Triangular cases: The application of bilateral tax treaties in multilateral situations
Fett, E.E.

Citation for published version (APA):
Fett, E. E. (2013). Triangular cases: The application of bilateral tax treaties in multilateral situations

General rights
It is not permitted to download or to forward/distribute the text or part of it without the consent of the author(s) and/or copyright holder(s), other than for strictly personal, individual use, unless the work is under an open content license (like Creative Commons).

Disclaimer/Complaints regulations
If you believe that digital publication of certain material infringes any of your rights or (privacy) interests, please let the Library know, stating your reasons. In case of a legitimate complaint, the Library will make the material inaccessible and/or remove it from the website. Please Ask the Library: http://uba.uva.nl/en/contact, or a letter to: Library of the University of Amsterdam, Secretariat, Singel 425, 1012 WP Amsterdam, The Netherlands. You will be contacted as soon as possible.

Download date: 10 Dec 2018
Chapter 3

Double taxation relief in the residence state

3.1. Introduction

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

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

3.1.1. Methods of relieving double taxation

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

---

94 This Chapter deals only with typical PE triangular cases. The implications of dual-source based taxation in reverse triangular cases will be discussed in Chapter 11.


96 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases", para 40.

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

98 Refer to the analysis in Chapter 2, for further detail.

99 Relief may also be provided by allowing the foreign tax as a deduction from income (the deduction method), but this method can result in a high overall tax burden on foreign income and is not widely accepted. Where it is used, the deduction method is often a fallback which is available if, for example, no credit is allowed under the foreign tax credit provisions. (See: Vann, R., "International Aspects..." at p. 757.) Given that it is not generally used in tax
which of these methods is the most appropriate, based on the concepts of capital import neutrality (supporting the exemption method) and capital export neutrality (supporting the credit method). In practice, many states use a combination of methods in their domestic law, with the applicable method often depending on the circumstances and the type of income involved. Both methods of relief are also used in income tax treaties, as reflected in the two alternative relief provisions in the OECD Model. The first of these, Article 23A, provides for exemption relief in most cases but provides for the credit method in relation to income falling under the distributive rules of Article 10 (dividends) and Article 11 (interest). Article 23B requires the residence state to provide relief using the credit method regardless of the type of income involved.

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

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

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

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

If the residence state exempts the income attributable to the PE in a PE triangular case, then it is generally considered to be incapable of fully relieving double taxation unless relief is also granted in the PE state. Even though the residence state does not impose any tax on the income, the income has still treaties and is not commonly used in domestic law, the deduction method will not be discussed further in this chapter.

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


102 Article 23A, para 2 provides: "Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 [dividends] and 11 [interest], may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State." To the extent that the treaty allows source-based taxation of royalties, the credit method usually also applies to royalty income.

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

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

105 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases," para 40.
been taxed in two different states (i.e., the source state and the PE state) without relief being provided in either of those states. This conclusion is questionable, however, in a situation where the rates of tax imposed in the two source states (i.e., the source state and the PE state) are, in aggregate, lower than the applicable tax rate in the residence state. This is because if the residence state had applied the credit method in this situation, then it would have been able to credit the entire amount of the tax imposed in the two source states and thus, would generally be considered to have prevented double taxation.\textsuperscript{106} Given that the outcome is the same when the residence state exempts the income (and in fact, less tax may even be imposed overall), it does not seem reasonable to reach a different conclusion simply because the residence state grants relief using the exemption method instead of the credit method. The contrary argument is that if it were merely a bilateral situation involving, say, the source state and the PE state without the residence state being involved, then there would clearly be unrelieved double taxation in the absence of relief in the PE state (i.e., tax imposed in the source state and the PE state with no relief). The question then, is how the successful relief of juridical double taxation should be determined in multilateral situations.\textsuperscript{107}

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


\textsuperscript{107} According to the OECD Commentary, juridical double taxation occurs "... where the same income or capital is taxable in the hands of the same person by more than one state." (OECD Commentary on Articles 23A and 23B, paras 1 and 2.) While this provides a clear definition of juridical double taxation, it does not address how relief of such double taxation should be assessed, particularly in situations involving more than two states.

