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

Fett, E.E.

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Chapter 5  
Limitation of the source state's taxing rights

5.1. Introduction

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

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

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

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

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

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

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

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

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

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

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

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

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

5.2.2.1. To eliminate double taxation

The primary purpose of tax treaties is to eliminate double taxation, which they do through limiting the amount of tax that can be imposed in the source state and by requiring the residence state to grant double taxation relief.340 In a PE triangular case, the application of the conditions of the PE-S treaty in the source state may be important for achieving this aim. This is because if the PE state grants credit relief for tax imposed in the source state under non-discrimination principles,341 then the amount of the credit available in the PE state may be limited to the amount of tax that the source state could have imposed if the PE-S treaty had applied.342 To the extent that the taxation actually imposed in the source state exceeds that amount, unrelieved double taxation may persist. This is demonstrated in the following example.

**Example**

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

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

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

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

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

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

![Diagram](diagram)

<table>
<thead>
<tr>
<th>Source State</th>
<th>Application</th>
<th>Tax on Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>R</td>
<td>PE-S treaty</td>
<td>15%</td>
</tr>
<tr>
<td>S</td>
<td>PE-S treaty</td>
<td>10%</td>
</tr>
<tr>
<td>PE</td>
<td>PE-S treaty</td>
<td>10%</td>
</tr>
</tbody>
</table>

Table 1: Example showing the impact of the application of the PE-S treaty on relief of double taxation

<table>
<thead>
<tr>
<th>Source State</th>
<th>Application</th>
<th>Tax on Interest</th>
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</thead>
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<tr>
<td>R</td>
<td>PE-S treaty</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>S</td>
<td>PE-S treaty</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>PE</td>
<td>PE-S treaty</td>
<td>10%</td>
<td></td>
</tr>
</tbody>
</table>

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

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

345 It is assumed that the PE state provides credit relief on the basis of the non-discrimination article (Article 24(3)) of the R-PE treaty. It is further assumed that the amount of the credit in the PE state is limited to the amount of tax that the source state could impose if it applied the terms of the PE-S treaty in relation to the income attributable to the PE.
Unrelieved double taxation

Where the source state doesn’t apply the PE-S treaty then, in this example, the PE state does not provide full relief for the tax imposed in the source state. This occurs because the relief in the PE state is limited to the amount of tax that could be imposed in the source state under the PE-S treaty, if it applied, and the tax imposed in the source state exceeds this amount. Furthermore, the residence state is unable to provide any additional relief to compensate for the lack of full relief in the PE state. Ultimately, the non-application of the PE-S treaty in the source state in this case results in unrelieved double taxation.

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

Nevertheless, if the source state is required to apply the conditions of the PE-S treaty, then the potential for unrelieved double taxation identified in the above example will be avoided and, more broadly, the application of the conditions of the PE-S treaty in the source state may be necessary in some cases to prevent unrelieved double taxation.

5.2.2.2. To allocate taxing jurisdiction

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

Example

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

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

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

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

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

This situation is illustrated in the following diagram.

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

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

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

As can be seen in the table above, if the R-S treaty applies and the rate agreed between the source state and the residence state is 5%, then the source state collects $5 of tax and the PE state collects $25 of tax. However, if the rate agreed between the source state and the residence state is 15%, then the source state and the PE state each collect $15 of tax. Thus, in this example, the allocation of tax revenue between the source state and the PE state depends primarily on the result of the negotiation between the residence state and the source state even though, in both cases, the residence state does not collect any tax in relation to the income.348 By contrast, if the source state applies the PE-S treaty instead of the R-S treaty, 348 This will not occur so clearly in all situations. If, for example, the PE state grants relief using the exemption method, then the amount of tax it collects (i.e., none) will not be influenced by the amount of tax imposed in the source state. If, however, the PE state is required to grant the exemption as a result of the non-discrimination article (Article 24(3)) of the R-PE treaty, then it is still the PE state’s bargain with the residence state (rather than with the source state) that is controlling the amount of tax it collects. In addition, if the PE state uses the credit method and the credit available in the PE state is limited to the amount of tax that the source state would be entitled to impose if
then the relative amounts of tax collected in the PE state and the source state depend on the bargain struck between those two states as reflected in the PE-S treaty. Discussing the *Crown Forrest Industries* case,349 Vann writes:

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

Clearly, the split of tax revenues between the PE state and the source state should be a matter for negotiation between those two states and should not depend on separate negotiations between those states and the residence state. This strongly supports the application of the conditions of the PE-S treaty in the source state in relation to income attributable to the PE.

5.2.2.3. To facilitate international trade and investment

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

5.2.2.4. To prevent tax evasion

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

"The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind..."

it applied the PE-S treaty, then the tax collected in the PE state would depend on the terms of the PE-S treaty. Even in this case, however, the amount of tax collected in the PE state is ultimately controlled by the provisions of the R-PE treaty, which gives rise to the obligation to grant relief (i.e., under Article 24(3)). In the source state, the impact of applying the R-S treaty conditions rather than the PE-S treaty conditions may also be less clear, for example where the source state imposes less tax under its domestic law than the maximum allowed under the R-S treaty. Even in this case, however, the source state is nevertheless bound by the conditions it has agreed with State R rather than those it has agreed with State PE.

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

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

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

5.2.2.5. The reciprocity principle

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

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

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

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

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

5.2.2.6. Conclusions

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

5.2.3. The role of the residence concept in tax treaties

Given that the extension of treaty benefits to PEs would further many of the aims of tax treaties, it is important to consider why the benefits of tax treaties are limited to persons who are resident in one or both of the contracting states. This is established in Article 1 of the OECD Model, which defines the "persons covered" by the treaty, and is also reflected in the wording of many specific treaty provisions. Residence is determined under Article 4, which provides that:

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

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

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359 Article 1 provides that "This Convention shall apply to persons who are residents of one or both of the contracting states." For a discussion of the role of Article 1, and a discussion of certain exceptions to this general rule, see: Hattingh, P.J., "The Role and Function...."

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

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

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

5.2.3.1. The residence concept in early treaties

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

The League of Nations period

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

362 The residence concept in tax treaties will be discussed further in Chapters 9 and 10, dealing with dual resident triangular cases. See also: Couzin, R., Corporate Residence and International Taxation, (Amsterdam: IBFD Publications, 2002) and Maisto, G. (Ed.), Residence of Companies under Tax Treaties and EC Law, (Amsterdam: IBFD, 2006).
364 For the discussion of fiscal domicile, see pp. 25-26 of the four economists' report. The report stated, under the heading "Residence and Domicile" (at p. 25), that: "It is clear that by residence in this sense we mean not mere temporary residence, but permanent residence, or what in some
double taxation was for countries to impose only residence-based taxation, and to reciprocally exempt the income of non-residents, although recognised that this may not be acceptable to many countries.\textsuperscript{368}

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

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

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

The Commentary to the 1927 Model notes that states which wish to limit the scope of the convention to their own nationals may delete the last part of this provision;\textsuperscript{378} this is likely to have been a reaction to the practice in some early treaties of limiting treaty benefits to nationals of the contracting states.\textsuperscript{379} The

\textsuperscript{368} League of Nations, Document EF S73 F19, at p. 51.
\textsuperscript{369} League of Nations, "Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee" (Geneva, League of Nations, 1925), Document F.212.
\textsuperscript{370} League of Nations, Document F.212., at pp. 14-15. See also: Vann, R., "'Liable to Tax'…" at p. 214 (Section 7.3.1.2).
\textsuperscript{371} The experts suggested in their report that the committee should be enlarged and that it should be requested to prepare preliminary draft conventions, perhaps on the basis of their own Resolutions. League of Nations, Document F.212. at p. 29.
\textsuperscript{372} League of Nations, Document F.212. at p. 33. The definition of fiscal domicile of individuals in the committee's resolutions reads as follows: "The state of domicile, for the purposes of the general income-tax, shall be the State in which the taxpayer normally has his residence for a portion of the year, the term 'residence' being understood to mean a permanent home." A different definition was provided for succession duties, and it was further provided that "State's shall always be free to tax their own nationals on the whole of their income wealth or capital…" (at p. 33).
\textsuperscript{373} League of Nations, Document F.212. at p. 34. The definition of fiscal domicile of companies in the committee's resolutions reads as follows: "The State which has the right to levy the tax is the State in which the head office is situated or, if that office is not the real centre of management and control of the undertaking, the State in which this centre is situated."
\textsuperscript{374} Hattingh writes: "From the 1925 Report, it can be seen that a contracting state could subject a person to tax: (i) on income that was sourced in that state’s jurisdiction based on "fiscal domicile" or "origin" (according to the doctrine of economic allegiance) or (ii) on all of the person’s income if he was a national of that state and had not been taxed at source on that income." See: Hattingh, P.J., "Article 1 of the OECD Model…"
\textsuperscript{375} League of Nations, "Double Taxation and Tax Evasion, Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion" (Geneva, League of Nations, 1927), Document C.216 M.85. Both the 1927 and 1928 reports were prepared by an expanded group of technical experts.
\textsuperscript{377} League of Nations, Document C.216 M.85. at p. 10.
\textsuperscript{378} League of Nations, Document C.216 M.85. at p. 13.
\textsuperscript{379} Vann, R., "'Liable to Tax'…" at p. 217 (Section 7.3.1.3).
Model contains a definition of fiscal domicile for individuals, based again on their "permanent home", but contains no definition or discussion of fiscal domicile for companies. Article 1 of the 1928 Models contain similar wording to Article 1 of the 1927 Model, and are likewise limited to "taxpayers" of the contracting states. The 1928 report also defines fiscal domicile only in the context of individuals, and contains no discussion of fiscal domicile in relation to companies.

