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

Fett, E.E.

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Chapter 6
Potential solutions

6.1. Introduction

The previous three chapters have discussed the issues that can arise in PE triangular cases from the perspective of the residence state, the PE state and the source state. This chapter will take a broader view; it's purpose is to identify the fundamental causes of the issues that can arise in PE triangular cases and, in particular, to identify and assess potential solutions. First, however, this introductory section will give a brief overview of the specific issues discussed in previous chapters and, in some cases, an indication of what may be required to resolve them.

The solutions considered in this study are limited to those which would operate within the existing international tax framework, i.e., with taxation imposed on income, generally on the basis of the residence and source principles. It will not consider, for example, the possibility of a global move to purely consumption based taxes or to a system of multilateral formulary apportionment. A move to either of these systems would represent a drastic change which, without other motivating factors, would be completely out of proportion to the issues arising in PE triangular cases and the frequency of such cases. In addition, whilst they may avoid the existing problems arising in PE triangular cases, such systems could give rise to other issues in situations involving more than two states which would then have to be resolved within the framework of whatever system was implemented. For the same reasons, this study will not consider the extent to which a system of territoriality (i.e., taxation of locally sourced income only), if implemented on a global basis, could resolve the issues in PE triangular cases.

6.1.1. Overview of issues arising in PE triangular cases under the existing framework

6.1.1.1 Unrelieved double taxation

In PE triangular cases, the residence state will have an obligation under the R-PE treaty to grant relief for tax imposed in the PE state and, under the R-S treaty, will have an obligation to grant relief for tax imposed in the source state. However, where tax has been imposed on a source basis in both the source state and the PE state, the residence state may not be in a position to fully relieve double taxation.649 This will generally occur if the total amount of tax imposed in the source state and in the PE state is greater than the amount of tax which the residence state seeks to impose on the income prior to granting any relief.650 As discussed in Chapter 3, this is the case regardless of whether the residence state uses the exemption method or the credit method. If the residence state uses the credit method, then in general the residence state will not be able to credit all the tax imposed in the PE state and the source state unless the total amount of tax imposed in those states is less than the amount the residence state seeks to impose prior to granting any relief.660 Similarly, if the residence state uses the exemption system, the residence state should only be considered to have fully relieved double taxation if the total amount of tax imposed in the source state and the PE state is less than the amount that the residence state would have imposed in the absence of the exemption.

Where the residence state uses the credit method, then depending on the applicable credit limitations, the amount of credit provided may be sufficient to fully relieve double taxation even in situations where the tax imposed in the source state and the PE state is greater than the amount of tax imposed in the residence state (prior to relief).651 However, in this case the residence state is effectively reducing the

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649 This section contains only a brief discussion of the residence states ability to fully relieve double taxation in PE triangular cases. For a more detailed discussion, refer to Chapter 3 (see Section 3.2.).
650 In Chapter 3, it was submitted that in multilateral situations, unrelieved double taxation should be considered to occur only if the overall tax burden imposed on one person in relation to a particular item of income is higher than the highest of the applicable tax rates in each of the three states that seek to impose tax on the income (see Section 3.2.1.).
651 This may occur where the residence state’s credit limitation rules allow the tax imposed in the PE triangular case to be offset against the tax imposed in the residence state in relation to other income. This is discussed in Chapter 3 (see Section 3.2.3.1.).
amount of tax it collects in relation to other items of income, resulting in an inequitable distribution of tax revenue between the three states involved.

The most important contributor to the potential for unrelieved double taxation in PE triangular cases is a lack of double taxation relief in the PE state. Relief in the PE state would both ensure that unrelieved double taxation can be prevented and ensure an equitable distribution of tax revenues between the PE state and the residence state.652 In some states, unilateral relief measures are extended to situations where income is derived by a non-resident through a local PE (or where an equivalent domestic law threshold is satisfied).653 In addition, the PE state may have an obligation under the non-discrimination article (Article 24(3)) of the R-PE treaty to grant relief equivalent to that which is available to resident taxpayers.654 This obligation may extend to both the relief available to resident taxpayers under domestic law and the relief that would be available to a resident taxpayer under the PE-S treaty (referred to as "treaty relief"). However, the obligation to provide relief under non-discrimination principles is not accepted by all states, particularly with respect to the obligation to extend treaty relief to PEs. In addition, if the PE state does extend treaty relief to PEs and the PE-S treaty provides for the credit method of relief, there may be difficulties in determining the appropriate limitations that should apply to the amount of the credit to be provided.655 In general, to the extent that the PE state imposes tax on the income arising in a PE triangular case, it should be obliged to grant relief for tax imposed in the source state, and it would be preferable for this obligation to be more explicit than the existing obligations (or potential obligations) under Article 24(3).656 Alternatively, unrelieved double taxation could be avoided in PE triangular cases by preventing either the source state or the PE state from imposing tax on the income, in which case the relief provided in the residence state would be sufficient.

6.1.1.2. Applicable treaty conditions in the source state

In accordance with the existing treaty framework, a PE is not a resident person for treaty purposes and is thus generally not eligible for treaty benefits.657 As a result, the source state in PE triangular cases is required to apply the conditions of the R-S treaty to the income attributable to the PE, even though, for the reasons discussed in Chapter 5, it would arguably be more appropriate for the source state to apply

652 If the PE state uses the exemption method, then tax would be imposed only in the source state and the residence state and the residence state would provide relief (either by exempting the income or by providing a credit for the tax imposed in the source state). If the PE state uses the credit method, all three states would impose tax on the income, but the PE state would provide credit for the tax imposed in the source state and the residence state would either exempt the income or provide a credit for the tax imposed in the source state and the net amount of tax imposed in the PE state (i.e., after the credit for tax imposed in the source state). In either case, there will be no unrelieved double taxation. For further discussion, see Chapter 3 (Section 3.2.2.2.).

653 For examples of states that extend unilateral relief to PEs, see Chapter 4 (Section 4.2.2.1.).

654 For a more detailed discussion of the PE state's potential obligation to provide relief under the non-discrimination article of the R-PE treaty, see Chapter 4 (Section 4.3.).

655 The issues associated with the amount of credit relief to be provided were discussed in detail in Chapter 4 (see Section 4.3.5.). The OECD Commentary suggests that where the PE state extends treaty relief to PEs using the credit method, the amount of the credit should be the lesser of (i) the amount of tax actually imposed in the source state and (ii) the amount of tax that could have been imposed in the source state if the treaty between the source state and the PE state had applied (OECD Commentary on Article 24, para 70). It was concluded in Chapter 4 that there is an inconsistency inherent in applying both these limitations under the current wording of Article 24(3), but that it would not be appropriate to apply either one in isolation, and that therefore, it would be highly desirable for treaties to include specific wording establishing the applicable limitations.