\textsuperscript{108} The main difficulty with applying this definition arises from the effect of reductions in the rate of source based taxation under tax treaties, i.e., with respect to passive income. For the purposes of the following discussion, this definition will be applied on the basis that double taxation is only relieved if the total amount of tax imposed is equal to (or less than) the highest of the three applicable rates, as determined after the application of tax treaties. However, where passive income is involved and a treaty limits the rate of tax the source state may impose, that reduction in source-based tax also serves to limit double taxation. Thus, in certain situations, the available relief may be considered to be sufficient if the pre-treaty tax rates are used to apply the definition, but not if after-treaty tax rates are used. This will generally only occur if the pre-treaty rate in the source state is greater than the applicable tax rates in the PE state and the residence state, and thus becomes the reference rate. In most cases, however, it will not make any difference to the analysis.

\textsuperscript{109} Note that according to the suggested definition, the deduction method would not generally be capable of preventing unrelieved double taxation. Given that the deduction method is not widely accepted (Vann, R., "International Aspects…", at p. 757), this is not considered fatal to applying such a definition.

\textsuperscript{110} Assuming the income in question is the only income earned by the company and the company has no deductible expenses.
definition, there would only be unrelieved double taxation to the extent that the overall tax burden imposed on the income exceeds 30% (i.e., the highest of the three applicable tax rates).\footnote{Note that in this example, double taxation can only be prevented if the PE state grants relief. The residence state is not in a position to fully relieve double taxation. If, however, the rate in the source state was 5%, the rate in the PE state was 25%, then the residence state (with its tax rate of 25%) would be able to fully relieve double taxation.}

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

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

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

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

#### 3.2.2.1. Relative tax rates

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

**Example:**

Assume that a company resident in State R earns interest income of $100 in a PE triangular case. The interest is the company’s only income and the company has no expenses. Both State S and State PE impose tax on the income at a rate of 10%. State R imposes tax on the income at a rate of either (i) 30% or (ii) 15%. It is assumed that the PE state does not grant any relief for tax imposed in the source state. It
is also assumed that the residence state applies a gross-up for the tax imposed in the source state and PE state when calculating the company's tax liability. This situation is illustrated in the following diagram.

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

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

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

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

3.2.2.2. Relief in the PE state

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

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

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

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

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

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

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

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

---

is less than the applicable tax rate in the residence state, and the residence state uses the credit method of relief, then the relief in the PE state has no impact on the overall tax burden imposed on the income.113

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

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

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

3.2.3.1. Domestic credit limitations

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

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

---

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

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

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

1. **Full credit:** If a full credit is available, foreign taxes on foreign income can be offset not only against domestic taxes on foreign income but also against domestic taxes on domestic income.\(^{116}\) Very few countries allow a full credit.\(^{117}\)

2. **Overall/worldwide limitation:** Typically, the amount of credit relief is limited to the domestic tax payable in relation to foreign income.\(^{118}\) This is known as an overall or worldwide limitation, and is intended to prevent foreign tax credits from being used to offset tax imposed on domestic income.

3. **Country-by-country limitation:** Some states apply a country-by-country limitation, whereby the credit for tax imposed in a particular country is limited to the domestic tax imposed on income from sources in that country;\(^{119}\) this method prevents averaging between high and low tax countries, but does not prevent the averaging of tax rates with respect to high-taxed and low-taxed categories of income from the same country.\(^{120}\)

4. **Item-by-item limitation:** Another limitation that applies in some countries is what is known as an item-by-item limitation, or "basket" system, whereby the credit for tax imposed on a certain category of income (such as passive income) is limited to the amount of domestic tax imposed on income of that type from all foreign sources.\(^{121}\) This type of system prevents averaging of tax rates between high-taxed and low-taxed categories of income, but does not prevent averaging of tax rates between high tax and low tax countries.\(^{122}\)