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

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

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

The work of the League of Nations in the 1930s and into the early 1940s culminated in the London and Mexico Models, both published in 1946. These models were both intended to apply to "taxpayers" of the contracting states, however, unlike the 1928 Model, the term "taxpayer of a contracting state" was defined to include only those taxpayers who had their fiscal domicile in the state in question. Thus, the term "taxpayer" had a different meaning in the London and Mexico Models to that which it had in the earlier model treaties. There is little explanation for this change to the scope of the model (as compared to the earlier models), but the Commentary does indicate a concern that:

380 League of Nations, Document C.216 M.85., Article 10 at p. 11.
381 Vann, R., ""Liable to Tax'..." at pp. 197-271 at p. 215 (Section 7.3.1.2).
382 League of Nations, Document C.562 M.178. 1928.II, at p. 7, p. 16 and p. 19. The 1928 report contained three model conventions (models 1a, 1b and 1c). Model 1a was based closely on the 1927 model, whereas Model 1b and Model 1c were designed to be concluded between states which do not draw a distinction between personal and impersonal taxes (see p. 7 of the 1928 report). The wording of Article 1 of the three models differs accordingly.
383 Along with the PE concept, royalties and transfer pricing. These issues were identified for further work during the preparation of the original models. For further detail of the work conducted by the League of Nations during this period, see: Vann, R., ""Liable to Tax'..." at pp. 216-223 (Section 7.3.1.3.).
384 Vann, R., ""Liable to Tax'..." at p. 217 (Section 7.3.1.3.).
386 Vann, R., ""Liable to Tax'..." at p. 217 (Section 7.3.1.3.). The report contains no explanation of why the convention would be limited to those with "fiscal domicile" in one of the contracting states. For an explanation of the draft, see: League of Nations, Document C. 415.M.171. at pp. 8-10.
387 League of Nations Fiscal Committee, "London and Mexico Model Tax Conventions, Commentary and Text," (Geneva, League of Nations, 1946), Document C.88.M.88.1946.II.A. The Mexico Model resulted from the work of a group of experts, a Sub-Committee of the League of Nations Fiscal Committee, who met in Mexico in 1940 and 1943, while the London Model resulted from the work of a similar Sub-Committee (although with considerably different membership) which met in London in 1946.
388 Article 1 of the Mexico Model provided that: "The present Convention is designed to prevent double taxation in the case of the taxpayers of the contracting States, whether nationals or not, as regards the following taxes..." Article 1 of the Protocol to the Model provides that: "The terms 'taxpayer of a contracting State' and 'enterprise of a contracting State mean a taxpayer or an enterprise whose fiscal domicile is in the said state." The corresponding articles of the London Model (Article 1 of the Model and Article 1 of the Protocol) contain exactly the same wording. One significant difference between the two models is that the Mexico Model provides that companies' fiscal domicile is in "...the State under the laws of which they were constituted" (Protocol, Article II(4)) whereas the London Model continues to refer to the "real centre of management" (Protocol, Article II(4)). League of Nations, Document C.88.M.88.1946.II.A. pp. 58-59, and 72-73.
389 Hattingh, P.J., "Article 1 of the OECD Model...."
"Any person who is taxable in one country on account of his personal status and who receives income from another country or holds property therein is exposed to such double taxation."\(^{390}\)

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

**The work of the OEEC and the OECD**

In the 1950s the work on model tax treaties was taken over by the OEEC, the forerunner to the present-day OECD.\(^{391}\) The work of the Fiscal Committee of the OEEC ultimately led to the publication of four reports which formed the basis for the 1963 OECD Model.\(^{392}\) One of the first observable changes in the OEEC period is that the term "resident" was introduced; it was intended to be a more convenient shorthand for referring to the concept of "fiscal domicile".\(^{393}\) It was also during this period that the modern form of the residence definition appeared; that is, one referring to the existence of a tax liability under domestic laws.\(^{394}\)

With respect to limiting the personal scope of the treaty, the reports of the Working Parties of the Fiscal Committee\(^{395}\) seem to have based their recommendations primarily on the existing treaty practice of limiting treaty benefits to persons with fiscal domicile in one or both of the contracting states.\(^{396}\) However, their recommendations also seem to have been motivated by the desire to exclude residents of non-OEEC countries (at a time when multilateral conventions were still being considered), in order to preserve the OEEC countries’ freedom to negotiate with non-OEEC countries.\(^{397}\) It was recognised that, as a result of this limitation, double taxation would not be resolved in situations where a person had a limited tax liability (as opposed to a full tax liability) in two different states; the resolution of such cases was left to "agreement in each individual case".\(^{398}\) Interestingly, the OEEC also recognised the difficulty of providing solutions (under bilateral treaties) for cases involving third states, i.e., triangular cases.\(^{399}\)

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391 The League of Nations was dissolved in 1946 and was succeeded by the United Nations. The Organisation for European Economic Co-operation (the OEEC) was formed in 1948 and was transformed in 1961 into the Organisation for Economic Co-operation and Development (the OECD).
392 Hattingh, P.J., "Article 1 of the OECD Model….”
393 Vann, R., "'Liable to Tax'…” at p. 224 (Section 7.3.2.1.).
394 It was proposed by Switzerland, and was reported in Annex 2 to the third report of Working Party 2 of the Fiscal Committee of the OEEC and was incorporated into the second report of the Fiscal Committee. See: OEEC, Working Party 2 of the Fiscal Committee, "Third Report on the Concept of Fiscal Domicile" (Paris: OEEC, 1957), Document FC/WP2(57)2 at p. 9; and OEEC Fiscal Committee, "The Elimination of Double Taxation: 1st Report of the Fiscal Committee of the OEEC" (Paris: OEEC, 1958) at p. 35). The requirement for there to be a liability to tax under domestic law will be discussed further below (see Section 5.2.2.3.). See also: Vann, R., "'Liable to Tax'…” at p. 226 (Section 7.3.2.2.).
395 In 1956, the Fiscal Committee of the OEEC formed Working Party 2 ("WP2") to study the concept of fiscal domicile. WP2 initially examined fiscal domicile from the perspective of the coverage of the convention (i.e., the current Article 1) and from the perspective of defining fiscal domicile (i.e., the current Article 4), however, the Fiscal Committee ultimately instructed WP2 to focus solely on the definition. Nevertheless, when Working Party 14 ("WP14") returned to consider the scope of the convention, it drew on the earlier work of WP2. For a detailed overview of the work of the OEEC in this respect, see: Vann, R., "'Liable to Tax'…” at pp. 224-238 (Section 7.3.2.).
397 OEEC WP2, "Third Report on…” (Document FC/WP2(57)2) at p. 1; OEEC, WP14, “Interim Report…” (Document FC/WP14(60)1), at p. 3. See also: Vann, R., "'Liable to Tax'…” at p. 228 (Section 7.3.2.3.).
399 OEEC Fiscal Committee, "The Elimination of…” at p. 11.
The wording proposed in the reports of the Fiscal Committee of the OEEC was adopted in Article 1 and Article 4 of the 1963 OECD Model. The wording of Article 1 has remained the same ever since (with the exception of a change to the title from "Personal Scope" to "Persons Covered" in 1995\(^{400}\)) and Article 4 of the OECD Model has also undergone very little change.\(^{401}\) Nevertheless, the OECD has put significant work into considering the circumstances in which treaty benefits should be available and in further developing the residence concept, particularly in relation to treaty shopping and the meaning of the phrase "liable to tax", which has been reflected in changes to the OECD commentary (and will be discussed briefly below).\(^{402}\)

**Conclusions**

In the development of the early model treaties there was little focus on the residence concept and, apparently, little focus on the personal scope of tax treaties. During the League of Nations period in particular, the focus was often on the place of management as a sourcing principle rather than as a residence principle.\(^{403}\) After examining the history of the residence concept in tax treaties, Vann writes:

"The history outlined above … indicates that this limitation [i.e., that contained in Article 1] was not regarded as fundamental ... and it developed without too much consideration of its policy and implications."\(^{404}\)

It was in this context that Article 1 was developed, and it wasn’t until sometime after the 1963 update of the OECD Model that treaty shopping, and thus limiting the availability treaty benefits, became a major concern.\(^{405}\)

5.2.3.2. Reasons for confining treaty benefits to residents

In light of the history outlined above, it is interesting to consider the reasons why modern treaties continue to confine treaty benefits to residents of the contracting states. The arguments for doing so are generally discussed in the context of treaty shopping and, in particular, in explaining why residents of third states should be prevented from accessing a particular treaty (e.g., by diverting income through a conduit company resident in one of the contracting states\(^ {406}\)). The most common arguments are:

1. **Reciprocity:** Where treaty shopping occurs, the principle of reciprocity is breached because the benefits of a treaty concluded between two contracting states are economically extended to a resident of a third state in a way that was not intended by the contracting states.\(^ {407}\)

2. **Insufficient taxation:** Income may escape taxation or may be subject to less taxation than was intended by the contracting states.\(^ {408}\) In a related vein, treaty shopping is perceived to result in a significant loss of tax revenue to source states.\(^ {409}\)

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\(^{400}\) For a brief discussion of this change, see: Hattingh, P.J., "Article 1 of the OECD Model…".

\(^{401}\) The second sentence of Article 4(1) was added in 1977. It provides that a person will not be resident in a particular state if they are taxed only on income from sources in that state. This provision will be discussed in detail in Chapter 10, which deals with dual-resident triangular cases.

\(^{402}\) Refer to the OECD Commentary on Article 1 and Article 4.

\(^{403}\) Vann, R., "'Liable to Tax'…" at pp. 209-223 (Section 7.3.1). The distinction, or lack thereof, between residence and source principles in relation to companies will be discussed below.

\(^{404}\) Vann, R., "'Liable to Tax'…" at p. 244 (Section 7.4.1.).

\(^{405}\) Vann, R., "'Liable to Tax'…" at p. 240 (Section 7.3.3.2.). Vann mentions that there was some concern expressed about treaty shopping prior to this, but not in the modern form involving companies (at p. 230).

\(^{406}\) Treaty shopping is discussed further below. See Section 5.2.6., below, which includes a brief description of "conduit company" structures and "stepping-stone conduit" structures.

