13. Other income

Article 21, titled “other income,” applies to any income not dealt with elsewhere in the treaty. It provides that:

“1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

Thus, Article 21 does not allow any taxation of other income outside the residence state unless the income is attributable to a local PE, in which case Article 7 applies.

This section deals with a situation where a dual resident person, resident in State W and in State L, receives other income from outside those two states. The residence of the dual resident person is assigned to State W for the purposes of the treaty between the two residence states. The income is paid by a resident of State R and originates from a PE of the payor located in State PE. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 9 (Section 9.4.). For a brief overview of the outcome of a reverse PE triangular case involving other income, refer to Chapter 12 (Section 12.2.3.).

3.13.1. Existing treaty framework
The payor’s residence state (State R): State R must apply the conditions of both the W-R treaty and the L-R treaty. For the purposes of both these treaties, Article 21 will apply and State R will be prevented from imposing tax on the income.

The payor’s PE state (State PE): State PE must apply the conditions of both the W-PE treaty and the L-PE treaty. For the purposes of both these treaties, Article 21 will apply and State PE will be prevented from imposing tax on the income.

The losing residence state (State L): State L must apply the conditions of the W-L treaty. For the purposes of this treaty, Article 21 will apply and State L will be prevented from imposing tax on the income.

The winning residence state (State W): State W must apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the income and, since State R, State PE and State L are all prevented from imposing tax under their respective treaties with State W, State W will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State W. One issue which arises in this situation is that the source states, State R and State PE, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W and State L). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

3.13.2. Application of proposed solutions

The payor’s residence state (State R): State R must continue to apply the conditions of the W-R treaty but no longer has to apply the L-R treaty. This is unlikely to have any practical impact, however, since State R will continue to be prevented from imposing tax under Article 21 of the W-R treaty.

The payor’s PE state (State PE): State PE must continue to apply the conditions of the W-PE treaty but no longer has to apply the L-PE treaty. Again, this is unlikely to have any practical impact since State PE will continue to be prevented from imposing any tax under Article 21 of the W-PE treaty.

The losing residence state (State L): State L will continue to apply the W-L treaty. For the purposes of this treaty, Article 21 will apply and State L will be prevented from imposing any tax on the income.

The winning residence state (State W): State W must continue to apply the conditions of the W-R treaty, the W-PE treaty and the W-L treaty. State W may impose tax on the gain and will have no obligation to provide relief since State R, State PE and State L are all prevented from imposing any tax under their respective treaties with State W.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W and will no longer be obliged to apply their treaties with State L, which means they are no longer subject to multiple treaty conditions in respect of the same capital gain. This is unlikely to have any practical impact, however, since they will both continue to be prevented from imposing tax under their respective treaties with State W. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

3.14. Conclusions

This section has discussed a situation where a dual resident triangular case is combined with a reverse PE triangular case. The analysis above illustrates that the issues arising in this situation are generally the same as those arising in the basic triangular cases which it comprises. Reverse PE triangular cases only give rise to dual source-based taxation in relation to interest income and royalties (where the applicable treaties differ from the OECD Model) and thus, dual source based taxation may only occur here where interest and royalties are involved. In all other cases, the outcome in this situation is essentially the same as the outcome in a dual resident triangular case (outlined in Chapter 9).
The primary issue in dual resident triangular cases is the application of multiple treaty conditions in the source state or states. Where this occurs, the source states can only meet their treaty obligations by applying the terms of the treaty that are most favourable to the person deriving the income (or capital gain). Preventing a dual resident from being resident in their losing residence state for the purposes of treaties between that state and third states ensures that the source states are not subject to multiple treaty conditions in relation to the income and capital gains derived by the dual resident. It means that the source states will only be subject to the conditions of their treaties with the state to which the dual resident’s residence is assigned under the tie-breaker provision of the treaty between the two residence states, i.e., the winning residence state. It also addresses concerns regarding improper access to the treaties concluded between the losing residence state and third states in situations where the losing residence state is prevented from imposing tax under the treaty between the two residence states.

The analysis in this section has also demonstrated the application of the proposed solution for reverse PE triangular cases involving interest. Under this proposed solution, interest which originates in a PE in a third state is not considered to arise in the residence state of the payor (subject to certain conditions) under Article 11(5). As a result, the residence state of the payor is not entitled to impose tax under Article 11 and is prevented from imposing tax under either Article 7 or Article 21. Source-based taxation may therefore only be imposed in the PE state of the payor. A similar solution is proposed for royalties in situations where the applicable treaties differ from the OECD Model (as many concluded treaties do) and allow source based taxation of royalties under Article 12.

Finally, the analysis in this section has uncovered no special problems relating to the interaction of the proposed solutions for dual resident triangular cases and for reverse PE triangular cases, and no problems or issues which require special consideration. As mentioned above, the issues arising in the situations discussed in this section are generally the same as those arising in the relevant basic triangular cases.
Section IV: Dual-resident triangular case combined with a reverse dual-resident triangular case

4.1. Introduction

The case discussed in this section is a combination of a dual resident triangular case\textsuperscript{1612} and a reverse dual resident triangular case.\textsuperscript{1613} It involves a person who is resident in two states receiving income from a person who is resident in two other states.

The recipient of the income is resident in “State W1” and “State L1” under their respective domestic laws and for treaty purposes. For the purposes of the treaty between these two states (the W1-L1 treaty), the tie-breaker provision assigns residence to State W1 (also referred to as the winning residence state). The state to which residence is not assigned is referred to as State L1 (or the losing residence state).

The payor of the income is resident in “State W2” and “State L2” under their respective domestic laws and for treaty purposes. For the purposes of the treaty between these two states (the W2-L2 treaty), the tie-breaker provision assigns residence to State W2 (also referred to as the winning residence state). The state to which residence is not assigned is referred to as State L2 (or the losing residence state).

State W2 and State L3 are collectively referred to as the “source states.”

Finally, it is assumed that neither the payor nor the recipient has a PE in any state, including their respective losing residence states. This situation is illustrated in the following diagram:

For the purposes of this analysis, it is assumed that the allocation of residence under the tie-breaker provision of a particular treaty is not effective for the purposes of treaties concluded between the losing residence state and third states. This means that any amount received by the dual resident recipient will continue to be received by a resident of State L1 for the purposes of that state’s treaties with the source states. It also means that any amount paid by the dual resident payor will continue to be considered to be paid by a resident of State L2 for the purposes of that state’s treaties with the recipient of the income. This assumption is not free from doubt; for further discussion of the application of treaties between a losing residence state and third states, please refer to Chapter 11.\textsuperscript{1614}

4.1.1. The existing treaty framework

Under the existing treaty framework, the applicable treaties in this case will be:

(i) the treaty between the winning residence state of the recipient and the winning residence state of the payor (the W1-W2 treaty);

\textsuperscript{1612} For a detailed overview of the application of tax treaties in dual resident triangular cases, refer to Chapter 9.

\textsuperscript{1613} For a detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

\textsuperscript{1614} Chapter 11 deals with the application of treaties between the losing residence state and third states in dual resident triangular cases, but is equally relevant in reverse dual resident triangular cases. The OECD Commentary takes the position that a dual resident will not be considered a resident of the losing residence state for the purposes of treaties concluded between that state as a result of the second sentence of Article 4(1). The second sentence of Article 4(1) provides that a person will not be resident in a particular state if they are “liable to tax in that State in respect only of sources in that State”. It is argued that a dual resident does not meet this condition for the purposes of treaties concluded between their losing residence state and third states as a result of the restrictions imposed on the losing residence state’s taxing rights under the treaty between the two residence states. This position is controversial, however, and is discussed in detail in Chapter 11 (Section 11.2.).
(ii) the treaty between the losing residence state of the recipient and the winning residence state of the payor (the L1-W2 treaty);

(iii) the treaty between the winning residence state of the recipient and the losing residence state of the payor (the W1-L2 treaty);

(iv) the treaty between the losing residence state of the recipient and the losing residence state of the payor (the L1-L2 treaty); and

(v) the treaty between the winning and losing residence states of the recipient (the W1-L1 treaty).

The treaty between the payor's residence state and the payor's PE state (the W2-L2 treaty) will not apply because for the purposes of this treaty, the income is not received by a resident of one of the contracting states.

4.1.2. Application of proposed solutions

The relevant proposals for the situation discussed in this section are those which are aimed at dealing with dual-resident triangular cases and reverse dual resident triangular cases. In fact, as will be seen below, there is a single solution proposed to deal with both these types of triangular cases.

Making the allocation of residence effective for the purposes of treaties with third states

It is proposed that dual-resident persons be specifically excluded from being resident in their losing residence state for the purposes of treaties between that state and third states. This would essentially make the allocation of residence under the treaty between the two residence states of a dual resident person effective for the purposes of other treaties. It is proposed that this be achieved by including a specific provision in tax treaties, which could be worded along the following lines (for inclusion in Article 4, i.e., the residence article):

"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."

In the case of a dual-resident receiving income from third states, this would mean that the dual-resident could no longer claim the benefit of treaties concluded between its losing residence state and the state (or states) where income arises. As a result, source state(s) would no longer be subject to multiple treaty conditions in respect of income derived by a dual-resident.

In the case of a dual-resident making payments of passive income to residents of a third state, this would mean that the dividends, interest or royalties would be paid by a person who is not resident of the losing residence state for the purposes of the treaty between that state and the state where the person receiving the income is resident (e.g., the W1-L2 treaty). As will be seen below, the losing residence state of the payor (State L2) would generally be prevented from imposing source-based taxation as a result.

For the purposes of the discussion in this appendix, it is assumed that the dual-resident recipient of the income does not have a PE in the losing residence state (State L1) and thus, will State L1 generally be prevented from imposing tax on the income. If there is a PE in the losing residence state then that state would be entitled to impose tax on a number of categories of income to the extent that they are attributable to the PE; in this case relief would be required in that state. This could be achieved by

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1615 This proposal is discussed in detail in Chapter 11 (Section 11.3.2.) and, in the context of reverse dual resident triangular cases, in Chapter 12 (Section 12.3.5.).

1616 This proposed provision is extracted from Chapter 11 (Section 11.3.2.) where it is discussed in-depth.

1617 For an analysis of the outcome of dual-resident triangular cases involving various categories of income (in situations where there is no PE in the losing residence state) refer to Chapter 9 (Sections 9.4.1. and 9.4.2.).

1618 For a discussion of situations where the dual resident does have a PE in the losing residence state, refer to Chapter 9 (Section 9.4.3.). In such cases, the losing state may impose tax on certain categories of income attributable to the PE and the situation becomes similar to a typical PE triangular case.
implementing the extension of treaty benefits to PEs as outlined briefly above.\textsuperscript{1619} It is further assumed that the dual-resident payor does not have a PE in its losing residence state. If it did have a PE in that state, then that state may be entitled to impose tax on certain types of income to the extent that they originate from the PE, this would effectively be a reverse PE triangular case. This would effectively be the same as a situation combining a dual resident triangular situation and a reverse PE triangular case; such cases are discussed in Section S4.4. above.

\textit{Applicable treaties}

If the proposed provisions are included in all the relevant treaties, the applicable treaties in this case will be:

(i) the treaty between the winning residence state of the recipient and the winning residence state of the payor (the W1-W2 treaty);

(ii) the treaty between the winning residence state of the recipient and the losing residence state of the payor (the W1-L2 treaty); and

(iii) the treaty between the winning and losing residence states of the recipient (the W1-L1 treaty)

The treaty between the payor's residence states (the W2-L2 treaty) will not apply because for the purposes this treaty, the income is not received by a resident of one of the contracting states. In addition, as a result of the person receiving the income no longer being resident in State L1 for treaty purposes, the L1-W2 treaty and the L1-L2 treaty will no longer apply.

The following sections will discuss the application of tax treaties in this situation where different categories of income are involved, firstly under the existing framework and secondly where the relevant treaties include the proposed provisions outlined above.