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

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

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

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

\(^{116}\) OECD Commentary on Articles 23A and 23B, para 16.
\(^{119}\) One issue which may arise in triangular cases in relation to a country-by-country limitation is which country the income should be attributed to for the purposes of the limitation (i.e., the PE state or the source state), given that the income effectively has a dual source. This is, of course, a matter for the domestic law of the residence state. One possibility is that the residence state would apply its own source rules to determine the source of the income for the purposes of the credit limitation. In this case, the tax imposed in the other source state (i.e., the state where the income is not considered to be sourced) would not be creditable unless other low-taxed income were derived from sources in that state. To the extent source-based taxation is not creditable, there will generally be unrelieved double taxation. Conversely, if the income is included in the calculation of the credit limit for both the PE state and the source state, then arguably, the calculation of the credit limit would allow too high a credit because the foreign income is being double counted for the purposes of the limitation. This may effectively allow the foreign tax credit to be offset against domestic income.
\(^{120}\) Rohatgi, R., *Basic International Taxation*, at p. 284.
\(^{123}\) Rohatgi, R., *Basic International Taxation*, at p. 284.
sharing of tax revenues between the states involved, particularly between the residence state and the PE state, because the residence state is effectively reducing the amount of tax it collects in relation to other income.\textsuperscript{124} Therefore, to ensure an equitable sharing of tax revenues, it would be desirable for the PE state to provide relief for tax imposed in the source state even if the residence state would be able to fully relieve double taxation based on the application of its domestic credit limitation provisions.

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

If the company earning income in a triangular situation is resident in a state that allows excess foreign tax credits to be carried forward to future income years or back to prior income years\textsuperscript{125} then it may be possible for the residence state to fully relieve double taxation in circumstances where it would not otherwise be able to do so. That is, it may be able to credit all the tax imposed in the source state and the PE state even where the combined rate of tax\textsuperscript{126} imposed in the source state and the PE state is higher than the rate of tax imposed in the residence state.\textsuperscript{127} This would occur if the company had other foreign income in the carry-forward or carry-back period that was either not subject to foreign tax or was subject to foreign tax at a rate lower than the applicable rate in the residence state (assuming the residence state applies an "overall limitation"). In this case, there would be residual domestic tax imposed on the foreign income of a later (or prior) year in the residence state against which the excess foreign tax credits arising in the triangular situation could be offset. Again, this may allow the residence state to fully relieve double taxation in a situation where the overall rate of tax imposed in the source states is higher than the rate applicable in the residence state and the PE state provides no relief. However, this would not result in an equitable distribution of tax revenues between the residence state and the PE state because the residence state would effectively be reducing the amount of tax it collects in relation to income derived from other sources.

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

### 3.2.3.3. Impact of losses

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

\textsuperscript{124} A residence state which uses the credit method and allows credits to be offset against the tax imposed on other income will generally collect less tax overall than if it had simply exempted the income arising in the PE triangular case.

\textsuperscript{125} Rohatgi, R., \textit{Basic International Taxation}, at p. 286.

\textsuperscript{126} As mentioned above, any references to tax rates or to the overall tax burden refer to the effective rate of tax on the net income (after deductible expenses); this is not necessarily the same as the statutory tax rate which may be imposed on the gross amount of the income. In many situations involving passive income, such as dividends and interest, source-based taxation may be imposed by way of a final withholding tax on the gross amount of the income and the limits on source state taxation of such income in tax treaties are also generally based on the rate of tax that can be imposed on gross income. When expenses are taken into account, this can result in a very high effective tax rate and it is this effective tax rate that is relevant for determining whether there is any unrelieved double taxation. In addition, if one of the states (e.g., the residence state) imposes tax using a progressive rate scale, a reference to the tax rate should also be read as a reference to the effective tax rate on the net amount of the income, i.e., the average rate that applies to that income. It is also possible that the tax imposed in the source state will exceed the amount of net income in the residence state; in this case the residence state is clearly unable to prevent unrelieved double taxation (regardless of whether it is a bilateral or triangular situation). This type of unrelieved double taxation could only be prevented by sufficiently reducing (or perhaps eliminating) the tax imposed in the source state. Further discussion of this issue is beyond the scope of this thesis.