3. Diminished incentive to negotiate treaties: To the extent that the benefits of existing treaties can be accessed through treaty shopping, states will have less of an incentive to negotiate new treaties.\textsuperscript{410}

Taking these factors into account, it seems that, in the context of treaty entitlement, the residence concept primarily aims to achieve two things.\textsuperscript{411} Firstly, the residence concept attempts to define those taxpayers who may be subject to double taxation as a result of being taxed in one of the contracting states on the basis of their worldwide income (i.e., on a residence basis) whilst being taxed on a source basis in the other. This is clearly evident from some of the early work on tax treaties\textsuperscript{412} and is supported by the stated purpose of double tax conventions, which is to prevent juridical double taxation.\textsuperscript{413} It is also reflected in the general structure of modern tax treaties, which are framed around relieving double taxation where taxation is imposed on a source basis in one state and on a residence basis in the other.\textsuperscript{414} Finally, it is evident in the expectation that the income derived by a resident of one of the contracting states will be taxed in their residence state (reflected in the second argument against treaty shopping mentioned above).

Secondly, the residence concept attempts to define those persons who have a sufficient personal or economic connection to a particular state to benefit from that state's treaty network, even though they may not suffer any double taxation as a result.\textsuperscript{415} This is closely tied in to the reciprocity principle and is reflected in the fact that there is no requirement for a person to actually pay tax in a particular state to be resident there for treaty purposes, and in the fact that reductions in source based taxation are generally available regardless of whether the particular income in question is actually taxed in the residence state.\textsuperscript{416}

It is also closely related to the concern that states will not have a sufficient incentive to conclude further treaties if the benefits of the existing treaty network are available to residents of third states through treaty shopping.

**Implications for the extension of treaty benefits to PEs**

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

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\textsuperscript{408} See, inter alia: OECD, "Double Tax Conventions and the Use of Conduit Companies" at p. 90; Van Weeghel, S. The Improper... at pp. 117-119;

\textsuperscript{409} Avi-Yonah, R.S., & Panayi, C., “Rethinking Treaty Shopping....”

\textsuperscript{410} See, inter alia: OECD, "Double Tax Conventions and the Use of Conduit Companies" p. 90; Van Weeghel, S., The Improper Use... at pp. 117-120; Avi-Yonah, R.S., & Panayi, C., “Rethinking Treaty Shopping....”

\textsuperscript{411} There is, however, disagreement with respect to the underlying policy behind the residence requirement and, in particular, the liable to tax requirement. For an overview, see: Wheeler, J.C., “The missing keystone of income tax treaties,” 3 World Tax Journal 2 (2011), pp. 247-367 at pp. 253-255.

\textsuperscript{412} See the history outlined above and, in particular, see: League of Nations, Document C.88.M.88.1946.II.A. at p. 8.

\textsuperscript{413} OECD Commentary, Introduction, paras. 1-3.

\textsuperscript{414} Couzin, R., Corporate Residence... at p. 149 (Section 3.1.4.1.).

\textsuperscript{415} Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions... at p. 229 (m.no. 24a).

\textsuperscript{416} Couzin, R., Corporate Residence... at pp. 107-111 (Section 3.1.1.1.).

\textsuperscript{417} The extent of the connection required for corporate residence will be discussed in Sections 5.2.2.3. and 5.2.2.4., below. The level of activity required in order for a PE to exist will be discussed in Section 5.2.4. and the economic basis for the attribution of income to PEs will be discussed in Section 5.2.5.
residents would only be entitled to treaty benefits in certain limited circumstances. These points will be developed further throughout the remainder of this chapter.

5.2.3.3. Difficulties in determining residence for treaty purposes

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

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

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

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

5.2.3.4. Declining factual basis for corporate residence

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

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

This limits the usefulness of the residence concept as the sole basis for determining whether treaty benefits should be available, at least to the extent that the underlying policy rationale is to identify those persons who have a sufficient connection to a particular state to warrant the availability of treaty benefits.

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

425 OECD, “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles,” (Paris: OECD, 2010); Couzin, R., Corporate Residence... at pp. 123-126 (Section 3.1.1.5.).
426 OECD Commentary on Article 1, paras. 6.35-6.39; OECD, “Discussion Draft on the Application of Tax Treaties to State-Owned Entities, Including Sovereign Wealth Funds,” (Paris: OECD, 2010); Couzin, R., Corporate Residence... at pp. 111-112 (Section 3.1.1.2.).
427 OECD Commentary on Article 1, para. 26.1.
428 With respect to dual residents, the main difficulty is in determining whether a dual resident will be considered resident in the “losing” residence state (i.e., the state to which residence is not assigned under the treaty between the two residence states) for the purposes of treaties between that state and third states. This will be discussed in detail in Chapter 10 and, in particular, in Chapter 11. Difficulties can also arise with respect to the application of the residence tie-breaker provisions in Article 4 (paragraphs 2 and 3). This will be discussed in Chapter 10.
429 For a more detailed discussion of corporate residence rules, refer to Chapter 10 (Section 10.2.2.), which gives an overview of the common tests employed for determining corporate residence under domestic laws.
430 Vann, R., “Liable to Tax...” at p. 251 (Section 7.4.2.).
“The participants remarked that both the place of incorporation test and the place of management test are subject to manipulation by taxpayers. Traditionally, the shareholders of a corporation were generally resident in the same country as the corporation. Therefore, corporate residence could be used as a proxy for determining the residency of the shareholders. With the increased mobility of capital and increased tax planning, however, the tie between corporate residence and individual residence has become weaker.”

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

5.2.3.5. Source role of corporate taxation in an international context

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

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

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

438 Schön, W., “International Tax Coordination…” at p. 69; Fantozzi, A., Et al., “Round Table: The Issues, Conclusions and Summing Up” bound in Residence of Companies under Tax Treaties and E.C. Law, (Amsterdam: IBFD, 2006), pp. 889-933, at pp. 915-923, (Chapter 24, Section 24.4.2.). This section of Chapter 24 (Section 24.4.), written by Nikolakakis, A., is titled “The Unbearable Lightness of Being Incorporated.”
439 Fantozzi, A., Et al., “Round Table…” at p. 916 (Chapter 24, Section 24.4.2.)
may appear at first sight.\textsuperscript{441} Not only is a PE similar to a resident enterprise in many ways (as will be discussed below), but in an international context, corporate residence has a similar role to that of the PE concept with respect to the imposition of source-based taxation. As Schön writes, “Residence and source are not clearly discernible anymore.”\textsuperscript{442}

5.2.3.6. Conclusions

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

5.2.4. The PE concept and the taxation of PEs

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

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

5.2.4.1. The existence of a PE

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

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

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

i. the enterprise must have a place of business;

\textsuperscript{441} In this respect, Vann writes: “Taxation of subsidiaries … on a residence only basis is in policy terms a source tax on that portion of a group’s income. (Or conversely, the taxation of PEs has much in common with residence taxation of subsidiaries and may be thought of as quasi-residence taxation).” See: Vann, R., “Liable to Tax…” at pp. 199-200 (Section 7.2.1.).

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

iii. the enterprise must carry on its business through the fixed place.\(^{443}\)

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

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

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

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

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

\(^{443}\) OECD Commentary to Article 5, para 2.

\(^{444}\) OECD Commentary to Article 5, para 12.

\(^{445}\) OECD Commentary to Article 5, para 5. See also: Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions...* at p. 286 (m.no. 24).

\(^{446}\) Skaar, A.A., *Permanent Establishment...* at pp. 128-52. See also: Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions...* at p. 286 (m.no. 24a).


\(^{448}\) OECD Commentary to Article 5, para 4.1. See also: Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions...* at pp. 286-7 (m.no. 25); Skaar, A.A., *Permanent Establishment...* at p. 157.

\(^{449}\) OECD Commentary to Article 5, para 6.


\(^{451}\) Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions...*, at p. 321 (m.no. 116).

\(^{452}\) OECD Commentary to Article 5, para 10. See also: Vogel, K., Engelschalk, M., & Görl, M., *Klaus Vogel on Double Tax Conventions...*, at p. 344.


\(^{454}\) For discussion of the practical application of the agency PE rule, see: Sasseville, J., & Skaar, A., “General Report” at pp. 49-55.
provides that an enterprise shall not be deemed to have a PE “merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.” The main practical issue which arises in applying Article 5(6) is determining whether an agent qualifies as an “agent of independent status.”

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

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

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

458 UN Model Convention, Article 5(3)(b).
459 The services PE provision contained in the OECD Commentary is as follows: “Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State, the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.” (Commentary on Article 5, para. 42.23.)
460 OECD Commentary on Article 5, para. 42.34.
461 OECD Commentary on Article 5, para. 42.35. This subparagraph provides that an enterprise of a contracting state will have a PE in the other contracting state if it performs services in that State “a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual.”
462 Subparagraph b) provides that an enterprise of a contracting state will have a PE in the other contracting state if it performs services in that State “b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State.”
463 Sasseville, J., & Skaar, A., “General Report” at p. 58. Some guidance is given in the OECD Commentary on Article 5 (at paras. 42.40 and 42.41.).
The UN Model also contains a provision deeming an insurance enterprise to have a PE in a state if it "collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of independent status" (with an exception for reinsurance). 464

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

5.2.4.2. Taxation under domestic laws

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

Thus, under the domestic laws of many states, the taxation of business income attributable to a local PE (or derived in circumstances where an equivalent criteria is met) may be considered a hybrid between pure source-based taxation by way of withholding on one hand, and full residence-based taxation imposed on a net basis on the other. Some states go even further, considering a local PE to be a resident taxpayer in its own right. 474 Of course, given the extent of variation in domestic laws, not all states will follow this pattern, but the fact that it is common for PEs and resident enterprises to be taxed similarly under domestic laws lends support to the notion that it may be appropriate to treat PEs more like resident enterprises for treaty purposes.