656 The need for relief in the PE state was discussed in detail in Chapter 3, where it was concluded that the PE state should provide relief both to prevent unrelieved double taxation and to ensure an equitable distribution of taxing revenues (see, in particular, Section 3.2.2.2.). The PE state's potential obligations to grant relief were discussed in Chapter 4, where it was concluded that the PE state should have an obligation to grant relief under the non-discrimination article of the R-PE treaty. However, it was also concluded in Chapter 4 that, given the uncertainty surrounding the extent of this obligation, it would be preferable for the PE state to have an explicit obligation to grant relief.

657 For further discussion, refer to Chapter 2 (Section 2.3.), which explains that treaty benefits are not available to PEs, because they are not considered "persons" but are simply part of a broader enterprise.
the conditions of the PE-S treaty. To resolve this issue, the conditions of the PE-S treaty should be made to apply in the source state and the application of the R-S treaty should be excluded.

The exclusion of the R-S treaty provisions also addresses another issue arising in triangular cases, which is the potential for a person to claim the benefits of the R-S treaty in situations which the source state considers to be abusive. This may occur where a person claims a reduction in source based taxation under the R-S treaty in relation to income which, as a result of being attributable to a PE in a third state, is exempt in the residence state and which is not subject to tax (or is subject to only minimal tax) in the PE state.658

The discussion above, and in Chapter 5, has focused on making the conditions of the PE-S treaty apply in the source state and excluding the application of the R-S treaty, however, there are certain alternative solutions where this will not be relevant. Specifically, the application of the PE-S treaty in the source state will not be relevant if either the PE state or the source state is prevented from imposing tax on the income (discussed in Section 6.4., below) or if a multilateral treaty has been concluded between the states involved (discussed in Section 6.5., below).

Further considerations which may arise if the source state applies the conditions of the PE-S treaty in PE triangular cases, including the potential for improper use of the PE-S treaty, will be discussed in Chapter 7, Chapter 8 and Chapter 9.

6.1.1.3. Potential dual-relief obligation in the residence state

The residence state’s obligation to provide relief under two separate treaties may also oblige the residence state to grant dual-relief.659 Where, for example, one of the two applicable treaties requires the residence state to exempt the income and the other requires the residence state to provide credit relief, the residence state may potentially be required to both exempt the income and provide a credit in order to meet its treaty obligations. For various reasons (as discussed in Chapter 3), the residence state should not be required to provide dual relief, but states which remain concerned about this risk may wish to take steps to ensure that they will never be obliged to grant dual relief in PE triangular cases. Some potential options which may be available to resolve this issue were discussed in Chapter 3,660 and will not be specifically discussed in this chapter.

6.2. Underlying issues and introduction to possible solutions

In order to identify potential solutions to the issues outlined above and in earlier chapters, it is helpful to examine the underlying reasons for the problems arising in PE triangular cases; these will be discussed in this section.

6.2.1. Overlap between treaty source rules

Although the articles of the OECD Model do not contain explicit source rules, they do set out the circumstances under which each contracting state may impose tax on income derived by residents of the other contracting state, which, in effect, operate as source rules.661 One of the reasons why problems arise in PE triangular cases is that there is an overlap between the source rules contained in the R-S treaty and

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658 OECD Committee on Fiscal Affairs, "Triangular Cases," para. 21; Van Weeghel, S., The Improper Use... at pp. 124-126.

659 This issue is discussed in further detail in Chapter 3 (see Section 3.3.).

660 See Section 3.3.9. The potential solutions proposed in that section are: (i) including a provision in the relief articles of treaties to the effect that no credit is available to the extent that the income is exempt under another income tax treaty and (ii) incorporating a provision in domestic law to the effect that income that is exempt under a tax treaty is also considered to be exempt under domestic law. See Chapter 3 for further detail (Section 3.3.9.).

661 See, for example, the Introduction to the 2010 OECD Model, para 19, which describes a contracting state which is entitled to impose tax on income derived by residents of the other contracting state as the "state of source." See also Vogel, K., "State of Residence' may as well be 'State of Source' – There is no Contradiction," 59 Bulletin for International Fiscal Documentation 10, (2005), pp. 420-423.
those contained in the R-PE treaty.\textsuperscript{662} For the purposes of the R-S treaty, the income arising in a PE triangular case is generally considered to be sourced in State S and, depending on the type of income involved, State S may be entitled to impose tax. For the purposes of the R-PE treaty, however, the income effectively considered to be sourced in the PE state and is taxable in that state as a result of being attributable to the PE. The PE concept is not generally considered a sourcing rule; rather, it establishes a minimum threshold below which no tax can be imposed on locally sourced business profits.\textsuperscript{663} However, in allowing source based taxation, the existence of a PE effectively means that the income attributable to the PE is considered to be sourced in the PE state for treaty purposes. Consequently, income arising in a PE triangular case is considered to be sourced in State S for the purposes of the R-S treaty and in State PE for the purposes of the R-PE treaty and therefore has a dual source for treaty purposes. Vogel describes the concept of "state of source" as being "treaty relative" in this situation.\textsuperscript{664}

This suggests that the issues arising in PE triangular cases could be effectively dealt with by resolving the overlap between the tax treaty sourcing rules. This could be done either by preventing the PE state from imposing tax on income arising in PE triangular cases, or by preventing the source state from imposing tax on the income attributable to the PE. These options will be discussed in Section 6.4., below.

6.2.2. Hybrid nature of the PE concept

As discussed above, the PE concept is a threshold for determining the minimum presence required in order for a state to impose source-based taxation on business profits\textsuperscript{665} and effectively operates as a sourcing rule for treaty purposes. There are, however, a number of reasons (as discussed in Chapter 5\textsuperscript{666}) for considering the PE concept as something of a quasi-residence concept or at least a "residence-supporting" concept.\textsuperscript{667}