4.2. Business profits

Article 7 deals with business profits and allows the residence state of the person deriving the income to impose tax. It also allows the other contracting state to impose tax, but only in relation to profits which are attributable to a PE in that other state.\textsuperscript{1620} Article 7 (in paragraphs 1 and 2) provides as follows:

\begin{quote}
"1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article \{23 A\} \{23B\}, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."\textsuperscript{1621}
\end{quote}

Thus, the source state may not impose any tax on business profits except to the extent they are attributable to a PE. For further discussion of the PE concept and the attribution of profit to PEs, refer to the discussion in Chapter 5 (Sections 5.2.3. and 5.2.4.).

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives business profits from outside those two states. The income is also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the recipient of the income is

\textsuperscript{1619} For a brief overview of this proposal, see Section S4.2.1. above. This proposal is discussed in detail throughout Chapter 7 and Chapter 8.

\textsuperscript{1620} The term “permanent establishment” is defined in Article 5.

\textsuperscript{1621} Article 7, paragraphs 1 and 2.
assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. This situation is illustrated in the following diagram:

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (in particular, Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, including a brief overview of the outcome of reverse dual-resident triangular cases involving business profits, refer to Chapter 12 (Section 12.3.).

### 4.2.1. Existing treaty framework

**The winning residence state of the payor (State W2):** State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. For the purposes of both these treaties, Article 7 will apply and, given that the income is not attributable to a PE of the recipient in State W2, State W2 will be prevented from imposing tax.

**The losing residence state of the payor (State L2):** State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 7 will apply and, given that the income is not attributable to a PE of the recipient in State L2, State L2 will be prevented from imposing tax.

**The losing residence state of the recipient (State L1):** State L1 must apply the conditions of the W1-L1 treaty. For the purposes of this treaty, Article 7 will apply and State L1 will be prevented from imposing tax.

**The winning residence state of the recipient (State W1):** State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax and, since State W2, State L2 and State L1 are all prevented from imposing tax, State W1 will have no obligation to provide relief.

**Overview:** Under the existing treaty framework, tax may only be imposed in State W1 and there will be no unrelieved double taxation. This situation is effectively the same as a dual resident triangular case involving business profits, since both source states are prevented from imposing tax. The main concern in this situation is the application of multiple treaty conditions in the source states, although though this would generally have no practical impact (at least where the applicable treaties follow the OECD Model).

### 4.2.2. Application of proposed solutions

**The winning residence state of the payor (State W2):** State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. For the purposes of the W1-W2 treaty, Article 7 will apply and State W2 will be prevented from imposing tax on the income. This is the same outcome as under the existing treaty framework, however the outcome could be different if there is a difference between the terms of the W1-W2 treaty and the L1-W2 treaty.

**The losing residence state of the payor (State L2):** State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. For the purposes of the W1-L2 treaty, Article 7 will apply and State L2 will be prevented from imposing tax on the income. This is the same outcome as under the existing treaty framework, however the outcome could be different if there is a difference between the terms of the W1-L2 treaty and the L1-L2 treaty.
The losing residence state of the recipient (State L1): State L1 must continue to apply the conditions of the W1-L1 treaty. For the purposes of this treaty, Article 7 will apply and State L1 will be prevented from imposing tax on the income.

The winning residence state of the recipient (State W1): State W1 must continue to apply the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax and, since all the other states are prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: The proposed solutions would generally have little practical impact in this situation, since the distributive rules for business profits do not generally differ between treaties. One situation where a different outcome may arise is where the PE definition contained in a source states’ (State W2 and State L2) treaties with State W1 differ from those contained in their treaties with State L1. As a result, one of the source state’s may be entitled to impose tax under the conditions of its treaty with State W1 but not under the conditions of its treaty with State L1 or vice versa. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to income dealt with under Article 7.

4.3. Dividends

Dividends are dealt with in Article 10. Article 10 allows the state where the payor of dividends is resident (the source state) to impose tax, but limits the amount of the tax to a certain percentage of the gross amount of the dividends. Article 10 provides as follows (in paragraphs 1 and 2):

“1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

   b) 15 per cent of the gross amount of the dividends in all other cases.”

Thus, the rate of tax that may be imposed in the source state depends on recipient’s interest in the company paying the dividends.1622 The exact rates are a common point of negotiation, however, and often vary between treaties. The ownership thresholds also vary in many concluded treaties and some treaties may provide only a single maximum tax rate. Furthermore, if the dividends are attributable to a PE of the recipient which is located in the source state, then as a result of Article 10(3), Article 7 will apply instead of Article 10 and the source state may impose tax on the basis of the profit attributable to the PE.

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, receives dividends from outside those two states. The dividends are also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the recipient of the dividends is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. This situation is illustrated in the following diagram:

1622 The application of this threshold (and other treaty thresholds) in situations where treaty benefits are claimed in relation to the income attributable to a PE are discussed in Chapter 8 (Section 8.6.2.).
For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (in particular, Section 10.4.). For a detailed discussion of reverse dual resident triangular cases involving dividends, refer to Chapter 12 (Section 12.3.4.).

4.3.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. For the purposes of both these treaties, Article 10 will apply and State W2 will be entitled to impose tax on the dividends at a limited rate. If the applicable rate differs between the two treaties, State W2 can only satisfy its treaty obligations by applying the lower of the two rates.1623

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 10 will apply and State L2 will be entitled to impose tax on the dividends at a limited rate. If the applicable rate differs between the two treaties, State L2 can only satisfy its treaty obligations by applying the lower of the two rates.1624 State L2 may be prevented from imposing tax, however, under Article 10(5) of the W2-L2 treaty.1625 State L2 may be prevented from imposing tax, however, under Article 10(5) of the W2-L2 treaty.

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. Article 10 will not apply because the dividends are not paid by a resident of State L1. Instead, either Article 7 or Article 21 will apply, depending on whether the dividends are considered to be business profits. Regardless of which of these two articles applies, State L1 will be prevented from imposing any tax on the dividends.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax but will be obliged to provide relief (using the credit method) for tax imposed in State W2 and possibly also State L2 (no relief will be required if State L2 is prevented from imposing tax under Article 10(5) of the W2-L2 treaty). State W1 will not be obliged to provide any relief under the W1-L1 treaty, since State L1 is prevented from imposing tax under its treaty with State W1. There will be no unrelieved double taxation.


1625 Article 10(5) provides that: "Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.” Thus, this provision should prevent the losing residence state from imposing tax on the dividends. The main problem with applying this provision is that it applies under the treaty between the two residence states of the payor and, for the purposes of this treaty, the recipient of the dividends is not a resident of either of the contracting states. In addition, it may apply only where the company derives profits or income from the state seeking to impose tax on the dividends. Article 10(5) is discussed in detail in Chapter 12 (see Section 12.2.1. and Section 12.3.4.).
**Overview:** In this situation, tax may be imposed in State W2, State W1 and potentially also in State L2. State W1 will have an obligation to provide relief (using the credit method) for tax imposed in State W2 and, if applicable, State L2. An important issue in this situation is that both State W2 and State L2 are subject to multiple treaty conditions in respect of the same income. This may give rise to concerns about the potential for improper use of the L1-W2 treaty, particularly given that State L1 is prevented from imposing any tax on the dividends by the conditions of the W1-L1 treaty. Another important issue is the potential for dual source-based taxation (subject to the application of Article 10(5) of the treaty between the two residence states of the payor) and, if State W1 cannot provide sufficient relief, unrelieved double taxation.

**4.3.2. Application of proposed solutions**

**The winning residence state of the payor (State W2):** State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. For the purposes of the W1-W2 treaty, Article 10 will apply and State W2 will be entitled to impose tax on the dividends at a limited rate. State W2 is no longer required to apply multiple treaty conditions.

**The losing residence state of the payor (State L2):** State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. In addition, the payor of the dividends will no longer be considered a resident of State L2 for the purposes of the W1-L2 treaty. As a result, Article 10 of the W1-L2 treaty will not apply. Instead, Article 7 or Article 21 will apply, depending on whether the dividends are considered to be business profits, and State L2 will be prevented from imposing tax. If State L2 is prevented from imposing tax as a result of Article 10(5) of the W2-L2 treaty under the existing treaty framework, then the outcome in this case will not be any different (and Article 10(5) may also continue to prevent State L2 from imposing tax). However, there is some uncertainty regarding the application of Article 10(5) in this situation and preventing State L2 from imposing tax under the terms of the W1-L2 treaty makes the outcome clearer and more certain.

**The losing residence state of the recipient (State L1):** State L1 must continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 10 will not apply because the dividends are not paid by a resident of State L1. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits, and State L1 will be prevented from imposing any tax on the income.

**The winning residence state of the recipient (State W1):** State W1 must continue to apply the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax but is obliged to provide relief (using the credit method) for tax imposed in State W2. State W1 will not be obliged to provide relief under the W1-L2 treaty or the W1-L1 treaty since both State L2 and State L1 are prevented from imposing tax.

**Overview:** The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same income and addresses the risk of improper use of the treaties between the losing residence state and the source states. Furthermore, under the proposed treaty provisions, the dual-resident payor of the dividends would no longer be considered a resident in State L2 for the purposes of the treaties between that state and the residence state (or states) of the recipient of the dividends. This makes it more certain that State L2 will be prevented from imposing tax and thus, that dual source-based taxation will be prevented.

**4.4. Interest**

Interest is dealt with in Article 11, which allows the state where interest arises to impose a tax at a limited rate. Article 11 reads as follows (paragraphs 1 and 2):

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a...
resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.”

Thus, where Article 11 applies, the source state is limited to imposing an amount of tax equal to 10% of the gross amount of the interest. This rate is a common point of negotiation, however, and often varies between concluded treaties. Furthermore, if the interest is attributable to a PE of the recipient which is located in the source state then, as a result of Article 11(4), Article 7 will apply instead of Article 11 and the source state may impose tax on the basis of the profit attributable to the PE.1626

Whether interest arises in a particular state is determined in accordance with Article 11(5) which provides that:

“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 in a Contracting State 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.”

Thus, interest arises in a particular state if it is paid by a resident of that state or, in broad terms, is borne by a PE located in that state.

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives interest income from outside those two states. The interest is also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the recipient of the interest is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. This situation is illustrated in the following diagram:

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.4.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of the W1-W2 treaty and the L1-W2 treaty. Under Article 11(5) of both these treaties, the interest will be considered to arise in State W2 since it is paid by a resident of that state. Article 11 will therefore apply for the purposes of both treaties and State W2 will be entitled to impose a limited rate of tax on the interest. If the applicable rates differ between the two treaties, State W2 can only satisfy its treaty obligations by applying the lower of the two rates.1627

1626 Article 11(4) provides that: “The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

The losing residence state of the payor (State L2): State L2 must apply the conditions of the W1-L2 treaty and the L1-L2 treaty. Under Article 11(5) of both these treaties, the interest will be considered to arise in State L2 since it is paid by a resident of that state. Article 11 will therefore apply and State L2 will be entitled to impose a limited rate of tax on the interest. If the applicable rate differs between the two treaties, State L2 can only satisfy its treaty obligations by applying the lower of the two rates.\textsuperscript{1628}

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. Article 11 will not apply for the purposes of the W1-L1 treaty since the interest is not paid by a resident of State L1. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits, and since the income is not attributable to a PE in State L1, State L1 will be prevented from imposing tax.

The winning residence state of the recipient (State W1): State W1 must apply the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax, but will be required to grant relief under both the W1-W2 treaty and the W1-L2 treaty. This would generally be credit relief, regardless of the general method of relief under those treaties. Given that State W1 has an obligation to provide relief for tax imposed in two states, it may not be able to provide sufficient relief to prevent unrelieved double taxation.\textsuperscript{1629}

Overview: In this situation, source-based taxation may be imposed in both State W2 and State L2. For the purposes of State W2’s treaties with the two residence states, the interest is considered to arise in State W2 and for the purposes of State L2’s treaties with the two residence states, the interest is considered to arise in State L2. As a result, both State W2 and State L2 may impose tax on the interest under Article 11 of their respective treaties with State W1 and State L1. State W1 will be obliged to provide relief for tax imposed in both State W2 and State L2, but may not be able to provide sufficient relief to prevent double taxation. An important issue in this situation is that both State W2 and State L2 are subject to multiple treaty conditions in respect of the same income. This may give rise to concerns about the potential for improper use of the L1-W2 treaty, particularly given that State L1 is prevented from imposing any tax on the interest by the conditions of the W1-L1 treaty.