5.2.4.3. Quasi-resident status of PEs under tax treaties

The role of the PE concept in tax treaties may seem to be relatively straight forward, in that it can be viewed simply as a threshold for determining when source-based taxation can be imposed on business income (and certain other income attributable to the PE). In many ways, however, the PE concept has a broader role and effectively operates as a kind of quasi-residence concept. 475 This is perhaps clearest in

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467 Couzin, R., Corporate Residence… at p. 4-5 (Section 1.1.).
468 Couzin, R., Corporate Residence… at p. 4-5 (Section 1.1.).
469 Couzin, R., Corporate Residence… at p. 4-5 (Section 1.1.).
470 Couzin, R., Corporate Residence… at p. 4-5 (Section 1.1.). See also: Phillips, J.S., & Collins, M.H., “General Report” bound in The Assessment and Collection of Tax from Non-residents, IFA Cahiers de Droit Fiscal International, Vol. LXXa, (Deventer, Kluwer, 1985), at p. 28. This type of taxation may also apply to income and gains derived from real property.
471 Couzin, R., Corporate Residence… at p. 4-5 (Section 1.1.).
472 Couzin, R., Corporate Residence… at p. 4-5 (Section 1.1.).
474 Langoth, B., "Treaty Entitlement…" 475 Vann, R., "Reflections on Business…” at p. 144. Vann argues for equal treatment of PEs and subsidiaries, but on a "whole of enterprise" approach rather than a transactional approach, on the basis that a transactional approach
The quasi-residence nature of the PE concept is also reflected in the way in which the existence of a PE in the source state overrides the implicit sourcing rules which are contained in the OECD Model for various categories of income. Dividends, for instance, are generally only taxable in the non-residence state under Article 10 if they are paid by a resident of that state. Similarly, interest is generally only taxable outside the residence state if it “arises” in the other contracting state by being paid by a resident of that state or borne by a local PE. Where a PE exists, however, the PE state may impose tax on the income attributable to the PE without regard to the implicit source rules contained in the treaty, i.e., even if the income would not be considered to be sourced in that state in the absence of a PE. This is similar to the way in which the residence principle overrides the source principle in states that tax residents on their worldwide income. That is, if the taxpayer is a resident of a particular state then the source of the income is usually irrelevant for determining whether it is taxable.

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

The quasi-residence nature of the PE concept in tax treaties is also evident in the sourcing rule for interest. Article 11(5) of the OECD Model provides that interest arises in a particular state if it is paid by a resident of that state. However, if the debt claim giving rise to the interest payment is effectively connected with a PE of the payor in one of the contracting states, and the interest is borne by the PE, then the interest is instead deemed to arise in the PE state. Thus, for the purposes of determining the source of income, the "payment" of interest by a PE is treated as being equivalent to the payment of interest by a resident person.

Another way in which the OECD Model likens the taxation of a PE to that of a resident taxpayer is the PE non-discrimination article (Article 24(3)), which requires the PE state to impose tax on the PE "not less favourably" than on a resident enterprise. There is no equivalent rule for income earned by a non-resident in the absence of a PE. The underlying principle behind Article 24(3) is evidently that the taxation of a PE is similar enough to residence-based taxation that a PE should not suffer a greater tax burden in the PE state than that which a resident enterprise carrying on the same activities would suffer.

Vann, R., "Reflections on Business…" at p. 144. It should be noted, however, that this does not apply if the interest is borne by a resident of a third state (i.e., in a reverse PE triangular case); reverse PE triangular cases and the application of Article 11(5) will be discussed in Chapter 11.
Finally, and perhaps most clearly, the residence-like nature of the PE concept can be seen by considering its role in supporting the residence concept in tax treaties. Vann illustrates this by considering the likely result (at least in OECD countries) of abandoning the taxation of PEs. He writes:

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

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

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

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

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

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

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

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

The OECD, in its “Authorised OECD Approach”, clearly takes the view that the different legal nature of a PE and a company should be largely ignored for profit attribution purposes, that PEs should be treated as though they are able to (economically) own assets, to assume risks and to have a capital structure (as will be discussed below in Section 5.2.5.). However, this approach has been subjected to a great deal of criticism484 and further, is limited to determining the profit attributable to the PE, which is explicitly based on the assumption that the PE is a "separate and independent" enterprise.485 More generally, there

482 Vann, R., "Reflections on Business…" at p. 147.
483 Vann, R., "Reflections on Business…" at p. 147, note 41.
485 Article 5(2) of the 2010 OECD Model provides that: "...the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.” Similarly, Article 5(2) of the 2008 OECD Model (and earlier models) provided that: "...there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make.
is a trend towards treating PEs and subsidiaries in the same way on the basis that the economic substance of the two different forms of business is effectively the same. To the extent that this is the case, i.e., to the extent that the economic substance of a PE and a subsidiary is the same, this would support treating the two forms of business enterprise in the same way for treaty purposes, and thus extending treaty benefits to income earned through PEs. The question then is the extent to which the difference in the legal nature of a PE and a subsidiary impacts upon the economic substance of the situation.

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

Variations in the legal nature of PEs and subsidiaries

It is generally assumed that the legal structure of PEs and subsidiaries follow the classic pattern outlined above, i.e., with a PE simply being part of a broader enterprise from a legal perspective, whilst a subsidiary is a separate legal entity. In many cases, however, the reality is not so clear-cut. For tax purposes, it is clearly the case that a PE is not treated as a separate taxable entity. However, where an entity with foreign owners is treated as fiscally transparent in the state where it is located, then depending on its activities and whether its presence in the state where it is located meets the requirements of the PE definition, it may be give rise to a PE of those foreign owners for treaty purposes. Thus, a PE may effectively arise as a result of activities conducted by what may be considered a separate entity from a legal perspective. In some cases, an entity which would generally be considered to be a corporate entity from a legal perspective, or which has significant corporate features, may be taxed on a flow-through basis in the state where it is located. The classic example of where this may occur is under the US check-the-box rules, which essentially allow certain entities to elect to be taxed either as corporations or on a flow-through basis, but it can also occur under the domestic tax laws of other states. The income of the resulting PE would of course have to be determined through a process of attribution, and not by simply looking at the income of the fiscally transparent entity giving rise to the PE, but in many cases the income earned by that entity and the income attributable to the PE are likely to coincide.

Conversely, there are also situations where various other types of entities which would not generally be considered to be companies from a legal perspective, e.g., partnerships, are treated as separate taxable

if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.”

486 Schön, W., “International Tax Coordination…” at p. 106.
489 Schön writes: “In this context it should be taken into account that there is again a continuum of choices between extremities, including partnerships, S corporations, LLCs or LLPs, which may be treated as ‘transparent’, resulting in characterization of their activity as a permanent establishment notwithstanding their undisputed recognition as legal entities under civil and corporate law.” See: Schön, W., “International Tax Coordination…” at p. 96.
490 In an international context, this often leads to issues associated with “hybrid entities,” entities which are subject to corporate tax in one state but taxed on a flow-through basis in another. For discussion of hybrid entities, see, inter alia: Barenfeld, J., Taxation of Cross-Border Partnerships…; OECD, “The Application of the OECD Model Convention to Partnerships…”
491 US Internal Revenue Code, Treas. Reg. § 301.7701-1 through 3. The “check-the-box” regulations were issued in 1996 and permit owners of certain eligible business entities to select how the business entity will be classified for federal tax purposes.
entities and subject to corporate taxation.492 Such entities are in principal entitled to treaty benefits, notwithstanding the fact that they may not be considered to be separate entities from a purely legal perspective. It thus becomes evident that legal form falls along a continuum, particularly in an international context.493 At one end of the spectrum are entities which are clearly corporate, with limited liability and free transferability of interests for shareholders, the ability to hold assets, to enter into contracts and to sue and be sued. At the other end are, for example, partnerships constituted simply by a relationship between parties and not considered to be separate entities from a legal perspective. In between, there are all manner of entities with varying combinations of features, some more similar to the classic idea of a corporation and others less so. States use their own criteria for determining whether a particular entity is fiscally transparent or pays tax in its own name,494 and ultimately it is this determination, rather than the nature of the entity itself, which may determine whether there is a PE or a treaty eligible “subsidiary” in a particular state. As Schön writes:

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

Thus, the determination of whether a particular entity is taxable in its own right or is treated as fiscally transparent under domestic laws may not be consistent between different states, since different states base their classification on different factors and draw the line between taxable and fiscally transparent entities differently.496 What is considered a PE under the domestic law of one state may be considered a separate taxable entity under the laws of another state and vice versa. It therefore makes little sense to deny treaty benefits to PEs simply on the assumption that they have no separate legal capacity and on the assumption that there is a significant difference in the legal nature of a PE and a subsidiary. Furthermore, the fact that certain entities which are taxed as corporations do not have separate legal personality does not prevent them from claiming treaty benefits, and this factor should similarly not prevent claims for treaty benefits by PEs. Again, Schön writes:

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

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


495 Schön, W., “International Tax Coordination…” at p. 67.

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

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

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

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

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

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

498 Schön writes: “Because the PE is described in Article 5(1), OECD model tax convention as a ‘fixed place of business’, one thereby associates some organizational degree of independence that could also be used as a basis for legal isolation.” See Schön, W., “Attribution of Profits…” at p. 1060.
502 Schön, W., “Persons and Territories…”; Schön, W., “Attribution of Profits…” at p. 1060; Wheeler, J.C., “The Missing Keystone…” at p. 286. The attribution of profit to PEs, and the increasing notional independence of PEs for this purpose, will be discussed in detail below (see Section 5.2.5.)
504 Schön, W., “International Tax Coordination…” at p. 111.
income (e.g., dividends, interest or royalties arising in a third state).\textsuperscript{505} To the extent that there is no foreign income included in the income attributable to the PE, the eligibility for treaty benefits is purely theoretical, since there is no income for which the PE could actually claim such benefits. If the income of a PE does include foreign income, then the PE must have sufficient activities and a sufficient presence in the PE state for the income to be attributable to it. Where this is the case, the fact that the PE does not have sufficient activities to be considered equivalent to a fully functioning separate enterprise, operating independently from the enterprise to which it belongs, should not prevent treaties between the PE state and third states from applying to that income. Nevertheless, to put a PE on the same footing as a resident enterprise, the eligibility for treaty benefits could depend on the PE being “liable to tax” in the PE state (i.e., in the sense required for residence under Article 4(1)). This will be discussed further in Chapter 8.