\textsuperscript{127} Creus, J., & De Jong, D., "Dividends Paid by..." at p. 169.
reduce the amount of losses which are available for carry forward to future income years. To the extent that those losses could have been used in later income years, this effectively results in the income arising in the PE triangular case increasing the tax burden in those years and may effectively result in unrelieved double taxation. This issue also arises in bilateral situations and in order for it to be resolved, the residence state must somehow take into account the inability of the recipient of the income to use the credits (e.g., by allowing unused credits to be carried forward). This issue does not arise where the residence state uses the exemption method, because the exempt income would typically not reduce the losses available for carry forward.

3.2.4. Conclusion

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

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

3.3. Potential obligation to provide dual relief

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

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

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

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

\textbf{3.3.1. Dutch case law}

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

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

---

\begin{footnotesize}
\begin{itemize}
\item The OECD report on triangular cases indicates that most states, in the position of the residence state, would not consider themselves bound to provide a credit for tax imposed in the source state if the income of the PE is exempt under the treaty with the PE state.\textsuperscript{131} In addition, the issue of dual-relief in the residence state in a PE triangular situation was raised in two cases in the Netherlands, one in 2002\textsuperscript{132} and the other in 2007,\textsuperscript{133} and in both these cases it was decided that no credit was required. These cases (which will be discussed in Section 3.3.1.) may seem to settle the matter, but the reasoning behind these decisions (if not the reasonableness of the result) has been subject to criticism\textsuperscript{134} and this issue is generally regarded as an open one in the literature.\textsuperscript{135}

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

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

\textbf{3.3.1. Dutch case law}

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

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

---

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

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

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

---

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

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

"It could be questioned whether the approach of the Supreme Court is entirely accurate from the perspective of the Vienna Convention on the Law of Treaties (hereinafter: the Vienna Convention). Art. 31 of the Vienna Convention clearly takes the wording of the treaty provision as a point of departure. Even though the outcome reached by the Supreme Court is reasonable, in that it permits the purpose of a treaty to prevail on its wording, it could be regarded as being tantamount to a teleological interpretation, which is not fully in alignment with Art. 31 of the Vienna Convention." 142

This point was first raised in 2002 in relation to the Japanese Royalties case.143 The relief provisions required the Netherlands to grant a credit to the extent that the income was included in the "taxable base" in the Netherlands; due to the way in which the exemption operated in the Netherlands (i.e., a "tax exemption"), the income was in actual fact still included in the taxable base despite the treaty exemption. From a mechanical perspective, the exemption effectively operated in the same way as a credit. Various authors have noted that a literal interpretation of the wording of the taxable base requirement would seem to support the granting of the tax credits (i.e., the credit for the withholding tax and the tax sparing credit).144 This does not mean, however, that a proper interpretation of the wording of the credit provisions in treaties will always lead to the result that the residence state should be obliged to grant dual relief, as will be seen below.

---

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

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


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


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

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

"1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax."145

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

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

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

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

b) ...

Such deduction ... shall not, however, exceed that part of the income tax ... as computed before the deduction is given, which is attributable ... to the income ... which may be taxed in that other State."

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

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

---

145 Paragraph 2 deals with the categories of income to which the credit method applies (i.e., interest and dividends). Paragraph 3 allows the residence state to apply exemption with progression.
146 See, for example: Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions...*, at pp. 1126-1127 (m.no. 13-20). For the purposes of the following discussion, it will always be assumed that the exemption operates as an "income exemption." For situations where the exemption operates as a "tax exemption," refer to the discussion regarding situations where both treaties require credit relief (Section 3.3.7., below).
147 Article 23A(2) reads as follows: "Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax imposed in that other State as computed before the deduction is given, which is attributable to such items of income as derived from that other State."
148 Potgens, F.P.G., "The Netherlands Supreme Court...."
149 Potgens, F.P.G., "The Netherlands Supreme Court...."
150 Potgens, F.P.G., "The Netherlands Supreme Court...."
e.g., a “tax exemption”, there would generally be no tax imposed in the residence state which could be attributable to income which is exempt under a treaty. The question turns, therefore, to whether the exemption under one treaty should be taken into account for the purposes of applying the credit provisions of another treaty.