\textbf{4.4.2. Application of proposed solutions}

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. Under Article 11(5) of the W1-W2 treaty, the interest would be considered to arise in State W2 and State W2 would be entitled to impose tax in accordance with Article 11.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. For the purposes of the W1-L2 treaty, however, the payor of the interest will no longer be resident in State L2. As a result, the interest will not be considered to arise in State L2 under Article 11(5) and, consequently, Article 11 of the treaty will not apply. Instead Article 7 or Article 21 will apply, depending on whether the interest is considered to be business profits, and State L2 would be prevented from imposing tax on the income.

The losing residence state of the recipient (State L1): State L1 must continue to apply the W1-L1 treaty. Article 11 will not apply for the purposes of the W1-L1 treaty since the interest is not paid by a resident of State L1. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits, and, since the income is not attributable to a PE in State L1, State L1 will be prevented from imposing tax.


\textsuperscript{1629} Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation where it is required to provide relief for tax imposed on a source basis in two separate states; this discussion is framed in terms of PE triangular cases but applies equally to other situations. Broadly, the residence state’s ability to grant sufficient relief will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.
The winning residence state of the recipient (State $W_1$): State $W_1$ must continue to apply the $W_1-W_2$ treaty, the $W_1-L_2$ treaty and the $W_1-L_1$ treaty. State $W_1$ may impose tax but is obliged to provide relief (using the credit method) for tax imposed in State $W_2$. State $W_1$ will not be obliged to provide relief under the $W_1-L_2$ treaty or the $W_1-L_1$ treaty, since both State $W_2$ and State $L_1$ are prevented from imposing tax.

Overview: The source states will now be subject only to the conditions of their respective treaties with State $W_1$ and will no longer be obliged to apply their treaties with State $L_1$. This means they are no longer subject to multiple treaty conditions in respect of the same income and addresses the risk of improper use of the treaties between the losing residence state and the source states. In addition, since the payor of the interest is no longer considered to be resident in its losing residence state for the purposes of treaties between that state and third states, the interest is only considered to arise in one state for treaty purposes (i.e., State $W_2$) and thus may not be subject to dual source-based taxation.

4.5. Royalties

Royalties are dealt with in Article 12, which allows tax to be imposed only in the residence state. Article 12 (paragraph 1) reads as follows:

“Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.”

If, however, the royalties are attributable to a PE of the recipient which is located in the source state, then as a result of Article 12(2), Article 7 will apply instead of Article 12 and the source state may impose tax on the basis of the profit attributable to the PE. Thus, the OECD Model does not allow any source-based taxation of royalties except where they are attributable to a PE in the source state.

As outlined in Chapter 12 (see Section 12.2.2.), the UN Model and many concluded treaties do allow states to impose a limited rate of source based taxation on royalties which arise in one contracting state and are paid to a resident of the other contracting state. In general, the rules for determining whether royalties arise in a particular state mirror the rules of Article 11(5) which apply in relation to interest.\(^\text{1630}\)

To the extent that the applicable treaties do allow source-based taxation of royalties and determine where royalties arise under a provision equivalent to Article 11(5), the analysis in relation to royalties would be exactly the same as that outlined for interest above. The analysis below briefly considers both situations where the applicable treaties do allow source based taxation of royalties under Article 12 and situations where they do not. Where source-based taxation of royalties is allowed, it is assumed that the relevant treaty contains a provision mirroring Article 11(5) for determining whether royalties arise in a particular state. Where Article 12 does not allow source based taxation of royalties, the place where royalties arise becomes less important because if the royalties are not considered to arise in a particular state, then that state will nevertheless generally be prevented from imposing tax under either Article 7 or Article 21 of the treaty (depending on whether the income is considered to be business profits).\(^\text{1631}\) The result will therefore be the same regardless of whether the royalties are or are not considered to arise in the state applying the treaty.

This section deals with a situation where a dual resident person, resident in State $W_1$ and in State $L_1$, derives royalties from outside those two states. The royalties are also paid by a dual resident, a person who is resident in State $W_2$ and in State $L_2$. The residence of the recipient of the royalties is assigned to State $W_1$ under the tie-breaker provision of the $W_1-L_1$ treaty, and the residence of the payor is assigned to State $W_2$ under the tie-breaker provision of the $W_2-L_2$ treaty. This situation is illustrated in the following diagram:

\(^{1630}\) See, for example, Article 12(5) of the UN Model Treaty (2001), which provides that: "Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.5.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of the W1-W2 treaty and the L1-W2 treaty. For the purposes of applying both these treaties the income would generally be considered to arise in State W2, in which case Article 12 would apply. If Article 12 of either of the two treaties does not allow any source based taxation, State W2 will be prevented from imposing tax. If both treaties do allow source-based taxation under Article 12 then State W2 would be entitled to impose tax at a limited rate. If the applicable rates differ between the two treaties, State W2 can only satisfy its treaty obligations by applying the lower of the two rates.\footnote{See, inter alia: Van Raad, K., "The 1992 OECD Model Treaty: Triangular Cases" 33 European Taxation 9, (1993), pp. 298-301; 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; Gusmeroli, M., "Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1" 45 European Taxation 1, (2005), pp. 2-13;}

The losing residence state of the payor (State L2): State L2 must apply the conditions of the W1-L2 treaty and the L1-L2 treaty. For the purposes of applying these treaties the income would generally be considered to arise in State L2, in which case Article 12 would apply. If Article 12 of either of the two treaties does not allow any source based taxation, State L2 will be prevented from imposing tax. If both treaties do allow source-based taxation under Article 12 then State L2 would be entitled to impose tax at a limited rate. If the applicable rates differ between the two treaties, State L2 can only satisfy its treaty obligations by applying the lower of the two rates.\footnote{See, inter alia: Van Raad, K., "The 1992 OECD Model Treaty: Triangular Cases" 33 European Taxation 9, (1993), pp. 298-301; 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; Gusmeroli, M., "Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1" 45 European Taxation 1, (2005), pp. 2-13;}

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. Article 12 will not apply for the purposes of the W1-L1 treaty since the royalties would not generally be considered to arise in State L1. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits and, since the income is not attributable to a PE in State L1, State L1 will be prevented from imposing tax.

The winning residence state of the recipient (State W1): State W1 must apply the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax, but to the extent that either State W2 or State L2 (or both) may impose tax on the income, State W1 will be obliged to grant relief. If State W1 has an obligation to provide relief for tax imposed in both these two states, it may not be able to provide sufficient relief to prevent unrelieved double taxation.\footnote{Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation where it is required to provide relief for tax imposed on a source basis in two separate states; this discussion is framed in terms of PE triangular cases but applies equally to other situations. Broadly, the residence state’s ability to grant sufficient relief will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.}

Overview: The existence of dual source-based taxation of royalties in this situation will depend on the terms of the applicable treaties; it may be that tax is imposed in State W2, in State L2, in both of these...
states or in neither of them. State W1 will be obliged to provide relief, but if tax is imposed in both State W2 and in State L2, State W1 may not be able to provide sufficient relief to prevent double taxation. An important issue in this situation is that both State W2 and State L2 are subject to multiple treaty conditions in respect of the same income. This may also give rise to concerns about the potential for improper use of the treaties between State L1 and the source states, given that State L1 is prevented from imposing any tax on the royalties under the W1-L1 treaty.

4.5.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. For the purposes of this treaty, the royalties would generally be considered to arise in State W2 and Article 12 would apply. Depending on the terms of Article 12, State W2 may either be prevented from imposing tax or may be entitled to impose tax at a limited rate.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. The payor of the royalties would no longer be considered to be resident in State L2 for the purposes of treaties concluded by that state with third states. For the purposes of the W1-L2 treaty, the royalties would therefore not be paid by a resident of State L2 and would not be considered to arise there.1635 As a result, Article 12 of the treaty would generally not apply. Instead Article 7 or Article 21 would apply, depending on whether the income is considered to be business profits, and State L2 would be prevented from imposing tax.

The losing residence state of the recipient (State L1): State L1 must continue to apply the W1-L1 treaty. Article 12 will not apply for the purposes of the W1-L1 treaty since the royalties do not arise in State L1. Instead, Article 7 or Article 21 will apply, depending on whether the income is considered to be business profits, and since the income is not attributable to a PE in State L1, State L1 will be prevented from imposing tax.

The winning residence state of the recipient (State W1): State W1 must continue to apply the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax but if State W2 may also impose tax (under the W1-W2 treaty), then State W1 will be obliged to provide relief (using the credit method) for tax imposed in State W2. State W1 will not be obliged to provide relief under the W1-L2 treaty or the W1-L1 treaty, since both State L2 and State L1 are prevented from imposing tax.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply the conditions of their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same income, and also addresses the risk of improper use of the treaties between the losing residence state (State L1) and the source states. In addition, the payor of the royalties is no longer considered to be resident in its losing residence state (State L2) for the purposes of treaties between that state and third states. As a result, the royalties are no longer considered to arise in two separate states for treaty purposes and source-based taxation may only be imposed in State W2 (depending on the terms of Article 12 of the W1-W2 treaty). This ensures that there is no dual source-based taxation of the royalties.

4.6. Income from immovable property

Income from immovable property is dealt with in Article 6, which allows the state where the property is located to impose tax on the income. Article 6 (paragraph 1) provides as follows:

“Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

1635 Either under general principles or, if applicable, under the specific provision which is proposed to be included in Article 12 in situations where Article 12 allows source based taxation of royalties.
Immovable property is defined in Article 6(2) by reference to the domestic law of the state where the property is located. Article 6(2) also lists certain things, such as property accessory to immovable property and livestock, which are always considered to be immovable property for the purposes of the treaty.

Where immovable property is located in a third state for the purposes of a particular treaty, there is some debate regarding the appropriate treaty article to apply. This was discussed in detail in Chapter 2 (see Section 2.6.), where it was concluded that the income may fall under the distributive rule of either Article 7 or Article 21. Article 7 may apply either because the income is considered to be business profits or because is attributable to a PE (i.e., as a result of Article 21(2)). The income will generally fall under Article 21 only if it is not considered to be business profits and is not attributable to a PE. For a detailed discussion, please refer to Chapter 2 (Section 2.6.).

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives income from immovable property located outside those two states. The income is also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the recipient of the income is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. For the purposes of the analysis below, it is assumed that the immovable property is located in State L2. This situation is illustrated in the following diagram:

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4 For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.6.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. Article 6 will not apply for the purposes of either of these treaties because the immovable property is not located in State W2. Instead, Article 7 or Article 21 will apply (depending on whether the income is considered to be business profits) and State W2 is prevented from imposing tax on the income.

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1636 Article 6(2) provides that: “The term ‘immovable property’ shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.”

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 6 will apply and, given that the immovable property is located in State L2, State L2 will be entitled to impose tax on the income.

The losing residence state of the recipient (State L1): State L1 will be subject to the conditions of the W1-L1 treaty. For the purposes of this treaty Article 6 will not apply because the immovable property is not located in State L1. Instead, Article 7 or Article 21 will apply (depending on whether the income is considered to be business profits) and State L1 will be prevented from imposing tax on the income.

The winning residence state of the recipient (State W1): State W1 must apply the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax but will have an obligation to provide relief (either exemption or credit) under the W1-L2 treaty. State W1 will not have a relief obligation under either the W1-W2 treaty or the W1-L1 treaty because the terms of those treaties do not allow State W2 or State L1, respectively, to impose any tax on the income.

Overview: In this situation, tax is imposed in the where the property is located (State L2) and in State W1, and State W1 will have an obligation to provide relief. State W2 and State L1 are both prevented from imposing tax on the income. In this situation State W2 and State L2 are both subject to multiple treaty conditions in respect of the same income, however this is unlikely to have any practical impact in those states. State W2 (the state where the property is located) would generally be entitled to impose tax under both treaties and State L2 (where the property is not located) would generally be prevented from imposing tax under both treaties. Nevertheless, there may be situations where the terms of the two applicable treaties do differ in a way that impacts on one of the source states’ taxing rights.