\textbf{5.2.4.6. Conclusions}

The similarities between the PE concept and the residence concept, as well as the similarities between PE taxation and residence taxation under the domestic laws of many states and under tax treaties, reveal the PE principle as something of a hybrid between the source and residence principles. Vann argues that, at least in the context of treaties between developed countries, the PE concept is mainly a residence-supporting concept, in that it "...overcomes problems of defining corporate residence by ensuring that taxing rights follow substantial activities."\textsuperscript{506} That is, if substantial activities are conducted in a particular state, then these activities justify residence-like taxation and a resident entity is effectively created there regardless of whether the business activities are conducted through a separate legal entity or by part of a larger entity.\textsuperscript{507,508} Furthermore, the legal distinction between PEs and subsidiaries is not as clear cut as it is generally considered to be, with the legal nature of different entities falling along a continuum, particularly in an international context. For the reasons outlined above, the presumption that a PE does not have any separate legal existence should not prevent treaty benefits from being extended to PEs.

\textbf{5.2.5. Separate entity approach to attributing profit to PEs}

For the purposes of determining the profit attributable to a PE, the PE must be considered a "separate and independent enterprise engaged in the same or similar activities under the same or similar conditions..."\textsuperscript{509} This is known as the “separate entity approach” and in a broad sense, it requires the application of transfer pricing concepts to determine the profit attributable to a PE as though that PE operated independently from the enterprise as a whole. The first part of this section will trace the historical development of the separate entity approach to attributing profits to PEs, while the second will discuss the recent work of the OECD and the new "Authorised OECD Approach" (AOA) for the

\textsuperscript{505} With respect to the service PE, for instance, the OECD Commentary provides that “taxation should not extend to services performed outside the territory” of the state where the PE is located. See: 2010 OECD Commentary on Article 5, para. 42.23.

\textsuperscript{506} Vann, R., "Reflections on Business…” at p. 147.

\textsuperscript{507} Vann, R., "Reflections on Business…” at p. 147. Vann also suggests that the application of the exemption method to income attributable to a PE could be seen as recognition of the quasi-resident nature of PEs and identifies the potential for overlaps between PE concepts and corporate residence principles (p 144-5, note 37).

\textsuperscript{508} In the treaty context, this is based on the existence of a PE. Domestic source rules vary and, under domestic laws, net basis taxation of business income may or may not depend upon the existence of a PE. Many countries do use a PE concept for domestic law purposes, and only tax business profits of non-residents if they are carrying on business within the country through a PE (or the local equivalent), while others supplement a domestic PE concept with other source rules, and tax non-residents on certain business income even in the absence of a PE. Some countries tax business income derived by non-residents on a net basis if they are "trading" or "carrying on a business" within that country's jurisdiction, without the need for a fixed place of business or PE. For example, the US, taxes non-residents on income that is effectively connected to the conduct of a "trade or business" in the United States (IRC Sec 871(b)(1), IFA Cahiers, Vol. 90a, p713.). In France, business income of a non-resident will be subject to corporate income tax if the non-resident carries out a "complete commercial cycle" in France (see: IBFD country analysis, Section 7.1.1.). Many countries have an even lower threshold for imposing tax on the business income of non-residents on a net basis under their domestic law (see: Rothaghi, R., \textit{Basic International Taxation} at p. 224.).

\textsuperscript{509} 2010 OECD Model, Article 7(2).
5.2.5.1. Historical development

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

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

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

Thus the principle was established that, for profit attribution purposes, PEs should be treated in the same manner as independent enterprises operating under the same or similar conditions. This went on to form the basis of the relevant articles of the Mexico Model Convention of 1943 and the London Model Convention of 1946, both published by the League of Nations, and was subsequently adopted in Article 7 of the 1963 OECD Model Convention. The wording of Article 7 contained in the 1963 OECD Model Convention also included an alternative method based on the percentage of turnover, to be applied in situations where there were no accounts or the accounts could not be adjusted to reflect the normal usages of the trade. See Avery Jones, J.F., et al., "The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States" 60 Bulletin for International Taxation 6, (2006), pp. 220-54.


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

Russo, R., "Tax Treatment of..."


Burgers, I.J.J., "Commentary on..."

The 1933 Model also provided for an alternative method based on the percentage of turnover, to be applied in situations where there were no accounts or the accounts could not be adjusted to reflect the normal usages of the trade. See Avery Jones, J.F., et al., "The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States" 60 Bulletin for International Taxation 6, (2006), pp. 220-54.
Model remained substantially unchanged until the adoption of a revised Article 7 in the 2010 OECD Model. Prior to the 2010 update, Article 7(2) of the OECD Model provided that:

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

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

**Development of the "Authorised OECD Approach"**

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

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

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\(^{518}\) Article 7(4) of the 2008 OECD Model reads as follows: "Insofar as it has been customary in a contracting state to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the profits of the total enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment shall, however, be such that the result shall be in accordance with the principles contained in this Article."


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

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

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

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

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

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

5.2.5.2. The "Authorised OECD Approach" (AOA)

Under the AOA, the attribution of profits to a PE is based on the calculation of profits (or losses) from all its activities, including transactions with third parties and transactions with other parts of the enterprise. The application of the AOA involves, firstly, a "functional and factual analysis," which is performed in order to hypothesise the PE as a distinct and separate enterprise and to "identify the economically significant activities and responsibilities undertaken by the PE." The functional and factual analysis required by the AOA is similar to the functional analysis that must be performed to apply the arm's length principle to transactions between associated enterprises (i.e., under Article 9 of the OECD Model). The outcome of the analysis in Step 1 of the AOA will be an allocation of assets, risks and capital to the PE. The second step in the AOA is to apply the OECD's Transfer Pricing Guidelines (by analogy) to determine the appropriate remuneration for any dealings between the PE and other parts of the enterprise.

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

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

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

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

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

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

5.2.5.3. The AOA for financial institutions and financial assets

The final report published by the OECD in 2008 (and updated in 2010 to reflect the new wording of Article 7) contains separate sections dealing with specific issues that arise in determining the profits attributable to PEs in certain financial sectors, namely banking (Part II), global trading (Part III) and insurance (Part IV). One of the key differences in the application of the AOA in the financial sector is that the allocation of the economic ownership of financial assets is based on "key entrepreneurial risk-taking functions" (KERT functions) rather than "significant people functions." KERT functions are said to be those which "require active decision-making with respect to the acceptance and/or management of individual risk and portfolios of risks" and would generally be those involved in creating and subsequently
managing a financial asset.\textsuperscript{549} The OECD report explains that the "KERT functions" terminology is used in the case of financial assets in the financial sector because of the close link between assets and risks.\textsuperscript{550} In relation to insurance companies, the allocation of investment assets to PEs is not based on KERT functions or significant people functions, but instead follows the allocation of insurance risks.\textsuperscript{551} As will be discussed in Chapter 9 (Section 9.2.3.), this raises particular issues for the potential application of the PE-S treaty in relation to investment income derived by insurance companies, since the determination of the investment income attributable to the PE may not be based on an allocation of specific income derived from specific assets.\textsuperscript{552}

5.2.5.4. Implications of the AOA

Under the AOA, PEs are treated much more like independent enterprises than they were previously, at least for profit attribution purposes. This can be expressed as an increase in the level of independence of PEs. PEs may have different levels of theoretical independence, representing the extent to which they are treated as separate entities and the scope of any restrictions placed on the separate entity approach for determining the profits attributable to the PE. In this respect, it is possible to distinguish between absolute (hypothetical) independence and restricted independence.\textsuperscript{553} In the case of absolute independence, a PE is treated in exactly the same way as a legally independent subsidiary for the purpose of determining the profits which are attributable to it, with differences between the legal form of a PE and a subsidiary considered to be irrelevant.\textsuperscript{554} This means, for example, that the PE may be treated as owning assets independently from the enterprise as a whole and that dealings between a PE and other parts of the enterprise are treated as binding contractual arrangements, which may be recognised in determining the profit attributable to the PE.\textsuperscript{555} By contrast, where the restricted independence approach applies, more recognition is given to the fact that the PE is not a legally separate enterprise and thus, the PE and the head office cannot transact with each other in the same way as independent parties.\textsuperscript{556} In addition, the PE is not treated as owning assets and dealings between the PE and other parts of the enterprise are not recognised for tax purposes.\textsuperscript{557} The AOA clearly moves in the direction of absolute independence for PEs\textsuperscript{558} and results in PEs treated more like independent enterprises for profit attribution purposes.

One of the limits which has historically been placed on the separate entity approach relates to the treatment of dealings between the PE and other parts of the enterprise. With the adoption of the AOA, this limit has essentially been removed and replaced with a framework for assessing whether a particular dealing meets the criteria for recognition. Under the AOA, an internal dealing may be recognised if a "real and identifiable event has occurred."\textsuperscript{559} According to the OECD report, "[t]his requires a determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the 'dealing'."\textsuperscript{560} As a result, it is now possible for internal dealings such as payments of royalties or service fees to be recognised for the purposes of determining the profit attributable to the PE. In some circumstances, it may also be possible to recognise internal interest payments, including a profit margin; namely, where part of the enterprise conducts treasury operations.\textsuperscript{561} This is a significant departure from the approach reflected in the previous OECD commentary, which specifically provided that no deduction

\textsuperscript{549} OECD, "2010 Report...," Part II, Section B-1(iii), para 8.
\textsuperscript{550} OECD, "2010 Report...," Part I, Section B-3(i), para 16.
\textsuperscript{551} OECD, "2010 Report...," Part III, Section C-1(iii), paras 127-8.
\textsuperscript{552} OECD, "2010 Report...," Part III, Section C-1(iii), paras 165-70.
\textsuperscript{553} Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions...} at p. 428 (m.no. 64). See also: Baker, P., & Collier, R., "General Report" at p. 36.
\textsuperscript{554} Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions...} at p. 428 (m.no. 64).
\textsuperscript{555} Baker, P., & Collier, R., "General Report" at p. 36.
\textsuperscript{556} Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions...} at p. 428 (m.no. 64).
\textsuperscript{557} Baker, P., & Collier, R., "General Report" at p. 36.
\textsuperscript{558} Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions...} at p. 428 (m.no. 64).
\textsuperscript{560} OECD, "2010 Report...," Part I, Section B-3(v), para 35.
\textsuperscript{561} OECD, "2010 Report...," Part I, Section D-2(vi), para 178.
should be available for notional interest payments (except, in certain circumstances, for banks). One area where the limitation on internal dealings has not been removed is in the case of creditworthiness; the AOA requires that the PE is considered to have the same creditworthiness as the entity as a whole. Nevertheless, on the whole, the AOA has greatly expanded the situations in which internal dealings may be recognised.