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

### 3.3.3. Interaction between tax treaties

Whether the residence state has an obligation to grant dual relief may depend upon whether the exemption of the income under one treaty is taken into account for determining whether there is any tax imposed in the residence state that is attributable to the income for the purposes of the other applicable treaty.\(^{151}\) If the exemption is taken into account, then there is clearly no tax attributable to the income in the residence state and thus, no credit should be available.\(^{152}\)

It is often stated that income tax treaties are bilateral in nature and thus, can only give rise to rights and obligations in relation to the contracting states and persons who are resident in one or both of those states.\(^{153}\) While this may be true, it does not necessarily follow that the application of one treaty cannot have any effect on the application of another treaty. Van Raad gives the following example:

"Let us assume that one treaty requires, for its application to person X, that X have a particular legal characteristic, but X no longer has that characteristic because of the restrictive effect that another applicable treaty has on the application of e.g., the domestic law of X's residence state; thus, the latter treaty influences the outcome of the former treaty's application to X. Consequently, the latter treaty does affect the application of the former."\(^{154}\)

Van Raad goes on to distinguish between this effect and the cumulative effect that two treaties may have on the taxation of a single person. Van Raad characterises question of dual relief in the residence state in a triangular situation as the cumulative effect of two treaties and states that relief must be granted under both treaties.\(^{155}\) However, this characterisation seems to ignore the effect that the application of the treaty providing for exemption relief has on the domestic law of the residence state, i.e., the treaty changes the amount of tax payable in that state by the person deriving the income. This appears more akin to the first type of effect mentioned in the quote above, because the application of one treaty has changed the facts

---

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

\(^{152}\) Based on the limitation in Article 23A ("Such deduction ... shall not, however, exceed that part of the income tax ... as computed before the deduction is given, which is attributable ... to the income ... which may be taxed in that other State.") and the corresponding limitation in Article 23B ("Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income as derived from that other State.")

\(^{153}\) See, for example: Zhai, G., "Triangular Cases...."

\(^{154}\) Van Raad, K., "2008 OECD Model...."

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

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

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

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

---

\(^{156}\) Dual residence will be discussed in detail in Chapters 9 and 10.

\(^{157}\) OECD Commentary on Article 4, para 8.2. This will be discussed in depth in Chapter 10.

\(^{158}\) Whilst this interpretation of Article 4(1) in the case of dual-resident companies has been criticised, this criticism has not focussed on whether the application of one treaty can have an impact on the application of another. See, for example, Van Raad, K., “2008 OECD Model…”; Avery Jones, J.F., “The Interaction Between Tax Treaty…” at pp. 137-140 (Chapter 6, Section 6.4.1.).

\(^{159}\) Similarly, if a company has a PE in a particular state under the treaty between its residence state and that other state, that does not mean it will necessarily have a PE in that state for the purposes of any other income tax treaty. The definition of "permanent establishment" in the treaty between the residence state and the "PE state" does not apply for the purposes of any other treaties. This will be discussed in more detail in Chapter 8 (see Section 8.2.3.).

\(^{160}\) Zhai, G., “Triangular Cases…,” who states: "If we admit that every treaty in force is binding on the parties to it, we must accept that the effect of one treaty concluded by one state with another state should not be affected by that of another treaty concluded by the first state with a third state. This principle is often referred to as the bilateral effect of treaties." See also: Gomes Behrndt, M.A., “Passive Income…,” at p. 57.