4.6.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under either Article 7 or Article 21 of the W1-W2 treaty. Article 6 will not apply because the immovable property is not located in State W2.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Article 6 will continue to apply for the purposes of the W1-L2 treaty and State L2 will be entitled to impose tax on the income.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. Article 6 of the treaty will not apply because the immovable property is not located in State L1. Instead, Article 7 or Article 21 will apply (depending on whether the income is considered to be business profits) and State L1 will be prevented from imposing tax on the income.

The winning residence state of the recipient (State W1): State W1 must continue to apply the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax but will be obliged to provide relief (either credit or exemption) under the W1-L2 treaty. State W1 will not be obliged to provide relief under the W1-W2 treaty or the W1-L1 treaty, since both State W2 and State L1 are prevented from imposing tax.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply the conditions of their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same income and also addresses the risk of improper use of the treaties between the losing residence state and the source states. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to income from immovable property.

4.7. Income from shipping and air transport

Article 8 deals with income from shipping, inland waterways transport and air transport and provides (in paragraphs 1 and 2) that:
“1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

Thus, under Article 8, income from shipping, inland waterways transport and air transport may only be taxed in the state where the enterprise’s place of effective management is located.1638

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives income from shipping, inland waterways transport and/or air transport from outside those two states. The income is also paid by a dual resident, a person who is resident in State W2 and in State L2. The place of effective management of the recipient of the income is located in State W1 and that person’s residence is thus assigned to State W1 under the tie-breaker provision of the W1-L1 treaty. The residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. This situation is illustrated in the following diagram (in which “POEM” denotes the place of effective management of the person deriving the income):

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.7.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. For the purposes of both these treaties, Article 8 will apply and the income may only be taxed in the state where the place of effective management is located. For the purposes of the W1-W2 treaty it is quite clear that, since the place of effective management is located in State W1, State W2 will be prevented from imposing tax on the income. For the purposes of the L1-W2 treaty, however, the place of effective management is located in a third state and it is therefore unclear how Article 8 should be applied. In any case, this will not have any practical impact since State W2 is already prevented from imposing tax under the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 8 will apply and the income may only be taxed in the state where the place of effective management is located. For the purposes of the W1-L2 treaty it is quite clear that, since the place of effective management is located in State W1, State L2 will be prevented from imposing tax on the income. For the purposes of the L1-L2 treaty, however, the place of effective management is located in a third state and it is thus unclear how Article 8 should be applied.1639 In any case, this will not have any practical impact since State L2 is already prevented from imposing tax under the W1-L2 treaty.

1638 The place of effective management will generally be in the residence state of the enterprise, and this is assumed to be the case for the purposes of the discussion below. For further discussion of the location of the place of effective management in the context of applying tax treaties in PE triangular cases involving income from shipping, inland waterways transport and air transport, please refer to Chapter 2 (Section 2.7.).

1639 This is discussed further in Chapter 2 (see Section 2.7.).
The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. For the purposes of this treaty, Article 8 will apply and the income may only be taxed in State W1, i.e., the state where the place of effective management is located. State L1 will thus be prevented from imposing any tax on the income.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the income and, since all the other states are prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State W1, since all the other states involved will be prevented from imposing tax under Article 8 of their respective treaties with State W1. One issue which arises in this situation is that the source states, State W2 and State L2, will be bound by multiple treaty conditions in respect of the income. This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ. It is also unclear how Article 8 of the treaties between State L1 and the source states should be applied, given that the place of effective management of the person deriving the income is located outside the contracting states.

4.7.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under Article 8 of the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Again, this is unlikely to have any practical impact since State L2 will continue to be prevented from imposing tax under Article 8 of the W1-L2 treaty.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 8 will apply and State L1 will be prevented from imposing any tax on the income.

The winning residence state of the recipient (State W1): State W1 must continue to apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the income and, since all the other states are prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply the conditions of their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same income. In relation to income from shipping and air transport, however, this is unlikely to have any practical impact since State W2 and State L2 will continue to be prevented from imposing tax under their respective treaties with State W1. Nevertheless, this does resolve the uncertain application of Article 8 of the treaties between State L1 and the source states, since these treaties no longer apply. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to income dealt with under Article 8.

4.8. Capital gains from the alienation of immovable property

Capital gains derived from the alienation of immovable property are dealt with in Article 13(1), which provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.”
Thus, Article 13(1) applies where a resident of one state derives capital gains from the alienation of immovable property located in the other contracting state, and allows the state where the property is located to impose tax on the gain. The reference to Article 6 in Article 13(1) is a reference to the definition of immovable property, which in turn refers to the domestic law of the state where the property is located, as well as containing a list of certain property which is always considered to be immovable property for the purposes of the treaty.1640

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives a capital gain from the alienation of immovable property located outside those two states. The amount giving rise to the gain is also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the person deriving the gain is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. For the purposes of the discussion below, it will generally be assumed that the immovable property from which the gain arises is located in State L2. This situation is illustrated in the following diagram:

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.8.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. Article 13(1) will not apply for the purposes of either of these treaties because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State W2 will be prevented from imposing tax on the gain.1641

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 13(1) will apply and State L2 will be entitled to impose tax on the gain.

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State L1 will be prevented from imposing tax on the gain.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax, but will be required to provide relief (either exemption or credit) under the W1-L2 treaty (i.e., for tax imposed in the state where the property is located).

1640 For further discussion of the definition of immovable property and the application of tax treaties in PE triangular cases involving capital gains from immovable property, please refer to Chapter 2 (particularly Section 2.8.1.).

1641 Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of movable property forming part of the business property of a PE (para 2), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4). These paragraphs will be discussed in more detail below.
Overview: In this situation, tax may be imposed in the state where the immovable property is located (State L2) and in State W1, and State W1 is obliged to provide relief. This will be either exemption or credit relief, depending on the terms of the treaty. One issue which arises in this situation is that the source states, State W2 and State L2, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W1 and State L1). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

4.8.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under Article 13(5) of the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Again, this is unlikely to have any practical impact since State L2 will simply continue to apply Article 13(1) of the W1-L2 treaty, and may continue to impose tax on the gain.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 13(5) will apply and State L1 will continue to be prevented from imposing any tax on the gain.

The winning residence state of the recipient (State W1): State W1 must continue to apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain and, since all the other states are prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. This is unlikely to have any practical impact, however, unless there is some difference between the relevant terms of the two treaties. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to capital gains dealt with under Article 13(1).

4.9. Capital gains from the alienation of movable property of a PE

Article 13(2) deals with capital gains from the alienation of movable property forming part of the business property of a PE. It provides that:

“Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.”

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives a capital gain from the alienation of movable property forming part of the business property of a PE located outside those two states. The amount giving rise to the gain is also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the person deriving the gain is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. In the situation discussed in part of the appendix it is generally assumed that the dual resident does not have a PE in either of the source states, however for the purposes of the discussion in this section, it will be assumed that the movable property forms part of the business property of a PE located in State L2 (i.e., the losing residence state of the payor). This situation is illustrated in the following diagram:
For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.9.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. Article 13(2) will not apply for the purposes of either of these treaties because the capital gain does not arise from the alienation of movable property of a PE located in State W2. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State W2 will be prevented from imposing tax on the capital gain.\textsuperscript{1642}

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. Article 13(2) applies for the purposes of both these treaties and State L2 will be entitled to impose tax on the capital gain.

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. Article 13(2) will not apply for the purposes of this treaty because the capital gain does not arise from the alienation of movable property of a PE located in State L1. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State L1 will be prevented from imposing tax on the capital gain.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax, but will be required to provide relief (either exemption or credit) under the W1-L2 treaty.

Overview: In this situation, tax may be imposed in the state where the PE to which the property belongs is located (State L2) and in State W1, and State W1 is obliged to provide relief (either exemption or credit). State W2 and State L1 are both prevented from imposing tax under their respective treaties with State W1. One issue which arises in this situation is that the source states, State W2 and State L2, will be bound by multiple treaty conditions in respect of the capital gain, i.e., their respective treaties with both State W1 and State L1. This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

4.9.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under Article 13(5) of the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Again, this is unlikely to have any practical impact

\textsuperscript{1642} Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4). These paragraphs will be discussed in more detail below.
since State L2 will simply continue to apply Article 13(2) of the W1-L2 treaty and may still impose tax on the gain.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 13(5) will apply and State L1 will be prevented from imposing any tax on the gain.

The winning residence state of the recipient (State W1): State W1 must continue to apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax, but will be required to provide relief (either exemption or credit) under the W1-L2 treaty. State W1 will have no obligation to provide relief under either the W1-W2 treaty or the W1-L1 treaty, since both State W2 and State L1 are prevented from imposing tax on the gain.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. This is unlikely to have any practical impact, however, unless there is some difference between the terms of the two treaties. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to capital gains dealt with under Article 13(2).

4.10. Capital gains from the alienation of ships and aircraft in international traffic

Article 13(3) deals with capital gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated assets. It provides that:

“Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives a capital gain from the alienation of ships, aircraft and/or associated assets. The amount giving rise to the gain is paid by a resident of State W2 and originate from a PE of the payor located in State L2. The place of effective management of the person deriving the capital gain is located in State W1 and consequently, the residence of the dual resident person is assigned to State W1 for the purposes of the treaty between the two residence states. The residence of the dual resident payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. This situation is illustrated in the following diagram:

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.10.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. For the purposes of both these treaties, Article 13(3) will apply and the gain may only be taxed in the state where the place of effective management is located. For the purposes of the W1-W2 treaty it is quite clear that, since the place of effective management is located in State W1, State W2 will be prevented from imposing tax on the gain. For the purposes of the L1-W2 treaty, however, the place of effective management is located in a third state and it is thus unclear how Article
13(3) should be applied. In any case this is not likely to have any practical impact, since State W2 is already prevented from imposing tax under the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 13(3) will apply and the gain may only be taxed in the state where the place of effective management is located. For the purposes of the W1-L2 treaty it is quite clear that, since the place of effective management is located in State W1, State L2 will be prevented from imposing tax on the gain. For the purposes of the L1-L2 treaty, however, the place of effective management is located in a third state and it is thus unclear how Article 13(3) should be applied. In any case this is not likely to have any practical impact because State L2 is already prevented from imposing tax under the W1-L2 treaty.

The losing residence state of the recipient (State L1): State L1 must apply the conditions of both the W1-L1 treaty and the L1-L1 treaty. For the purposes of both these treaties, Article 13(3) will apply and State L1 will be prevented from imposing any tax on the gain.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain and, since all the other states are prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State W1; all the other states involved will be prevented from imposing tax under Article 13(3) of their respective treaties with State W1. One issue which arises in this situation is that the source states, State W2 and State L2, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W1 and State L1). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ. It is also unclear how Article 13(3) of the treaties between State L1 and the source states should be applied, given that the place of effective management of the person deriving the gain is located outside the contracting states.

4.10.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under Article 13(3) of the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Again, this is unlikely to have any practical impact since State L2 will continue to be prevented from imposing tax under Article 13(3) of the W1-L2 treaty.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 13(3) will apply and State L1 will be prevented from imposing any tax on the gain.

The winning residence state of the recipient (State W1): State W1 must continue to apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain and, since all the other states are prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. In relation to capital gains from the alienation of ships, aircraft and similar assets, however, this is unlikely to have any practical impact since State W2 and State L2 will continue to be prevented from imposing tax under their respective treaties with State W1. Nevertheless, this does resolve the uncertainty regarding the application of Article 13(3) of the treaties between State L1 and the source states, since these treaties no longer apply. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no

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1643 This is discussed further in Chapter 2 (see Section 2.7.).
impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to capital gains dealt with under Article 13(3).

4.11. Capital gains from the alienation of shares in a real estate company

Article 13(4) deals with capital gains from the alienation of shares which derive their value from immovable property. It provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.”

Such gains may therefore be taxed in the state where the underlying immovable property is located. The OECD Model does not contain any other specific provision dealing with capital gains from the alienation of shares, but some concluded treaties also allow source based taxation of gains arising from:

3. The alienation of shares in a company having more than 50% of its assets located in the source state;1644 and/or
4. The alienation of shares where the person disposing of those shares has a "substantial participation" (i.e., a shareholding of more than a certain specified percentage) in the company whose shares are being alienated.1645

In general, where such provisions exist, they allow the source state (i.e., the state where the underlying property is located) to impose tax on the gains in the same way as Article 13(4) allows taxation of gains arising from shares in a real estate company. For the purposes of the discussion below, however, it will be assumed that all the applicable treaties follow the OECD Model.