First among these reasons is the PE state’s ability to impose tax on the worldwide income attributable to the PE. That is, the PE state may impose tax on any income that is attributable to the PE regardless of the extent to which that income is economically connected to a third state, e.g., as a result of being paid by a resident of that state. This of course gives rise to PE triangular cases. The hybrid nature of the PE concept is also evident in the non-discrimination article of tax treaties (specifically, Article 24(3)), which requires that the tax imposed in the PE state is levied "not less favourably" than the tax that would be levied on a resident enterprise. Implicit in this provision is the view that a PE is similar enough to a resident enterprise that it should generally be treated in the same way for tax purposes. This stands in contrast to the other paragraphs of Article 24, which prevent discrimination against nationals of the contracting states\textsuperscript{668} but which do not, in a general sense, prevent non-residents from being taxed less favourably than residents.\textsuperscript{669} In addition, the income attributable to a PE must generally be taxed on a net basis, in the same way as a resident taxpayer, rather than the gross basis upon which source-based taxation is often imposed. This is reflected in the wording of the treaty limitation on source based taxation for PEs (i.e., "profit attributable to the PE") under Article 7 as opposed to the limitations based on gross income that apply in the case of dividends (Article 10) and interest (Article 11) (and often also royalties (Article 12)). Additional support for the view that the PE is in effect a quasi-residence concept comes from the separate enterprise approach to determining the profit attributable to PEs, under which the PE must be hypothesised as a "distinct and separate enterprise."\textsuperscript{670} The recent work of the OECD, reflected in the new "Authorized OECD Approach" (or AOA) for the attribution of profit to PEs, has

\begin{enumerate}
\item Vogel, K., "State of Residence‘…’
\item Arnold, B.J., "Threshold Requirements…" at p. 473.
\item Vogel, K., "State of Residence‘…’
\item And to tax other income attributable to the PE on a net basis.
\item See Sections 5.2.3. and 5.2.4. These reasons are outlined in the text in this section (i.e., Section 6.2.2.).
\item Vann, R., "Reflections on Business…” at pp. 133-169. See also the discussion in Chapter 5.
\item See, in particular, Article 24(1) which prevents discrimination against nationals of the other contracting state.
\item In addition to Article 24(1), which prevents discrimination on the basis of nationality, Article 24(2) prevents discrimination against stateless persons, Article 24(4) prevents states from making disbursements non-deductible on the basis of being paid to residents of the other contracting state, and Article 24(5) prevents discrimination against enterprises owned by residents of the other contracting state.
\item OECD Model, Article 7.
\end{enumerate}
further increased the personalization of PEs, at least for profit attribution purposes, e.g., in its explicit requirement to apply the OECD’s transfer pricing guidelines for profit attribution purposes.671

Thus, the PE concept is revealed as something of a hybrid between the source and residence concepts. This gives rise to problems in PE triangular cases where the income which is attributable to the PE and which the PE state is entitled to tax under the R-PE treaty includes income which is sourced in a third state. Like a resident of the PE state, the PE is taxed on its worldwide income but, unlike a resident, the PE has no corresponding entitlement to treaty benefits and, as a result, the PE state has no direct obligation to grant relief for tax imposed in the source state (although an obligation may arise under non-discrimination principles) and the source state has no obligation to apply the conditions of the PE-S treaty. Thus, issues can arise in PE triangular cases because PEs are treated partially, but only partially, in the same way as persons who are resident in the PE state for treaty purposes.

This leads to the conclusion that the problems arising in PE triangular cases could be dealt with by resolving the hybrid nature of the PE concept. One way in which this could be achieved is by treating the PE concept more like a residence concept. This would involve, broadly, requiring the PE state to grant relief for tax imposed in the source state and requiring the source state to apply the conditions of the PE-S treaty in relation to income attributable to the PE. To date, this has been the basis for the majority of suggestions for dealing with PE triangular cases,672 but it should be noted that this approach encompasses a wide variety of specific measures which could be implemented in different ways. These are discussed primarily in Chapter 7, Chapter 8 and Chapter 9. This approach is discussed only briefly below (see Section 6.3.).

Alternatively, the problems arising in PE triangular cases could be resolved by reducing the extent to which the PE concept is treated like a residence concept. This would involve, in particular, preventing the PE state from imposing tax on the worldwide income of the PE. This second option is closely related to resolving the overlap in the source rules (as discussed above) and will be discussed in Section 6.4., below.

6.2.3. Bilateral nature of tax treaties

With only a few exceptions,673 tax treaties are bilateral in nature; they are concluded between only two states and, in broad terms, the operation of one bilateral tax treaty cannot have an impact on the operation of another.674 The bilateral nature of tax treaties is frequently identified as the main cause of the issues arising in PE triangular cases.675 However, as will be discussed below, the issue is not so much that tax treaties themselves are bilateral, but rather, that their provisions generally only contemplate bilateral situations and are not intended to interact with the provisions of other treaties.

The lack of interaction between tax treaties has an impact in PE triangular cases in a number of ways. Most clearly, the allocation of primary (or exclusive) taxing rights to the PE state under the R-PE treaty is not recognised for the purposes of the application of the PE-S treaty, i.e., the PE state is not required to grant relief under the PE-S treaty and the source state is not required to apply its conditions in relation to income attributable to the PE. In addition, the residence state may potentially have a dual-relief obligation as a result of its obligations to grant relief under both the R-PE treaty and the R-S treaty (although, as I have argued in Chapter 3 (Section 3.3.), this should not be the case).

671 The AOA and the increase in the personalisation of PEs under the AOA were discussed in detail in Chapter 5 (see Section 5.2.5.).
673 Notably, the Nordic Convention, the CARICOM Convention and the Andean Convention (all discussed in Section 6.5.1., below).
674 As discussed elsewhere (see Chapter 3, Section 3.3.3.), the results of the application of one bilateral tax treaty can have an impact on the application of another bilateral tax treaty where the first treaty has an impact on the facts to which the second treaty is being applied. See: Van Raad, K., “2008 OECD Model....”
675 See, for example: OECD Committee on Fiscal Affairs, "Triangular Cases", para 1.
Alternatively, if the PE is viewed as a purely source-based concept, then lack of interaction between the R-S treaty and the R-PE treaty means that the income arising in PE triangular cases has a dual source for treaty purposes, i.e., it is considered to be sourced in the PE state for the purposes of the R-PE treaty and is considered to be sourced in the source state for the purposes of the R-S treaty. The sourcing of income in a particular state under a bilateral tax treaty has no impact on where the income is considered to be sourced for the purposes of other bilateral treaties, and in PE triangular cases there is no mechanism to resolve this overlap.

Thus, the issues arising in PE triangular cases can be considered to arise as a result of the lack of interaction between tax treaties. However, the introduction of some kind of general principle requiring tax treaties to interact with each other, for example, by requiring those applying tax treaties to take into consideration the results of the application of other tax treaties, would most likely raise more issues than it solves. Specific solutions are required for each particular issue, identifying exactly when and how the results of the application of other tax treaties should be taken into account (this will be seen particularly in Chapter 7, Chapter 8 and Chapter 9).