\(^{161}\) Vienna Convention of the Law of Treaties, Article 26. Article 26 provides that: "Every treaty in force is binding upon the parties and must be performed by them in good faith."
interpreted in good faith in light of its object and purpose. The primary purpose of tax treaties is the avoidance of international juridical double taxation in order to facilitate international trade, and it does not seem to be contrary to this purpose, or to the principle of good faith, for a credit to be denied in relation to income which is already exempt in the residence state.

There also does not seem to be any support in the wording of the relief provisions of the OECD Model for limiting consideration to the domestic law of the residence state for determining whether there is any tax attributable to the income; the relevant limitations in Articles 23A and 23B do not contain any reference to the domestic law of the residence state. Even if consideration should, prima facie, be limited to the domestic law of the residence state, the distinction between domestic law on the one hand and tax treaties on the other is not always clear from a legal perspective. In many countries, the "laws of that state" include the provisions of tax treaties, which effectively become part of domestic law. In some countries, such as Australia, tax treaties are given effect by an act of Parliament and once enacted, become part of the domestic law, while in other countries, treaties become part of domestic law by virtue of specific constitutional provisions. Where tax treaties do form part of the domestic law of the residence state, there seems to be even less justification for excluding the effect of the application of a treaty when determining the amount of tax attributable to a particular item of income for the purposes of applying the relief provisions of another treaty.

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

Order of application of tax treaties

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

---

162 Vienna Convention of the Law of Treaties, Article 31. Article 31(1) provides that: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."
164 Sasseville, J., "A Tax Treaty Perspective..." at pp. 38-40 (Chapter 3, Section 3.2.). See also Vogel, who writes: "Under the theory of 'moderate dualism,' which seems to be generally accepted nowadays, international and domestic law are two spheres which exist separate of each other (save some exceptions). To exercise their intended influence on domestic law, treaties therefore have to be implemented by the domestic legislator. Thus, they receive the force of domestic law." (Vogel, K., "The Domestic Law Perspective" bound in Tax Treaties and Domestic Law, edited by Maisto, G., (Amsterdam: IBFD, 2006), pp. 3-11 at p. 3 (Chapter 1, Section 1.1.).)
166 Sasseville, J., "A Tax Treaty Perspective..." at p. 39 (Chapter 3, Section 3.2.), who gives the examples of France and the United States.
168 Potgens, F.P.G., "The Netherlands Supreme Court..."
applies first, the total relief can never exceed the amount of tax attributable to the income.\(^{169}\) This approach also seems to apply in the case of treaties whose relief provisions follow the wording of the OECD Model. Once it is accepted that the result of one treaty should be taken into consideration when applying other treaties, then the order of application of the treaties should not matter; in either case, no dual relief should be allowed.

### 3.3.4. Relief available under domestic law

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

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

1. The domestic law may provide that unilateral relief is not available if a treaty applies;\(^{170}\)
2. The taxpayer may apply the relief that is more favourable (i.e., treaty relief or domestic relief), to the exclusion of the other source of relief. This does not, however, solve the question of which source of relief is being applied if, for example, both the treaty and domestic law provide for an exemption;
3. The domestic relief may be applied first, with the treaty relief only applying to the extent that the domestic relief does not satisfy the requirements of the treaty;\(^{171}\)
4. The treaty relief may be applied first, with the domestic relief only applying to the extent that it provides for relief in excess of that available under the treaty;\(^{172}\) or
5. The treaty may refer directly to the relief provisions of domestic law and require the state concerned to provide relief in accordance with those provisions.\(^{173}\)

---

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

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

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

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

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

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

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

This is supplemented by Article 21, which provides:

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

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

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

3.3.4.1. Situations where there is a domestic exemption

Where income is exempt under domestic law, that exemption should generally not be supplanted by the relief measures of a tax treaty, regardless of whether the treaty specifies the credit method or the exemption method of relief. A good example of this exists in the Denkavit\textsuperscript{180} case of the ECJ, which involved a situation where dividends were received by a Dutch company from a company resident in France. The issue in this case related to the taxation of the dividends in France but, interestingly, the

---

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


\textsuperscript{176} Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1174 (m.no. 48).