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives a capital gain from the alienation of shares which derive more than 50% of their value from immovable property located outside those two states. The amount giving rise to the gain is also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the person deriving the gain is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. For the purposes of the discussion below, it will generally be assumed that the underlying immovable property is located in State L2. This situation is illustrated in the following diagram:

![Diagram of capital gain in dual resident situation]

Note that the place where the shares are registered is not relevant for the purposes of the discussion below.

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.11.1. Existing treaty framework

1645 See, for example the reservations of France, Chile, Sweden and Korea in the OECD Commentary to Article 13 of the OECD Model.
The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. Article 13(4) will not apply for the purposes of either of these treaties because the underlying property is not located in State W2. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State W2 will be prevented from imposing any tax on the gain.1646

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 13(4) will apply and State L2 may impose tax on the gain.

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. For the purposes of this treaty, Article 13(4) will not apply because the underlying property is not located in State L1. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State L1 will be prevented from imposing any tax on the gain.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain, but will be obliged to provide relief for tax imposed in State L2 under the W1-L2 treaty. State W1 will not have any relief obligation under the W1-W2 treaty or the W1-L1 treaty because both State W2 and State L1 are prevented from imposing tax under their respective treaties with State W1.

Overview: In this situation, tax may be imposed in State W1 and in State L2 and State W1 will be obliged to provide relief. One issue which arises in this situation is that the source states, State W2 and State L2, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W1 and State L1). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

4.11.2. Application of proposed solutions
The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under Article 13(5) of the W1-W2 treaty. Article 13(4) will not apply because the underlying immovable property is not located in State W2.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Again, this is unlikely to have any practical impact since State L2 will continue to apply Article 13(4) of the W1-L2 treaty and may still impose tax on the gain.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 13(4) will not apply because the underlying property is not located in State L1. Instead, Article 13(5) will apply and State L1 will be prevented from imposing any tax on the gain.

The winning residence state of the recipient (State W1): State W1 must continue to apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain and must provide relief in accordance with the W1-L2 treaty. State W1 will have no obligation to provide relief under either the W1-W2 treaty or the W1-L1 treaty since both State W2 and State L1 are prevented from imposing any tax under their respective treaties with State W1.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain. In relation to capital gains from the alienation of shares deriving their value from immovable property, however, this is unlikely to...

1646 Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of movable property forming part of the business property of a PE (para 2), and capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3).
have any practical impact since State W2 will continue to be entitled to impose tax under its treaty with State W1 and State L2 will continue to be prevented from imposing tax under its treaty with State W1. It could nevertheless have an impact if the relevant conditions of the treaties differ. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to capital gains dealt with under Article 13(4).

4.12. Capital gains from the alienation of other property

Article 13(5) deals with capital gains arising from the alienation of property not dealt with in the other paragraphs of Article 13 (referred to herein as “other property”). It provides that:

“Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.”

Thus, capital gains from the alienation of other property may only be taxed in the residence state of the person deriving the gain.

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, derives a capital gain from the disposal of other property from outside those two states. The amount giving rise to the gain is also paid by a dual resident, a person who is resident in State W2 and in State L2. The residence of the person deriving the gain is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. This situation is illustrated in the following diagram:

For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.12.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. For the purposes of both these treaties, Article 13(5) will apply and State W2 will be prevented from imposing tax on the gain.

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 13(5) will apply and State L2 will be prevented from imposing tax on the gain.

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. For the purposes of this treaty, Article 13(5) will apply and State L1 will be prevented from imposing tax on the gain.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain. Since State W2, State L2 and State L1 are all prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State W1. One issue which arises in this situation is that the source states, State W2 and State L2, will be bound by multiple treaty conditions in respect of the capital gain (i.e., their respective treaties with both State W1 and State L1). This is unlikely to have any
practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

4.11.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under Article 13(5) of the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Again, this is unlikely to have any practical impact since State L2 will continue to be prevented from imposing any tax under Article 13(5) of the W1-L2 treaty.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 13(5) will apply and State L1 will be prevented from imposing any tax on the gain.

The winning residence state of the recipient (State W1): State W1 must continue to apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain and will have no obligation to provide relief since State W2, State L2 and State L1 are all prevented from imposing any tax under their respective treaties with State W1.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same capital gain, however this is unlikely to have any practical impact since they will both continue to be prevented from imposing tax under their respective treaties with State W1. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to capital gains dealt with under Article 13(5).

4.13. Other income

Article 21, titled “other income,” applies to any income not dealt with elsewhere in the treaty. It provides that:

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

Thus, Article 21 does not allow any taxation of other income outside the residence state unless the income is attributable to a local PE, in which case Article 7 applies.

This section deals with a situation where a dual resident person, resident in State W1 and in State L1, receives other income from outside those two states. The income is also paid by a dual resident, a person resident in State W2 and State L2. The residence of the person deriving the gain is assigned to State W1 under the tie-breaker provision of the W1-L1 treaty, and the residence of the payor is assigned to State W2 under the tie-breaker provision of the W2-L2 treaty. This situation is illustrated in the following diagram:
For a more detailed discussion of dual resident triangular cases, refer to Chapter 10 (Section 10.4.). For a more detailed discussion of reverse dual resident triangular cases, refer to Chapter 12 (Section 12.3.).

4.13.1. Existing treaty framework

The winning residence state of the payor (State W2): State W2 must apply the conditions of both the W1-W2 treaty and the L1-W2 treaty. For the purposes of both these treaties, Article 21 will apply and State W2 will be prevented from imposing tax on the income.

The losing residence state of the payor (State L2): State L2 must apply the conditions of both the W1-L2 treaty and the L1-L2 treaty. For the purposes of both these treaties, Article 21 will apply and State L2 will be prevented from imposing tax on the income.

The losing residence state of the recipient (State L1): State L1 must apply the conditions of the W1-L1 treaty. For the purposes of this treaty, Article 21 will apply and State L1 will be prevented from imposing tax on the income.

The winning residence state of the recipient (State W1): State W1 must apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the income and, since State W2, State L2 and State L1 are all prevented from imposing tax under their respective treaties with State W1, State W1 will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State W1 and State W1 will therefore have no relief obligation. One issue which arises in this situation is that the source states, State W2 and State L2, will be bound by multiple treaty conditions in respect of the income (i.e., their respective treaties with both State W1 and State L1). This is unlikely to have any practical impact in most cases, but it could alter the source states’ ability to impose tax if the relevant conditions of the two treaties differ.

4.13.2. Application of proposed solutions

The winning residence state of the payor (State W2): State W2 must continue to apply the conditions of the W1-W2 treaty but no longer has to apply the L1-W2 treaty. This is unlikely to have any practical impact, however, since State W2 will continue to be prevented from imposing tax under Article 21 of the W1-W2 treaty.

The losing residence state of the payor (State L2): State L2 must continue to apply the conditions of the W1-L2 treaty but no longer has to apply the L1-L2 treaty. Again, this is unlikely to have any practical impact since State L2 will continue to be prevented from imposing any tax under Article 21 of the W1-L2 treaty.

The losing residence state of the recipient (State L1): State L1 will continue to apply the W1-L1 treaty. For the purposes of this treaty, Article 21 will apply and State L1 will be prevented from imposing any tax on the income.

The winning residence state of the recipient (State W1): State W1 must continue to apply the conditions of the W1-W2 treaty, the W1-L2 treaty and the W1-L1 treaty. State W1 may impose tax on the gain and will have no obligation to provide relief since State W2, State L2 and State L1 are all prevented from imposing any tax under their respective treaties with State W1.

Overview: The source states will now be subject only to the conditions of their respective treaties with State W1 and will no longer be obliged to apply their treaties with State L1. This means they are no longer subject to multiple treaty conditions in respect of the same income, however this is unlikely to
have any practical impact since they will both continue to be prevented from imposing tax under their respective treaties with State W1. Note that the fact that the payor is no longer considered resident in State L2 for treaty purposes has no impact in this situation, since the residence of the payor has no influence on the source state’s taxing rights in relation to income dealt with under Article 21.

4.14. Conclusions

This section has discussed a situation where a dual resident triangular case is combined with a reverse dual resident triangular case. The analysis above illustrates that the issues arising in this situation are generally the same as those arising in the basic triangular cases which it comprises. Reverse dual resident triangular cases only give rise to dual source-based taxation in relation to dividends and interest (and royalties where the applicable treaties differ from the OECD Model) and thus, dual source based taxation may only occur here where dividends, interest and royalties are involved. In all other cases, the outcome in this situation is essentially the same as the outcome in a dual resident triangular case (outlined in Chapter 10).

The primary issue in dual resident triangular cases is the application of multiple treaty conditions in the source state or states. Where this occurs, the source states can only meet their treaty obligations by applying the terms of the treaty that are most favourable to the person deriving the income (or capital gain). Preventing a dual resident from being resident in their losing residence state for the purposes of treaties between that state and third states ensures that the source states are not subject to multiple treaty conditions in relation to the income and capital gains derived by the dual resident. This means that the source states will only be subject to the conditions of their treaties with the state to which the dual resident’s residence is assigned under the tie-breaker provision of the treaty between the two residence states, i.e., the winning residence state. It also addresses concerns regarding improper access to the treaties concluded between the losing residence state and third states in situations where the losing residence state is prevented from imposing tax under the treaty between the two residence states.

This situation has also demonstrated the application of the proposed solution for reverse dual resident triangular cases. Under this proposed solution, a dual resident person would not be considered resident in the “losing” residence state for the purpose of treaties between that state and third states. As a result, any payments made by the dual resident are not considered to be paid by a resident of the losing residence state for the purposes of those treaties. This will only have an impact, however, in relation to categories of income for which there are distributive rules based on the residence of the payor, i.e., dividends, interest and royalties. With respect to other categories of income the residence (or non-residence) of the payor is generally irrelevant for the purposes of determining whether a particular state can impose source-based taxation. Thus, in most reverse dual resident triangular cases, the modification of the residence rules will have no impact on the application of the relevant treaties.

Finally, the analysis in this section has uncovered no special problems relating to the interaction of the proposed solutions for dual resident triangular cases and for reverse dual resident triangular cases, and no problems or issues which require special consideration. As mentioned above, the issues arising in the situations discussed in this section are generally the same as those arising in the relevant basic triangular cases.
Summary

Triangular Cases:

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

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. 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*

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:

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(iii) the treaty between the residence state and the source state (the “R-S treaty”); and  
(iv) 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, 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.1648 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”) generally not apply because PEs are not "persons" for treaty purposes and are thus not entitled to treaty benefits.1649

2.2. The residence state’s obligation to provide relief1650

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.1651 This gives rise to two main issues; (i) the 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).1652

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.1653 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.1654 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.1655

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.1656 This may occur either where the tax rate imposed in the residence state is simply higher than the

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1648 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.
1649 This is discussed in Chapter 2 (see Section 2.3).
1650 This aspect of PE triangular cases was discussed in Chapter 3.
1651 Refer to the analysis of PE triangular cases in Chapter 2. See also: OECD, "Triangular Cases," paras. 13 and 15.
1653 See, for example: OECD, "Triangular Cases," para 40.
1654 Refer to the analysis of PE triangular cases in Chapter 2.
1655 For a discussion of situations in which the residence state will and will not be able to provide sufficient relief, refer to Chapter 3 (Section 3.2).
total rate of tax imposed in the other two states or where the PE state grants relief for tax imposed in the source state. 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. 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. 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 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. 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. 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. 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.