One of the other key ways in which the AOA strengthens the independence of PEs is that, under the AOA, a PE may assume risks, may have economic ownership of assets and must be allocated sufficient capital to support its operations (i.e., functions performed, assets economically owned and risks assumed). In a major step towards hypothesising the PE as a separate entity, a PE is now considered to have notional legal capacity for profit attribution purposes. This is a significant development and is also a departure from the previous commentary, which made no reference to the extent of the (notional) legal capacity of a PE.

Another key development is that the AOA explicitly requires the application of the OECD’s Transfer Pricing Guidelines, both in the functional and factual analysis (step 1) and in relation to pricing dealings between a PE and other parts of the enterprise or other related parties (step 2). Under the previous commentary, there was no specific reference to the Transfer Pricing Guidelines. By contrast, under the AOA the transfer pricing framework becomes the “fundamental tool set” for profit attribution to PEs. The explicit application of the Transfer Pricing Guidelines to PEs also emphasises the AOA’s transactional approach to determining the profit attributable to PEs (as opposed to an “allocation” approach), which also brings the treatment of a PE conceptually closer to that of a separate enterprise.

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

Baker and Collier, noting the AOA’s dramatic shift in the direction of absolute independence, write:

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

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

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

5.2.6. Tax avoidance considerations

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

5.2.6.1. Treaty shopping: The current landscape

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

Direct conduit

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

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

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

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

OECD Committee on Fiscal Affairs, "Double Tax Conventions and the Use of Conduit Companies," at p. 88-89; See also: Van Weeghel, S., The Improper Use..., at p. 120.

OECD, "Double Tax Conventions and the Use of Conduit Companies" at p. 90. These can be assumed to represent the most common objections to treaty shopping (see: Van Weeghel, S., The Improper Use..., at p. 122).

OECD, "Double Tax Conventions and the Use of Conduit Companies" at p. 90.
"The existence of tax treaties may be jeopardized because certain existing treaties will be terminated as a result of their treaty shopping potential, and certain countries will no longer be able to enter into tax treaties. Uniformity may be jeopardized because new tax treaties will increasingly contain provisions to counteract treaty shopping, which are not based on model language contained in the OECD Model Convention, as long as the OECD Model Convention does not contain guidance in this respect. Both the threat to the existence of tax treaties and the threat to their uniformity strike at the heart of the rationale for the avoidance of double taxation, i.e., they may hamper the international exchange of goods and services and movements of capital." 583

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

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

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

"The recipient of a dividend is the ‘beneficial owner’ of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full 588 OECD, "Clarification of the Meaning of 'Beneficial Owner' in the OECD Model Tax Convention: Discussion Draft" (Paris: OECD, 2011), dated 29 April 2011 to 15 July 2011 at p. 4 (proposed para 12.4 of the Commentary on Article 10). See also: p. 6 (proposed para 10.2 of the Commentary on Article 11) and p. 9 (proposed para 4.3 of the Commentary on Article 11). Available online at: http://www.oecd.org/document/39/0,3746,en_2649_33747_48391591_1_1_1,00.html (viewed 13 January 2011).
right to use and enjoy the dividend; also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid.589

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

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

The Indofood case seems to indicate that a company will not be the beneficial owner of income if it is obliged, in legal, commercial or practical terms, to pass on the income it receives to another entity,594 however, it should be borne in mind that this case does have certain limitations. Firstly, as mentioned above, Indofood involved a UK court deciding, in a non-tax case, on what an Indonesian court would decide with respect to beneficial ownership in a hypothetical situation. In addition, the payments received by the interposed company were very closely tied to the payments it was required to make; it was required to pay its interest liabilities the day after the interest income was received and its interest income exactly equalled its interest obligations, such that it did not earn any "spread" on the interest and could not retain any of the income it received.595 The Court also stated that the company was precluded by the terms of the loan documentation from meeting its interest obligations from any other source of income.596 The important question then, and something which is not entirely clear, is the extent to which the decision in Indofood may apply in other circumstances where the amounts received and paid by the intermediary company are not so closely linked,597 for example, where the intermediary company earns a spread on the income it receives598 and has more substance in the state where it is established.

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

589 OECD, “Clarification of the Meaning….”
590 See, for example, the responses from Richard Collier (PwC), John Avery Jones, Richard Vann and Joanna Wheeler, The City of London Law Society (CLLS), Ernst & Young, HSBC and various others.
594 Cleave, B., Editorial comments in IBFD case summary.
596 This condition may not actually have been contained in the loan documentation, see: Baker, P., "Beneficial Ownership…” at note 4.
597 Baker, P., "Beneficial Ownership…”
598 Martín Jiménez suggests that it is implicit in the Indofood decision that if the intermediary company had retained any "spread" then it could have been regarded as the beneficial owner (Martín Jiménez, A., "Beneficial Ownership…”
dividends, however, and there was no predetermined or automatic flow of funds to its shareholders. In this case, the court found that the Dutch holding company was the beneficial owner of the dividends, stating that "the beneficial owner of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received." This demonstrates the difficulties inherent in applying the beneficial ownership concept in practice, particularly in cases where the intermediate company pays its income to its parent company in the form of dividends. One of the main difficulties lies in determining whether a company, which is under control of another company and therefore likely (but not legally obliged) to pay any income it receives on to its ultimate owner, could be regarded as the beneficial owner of its income.

States can also prevent improper claims for treaty benefits by including Limitation on Benefit (LOB) provisions in tax treaties. An LOB is generally a detailed provision which sets out the circumstances in which treaty benefits should be available. In very broad terms, it prevents a claim for treaty benefits unless the person claiming treaty benefits meets one of the specified tests, e.g., it is listed on a stock exchange in its residence state, meets ownership and base erosion tests, or receives the income in the conduct of business activities in the residence state. It has long been the policy of the United States to include LOB provisions in its treaties, and virtually all the treaties concluded by the US now contain an LOB. Most other countries do not regularly include LOB provisions in their treaties.

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

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601 Du Toit, C., "The Evolution of…"

602 For a somewhat more detailed discussion of LOB provisions (in the context of the PE state and non-discrimination principles), see Chapter 4 (Section 4.3.4.2.).

603 Exceptions include the US treaties with Poland and Hungary, although with respect to Hungary, a new treaty containing an LOB has been initialled. Negotiations for a new US-Poland treaty are ongoing. Van Weeghel, S., “General Report,” at p. 49.


606 Some of the doctrines that may be applied in various states include: sham (where the legal form of transactions does not correspond to their true nature), legally ineffective transactions, substance over form (which seeks to apply the tax law on the basis of the economic substance of transactions, rather than their legal form), abuse of law, fraud legis, or simply a general anti-avoidance rule that may apply, for example, where a transaction is primarily motivated by tax avoidance (see: Van Weeghel, S., “General Report,” at pp. 21-22). Some states also have specific anti-avoidance measures aimed at preventing treaty shopping, e.g., the US conduit financing rules. These rules effectively allow the US tax authorities (the IRS) to recharacterize certain back to back financing arrangements by disregarding one or more intermediate entities, and treating the ultimate provider of finance as the recipient of income (e.g., for withholding tax purposes), if the IRS determines that it is necessary to do so to prevent tax avoidance (see Treas. Reg. 1.881-3(a)(5)(i)).


608 See: Van Weeghel, S., “General Report” at p. 25
or leaves the facts unchanged but simply denies a tax benefit (or benefits) that would otherwise be associated with those facts.\(^{609}\)

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

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

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

5.2.6.2. Potential for treaty shopping through PEs

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

"... the PE rule is less subject to manipulation than the residence rules as it uses substantive activity based tests rather than purely formal tests such as place of incorporation or semi-formal tests such as place of board management or head office."\(^{612}\)

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

Internal transactions have no legal effect

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

\(^{609}\) De Broe, L., *International Tax Planning…* at p. 391 (Part 3, Chapter 4, Section 4.1.2., para. 158).

\(^{610}\) OECD Commentary on Article 1, para. 9.3.

\(^{611}\) For a detailed discussion of the extent to which there may be an implied anti-abuse rule in treaties, see: De Broe, L., *International Tax Planning…* Part 3, Chapter 3 (pp.301-376). For further discussion, and an overview of the case law of various countries in this respect, see: Van Weeghel, S., “General Report” at pp. 35-42. Van Weeghel notes that it is difficult to find a distinct pattern in the cases reported in the branch reports (at p. 41). For discussion of various provisions of the OECD Commentary dealing with tax avoidance, see: Arnold, B.J., “Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model” 58 *Bulletin for International Fiscal Documentation* 6, (2004) pp. 244-260.

\(^{612}\) Vann, R., “‘Liable to Tax’…” at p. 202 (Section 7.2.1.).
dealings. However, this situation may not be so different from the situation that exists within a corporate group; the OECD’s Transfer Pricing Guidelines note that "...contracts within an MNE [Multi-National Enterprise] could be quite easily altered, suspended, extended or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively." In a practical sense, therefore, the implications of dealings entered into between a PE and other parts of the enterprise may not be vastly different from the implications of those entered into between different companies in a corporate group; in both cases, the enterprise as a whole (i.e., the legal entity or the corporate group) may effectively choose to disregard or alter whatever agreement has been made.