The issues arising in PE triangular cases could be dealt with by including specific provisions in tax treaties which indicate when and how the results of the application of other tax treaties should be taken into account and indeed, this is how the majority of the suggested solutions to PE triangular cases operate. More specifically, such solutions may operate either by resolving the overlap in the sourcing rules, i.e., by preventing either the source state or the PE state from imposing tax on the income or by treating the PE more like a resident of the PE state. Alternatively, the issues arising in PE triangular cases could be resolved through the conclusion of a multilateral treaty between the states involved. However, as will be discussed below (in Section 6.5.), the drafters of any multilateral treaty should still consider exactly how PE triangular cases should be dealt with in order to come to an appropriate solution and specific provisions may be required. The existence of a multilateral treaty drafted along the lines of the OECD Model would not automatically resolve the issues arising in PE triangular cases.

The discussion above has identified certain ways in which the issues arising in PE triangular cases could be resolved. The remainder of this chapter will go on to discuss these potential solutions in much greater detail.

### 6.3. Treat PEs more like resident persons for treaty purposes

The vast majority of the literature to date has suggested solutions to PE triangular cases which effectively result in the PE being treated more like a resident person for treaty purposes. Such solutions generally, in one way or another, require the PE state to grant relief for tax imposed in the source state and require the source state to apply the conditions of the PE-S treaty in relation to income attributable to the PE. It is usually also suggested that the source state should not be required to apply the conditions of the R-S treaty. Where authors differ, however, tends to be in relation to the best way to achieve this outcome and

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676 Vogel, K., "State of Residence".


678 As discussed above and in Section 6.4., below.

679 i.e., by imposing a direct relief obligation on the PE state and requiring the source state to apply the conditions of the PE-S treaty in relation to income attributable to the PE, as discussed above. This will be discussed briefly in Section 6.3. below and in more detail in Chapter 7 and Chapter 8.


in the extent to which PEs should be treated in the same way as resident persons. Due to the wide variety of solutions encompassed by this approach and their complexity, this approach is considered to warrant a more extensive discussion than could be undertaken in this chapter. It will therefore be the subject of Chapter 7. Further issues and implications of this approach will be discussed in Chapter 8 and Chapter 9.

6.4. Treat PE concept as a source concept and resolve overlap in sourcing rules

If the PE concept is viewed purely as a source concept, then the appropriate response to the problems arising in PE triangular cases, at least from a theoretical perspective, would be to resolve the overlap between the implicit sourcing rules contained in the applicable treaties. This would involve preventing either the source state or the PE state from imposing tax in PE triangular cases and would result in the situation effectively becoming bilateral.

This would resolve the issues arising in PE triangular cases as follows:

1. Relief in the residence state: The residence state would no longer have a relief obligation in relation to the state which was prevented from imposing tax (i.e., the source state or the PE state). The residence state would only be required to provide relief for tax imposed on a source basis in a single state and, consequently, would generally be capable of fully relieving double taxation. There would also be no possibility of a dual-relief obligation arising.

2. There would be no need for relief to be provided in the PE state: Either the PE state would be prevented from imposing tax, and thus would not have any capacity to provide relief or, alternatively, the source state would be prevented from imposing tax and there would be no need for relief in the PE state.

3. There would be no need for the source state to apply the conditions of the PE-S treaty: If the PE state is prevented from imposing tax then taxing rights would not be transferred to the PE state under the R-PE treaty. There would therefore be no basis upon which to apply the conditions of the PE-S treaty. Alternatively, the source state would be prevented from imposing tax and, as a result, the application of the conditions of the PE-S treaty in the source state would have no relevance.

It is therefore possible to resolve the issues arising in PE triangular cases by resolving the overlap between the treaty sourcing rules. However, there are several important questions to be addressed with respect to this potential solution. They include the issue of which state should sacrifice its taxing rights, the extent to which this approach would open up opportunities for tax avoidance, and whether this solution is likely to be broadly acceptable to the states involved. This section will discuss these issues, first dealing with situations where the PE state is prevented from imposing tax and then with situations where the source state is prevented from imposing tax.

6.4.1. Preventing taxation in the PE state

This approach, whereby the PE state is prevented from imposing tax in PE triangular cases, would effectively redefine the source rules contained in the R-PE treaty such that income which has a strong economic connection to a third state would not be considered to be sourced in the PE state for the
purposes of that treaty. This may involve the income being excluded from the income attributable to the PE, in which case the PE state would not be entitled to impose tax and the residence state would not be required to grant relief. It resolves the overlap between the source rules of the R-S treaty (based on, e.g., the residence of the payor) and those of the R-PE treaty (based on the existence of the PE) in favour of the source state. This solution has a number of advantages, however as will be discussed below, it gives rise to significant tax avoidance concerns and may be unacceptable to states in the position of the PE state due to the extent of the restriction on the PE state’s taxing rights.

This solution could only be implemented by including a specific provision in the R-PE treaty.\(^{683}\) It could not be implemented in the domestic law of the PE state because even if the PE state does not impose tax on the income under domestic law, the residence state may be required to exempt the income under the relief provisions of the R-PE treaty as a result of it being attributable to the PE. It could also not be implemented by provisions included in the R-S treaty because the PE state is not party to the R-S treaty and that treaty therefore cannot impose any restriction on the taxing rights of the PE state. The PE-S treaty could potentially restrict the taxation of the income in the PE state, but in this case the residence state may still be required to exempt the income under the R-PE treaty (in the absence of a specific provision excluding relief) and, even if corresponding provisions were included in the R-PE treaty, this would be an unnecessarily complex way of implementing this solution. This would be further complicated by the fact that the income is not received by a resident of either of the contracting states. The best approach is therefore to include a specific provision in the R-PE treaty.

6.4.1.1. Operation of provision preventing taxation in the PE state

One of the key issues with designing a provision to implement this solution is determining which income the PE state would be prevented from taxing. The PE state should only be prevented from taxing income for which the source state is entitled to tax in accordance with the terms of the R-S treaty, since it is only in relation to this income that unrelieved double taxation may potentially arise in PE triangular cases.

It would not be appropriate to simply prevent the PE state from taxing income which does not have its "source" in the PE state as defined under that state’s domestic law. Given that the income is not derived by a resident of the PE state, the PE state is presumably imposing tax because it considers the income to be locally sourced as a result of the business activities of the PE. Similarly, it would not be appropriate to prevent the PE state from taxing any income which a third state considered to be locally sourced given the potentially broad scope of domestic sourcing rules in third states. Clearly, the provision should refer to the distributive rules in tax treaties.