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. 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. It has been argued, however, that for the purposes of applying this limitation only the tax

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1657 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).
1658 Refer to the analysis in Chapter 3 (Section 3.2.3).
1659 See, for example: OECD, "Triangular Cases," para 40.
1661 For further discussion, refer to the analysis in Chapter 3 (Section 3.2.1.).
1662 See, for example: Van Raad, K. "The 1992 OECD Model..."; Potgens, F.P.G., "The Netherlands Supreme Court..."; Zhai, G., "Triangular Cases..."
1664 OECD Model, Article 23A(2) and Article 23B(1).
1665 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.")
imposed under the domestic law of the residence state that should be considered.\textsuperscript{1666} 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 concluded by one of the parties with third states.\textsuperscript{1667} 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.\textsuperscript{1668} 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,\textsuperscript{1669} and it does not seem to be contrary to this purpose, or to the principle of good faith,\textsuperscript{1670} 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.\textsuperscript{1671}

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.\textsuperscript{1672} 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.\textsuperscript{1673} In addition, the amount of credit relief available under a tax treaty is commonly calculated by reference to domestic law calculation rules\textsuperscript{1674} 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.\textsuperscript{1675} Finally, treaty relief measures set the 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.\textsuperscript{1676} Thus no dual relief should be required. Nevertheless, for states that remain concerned about the risk of being obliged to grant dual relief...
relief there are certain measures which could be implemented to prevent such an obligation from arising. These are outlined in Chapter 3.1677

2.3. The PE state and non-discrimination principles1678

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.1679 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.1680 In addition, following the European Court of Justice (ECJ) decision in the Saint-Gobain case,1681 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).1682 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.1683 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.1684 If such relief is not extended to PEs, then 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.1685 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.1686 This will depend, however, on the comparison entity being entitled to relief under the treaty between the PE state and the source state.1687 Determining whether it would be entitled to such relief requires establishing the characteristics of the comparison entity and then hypothetically applying the PE-

1677 Refer to Section 3.3.8.
1678 This aspect of PE triangular cases is discussed in Chapter 4.
1679 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.).
1680 OECD, "Triangular Cases," para 30. For further discussion and examples see Chapter 4 (Section 4.2.2.1.).
1682 For further discussion, refer to Chapter 4 (Section 4.2.2.2. and 4.3.6.).
1683 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."
1687 For further discussion and analysis, refer to Chapter 4 (Section 4.3.3.2.).
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 (ii) it must be eligible for relief under the relief provision of the PE-S treaty. 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. 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. 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) 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. 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. 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. 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. 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 (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, 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). 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 that it would be 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

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. 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. 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. 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

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. Clearly a requirement for the PE state to grant relief under the PE-S treaty would promote the 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. 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

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. 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. This suggests that, in the context of treaty entitlement, the residence concept primarily aims to achieve two things: (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 from that state’s treaty network (even though they may not suffer any double taxation as a result). 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 straightforward, 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. Difficulties in determining treaty residence also arise, for example, in relation to partnerships and hybrid entities, collective investment vehicles, sovereign wealth funds, persons taxed on a

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1705 This is discussed in more detail in Chapter 5 (Section 5.2.3.).
1706 Article 1 provides that “This Convention shall apply to persons who are residents of one or both of the contracting states.” For a discussion of 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.
1708 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.
1710 For examples, see Section 5.2.3.3.
1711 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:
remittance basis\textsuperscript{1714} and dual residents.\textsuperscript{1715} 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.\textsuperscript{1716} In a treaty context, however, this means that corporate residence is often open to manipulation.\textsuperscript{1717} A company can be a resident of a particular state with little or no activity or economic presence in that state\textsuperscript{1718} 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 capacity to consume.\textsuperscript{1719} 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.\textsuperscript{1720} 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.\textsuperscript{1721} Thus, corporate residence effectively operates at least partly as a sourcing rule.\textsuperscript{1722} One implication of this is that corporate residence concepts and the PE concept have more in common than may appear at first sight.\textsuperscript{1723} 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.

\textit{Similarity between PE taxation and residence-based taxation}\textsuperscript{1724}

\textsuperscript{1714} OECD Commentary on Article 1, para. 26.1.

\textsuperscript{1715} 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).

\textsuperscript{1716} Vann, R., "'Liable to Tax' and Company Residence under Tax Treaties" bound in Maisto, G. (Ed.), \textit{Residence of Companies under Tax Treaties and EC Law}, (Amsterdam: IBFD, 2006), pp. 197-271 at p. 251 (Section 7.4.2.).

\textsuperscript{1717} Arnold, B.J., Sassville, J., & Zolt, M., "Summary of the Proceedings …" at p. 240.


\textsuperscript{1721} Schön, W., "International Tax Coordination… at p. 69; Fantozzi, A., Et al., "Round Table: The Issues, Conclusions and Summing Up" bound in \textit{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."


\textsuperscript{1723} 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.).

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.\footnote{The Assessment and Collection of Tax from Non-residents, IFA Cahiers de Droit Fiscal International, Vol. LXXa, (Deventer: Kluwer, 1985) at p 28.} 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.\footnote{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.} 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 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.\footnote{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.}

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.\footnote{2010 OECD Model, Article 11(5).} 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.\footnote{Martín Jiménez, A.J., García Prats, F.J., and Calderón Carrero, J.M., "Triangular Cases..." 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.} 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.\footnote{2010 OECD Model, Article 11(5).} 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.\footnote{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.} 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 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. 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. 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. 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. 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

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..." 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, 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," 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). The outcome of this analysis will be an allocation of assets, risks and capital to the PE. The second step in the AOA is to apply the OECD's Transfer Pricing

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1732 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.

1733 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...”

1734 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).

1735 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...”

1736 This is discussed in more detail in Chapter 5 (Section 5.2.4).

1737 2010 OECD Model, Article 7(2).


Guidelines (by analogy) to determine the appropriate remuneration for any dealings between the PE and other parts of the enterprise.\footnote{1741} 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.\footnote{1742} 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).\footnote{1743} 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.\footnote{1744} 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."\footnote{1745} 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).\footnote{1746} 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),\footnote{1747} which also brings the treatment of a PE conceptually closer to that of a separate enterprise.\footnote{1748} 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 attributable to the PE.\footnote{1749} 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\footnote{1750} 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

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**

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. 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 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. 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. 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. 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 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

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1751 This section provides a summary of the discussion in Chapter 6.
1752 This is discussed in more detail in Chapter 6 (Section 6.2.1. and Section 6.4.).
1755 This is discussed in more detail in Chapter 6 (Section 6.4.).
1756 Preventing taxation in the PE state is discussed in Chapter 6, Section 6.4.1.
1757 As outlined by: Vann, R., "Reflections on Business Profits...,” at p 147.
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. 1758

Alternatively, the source state could be prevented from taxing income which is attributable to a PE in a third state. 1759 This would effectively resolve the overlap in the sourcing rules in favour of the PE state. However, if 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 1760

The bilateral nature of tax treaties is frequently identified as the main cause of the issues arising in PE triangular cases. 1761 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. 1762 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. 1763 For example, all three states could be allowed to impose tax with the PE state and 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. 1764 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

1758 For an example of how this approach may lead to opportunities for tax avoidance, refer to Chapter 6 (Section 6.4.1.2).
1759 This is discussed in Chapter 6, Section 6.4.2.
1760 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases," para 1.
1761 Multilateral treaties are discussed in Chapter 6, Section 6.5.
1762 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.
1763 For more detailed discussion, see Chapter 6, Section 6.5.3.
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.\textsuperscript{1765} 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.\textsuperscript{1766} 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.\textsuperscript{1767} 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\textsuperscript{1768}

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 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\textsuperscript{1769}

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:

7. 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;

8. 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

\textsuperscript{1765} Arnold, B.J., Sasseville, J., and Zolt, M. "Summary of the Proceedings..."; Schön, W., "International Tax Coordination..."
\textsuperscript{1767} McIntyre, M.J., "Options for Greater..."
\textsuperscript{1768} This is discussed in more detail in Chapter 6 (Section 6.2.2.).
\textsuperscript{1769} 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).
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

9. 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.1770

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 potential for treaty shopping through PEs (which is discussed further below).1771 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 PEs1772

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:

5. 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.

6. 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 7.1773 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

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1770 Refer to Chapter 6 for a detailed discussion of these potential solutions for PE triangular cases.
1771 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).
1772 For further discussion of the possible approaches to extending treaty benefits to PEs, refer to Chapter 7 (Section 7.3.).
1773 Refer to Section 7.3.
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:

"(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
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, 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. 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. 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...”).

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

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. 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.

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1774 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.
1775 Refer to Chapter 8 (Section 8.2.5.) for a brief overview of the various terms used the OECD Model.
1776 See, for example: Yong, S., “Triangular Treaty Cases…”; Langoth, B., “Treaty Entitlement….”
1777 For further discussion, see Chapter 8 (Section 8.2.1.).
1778 For further discussion, see Chapter 8 (Section 8.2.2.).
1779 For further discussion refer to Chapter 8 (Section 8.2.3.).
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 and, in relation to dividends, interest and royalties, it must be the beneficial owner of the income. 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. 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.

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 and thus, the existence of a PE and the attribution of income to that PE should 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. 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.

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. Where a PE is claiming treaty benefits, the PE state should clearly be involved in this process, 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**

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 shopping under existing principles 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. 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, 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:** 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"):** 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:** 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 be determined by the contracting states, who may wish to

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1790 This was discussed in Chapter 5 (see Section 5.2.6.).
1791 Refer to the discussion of the ways in which states currently combat treaty shopping in Chapter 5 (Section 5.2.6.1.).
1792 Refer to the discussion in Chapter 5 (Section 5.2.6.2.).
1793 OECD Model on Article 1, paras. 13-26. These provisions are discussed in Chapter 8 (Section 8.4.).
1794 Refer to the discussion in Chapter 8, Section 8.4.2.
1795 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(c)).
1796 Refer to the discussion in Chapter 8 (Section 8.4.4.).
give further consideration to the types of activities or actions which would be taken into account when applying the provision.

Safe harbour provisions: 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

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.

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. 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. 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. 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:

5. The source state applies the conditions of the PE-S treaty in relation to that income; or

6. 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 to 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

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. 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. 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. 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.

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. 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. 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. If both these treaties apply then the source 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. 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

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1803 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.
1804 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.).
1805 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.).
1806 The place of effective management tie-breaker is discussed in Chapter 10, Section 10.3.3.1.
1807 Refer to Chapter 10 (Section 10.2.1.).
1808 Refer to the discussion in Chapter 10 (Section 10.4.).
1810 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";
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), 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).

3.1. Denial of treaty benefits under the second sentence of Article 4(1)

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. 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. 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. 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 the basis that they are subject to the tax system of the country and are only exempt because they meet certain criteria for exemption. 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. 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

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1812 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.

1813 This section gives an overview of the discussion in Chapter 10, Section 10.4.2.

1814 This is discussed in detail in Chapter 10, Section 10.4.2.1.


1816 This is discussed in detail in Chapter 10, Section 10.4.2.2.

1817 OECD Commentary to Article 4, paras 8.5 and 8.6.

1818 This is discussed in detail in Chapter 10, Section 10.4.2.3.
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.\textsuperscript{1819} 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 \textit{not sourced in that state} and, as a result, treaty benefits cannot be denied.\textsuperscript{1820} 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).\textsuperscript{1821} 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:

(iii) that it will apply (and thus treaty benefits will be denied) only if \textit{none} of the income taxable in the losing residence state can be considered to have a source outside that state; and

(iv) that it will apply (and thus treaty benefits will be denied) as long as \textit{all} the income taxable in the losing residence state can be considered to have its source in that state.

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 to 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\textsuperscript{1822}

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.\textsuperscript{1823} 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.


\textsuperscript{1820} Van Raad, K., "Dual Residence and the 1977...”; Van Raad, K., "2008 OECD Model...”

\textsuperscript{1821} Sasseville, J., "A Tax Treaty Perspective...”

\textsuperscript{1822} This section gives an overview of the discussion in Chapter 10, Section 10.4.3.

\textsuperscript{1823} 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 Treat...,” Chapter 6, Section 6.4.1.; Sasseville, J., "A Tax Treaty Perspective...,” Chapter 3, Section 3.4.
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.\footnote{Sasseville, J., "A Tax Treaty Perspective...," Chapter 3, Section 3.4.} However, in other cases it may potentially give rise to problems with the interaction between different provisions\footnote{For example, Cousin identifies various issues that may arise in relation to the interaction between the Canadian Section 250(5) and other provisions of Canadian law (Cousin, R., Corporate Residence..., at pp 213-218).} 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 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 unrelied 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, unrelied 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 unrelied 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

Reverse triangular cases can potentially result in dual source-based taxation of passive income. 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. 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

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. 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. 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. 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). 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.