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

\textsuperscript{178} Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 1174 (m.no. 48).

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

\textsuperscript{180} Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l’Économie, des Finances et de l’Industrie, C-170/05, 14 December 2006.
dividends were exempt under the domestic law of the Netherlands and, as a result, the Netherlands was not obliged to grant credit relief under the France-Netherlands treaty. In its judgement, the ECJ states:

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

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

3.3.4.2. Situations where domestic law provides for credit relief

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

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

3.3.4.3. Conclusions

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

---

181 See, similarly, the Amurta judgement of the ECJ, where it appears that Portugal was not obliged to grant the credit relief provided for under the applicable tax treaty in relation to dividends due to a domestic exemption of the income. (Amurta SGPS v Inspecteur van de Belastingdienst, C-379/05, 8 November 2007, paras. 10 and 63).
183 As will be discussed below (see Section 3.3.5.), the calculation of foreign tax credits available under tax treaties is commonly based on the provisions of domestic law.
3.3.5. Calculation of treaty credit relief by reference to domestic law

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

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

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

---

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

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

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

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

An alternative argument against denying dual relief on the basis of domestic calculation rules rests on Article 27 of the Vienna Convention, which provides that a state may not invoke the provisions of its internal law as justification for failure to perform a treaty. However, this should arguably not be considered to be a situation where the residence state is failing to perform its obligations under the treaty; rather, because of the exemption of the income and the operation of the domestic credit calculation principles, the obligation to grant a credit under the treaty with the source state simply does not arise.

This is quite clear where the treaty refers directly to domestic law, and simply requires the residence state to apply its domestic credit provisions, but may be more questionable in cases where the relevant treaty provisions do not refer to domestic law. In such cases, the denial of a credit may potentially be viewed as a treaty override and a failure on the part of the residence state to meet its treaty obligations.

In summary, domestic law restrictions on granting unilateral credit relief in relation to income that is exempt under a tax treaty should, in many cases, also be applicable for the purposes of determining the extent to which credit relief is available under an income tax treaty. To the extent that the domestic law denies credit relief in relation to income that is exempt under a treaty, the residence state should not be obliged to grant dual relief, at least in cases where the relevant treaty provisions do not refer to domestic law. In such cases, the denial of a credit may potentially be viewed as a treaty override and a failure on the part of the residence state to meet its treaty obligations.

3.3.6. Minimum requirement set by treaty relief measures

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

---

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

3.3.7. Both treaties provide for the same method of relief

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

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

3.3.8. Overview

Where a residence state is required to exempt the income arising in a PE triangular case under one of the applicable tax treaties, that state should not be obliged to grant credit relief under the other applicable treaty. For the reasons outlined above, the exemption of the income under one treaty should be taken into account for the purposes of applying the credit provisions of the other treaty and, as a result of the
application of the credit limitations in that treaty, no credit should be required. There will therefore be no dual-relief obligation in the residence state.

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

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

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

3.3.9. Potential solutions

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

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

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

202 Without such a rule, states would in principle have to apply both their domestic relief and the treaty relief in every situation. This clearly does not occur in practice.

203 This is already the case in some countries, i.e., the domestic law provides that double taxation will be eliminated through the exemption method in the case of certain types of income arising in countries with which there is a tax treaty (Sasseville, J., "A Tax Treaty Perspective…," at p. 58 (Chapter 3, section 3.1.), who gives the example of Canada (in Note 3): "See, for instance, Subsection 113(1) of the Canadian Income Tax Act and the related definitions of "exempt earnings" in regulation 5907(1) and "designated treaty country" in regulation 5907(11)"). This is also similar to the way some countries, such as Canada, deal with the issue of dual-resident companies which have their residence assigned to another state under an income tax treaty; Canada incorporates this allocation of residence into its domestic law and, as a result, the dual-resident person is not considered resident in Canada for the purposes
have the advantage over a provision included in the domestic credit rules that it could also be used by states whose treaty relief does not rely on the application of domestic credit provisions.

3.4. Conclusions

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

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

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