One option is for the R-PE treaty provision to specify the types of income which the PE state is prevented from taxing (i.e., without reference to the actual terms of the R-S treaty). These may include dividends, interest and royalties arising in a third state,\(^{684}\) income arising from immovable property situated in a third state,\(^{685}\) and certain capital gains (e.g., capital gains arising from the alienation of

\(^{683}\) Or, potentially, by amending the rules under which profit is attributed to the PE for the purposes of that treaty, i.e., the OECD Commentary on Article 7 and the Report on the Attribution of Profit to Permanent Establishments referred to in that Commentary (see paras. 19-20). However, the effectiveness of this approach may be uncertain given the significant departure from existing practices that such a change would represent and the ongoing debate regarding the applicability of changes to the OECD Commentary (let alone reports referred to in that commentary) made after the conclusion of a treaty (see, for example: Engelen, F., *Interpretation of Tax Treaties*… at pp. 439-473 (Chapter 10, Section 10.9.)). If this solution were implemented, the better approach would be to include specific provision in the R-PE treaty.

\(^{684}\) The term "arising" in a state is used here to denote situations where treaties allow source based taxation. Under the OECD Model, dividends may generally be taxed on a source basis in a particular state if they are paid by a resident of that state (Article 10(5)). Interest is considered to arise in a particular state if the payor is a resident of that state or if the payor of the interest has a PE in that state in connection with which the indebtedness on which the interest is paid was incurred and such interest is borne by the PE (Article 11(5)). The OECD Model does not specify the situations in which royalties (dealt with under Article 12) are considered to arise in a particular state.

\(^{685}\) The definition of immovable property in the OECD Model (Article 6(2)) refers primarily to the domestic law of the state where the property is located and therefore, it would be preferable for the relevant provision of the R-PE treaty to make the same reference to the domestic law of the state where the property is located. Alternatively, a
immovable property located in a third state). The terms of such a provision should be based either on the distributive rules of the OECD Model convention, or, to the extent that the residence states treaty policy differs from the OECD Model, on the common distributive rules that exist in the residence state’s treaties (which may require different provisions applicable for each of the contracting states since they may have different treaty policies). The main problem with this approach is that while it may resolve PE triangular cases in the majority of situations, it will not be effective where the R-S treaty allows the source state to impose tax in a situation which is not covered by the provision of the R-PE treaty preventing tax in the PE state.

The better option may be for the R-PE treaty to refer directly to the R-S treaty and to prevent the PE state from imposing tax on any income which the source state is entitled to tax in accordance with the terms of that treaty. Such a provision could be worded along the following lines:

"Where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, and where the profit attributable to that permanent establishment includes income which is taxable in a third state under the conditions of an applicable tax treaty between the residence state of the enterprise and that third state, then that income shall be excluded from the profit attributable to the PE for the purposes of this Convention."

This approach has the advantage that the prevention of tax in the PE state is directly linked to the source state’s taxing rights under its treaty with the residence state. States may be reluctant to take this approach, however, because it means that the extent of the PE state’s taxing rights depends on the particular terms of the treaty concluded between the residence state and the source state, over which the PE state has no control. Nevertheless, this should still be the preferred approach. One way of making it more acceptable to the states involved may be to limit its application to passive income (i.e., dividends, interest and royalties), which would make the scope and effect of the provision in the PE state more certain. These categories of income also generally present the greatest concern in PE triangular cases. A provision incorporating this limitation could be worded along the following lines:

"Where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, and where the profit attributable to that permanent establishment includes income which is taxable in a third state under an article applicable to dividends, interest or royalties of an applicable tax treaty between the residence state of the enterprise and that third state, then that income shall be excluded from the profit attributable to the PE for the purposes of this Convention."

This provision would also not prevent the PE state from imposing tax in situations where there is no treaty between the residence state and the source state, although this could be dealt at the option of the contracting states.

6.4.1.2. Assessment of this potential solution

Preventing the PE state from imposing tax on income which is sourced in a third state (i.e., under the R-S treaty) has a number of advantages. One of the main advantages is its relative simplicity. It does not require provisions to be included in multiple treaties, meaning that there is less potential for mismatch between the terms of different treaties and no need to be concerned about an incomplete implementation, i.e., where one of the relevant treaties does not include the required provisions. This solution also has the advantage that it avoids extending treaty benefits to PEs, with all the complications that may entail (as will be discussed in Chapter 7, Chapter 8 and Chapter 9).

Another advantage of this approach is that it would remove the potential for what may be considered improper use of the R-S treaty in PE triangular situations, i.e., in situations where the income is exempt in the residence state (as a result of being attributable to a PE) and is not taxed or is only minimally taxed in

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specific treaty definition could be formulated for this purpose or the definition could rely on the meaning of immovable property in the domestic law of, e.g., the PE state.

686 The PE state should be prevented from imposing tax on gains which may be taxed in the source state under the distributive rules of the OECD Model. Refer to Chapter 2 for a discussion of these distributive rules.
the PE state. This would no longer be a concern if the PE state is prevented from taxing the income, on the basis that the income is not attributable to the PE, because the residence state would never be required to exempt the income under the R-PE treaty. This concern regarding the improper use of the R-S treaty can also be addressed by specific provisions included in the R-S treaty, but preventing the income from being attributable to the PE may be a simpler approach.

Despite these advantages, preventing taxation in the PE state presents significant tax avoidance concerns because, if implemented, it would undermine the residence-supporting role of the PE concept in tax treaties. On one hand, this may not be seen as a significant issue since the PE state is only being prevented from imposing tax on income which is, admittedly, sourced in a third country. It is certainly less problematic than eliminating the taxation of PEs in full because income sourced in the PE state would continue to be taxable in the PE state in the same way as it would have been if the company had remained resident in that state. However, it may ultimately result in states being effectively unable to impose residence based taxation, particularly in relation to passive income. The tax avoidance concern here primarily relates to companies which are currently resident in the PE state or are contemplating establishing residence in the PE state if tax treaties incorporated a provision eliminating taxation of third country income attributable to PEs (i.e., by excluding such income from the profit attributable to PEs), these companies would have a strong incentive to shift their residence to states with lower tax rates or to states which exempt the income attributable to foreign PEs. In this way, companies could lower the rate of residence-based taxation imposed on income derived from sources in third states (potentially to zero) while continuing to conduct their activities in what is now the PE state. This of course relies on the new residence state having a good treaty network, such that treaty benefits continue to be available in the source state. This may tend to limit the opportunities for relocation, but in general it should not be too difficult to identify a state which has a strong treaty network and which exempts the profit attributable to foreign PEs (either under domestic law or tax treaties). The potential for tax avoidance is illustrated in the following example involving royalties.