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. 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

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1826 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.
1827 Refer to the analysis of reverse triangular cases involving different categories of income in Chapter 11.
1828 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.
1829 This section gives an overview of the discussion in Chapter 12, Section 12.2.
1830 Refer to Article 11(1) and Article 11(2) of the OECD Model.
1833 See, for example, Article 12(5) of the UN Model Treaty (2001).
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."1835 [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.1836 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.1837 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 cases1838

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.1839 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 and dual source-based taxation cannot effectively be prevented.1840 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.1841 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 1.1842 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.1843 Despite these issues, there is a strong argument that Article 10(5) could be used to prevent dual source based taxation of

1835 2010 OECD Commentary on Article 11, para 30.
1836 2010 OECD Commentary on Article 11, para 29.
1838 This section gives an overview of the discussion in Chapter 12, Section 12.3.
1839 Refer to the analysis of reverse triangular cases involving different categories of income in Chapter 11.
1840 Refer to the discussion in Chapter 12, Section 12.3.1.
1842 Refer to the discussion and analysis in Chapter 12 (Section 12.3.3.2.)
1843 Refer to the discussion and analysis in Chapter 12 (Section 12.3.3.1.)
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. 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).

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. States should be encouraged to implement such provisions, however 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. 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

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1844 Refer to the discussion in Chapter 12 (Section 12.3.2.).
1845 Refer also to the discussion of the second sentence of Article 4(1) in Chapter 10 (Section 10.4.2.).
1846 Refer to the discussion in Chapter 12 (Section 12.3.4.1.)
1847 Refer to the discussion in Chapter 12 (Section 12.3.4.2.)
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 between the residence state and the source state, it also ensures 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.

<table>
<thead>
<tr>
<th>Aim of the provision</th>
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| Preventing application of the R-S treaty:                 | "(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.

(3) This article shall apply to capital gains and profits in the same way as it applies to income.

(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 |
### Ensuring the residence state continues to have a relief obligation:

To ensure that the residence state continues to provide relief for tax imposed in the source state where necessary.

"(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."

### Extending treaty benefits to PEs:

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.

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.

Paragraph 2 ensures that treaty benefits are also available with respect to profits and capital gains attributable to the PE.

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.

See Chapter 8 (Section 8.2.) for discussion.

"(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."
Table: Preventing improper claims for treaty benefits by PEs:

<table>
<thead>
<tr>
<th>Description</th>
<th>Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preventing improper claims for treaty benefits by PEs:</td>
<td>Examples of provisions which could be included in tax treaties to prevent improper claims for treaty benefits by PEs, along with examples of safe harbour provisions to prevent the unreasonable denial of benefits. See Chapter 8 (Section 8.4.) for discussion.</td>
</tr>
<tr>
<td>Subject to tax provision:</td>
<td>&quot;Where this Convention applies under this article to income arising in a Contracting State and included in the income 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.&quot;</td>
</tr>
<tr>
<td>Anti-base erosion provision:</td>
<td>&quot;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.&quot;</td>
</tr>
<tr>
<td>Denial of treaty benefits where there is a tax avoidance motive:</td>
<td>&quot;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.&quot;</td>
</tr>
<tr>
<td>Safe harbour provisions:</td>
<td>&quot;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.&quot;</td>
</tr>
<tr>
<td>Activity provision:</td>
<td></td>
</tr>
</tbody>
</table>
Paragraphs X and Y 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 connected with such operations." |
| Amount of tax provision: | 
Paragraphs X and Y 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." |
| Alternative relief provision: | "[Paragraphs X and Y] shall not apply if the

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1848 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.

1849 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.
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.”

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.

<table>
<thead>
<tr>
<th>Aim of the provision</th>
<th>Suggested text</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Relief in the PE state:</strong></td>
<td>&quot;(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. (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 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. (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.”</td>
</tr>
<tr>
<td><strong>Preventing improper access to the R-S treaty:</strong></td>
<td>&quot;(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...&quot;</td>
</tr>
</tbody>
</table>

1850 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.
PE in a third state in situations which the contracting states consider to be improper. The suggested text is based on the wording of provisions included in many US treaties. See Chapter 7 (Section 7.5.1.) for discussion.

The 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) This article shall apply to capital gains and profits in the same way as it applies to income.

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.

<table>
<thead>
<tr>
<th>Aim of the provision</th>
<th>Suggested text</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dual-resident triangular cases and reverse dual-resident triangular cases: 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). See Chapter 11 (Section 11.3.2.) and Chapter 12 (Section 12.3.5.2.) for discussion. 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.</td>
<td>&quot;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.&quot;</td>
</tr>
<tr>
<td>Reverse dual resident triangular cases where there is no effective allocation of residence 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</td>
<td>“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</td>
</tr>
</tbody>
</table>
not assign residence to one state. 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).

See Chapter 11 (Section 11.3.2.) for discussion.

<table>
<thead>
<tr>
<th>Reverse PE triangular cases:</th>
<th>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].”</th>
</tr>
</thead>
</table>

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.

See Chapter 12 (Section 12.2.2.) for discussion.

"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 in a State other than that of which he is a resident, for the purposes of the treaty between the State of which he is resident and that other State, 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.”
Samenvatting proefschrift

**Triangular Cases:**

*De toepassing van bilaterale belastingverdragen in multilaterale situaties*

**Introductie**

Bilaterale belastingverdragen voorkomen niet altijd op een effectieve wijze dubbele belasting in situaties waarin meer dan twee landen betrokken zijn. Deze situaties worden "triangular cases" genoemd en ze ontstaan normaal gesproken waar een dual resident, of een persoon met een vaste inrichting ("VI")/permanent establishment ("PE") in een ander land, betrekkingen heeft met een inwoner van een derde land.

Er zijn vier standaard categorieën triangular cases die worden besproken in dit onderzoek, namelijk: (i) PE triangular cases; (ii) dual resident triangular cases; (iii) reverse PE triangular cases; en reverse dual resident triangular cases.

**Permanent Establishment ("PE") Triangular Cases**

PE triangular cases ontstaan wanneer een persoon die inwoner is van één staat (de "woonstaat" of "Staat W") inkomen verkrijgt vanuit een andere staat (de "brongaatst" of "Staat B") en dat inkomen is toe te rekenen aan een VI van de ontvanger in een derde staat (de "VI staat"). Deze situaties worden ook wel "typische" triangular cases genoemd, in het bijzonder wanneer zij zien op dividenden of interest.\footnote{Zie, bijvoorbeeld: OECD Committee on Fiscal Affairs, "Triangular Cases", in Model Tax Convention: Four Related Studies (Paris, OECD, 1992).} Een PE triangular case is in onderstaand diagram weergegeven.

Er zijn twee verdragen van toepassing in een PE triangular case; het verdrag tussen de woonstaat en de bronstaat (W-B verdrag) en het verdrag tussen de woonstaat en de VI staat (W-VI verdrag). Het verdrag tussen de VI staat en de bronstaat (VI-B verdrag) is in principe niet van toepassing omdat VI's geen "personen" zijn voor verdragsdoeleinden en daarom zijn zij in principe niet verdragsgerechtigd. Afhankelijk van het soort inkomen, de nationale wetgeving van de betreffende staten en de bepalingen in de relevante verdragen, is het mogelijk dat belasting over het inkomen wordt geheven in de bronstaat, de VI staat en de woonstaat.

**De verplichting van de woonstaat om voorkoming te verlenen**

In PE triangular cases kan de woonstaat de verplichting hebben onder het W-B verdrag om voorkoming te verlenen voor belasting geheven in de bronstaat terwijl het ook de verplichting kan hebben onder het W-VI verdrag om voorkoming te verlenen voor belasting geheven in de VI staat. Dit leidt tot twee issues. Het eerste issue betreft de vraag in hoeverre de woonstaat de dubbele belasting volledig kan voorkomen; waar belasting wordt geheven in de bronstaat en de VI staat is het mogelijk dat de woonstaat niet voldoende voorkoming kan verlenen om de dubbele belasting op te heffen. Het tweede issue is dat de verplichtingen van de woonstaat onder de verdragen met de bronstaat en de VI staat er toe kan leiden dat de woonstaat twee keer voorkoming dient te verlenen. Dit is het geval indien één verdrag (bijvoorbeeld
het W-VI verdrag) bepaald dat de woonstaat een vrijstelling dient te geven voor het inkomen dat kan worden toegerekend aan de VI staat en het andere verdrag (W-B verdrag) de woonstaat de verplichting oplegt om een verrekening te geven voor de belasting geheven in de bronstaat. In dat geval kan de woonstaat slechts aan zijn verplichtingen onder beide verdragen voldoen indien het zowel een voorkoming verleent voor dit inkomen alsmede een verrekening van dit inkomen toestaat. Dit leidt vanzelfsprekend tot een issue en betekent in feite dat de woonstaat een vermindering van belasting over ander inkomen dient te geven. Aan de andere kant, en dit is mijn inziens correct, indien de vrijstelling van het inkomen in aanmerking wordt genomen bij het bepalen van het bedrag dat verreken kan worden op basis van het andere verdrag, dan hoeft feitelijk geen verrekening te worden gegeven. Zelfs wanneer de vrijstelling op basis van het verdrag niet in aanmerking zou worden genomen, zijn er diverse redenen waarom de woonstaat geen dubbele voorkoming hoeft te verlenen.

**De VI staat en het non-discriminatie principe**

Voorzover de VI staat belasting heft over het inkomen in een PE triangular case, zou de VI staat voorkoming moeten verlenen voor de belasting geheven over dit inkomen in de bronstaat; zowel om zeker te stellen dat dubbele belasting kan worden voorkomen, alsmede om de correcte verdeling van de belastingopbrengsten tussen de VI staat en de woonstaat te waarborgen. Aangezien VI's in principe geen toegang hebben tot verdragen, bestaat er geen verplichting voor de VI staat om voorkoming te verlenen onder het VI-B verdrag. De VI staat kan echter een verplichting hebben om voorkoming van belasting te verlenen onder het non-discriminatie artikel in het verdrag tussen de VI staat en de woonstaat, welke bepaalt dat een VI niet nadeliger mag worden behandeld dan een lokale vennootschap. De reikwijdte van deze bepaling is onderwerp van veel discussie; het is vrij duidelijk dat de VI staat verplicht is om voorkoming die volgt uit haar nationale wetgeving ook te verlenen aan VIs, maar er is geen algemene consensus met betrekking tot de vraag of de VI staat ook voorkoming dient te verlenen die volgt uit het verdrag tussen de VI staat en de bronstaat. In plaats van de verplichting om voorkoming te verlenen op basis van het algemene principe van non-discriminatie, zou het de voorkeur hebben om de VI staat een directe verplichting te geven om voorkoming te verlenen.

**Beperking van het heffingsrecht van de bronstaat**

Op basis van de bestaande leer omtrent verdragstoepassing dient de belastingheffing over inkomen in de bronstaat in een PE triangular case te voldoen aan de bepalingen uit het verdrag tussen de woonstaat en de bronstaat (W-B verdrag). De bronstaat is niet verplicht om de bepalingen uit het verdrag tussen de VI staat en de bronstaat (VI-B verdrag) toe te passen, ondanks dat het W-VI verdrag het primaire (en wellicht volledige) heffingsrecht toewijst aan de VI staat. Diverse auteurs hebben daarom voorgesteld dat de bronstaat een verplichting heeft om de vrijstelling op basis van het W-B verdrag, maar de bepalingen uit het VI-B verdrag zouden moeten worden toegestaan door de VI staat.
Onderliggende thesis onderzoekt deze positie, waarbij ook in aanmerking wordt genomen waarom staten belastingverdragen afsluiten en akkoord gaan met verlaagde belastingtarieven op broninkomsten, de eigenschappen van VI's, de behandeling van VI's onder nationale wetgeving alsmede onder belastingverdragen en de "separate entity approach" om te bepalen wat de winst is die kan worden toegerekend aan een VI (op basis van de nieuwe "Authorized OECD Approach").