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

**Economic basis for allocation of income**

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

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

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

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

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

As a result of the income of PEs being determined on an economic basis, states may actually find it easier to challenge what they consider to be improper claims for treaty benefits when those claims involve PEs than when they involve legal entities. As discussed above, one of the primary means by which treaty shopping is countered under the existing framework is through the beneficial ownership concept, and there is a great deal of uncertainty surrounding its meaning for treaty purposes. In the case of a PE making a (potentially improper) claim for treaty benefits, the difficulties with the concept of beneficial ownership could be bypassed. Instead, the discussion regarding whether the claim for treaty benefits is appropriate can be based directly on whether the income is properly attributable to the PE. Thus, the focus would shift to the economic situation identified as part of the functional and factual analysis and to the significant people functions carried out by the PE. In the case of a PE, it is not possible for the taxpayer to rely on the legal arrangements to demonstrate that treaty benefits should be available and it may therefore be easier for the source state to challenge claims for treaty benefits through PEs than it would be in the case of legal entities. In addition, a much greater level of activity would generally be required in the PE state in order for the income to be properly attributable to the PE than that which would be required for a legal entity to be the beneficial owner of income. Where this standard has been met, and it has been agreed that the income is economically the income of the PE and arises from the PEs activities, it seems difficult to accept that the source state should not apply the conditions of the PE-S treaty in relation to that income.

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

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

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

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

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

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

If a direct conduit structure were set up with a PE in the place of the conduit company then there would generally be no recognition for tax purposes, in either the PE state or the residence state, of any repatriations of income ("dividends") from the PE to the rest of the enterprise. To the extent that the PE state did seek to impose some form of withholding tax (or equivalent) on the payment, it would be prevented from doing so by the treaty with the residence state.\(^{626}\) The ability to claim treaty benefits through PEs which can repatriate profits without tax consequences would clearly expand the situations in which treaty shopping would be feasible. This may suggest that, if treaty benefits are extended to PEs, the separate entity approach should be taken even further, such that notional transactions between the PE and the rest of the enterprise would also be recognised for the purposes of the other articles of the treaty,\(^{627}\) including the article dealing with dividend payments, allowing the PE state to impose tax on such notional payments.\(^{628}\) This is largely beyond the scope of this thesis, but will be discussed briefly in Chapter 9 (Section 9.3.2).

If a PE were substituted for the conduit company in a stepping-stone conduit structure, it may be possible to identify internal dealings which would constitute expenses for the PE and which would reduce the taxable profit attributable to the PE to a sufficiently minimal amount. This is significant because such payments would generally not be recognised other than for the purposes of determining the profit attributable to the PE. Thus, the residence state would not impose tax on the "income" received by the head office, and to the extent that the PE state did seek to impose some form of withholding tax (or equivalent), it would generally be prevented from doing so by the treaty with the residence state.\(^{629}\) It is important to note, however, that the reduction in the profit attributable to the PE will reduce the corresponding exemption or credit relief in the residence state and as a result, the income shifted to the residence state by the internal dealings may effectively be taxed in that state.\(^{630}\)

626 2010 OECD Commentary on Article 7, para 28.
627 That is, not limited to Article 7 and Article 23A/B.
628 Baker and Collier note that the AOA does not go to this extreme of independence for PEs, see: Baker, P., & Collier, R., “General Report” at p. 37.
629 2010 OECD Commentary on Article 7, para 28.
630 This is demonstrated by the following example: The income attributable to a PE includes $100 from sources in a third state. The company earns no other income and the residence state uses the exemption method of relief for PE profits. In this case, $100 will be taxable in the PE state and no income will be taxable in the residence state.

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A final aspect of the taxation of PEs which arguably facilitates treaty shopping is that many countries do not tax the business profits of non-residents to the extent that those profits are derived from foreign sources. In effect, a PE may be taxed on a territorial rather than a worldwide basis. Where a particular state does not impose tax on the foreign income attributable to the PE, but does impose tax on the foreign income of resident companies, this could facilitate the use of PEs as “conduits” in situations where a conduit company could not be used without triggering a tax liability. In practice, however, the income attributable to the PE for treaty purposes is likely to be considered to have its source in the PE state under that state’s domestic laws, i.e., as a result of the business activities carried out there. For example, interest income derived in the context of business activities may be considered, under the domestic laws of the PE state, to have its source in the state where those business activities are conducted (i.e., in the PE state). In addition, some states (such as Australia, France and Japan) impose tax under domestic law by reference to the taxing rights given by the treaty. Australia, for example, includes in all its treaties a provision that deems most items of income which are taxable in Australia under the treaty to be Australian source income. Nevertheless, there are likely to be situations where the income arising in a triangular situation is not included in the tax base in the PE state. To counter such situations, the availability of treaty benefits to PEs could be conditioned on the income being “subject to tax” in the PE state. This will be discussed further in Chapter 8.

5.2.7. Impact of EU law

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

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

Arnold, B.J., & Sasseville, J., "Source Rules for Taxing..." at p. 120.

In the 2003 Australia-UK treaty, for example, Article 21 provides: "Income or gains derived by a resident of the United Kingdom which, under any one or more of Article 6 to 8 and 10 to 16 and 18 may be taxed in Australia shall for the purposes of the laws of Australia relating to its tax be deemed to arise from sources in Australia." Arnold, B.J., and Sasseville, J., "Source Rules for Taxing..." at p. 120; Avery Jones, J.F., et al., "Tax Treaty Problems...."

Case C-307/97, Compagnie Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, [1999] ECR I-6161. The Saint-Gobain case involved a PE established in Germany by a French company. The income attributable to the PE included dividends received from companies located in various source states (including the United States and Switzerland) which were fully taxable in Germany. The case involved a request for three tax concessions with respect to the dividends received: (1) an exemption from the German corporation tax for dividends received from companies resident in the US and Switzerland which was available to German resident companies under the treaties concluded between Germany and those states; (2) an indirect tax credit for taxes imposed on the profits from which foreign dividends were paid which was available to German resident companies under German domestic law; and (3) a capital tax concession available to German resident companies under German domestic law. The taxpayer in Saint-Gobain claimed that, in order to comply with the freedom of establishment provisions of the EU treaty, these concessions should also have been granted to the PE. (ECJ, 21 September 1999, Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt, C-307/97, paras. 9–22.)

Article 49, titled "Right of Establishment" reads: "Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches, or subsidiaries by nationals of any Member State established in the territory of any Member State. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."

Article 54 reads: "Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States. 'Companies or firms'
respectively) of the EC Treaty. Following the decision in the Saint-Gobain case some authors have questioned whether the source state, if it is within the EU, may also be obliged to apply the conditions of its treaty with the PE state in relation to the income attributable to the PE under EU law. An in-depth discussion of this issue is beyond the scope of this thesis, but broadly, the assertion that the source state may also be bound to apply the PE-S treaty rests on the fact that the source state may otherwise be considered to be discriminating between residents and branches of the PE state for the purposes of EU law and thus violating the freedom of establishment.

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

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

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

means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit making.

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

If the taxation in the source state is made subject to the conditions contained in PE-S treaty, then the question arises as to whether the R-S treaty should continue to apply. If the R-S treaty does continue to apply then the source state will be obliged to satisfy the relevant conditions of both the R-S treaty and the PE-S treaty, which it can only do by applying those conditions which are most favourable to the taxpayer. If, for example, one treaty allows tax to be imposed up to a maximum rate of 10% and the other allows tax to be imposed up to a maximum rate of 15% in relation to a particular category of income (e.g., interest), the source state would be obliged to limit the tax imposed to 10%. This section will discuss the appropriateness of the source state to continuing to apply the conditions contained in the R-S treaty to income attributable to a PE in addition to the conditions of the PE-S treaty.

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

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

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

One important consideration with respect to the R-S treaty is that if the operation of the R-S treaty is completely excluded in relation to the income attributable to the PE, then the residence state will have no obligation to provide relief for tax imposed in the source state. If the income attributable to the PE is exempt in the residence state (either under domestic law or under the PE-S treaty) then this will of course not be a problem, and may even be desirable, but if the residence state uses the credit method of relief in the R-PE treaty and does not provide relief for tax imposed in the source state under domestic law, then unrelied double taxation may occur. Thus, if the residence state uses the credit method to provide relief for tax imposed in the PE state then the residence state should still have an obligation to provide relief for tax imposed in the source state.

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

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643 Van Weeghel, S., The Improper Use... at pp. 124-126. Some tax treaties contain provisions which deny reductions in source-based taxation under the treaty if the income in question is attributable to a PE in a third state.
644 As discussed above in Section 5.3.1. This would generally include: business profits (Article 7), income from immovable property located in the source state (Article 6), certain types of capital gains (Article 13), income from shipping, inland waterways and air transport (Article 8), and other income (Article 21).
645 This may be desirable because it may prevent a dual relief obligation from arising in the residence state, i.e., where the residence state is obliged to exempt the income under one treaty and provide a credit under the other applicable treaty. The potential for a dual relief obligation was discussed in Chapter 3 (Section 3.3.), where it was concluded that a dual relief obligation should not arise on the basis that the exemption under one treaty should be taken into account when determining the amount of tax imposed in the residence state in respect of the income for the purposes of applying the relief provisions of the treaty requiring credit relief. As a result, there will be no tax imposed on the income in the residence state for the purposes of that provision and no credit will be required (in accordance with the terms of Article 23A(2) or Article 23B, as applicable). Nevertheless, some states may remain concerned about this issue.
source state to apply the conditions of the treaty). However, this may also give rise to problems in certain circumstances. If the residence state uses the credit method of relief under the R-S treaty and the rate of tax imposed in the source state is higher than that which it would be entitled to impose under the R-S treaty, the question arises as to the amount of credit relief that the residence state should be required to provide. That is, whether the credit should be provided for the amount of tax actually imposed or the lower amount that the source state would be entitled to impose if the R-S treaty applied. If the credit is limited to this lower rate, then unrelieved double taxation may still occur. However, the residence state is not likely to accept an obligation to grant a credit in excess of the amount of tax that the source state would be entitled to impose if the R-S treaty applied. The question of relief in the residence state in these circumstances would be simplified if the R-S treaty continued to apply in addition to the PE-S treaty. This will be discussed further in Chapter 7 (Section 7.4.).