Example

Suppose a pharmaceutical enterprise ("NewPharm") is developing a new drug. The company is resident in State A and all the enterprise’s drug development operations are located in State A; i.e., all the decisions regarding whether to commence particular research, the direction of the research, and whether to continue the research are made in State A and the research itself is also conducted in State A. This research leads to the development of a drug ("MiracleCure") which cures a major illness affecting people worldwide. The enterprise patents the drug in various jurisdictions (including "State S") and intends to profit by granting enterprises in various countries licenses to manufacture and distribute MiracleCure. NewPharm expects to receive $100 million of royalties from a licensee in State S. State S imposes a withholding tax of 10% on royalties under its domestic law, however under the terms of the A-S treaty, State S is prevented from imposing any tax on the royalties. The general company tax rate in State A is 30% and, since State S is prevented from imposing tax on royalties, State A is not obliged to grant any relief under the A-S treaty.

State A has entered into a treaty with State B (the A-B treaty) containing a business profits article (Article 7) which follows the OECD Model, except that it provides that the PE state may not impose tax on any of the income attributable to the PE which arises in third states (i.e., it prevents taxation in the PE state in PE triangular cases). To take advantage of this provision, NewPharm transfers its residence to State B by transferring its place of effective management to that state. NewPharm is incorporated in State A and therefore becomes a dual resident, however, under the tie-breaker provision of the A-B treaty the company is treated as a resident in State B for the purposes of that treaty. Day-to-day licensing decisions continue to be made in State A and management of the licensing arrangements continues to be conducted

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687 This will be discussed in Chapter 8 (see Section 8.4.).
688 As outlined by: Vann, R., "Reflections on Business…” at p. 147.
689 As described by Vann (Vann, R., "Reflections on Business…” at p. 147.)
690 The following analysis is similar to that conducted by Vann in relation to the potential consequences of the non-taxation of PEs. See: Vann, R., "Reflections on Business…”.
in State A. For the purposes of the A-B treaty, the patents are economically owned by a PE in State A and, as a result, the royalties generated by the company are attributable to the PE in State A. State B uses the exemption method with respect to the profit attributable to the PE and therefore exempts the royalties which are derived from State S and which are attributable to the PE in State A. The general company tax rate in State B is 30%.

State B has a comprehensive treaty network. Under the treaty between State B and State S (the B-S treaty), State S may impose tax on royalties arising in State S and paid to a resident of State B, but the tax is limited to 5% of the gross amount of the royalties. After the transfer of its residence to State B, it is assumed that NewPharm is no longer resident in State A for the purposes of the A-S treaty. State S therefore applies the B-S treaty rate and imposes tax of $5 million on the royalties.

This situation is illustrated in the following diagrams; the first diagram illustrates the situation if NewPharm remains resident in State A, while the second diagram illustrates the situation if NewPharm transfers its residence to State B. The outcome in these two situations is outlined in the table below.

![Diagram](image)

**Figure 6.1.: Scenario (i), New Pharm remains resident in State A**

- **State A**
  - 30% tax rate
  - Royalties $100

- **State S**
  - Income exempt under A-B treaty

**Figure 6.1: Scenario (ii): NewPharm transfers residence to State B and income is attributable to a PE in State A**

- **State B**
  - 30% tax rate but prevented from taxing under A-B treaty

- **State A**
  - A-S treaty rate: 0%

- **State S**
  - Royalties $100

**Table 1: Comparing scenario (i), whereby NewPharm remains resident in State A, and scenario (ii), whereby NewPharm transfers its residence to State B and the royalties are attributable to a PE in State A.**

<table>
<thead>
<tr>
<th>Royalty income from State S</th>
<th>(i) NewPharm remains resident in State A</th>
<th>(ii) NewPharm transfers residence to State B and royalties are attributable to a PE in State A</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

691 The OECD Report on the Attribution of Profits to PEs states that: "The significant people functions relevant to the determination of economic ownership of internally created intangibles are those which require active decision making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property." (OECD, "2010 Report on the Attribution of Profits to Permanent Establishments," Part I, Section D-2(iii), para 85. Thus, in this scenario the patents should be economically owned by the PE and the royalty income should be attributable to the PE.

692 The second sentence of Article 4(1) provides that a person will not be resident in a particular state if they are "liable to tax in that State in respect only of sources in that State." The OECD Commentary (2010 OECD Commentary on Article 4, para 8.2) takes the position that a dual resident would not be resident in the losing residence state (in this case, State A) for the purposes of treaties with third states (i.e., State S) under this provision as a result of the restrictions imposed on the losing residence state’s taxing rights under the treaty between the two residence states. This position will be assessed in detail in Chapter 10.
In this simplified scenario, the company has reduced its overall tax liability from $30m to $5m, despite the B-S treaty conditions being less favourable than the A-S treaty conditions. This occurs as a result of State A being prevented from imposing tax on the income, despite the substantial activities conducted in State A and the substantial link between those activities and the income earned by the company. Thus, the company has effectively avoided being subject to any residence-based taxation simply by transferring its residence State B, without any major change in the nature or location of its operations and while continuing to have a substantial economic presence in State A.

It would be extremely difficult to develop an anti-avoidance rule to address this type of structure and to distinguish between situations where the PE state should and should not be entitled to impose tax. This difficulty basically lies in the fact that in all cases where the income is included in the profits attributable to the PE, it will have a strong economic link to the PE state. It is also not unusual for states to use the exemption method for income attributable to a PE. Thus, it would be difficult to identify the features which, if present, should lead to a structure being considered abusive. One approach may be to allow the PE state to impose tax in situations where the residence state exempts the income, but in this case taxing rights continue to be transferred to the PE state under the R-PE treaty and the source state is again applying the “wrong” treaty; the issues are not resolved. Alternatively, the PE state could be entitled to impose tax if there is a tax avoidance motive, e.g., where a "primary purpose" of any person involved in a transaction is to avoid tax. In the above example, where there is a transfer of residence immediately after the development phase and prior to deriving income, this may not be too difficult to prove. But in most cases the application of this type of rule would face tremendous practical difficulties in distinguishing between legitimate situations and those that should be considered abusive.

