Triangular cases: The application of bilateral tax treaties in multilateral situations
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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 nature of the 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

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25 See, for example: Zhai, G., "Triangular Cases..."; Yong, S., "Triangular Treaty Cases...."
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 Management International Forum 2, (2002), pp. 3-51.
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.

\textit{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. 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

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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 that 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

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.

\(^{49}\) 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.

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 unresolved 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 unresolved 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, interest, royalties, capital gains from the alienation of movable property forming part of the business property of a PE, and other income. 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 unresolved double taxation that does occur. In relation to other categories of income (such as income from immovable property and income from shipping and air transport) 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 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.59 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,60 while others have put forward arguments in support of it.61 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 law 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)), 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. 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, 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. 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 Pappalardo 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). Article 6(2) provides that "[t]he 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. 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...
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.\textsuperscript{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."\textsuperscript{71}

A similar argument to that of Scandone and Pappalardo was presented by Papotti and Saccardo,\textsuperscript{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,\textsuperscript{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.\textsuperscript{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.

\textsuperscript{70} Arnold, B.J., "At Sixes and Sevens….”
\textsuperscript{71} OECD Commentary on Article 6, para. 4.
\textsuperscript{72} Papotti, R., & Saccardo, N., "Interaction of Articles….”
\textsuperscript{73} Arnold, B.J., "At Sixes and Sevens….”
\textsuperscript{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. He 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 Rust, A., "Situs Principle….”

76 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, 

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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.

**Figure 2.8:** PE triangular case involving income from shipping, inland waterways transport and air transport

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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.

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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 showing PE triangular case](image)

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.88 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...."
Figure 2.12.: PE triangular case involving capital gains from the alienation of shares in a real estate company

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

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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). Under 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 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

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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

![Diagram](image)

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

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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.