5.3.2. Conditions for availability of treaty benefits

Article 1 of the OECD Model identifies the persons covered by the treaty, providing that "[t]his Convention shall apply to persons who are residents of one or both of the Contracting States."646 Residence for treaty purposes is determined in accordance with Article 4 and depends on the person involved being "liable to tax" in the state concerned (discussed in detail above). This concept of residence for treaty purposes supports, in principle, the continued application of the R-S treaty notwithstanding that the income is attributable to a PE and may be exempt in the residence state, e.g., under a domestic exemption. This is because the person involved continues to be liable to tax, notwithstanding the exemption of part of its income. Where, however, the residence state is required to exempt the income to satisfy its obligations under a tax treaty, the situation is arguably different from one where the residence state may impose tax on the income but simply chooses not to. Such situations seem to warrant an exception to the general principle that the availability of treaty benefits depends on the treatment of the person receiving the income, and not on whether the particular item of income in question is taxable. This general principle should not rule out the inclusion of a specific provision in tax treaties preventing their operation (in both the residence state and the source state) in relation to income which the residence state is required to exempt under a tax treaty with a third state.

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

Various authors have argued that the taxation in the source state should not be subject to multiple treaty restrictions, and thus that the conditions of the R-S treaty should not apply to the income derived in a PE triangular case.647 As was outlined above, the application of multiple treaty restrictions would have no impact to the extent that both the R-S treaty and the PE-S treaty follow the OECD Model. However, where the relevant conditions differ between the R-S treaty and the PE-S treaty and both treaties are applicable, the source state could only fulfi its treaty obligations by applying the conditions which are most favourable to the person deriving the income (e.g., in the case of dividends or interest, applying the lower of the two applicable rates). The source state is unlikely to be satisfied with this outcome and thus, from the source state's perspective, it would generally be desirable to exclude the application of the R-S treaty if the PE-S treaty is to be applied.

5.3.4. Conclusions

In general, the source state should not be required to apply the conditions of the R-S treaty in situations where it applies the conditions of the PE-S treaty in relation to income attributable to the PE. This is because applying the R-S treaty in such circumstances would result in the source state being subject to

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646 The term "persons" is defined in Article 3(1) to include "...an individual, a company and any other body of persons." The OECD Commentary to Article 3 emphasises that this definition is not exhaustive, and that it should be interpreted "in a very wide sense" (OECD Commentary to Article 3, para 2.). The term "company" is defined in Article 3(1) to mean "...any body corporate or entity that is treated as a body corporate for tax purposes."

multiple treaty conditions in relation to the same income. Excluding the operation of the R-S treaty also addresses treaty shopping concerns in cases where the income is exempt in the residence state. However, the case for excluding the operation of the R-S treaty is weaker in circumstances where the residence state uses the credit method with respect to the income attributable to the PE. In such cases, the risk of treaty shopping is minimal, since any reduction in source-based taxation is likely to be offset by the tax imposed in the residence state and, in addition, the residence state may need to provide relief for tax imposed in the source state in order to prevent unrelieved double taxation. The circumstances in which the operation of the R-S treaty should be excluded, and the way in which this could best be achieved, will be discussed further in Chapter 7.

5.4. Conclusions

In PE triangular cases, the R-PE treaty effectively allocates taxing rights in relation to the income attributable to the PE to the PE state, either completely (where the residence state exempts the income) or by giving the PE state the prior right to tax (where the residence state grants relief using the credit method). This factor alone arguably does not justify the application of the PE-S treaty to income attributable to the PE, however there are a number of other factors which should be taken into account.

One important factor is the potential consequences of not applying the PE-S treaty. In some circumstances, if the conditions of the PE-S treaty are not applied in the source state, the tax imposed in the source state could exceed the amount of relief that the PE state is willing to provide, particularly where the PE state is extending treaty relief to the PE in accordance with non-discrimination principles. Thus, in certain circumstances, unrelieved double taxation could occur as a result of the non-application of the PE-S treaty. In addition, if the PE-S treaty does not apply, then the division of taxing rights between the source state and the PE state effectively depends upon the conditions of the treaties which each of those states have concluded with the residence state, rather than the conditions of the treaty between those two states. This is an inappropriate outcome, firstly because the residence state generally has no interest in the split of revenues between the source state and the PE state, and secondly because the tax collected in the source state and the PE state should arguably reflect the bargain struck between those two states and reflected in the PE-S treaty. These arguments clearly support the application of the PE-S treaty in PE triangular cases.

This raises the question of why treaty benefits are restricted to residents of the contracting states. The arguments for doing so are generally presented in the context of treaty shopping, and focus on concepts of reciprocity, the possibility that income will escape taxation (or be subject to less taxation than intended by the contracting states) and the diminished incentive to negotiate new treaties if residents of third states are able to access existing treaties. However, applying the residence concept in tax treaties is often not so straightforward, particularly when you begin to consider the scale of non-taxability that may exist under domestic laws and the difficulty in determining exactly where to draw the line between a person who is “liable to tax” and is thus a “resident” for treaty purposes and person who is not. These arguments also assume that corporate residence implies a strong connection to the jurisdiction in question, which is not necessarily the case. In general it is relatively easy for a corporation to become resident in a particular jurisdiction, e.g., through incorporation, which limits the usefulness of the residence concept for determining entitlement to treaty benefits. The arguments for limiting treaty benefits to residents also seem to be based on the idea that there is a clear distinction between the taxation of resident enterprises on a worldwide basis and the taxation of non-residents on a source basis. However, in many ways, the corporate taxation imposed on a “residence” basis effectively operates as a source-based taxation imposed on the shareholders who, in economic theory, ultimately bear the tax. Thus, the residence concept does not always provide a solid foundation upon which to determine the circumstances in which a treaty should apply.

Essentially, the residence concept seeks to identify those persons who are likely to suffer double taxation as a result of being taxed on a source basis in one state and on a residence basis in another, and to identify those who have a sufficient connection to one of the contracting states to justify the application of the treaty. However, in many cases, these features will also be present where there is a PE in one of the contracting states. Under the domestic law of the state where it is located, a PE may be taxed on a net basis in a similar way to resident enterprises; this stands in contrast to the way most states tax passive
income accruing to non-residents, which is often subject to a final withholding tax. For tax treaty purposes, PEs are also treated similarly to resident taxpayers in a number of ways. Firstly, the PE concept overrides other source rules contained in tax treaties, allowing the PE state to impose tax on the worldwide income of the PE. In addition, for determining the source of interest income under Article 11(5), payment of interest by a PE is effectively considered to be equivalent to payment by a resident enterprise. Finally, Article 24(3) requires that the taxation of the PE in the PE state is "not less favourably" levied than the tax imposed on resident enterprises, indicating that a PE is considered similar enough to a resident enterprise that it should not be subjected to a greater tax burden.

The main difference between a PE and a resident enterprise (e.g., a subsidiary) essentially lies in the differing legal form of the operations, with a PE being simply part of a broader enterprise while a subsidiary is a separate legal enterprise. But even here the distinction is blurred, with some entities that would generally be considered to have separate legal personality being fiscally transparent for tax purposes and thus effectively being treated as a “PE” of their foreign owners. Conversely, there are also situations where entities which would not normally be considered to have separate legal personality, such as partnerships, being taxed in the same way as corporations and thus eligible for treaty benefits. Clearly, the eligibility for treaty benefits does not always follow legal form. Further, even where the legal form does follow the classic pattern of a subsidiary having separate legal personality while a PE does not, it is not clear what impact this has on the economic substance of the situation. The typical pattern whereby PEs lack separate legal personality should therefore not prevent the application of the PE-S treaty in PE triangular cases.

PEs are further assimilated to separate entities under the separate entity approach for profit attribution, particularly under the recently developed AOA. The AOA increases the independence of PEs in a number of ways, ensuring that they are equated more closely to resident enterprises for profit attribution purposes. Under the AOA, the attribution of income to PEs is based on a factual and functional analysis and depends largely on the "significant people functions" carried out by the PE. The AOA expands the situations in which internal transactions (i.e., those between the PE and other parts of the enterprise) can be recognised, and introduces the notion of a PE which can assume risk and have economic ownership of assets, and which must have an appropriate capital structure to support its operations. Thus, the nature of PEs, the way in which they are taxed, and the way in which the profit attributable to the PE is determined all support the application of the conditions of the PE-S treaty to income attributable to the PE.

The main concern with extending treaty benefits to PEs is that it would open up opportunities for treaty shopping. As was discussed above, states face significant challenges in combating treaty shopping under existing principles and for this reason, they may be understandably reluctant to open up a further avenue for improper claims for treaty benefits. Treaty shopping through PEs is a legitimate concern, primarily because transactions between the PE and the rest of the enterprise have no legal consequences for the entity as a whole and because common patterns of PE taxation may make it easier to obtain treaty benefits through a PE without triggering any additional tax liability in the PE state or the residence state. It may, however, be possible to address these concerns, for example through the inclusion of a "subject to tax" requirement. In addition, the fact that taxpayers could not rely on legal arrangements to support a PE’s claim for treaty benefits, and the analysis required for determining the profits attributable to a PE may actually make gaining access to tax treaties through PEs less attractive for taxpayers than obtaining treaty benefits through a legal entity. Further, the attribution of profits to PEs is based on an economic analysis and (at least under the AOA) depends on the "significant people functions" carried out by the PE; to the extent that the income is economically linked to the PE (and the PE state), it is difficult to see how the source state could legitimately object to the application of the PE-S treaty.

In principle, for the reasons set out above, the appropriate treaty conditions for the source state to apply in a PE triangular case are those contained in the PE-S treaty. This is subject, however, to the practical challenges involved in effecting such a change. Chapter 7 will address the various ways in which the PE-S treaty could be made to apply, while Chapters 8 and 9 will address some further challenges that are likely to arise in extending treaty benefits to PEs.

648 Various ways in which treaty shopping concerns could be addressed, such as the inclusion of a "subject to tax" requirement, will be discussed in Chapter 8 (Section 8.4.).