The above example also illustrates another important problem with preventing taxation in the PE state, which is that the income has a legitimate economic connection to the PE state and thus, the PE state should arguably be entitled to impose tax on the income. Source-based taxation is generally justified on the basis of the benefit principle, i.e., on the basis that the person earning the income has derived a benefit from participating in the economic life of that state and that, as such, that state should be entitled to impose tax. Where the person deriving the income has a sufficient presence in the PE state to give rise to a PE, and where the income in question has a sufficient connection to the activities conducted in that state to be attributable to the PE, the person deriving the income has clearly participated in the "economic life" of the PE state and the PE state should therefore be entitled to impose tax. This is particularly clear in the example outlined above, where the vast majority of the company’s economic activities are conducted in State A. States which find themselves in the position of the PE state are unlikely to accept a complete restriction on their right to tax income arising in third states and may prefer

<table>
<thead>
<tr>
<th>WHT collected in State S</th>
<th>$693</th>
<th>$694</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax collected in State A</td>
<td>30$95</td>
<td>$906</td>
</tr>
<tr>
<td>Tax collected in State B</td>
<td>N/A$97</td>
<td>$908</td>
</tr>
</tbody>
</table>

693 State S is prevented from imposing tax under the A-S treaty.
694 The WHT is limited to 5% under the B-S treaty ($5% x $100m = $5m).
695 State A imposes corporate tax on the royalties received at its domestic rate of 30%. It is assumed that State A uses the credit method, at least in relation to passive income, such that no relief is required in State A. Further, it is assumed that there are no carried-forward losses from the development phase available for deduction against the royalties; State A may not allow loss carry-forward, or the losses may already have been absorbed by royalty income from other countries where MiracleCure is licensed. It is also assumed that the company has no expenses, in order to simplify the example.
696 State A is prevented from imposing any tax on the income under the A-B treaty as a result of a provision which prevents PE states from imposing tax on income sourced in third states.
697 In this scenario, there is no link to State B and state B imposes no tax.
698 State B exempts the income attributable to the PE under the A-B treaty, and therefore imposes no tax on the income.
a solution that requires them simply to give relief for tax imposed in the source state, in which case the PE state may often be able to collect residual taxation, i.e., after the provision of credit relief; this is a feature of the solution discussed in Chapters 7, 8 and 9, whereby the PE is treated more like a resident of the PE state and is effectively entitled to treaty benefits.

Preventing taxation in the PE state would also contrast somewhat with the OECD Model's general approach for dealing with overlapping source rules within a single tax treaty, under which the PE concept generally overrides other sourcing rules. In a bilateral situation, for example, where a resident of one state receives dividends or interest arising in another state (the source state), those dividends and interest can generally only be taxed in the source state at a limited rate under Article 10 or Article 11 unless the recipient derives the income through a PE located in that state (i.e., they are attributable to a PE of the recipient in the source state), in which case the business profits article (Article 7) applies and there is no limitation on the rate of tax that can be imposed. This inconsistency also weigths against resolving the overlap in the treaty source rules in favour of the source state.

6.4.2. Preventing taxation in the source state

As an alternative to preventing the PE state from taxing income sourced outside the PE state, the source state could instead be prevented from taxing income which is attributable to a PE in a third state. This approach would effectively resolve the overlap in the sourcing rules in favour of the PE state.

The simplest way to achieve this outcome would be to include a provision in the R-S treaty to prevent the source state from imposing tax in PE triangular cases. This solution could also be implemented by a provision included in the domestic law of the source state, however the source state is unlikely to be willing to unilaterally give up its taxing rights in relation to any income which attributable to a PE outside the income recipient's residence state (and outside the source state). This is partly due to the lack of negotiating power which it would have to convince other states to implement reciprocal measures (either domestically or in tax treaties) but also, more importantly, due to the tax avoidance concerns discussed below. This solution could not be implemented by provisions included in either the R-PE treaty or the PE-S treaty; the R-PE treaty because it cannot impose any restriction on the source state, and the PE-S treaty because there is no treaty eligible resident of the PE state. The best approach would therefore be to include a specific provision in the R-S treaty.

6.4.2.1. Operation of provision preventing taxation in the source state

Taxation should only be prevented in the source state in situations where the income is attributable to a PE in the PE state for the purposes of the R-PE treaty, since it is only in these situations that the PE state will be entitled to impose tax, and the residence state obliged to grant relief, under the terms of the R-PE treaty. The best approach would be for the provision of the R-S treaty preventing the source state from imposing tax to refer directly to the treaty between the residence state and the PE state (i.e., the R-PE treaty). Without a specific reference to the R-PE treaty, the applicable PE definition for the purposes of the provision would be that contained in the R-S treaty. This would clearly be inappropriate because it could lead to situations where the source state is prevented from imposing tax on income which is not attributable to a PE for the purposes of the R-PE treaty. Conversely, the source state may continue to impose tax on income which is attributable to a PE in the PE state for the purposes of the R-PE treaty, in which case the issues arising as a result of the triangular situation would not be resolved.

A provision preventing taxation in the source state in PE triangular cases could be worded along the following lines:

"Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment of that enterprise in a third state for the purposes of the treaty between that Contracting State and the third state, then that income shall not be taxed in the other Contracting State."

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700 This will be discussed further in Chapter 8 (see Section 8.2.3.).
6.4.2.2. Assessment of this potential solution

Similarly to preventing PE state taxation, this approach has the advantage of simplicity; it requires a provision to be included in only a single treaty, with no corresponding provisions in other treaties. It also avoids the potential difficulties associated with extending treaty benefits to PEs (which will be discussed in Chapter 7, Chapter 8 and Chapter 9).

This approach would, however, give rise to significant tax avoidance concerns. If source states were prevented from imposing tax on income derived in PE triangular cases, then all source-based taxation could be avoided simply by operating through a PE in a third state (i.e., outside the residence state and the source state). This lack of source-based taxation in PE triangular cases could ultimately result in states not being able to effectively impose any source-based taxation at all. This occurs because it would be relatively easy for companies to become resident in a jurisdiction other than the one in which they conduct their activities and derive all their income through PEs located in the state where they do conduct activities, i.e., as in the NewPharm example given above. This would result in source states being prevented from imposing any tax.

In addition, if source state taxation is prevented in PE triangular cases then, in certain circumstances, the income may escape taxation altogether, i.e., where the PE state does not impose tax and where the residence state exempts the income attributable to the PE (either under the R-PE tax treaty or under domestic law). This concern could be mitigated by including a proviso that the source state may tax the income in accordance with the ordinary distributive rules of the R-S treaty if the income is not taxed in the PE state (i.e., a subject-to-tax clause), or is subject to a lower rate of tax than the source state considers to be sufficient (e.g., 60% of the residence state’s tax rate). A provision incorporating a subject to tax requirement could be worded along the following lines:

"Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment of that enterprise in a third state for the purposes of the treaty between that Contracting State and the third state, then that income shall not be taxed in the other Contracting State unless the profits of the permanent establishment are subject to an aggregate effective rate of tax in the first-mentioned Contracting State and the third state that is less than [X percent] of the effective rate of tax that would be applicable in the first-mentioned Contracting State if the income were not attributable to the permanent establishment."