PE triangular cases kunnen ook leiden tot vragen omtrent niet bedoelde toepassing van het verdrag tussen de woonstaat en de bronstaat (het W-B verdrag). Een inwoner van de woonstaat kan namelijk een lager bronbelasting tarief claimen onder het W-B verdrag met betrekking tot inkomen dat is vrijgesteld van belasting in de woonstaat (omdat het toerekenbaar is aan een VI in een derde staat) terwijl dit inkomen niet of laag belast is in de VI staat.1856 In deze situatie zou de bronstaat het toepassen van het W-B verdrag als misbruik kunnen zien.

**Toepassing van het verdrag tussen de VI staat en de bronstaat**

Het heeft de voorkeur om de problemen die zien op triangular cases op te lossen door het verdrag tussen de VI staat en de bronstaat toe te passen en om het verdrag tussen de woonstaat en de bronstaat buiten werking te laten. Over het algemeen zou deze benadering de problemen omtrent PE triangular cases op de volgende manier oplossen:

1. De bronstaat past de bepalingen van het VI-B verdrag toe met betrekking tot het inkomen dat toerekenbaar is aan de VI, in plaats van de bepalingen van het W-B verdrag. De bronstaat past derhalve de verdragsbepalingen toe die beter aansluiten bij het heffingsrecht omtrent het inkomen.

2. De VI staat dient voorkoming te verlenen door middel van de vrijstellings- of de verrekeningsmethode voor belasting geheven in de bronstaat. Deze voorkoming in de VI staat zou er in het algemeen voor moeten zorgen dat er geen dubbele belasting wordt geheven (in samenwerking met de voorkoming in de woonstaat).

3. De woonstaat geeft voorkoming voorzover dit noodzakelijk is om dubbele belasting te voorkomen. Afhankelijk van de bepalingen in de relevante verdragen en het soort inkomen kan de voorkoming de vorm hebben van een vrijstelling of een verrekening.

Het zou een enorme afwijking van de bestaande principes omtrent verdragstoepassing zijn indien VI's verdragsvoordelen zouden kunnen claimen. Echter, gezien het hybride karakter van VI's en de vergelijkbaarheid van de belastingheffing van VI's en die van belastbare lichamen, zouden de gevolgen van deze benadering wellicht minder groot zijn dan men op het eerste gezicht denkt. Het zou in ieder geval minder afwijken van de bestaande principes dan een andere oplossing, namelijk het afsluiten van multilaterale verdragen. Daarnaast heeft het ook minder verstrekende gevolgen met betrekking tot de verdeling van heffingsrechten dan een oplossing die voorkomt dat de VI staat of de bronstaat belasting kan heffen over het inkomen in PE triangular cases.

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Een van de grote zorgen die deze benadering met zich meebrengt is de mogelijkheid tot belastingontwijking, en, in het bijzonder, de mogelijkheid tot treaty shopping door middel van vaste inrichtingen.\textsuperscript{1857} Staten hebben moeite om treaty shopping onder de bestaande verdragsprincipes te voorkomen en het is daarom begrijpelijk dat ze wat onwillig staan tegenover een nieuwe mogelijkheid om oneigenlijk verdragsvoordelen te claimen. Deze thesis zal daarom ook ingaan op de mogelijkheden om oneigenlijk gebruik te maken van verdragen via VI's wanneer deze verdragsgerechtigd zouden worden. Hierbij zal rekening worden gehouden met de manier waarop staten momenteel oneigenlijk gebruik van verdragen proberen te voorkomen, het gebrek aan civielrechtelijke gevolgen van interne transacties, de economische basis voor het toerekenen van winsten aan een VI onder de Authorized OECD Approach en de impact van de algemene belastingheffing van VI's. Op basis van deze overwegingen lijkt het risico op treaty shopping door middel van VI's ten opzichte van die benadering niet zo groot te zijn. Het gerechtvaardigd is om het uitbreiden van verdragsgerechtigdheid tot VI's af te wijzen. Het risico van treaty shopping kan verder worden beperkt door bepaalde bepalingen in verdragen op te nemen die voorkomen dat VI's verdragsvoordelen verkrijgen in situaties waar dit niet de bedoeling is.

\textit{Dual Resident Triangular Cases}

Dual resident triangular cases vinden plaats wanneer een persoon, die voor belastingdoeleinden inwoner is van twee staten (dual resident), inkomen ontvangt vanuit een derde staat (de "bronstaat"). Dit is weergegeven in onderstaand diagram.

\begin{center}
\begin{tikzpicture}
  \node (woonplaats) at (0,0) {Woonplaats};
  \node (staatB) at (3,1) {Staat B};
  \node (inkomen) at (3,-1) {Inkomen};
  \draw[->] (woonplaats) -- (staatB);
  \draw[->] (woonplaats) -- (inkomen);
  \end{tikzpicture}
\end{center}

De woonplaats wordt voor verdragsdoeleinden bepaald op basis van Artikel 4 (of haar equivalent) en hangt normaal gesproken af van de woonplaatsbepalingen onder nationaal recht. Daardoor kan een persoon een dual resident zijn voor verdragsdoeleinden wanneer deze persoon in twee verschillende staten op basis van nationaal recht als inwoner wordt aangemerkt. Artikel 4 van het verdrag tussen de twee woonstaten bevat een "tie-breaker" regeling, die bedoeld is om de woonplaats van een dual resident toe te wijzen aan één van de twee woonstaten (Artikel 4 (2) en Artikel 4(3)). Echter, in sommige situaties werkt de tie-breaker regeling niet voldoende effectief en kan de persoon nog steeds dual resident zijn voor verdragsdoeleinden.

Of dubbele belasting ontstaat in dual-resident triangular cases hangt af van het soort inkomen dat wordt ontvangen. In veel gevallen zal, onder de bepalingen in het verdrag tussen de twee woonstaten, de staat aan wie de woonplaats niet is toegewezen (de verliezende woonstaat), geen belasting kunnen heffen over inkomen dat afkomstig is uit derde staten.

Een belangrijk issue in dual resident situaties is de mogelijkheid voor de dual resident om verdragsvoordelen te claimen onder verdragen afgesloten tussen de verliezende woonstaat en derde staten. Indien de dual resident gerechtigd is tot verdragen afgesloten onder de verdragen die afgesloten door beide woonstaten met de bronstaat, dan kan de bronstaat slechts aan haar verdragsverplichtingen voldoen indien zij de voorbelastingplichtige meest gunstige verdragsbepalingen toepast.\textsuperscript{1858} Dit kan leiden tot significante issues omtrent de mogelijkheid tot belastingontwijking omdat de bronstaat gehouden kan zijn de bepalingen uit te voeren.

\textsuperscript{1857} Het rapport uit 1992 van de OECD met betrekking tot PE triangular cases vermeld dat "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", in \textit{Model Tax Convention: Four Related Studies} (Paris, OECD, 1992), para 39).

het verdrag met de verliezende woonstaat toe te passen terwijl die staat geen heffingsrecht heeft onder het verdrag tussen de twee woonstaten.

De toewijzing van de woonplaats onder het verdrag tussen de twee woonstaten is over het algemeen slechts bepalend voor het verdrag tussen deze twee staten. De woonplaats dient voor ieder verdrag onafhankelijk te worden bepaald op basis van Artikel 4 van dat verdrag, dat wil zeggen, refererend aan de woonplaatsbepalingen onder de nationale wetgeving. Echter, het OECD commentaar stelt dat de dual resident geen inwoner is van de verliezende woonstaat voor de verdragen met derde staten. Het OECD commentaar baseert dit op de tweede zin van Artikel 4(1), welke bepaalt dat een persoon geen inwoner is van een bepaalde staat indien zij slechts belastingplichtig is in die staat met betrekking tot broninkomsten of kapitaal gelegen in die staat ("liable to tax in that State in respect only of sources in that State or capital situated therein."). De zienswijze vermeld in het OECD commentaar is dat de dual resident slechts belast is in de verliezende woonstaat voorover het inkomen heeft uit bronnen gelegen in die staat als een gevolg van de beperkingen opgelegd onder het verdrag tussen beide woonstaten. Deze benadering is controversieel, echter, wordt tot in detail besproken samen met de alternatieve benaderingen om verdragsgerechtigdheid te beperken voor dual residents.

**Reverse PE Triangular Cases**

Reverse PE triangular cases vinden plaats wanneer een vennootschap, die inwoner is van één staat (de "hoofdkantoor staat"), een bedrag betaald dat onderdeel is van het inkomen van een inwoner in een tweede staat (de "ontvanger staat"), en dit bedrag ontstaat in een VI van de betalende vennootschap in een derde staat (de "VI staat"). Dit is weergegeven in onderstaand diagram.

![Diagram Reverse PE Triangular Cases](https://example.com/diagram.png)

In een reverse PE triangular case, zouden zowel de woonstaat van de betaler alsmede de VI staat belasting kunnen proberen te heffen. In het algemeen, aannemende dat zowel de woonstaat als de VI staat van de betaler een verdrag hebben afgesloten met de de woonstaat van de ontvanger, zal slechts één van deze staten gerechtigd zijn tot het heffen van belasting. Echter, in het geval van interest, kunnen beide staten wellicht gerechtigd zijn tot het heffen van belasting op basis van Artikel 11 van de respectievelijke verdragen met de woonstaat van de ontvanger. Dubbele belasting aan de bron kan ook ontstaan in het geval van royalties indien de betreffende verdragen afwijken van het OECD Modelverdrag waar het betreft de gerechtigdheid om belasting te heffen in het bronland. Voorzover zowel de hoofdkantoor staat als de VI staat belasting mogen heffen zal de woonstaat van de ontvanger in principe voorkoming moeten verlenen onder de verdragen afgesloten met beide andere staten. Indien belasting wordt geheven in beide bronlanden, dan kan het echter voorkomen dat de woonstaat van de ontvanger niet voldoende voorkoming kan verlenen om dubbele belasting te vermijden.

**Reverse Dual Resident Triangular Cases**

Reverse dual resident triangular cases vinden plaats waar een dual resident vennootschap een bedrag betaald dat onderdeel uitmaakt van het inkomen van een inwoner van een derde staat. Dit is weergegeven in onderstaand diagram.

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1859 2010 OECD Commentaar bij Artikel 4, para 8.2
In een reverse dual resident triangular case zouden beide woonstaten van de dual resident betaler, belasting kunnen proberen te heffen aangezien de betaling is verricht door een inwoner. Echter, dubbele belasting aan de bron kan in principe slechts plaatsvinden in situaties waar de verdragen tussen de woonstaten van de betaler en de woonstaat van de ontvanger de heffing van belasting aan de bron toelaten wanneer betaald wordt aan een inwoner van de andere staat. Dit is normaal gesproken slechts van toepassing op dividenden, interest en royalties.

De tie-breaker regeling van Artikel 4 van het verdrag tussen de twee woonstaten van de dual resident zal normaal gesproken de woonplaats van deze dual resident toewijzen aan één van de twee staten. In dit geval lijkt het redelijk dat de staat aan wie de woonplaats niet wordt toegewezen (de verliezende woonstaat) ook geen heffingsrecht zal hebben aangezien de betaling niet langer plaatsvindt door een inwoner van haar staat. Echter, de toewijzing van de woonstaat onder de tie-breaker bepaling werkt wellicht niet door naar de verdragen die de woonstaten van de betaler hebben afgesloten met de woonstaat van de ontvanger, waardoor de dual resident nog steeds een inwoner is van zijn beide woonstaten onder deze verdragen. Met als gevolg dat deze bronlanden beide gerechtigd kunnen zijn tot het heffen van belasting op basis van Artikel 10, Artikel 11 of Artikel 12 (indien van toepassing) van de betreffende verdragen met de woonstaat van de ontvanger. Voorzover beide bronlanden inderdaad belasting heffen over dit inkomen zal de woonstaat van de ontvanger in principe gehouden zijn om voorkoming te verlenen, echter, deze staat kan wellicht niet voldoende voorkoming verlenen om dubbele belasting te voorkomen.
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