Under this provision, the normal rules of the treaty would apply if the tax imposed in the PE state and the residence state is considered insufficient, i.e., by reference to the tax that would be imposed in the residence state if the income were not attributable to the PE. However, the effectiveness of this type of rule would be compromised by companies' ability to become resident in the state with the lowest tax rate, with the result that the rule may be satisfied despite a relatively low tax burden in the PE state. There would also continue to be an incentive to derive income through PEs and thus escape source based taxation in situations where, for example, source-based taxation is imposed on a gross basis and there are significant expenses associated with the income such that the source-based taxation is effectively imposed at a very high rate. There would be similar incentives for enterprises that are tax exempt in their residence state, enterprises that have losses available for deduction, are tax exempt in their residence state, or (if the residence state uses the credit method) enterprises that have excess foreign tax credits which they are unable to use. Such enterprises would have a clear incentive to escape source-based taxation and the type of provision outlined above would not be particularly effective in such cases, since the tax that would be imposed in the residence state is likely to be minimal regardless of whether the income is attributable to a PE in another state.

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701 Unlike the solutions discussed in Chapter 7 (i.e., the extension of treaty benefits to PEs), which generally require provisions to be included in more than one treaty for their operation.

702 This wording is based in part on the wording of provisions included in many US treaties to prevent the application of the R-S treaty in certain triangular situations. Such provisions will be discussed in detail in Chapter 7 (see Section 7.5.1.1.).

703 Either in the current year, or in prior years where such losses can be carried forward for use in the current year.
This type of subject-to-tax provision would also not address the broader concern that even if the income is ultimately subject to the same amount of tax, none of that tax can be imposed in the source state. This would be a significant concern for capital importing states which would more often find themselves in the position of the source state. Aside from tax avoidance concerns, therefore, the main problem with this approach (aside from tax avoidance concerns) is that the income has a legitimate economic connection to the source state and that the source state should therefore be entitled to impose tax (i.e., in accordance with the benefit principle). This is especially true in relation to income from immovable property located in the source state, where the source state arguably has a much stronger taxing claim than the PE state. Thus, even if tax avoidance concerns can be addressed, the source state is unlikely to be willing to completely give up source-based taxing rights in relation to any income which is attributable to a PE in a third state.

Giving up all source based taxing rights would likely result in the source state collecting less tax in relation to the income than it would be entitled to collect under the normal provisions of either the R-S treaty or the PE-S treaty, at least with respect to certain categories of income. This solution therefore results in the source state having significantly less taxing rights than it would have if it continued to apply the R-S treaty or, alternatively, if it applied the conditions of the PE-S treaty in relation to the income attributable to the PE (as will be discussed in Chapter 7).

6.4.3. Conclusions

This section has discussed potential solutions to the issues arising in PE triangular cases whereby the overlap in the tax treaty sourcing rules would be resolved and either the PE state or the source state would be prevented from imposing tax on income arising in PE triangular cases. The main advantage of these solutions is their relative simplicity; they would not require significant interaction between various measures included in multiple tax treaties and would not involve replacing the existing network of bilateral tax treaties with a multilateral treaty. However, due to the significant tax avoidance concerns which they present, neither of these approaches is a viable solution. If source states were prevented from imposing tax on income attributable to PEs in third states, it is likely that there would be a dramatic shift to deriving income through PEs and that, as a result, states may be unable to effectively impose source-based taxation (except where there is a PE). If states were prevented from imposing tax on income attributable to local PEs but arising in third states, companies would have a strong incentive to shift their residence to lower-taxing states and instead operate through PEs, which would allow them to reduce their (residence-based) tax burden without significantly changing the location of their operations. This would undermine the residence-supporting role of the PE concept in tax treaties. In addition, both the PE state and the source state arguably have a valid taxing claim in relation to income arising in PE triangular cases and it is expected that they would be unwilling to give up their taxing rights. Resolving the overlap in the source rules is therefore not considered an appropriate solution for the issues arising in PE triangular cases.

6.5. Multilateral treaties

This section discusses how PE triangular cases could be dealt with in a multilateral treaty context. It focuses on situations where the source state, the PE state and the residence state are all party to a single multilateral treaty. Where there is a multilateral treaty in place between the three states involved in a PE triangular case, there is no need to change the treaty conditions which are applicable in the source state in relation to income attributable to the PE, e.g., the maximum withholding tax rates applicable to passive income. This is because in the context of a multilateral treaty the same conditions will generally apply with respect to income derived by residents of any of the states that are party to the treaty; the treaty conditions which the source state applies in relation to income derived by residents of the PE state will therefore be the same as those which it applies in relation to income derived by residents of State R. The main issue which must be dealt with in a multilateral treaty context is therefore the prevention of unrelieved double taxation.

704 This is because if only two of the three states are party to the multilateral treaty, then the multilateral treaty will effectively operate as a bilateral treaty between those two states.
6.5.1. Existing multilateral treaties

This section discusses the application of existing multilateral treaties\textsuperscript{705} in PE triangular cases. It also briefly discusses the application of the EU Parent-Subsidiary Directive,\textsuperscript{706} which, although it is not a multilateral treaty, does contain provisions which could potentially be adapted for inclusion in a multilateral treaty.

As mentioned above, it is assumed for the purposes of the discussion in this section that all three of the states involved in the triangular situation are party to the multilateral treaty (or, in relation to the Parent-Subsidiary Directive, are EU Member States).

6.5.1.1. The Nordic Convention

The most well-known multilateral tax treaty is the Nordic Convention,\textsuperscript{707} concluded between Denmark, the Faroe Islands, Finland, Iceland, Norway, and Sweden. It is based on the OECD Model, but with certain variations necessitated by the multilateral nature of the treaty\textsuperscript{708} and with a number of additional provisions for dealing with special circumstances that exist between particular contracting states.\textsuperscript{709} This section will discuss the application of the Nordic Convention in PE triangular cases involving various categories of income.\textsuperscript{710}

Interest and royalties

The Nordic Convention does not allow any source-based taxation of interest and royalties.\textsuperscript{711} Where interest or royalties arising in one contracting state are paid to a resident of another contracting state, tax

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\textsuperscript{705} This section discusses the Nordic Convention, the CARICOM Convention and the Andean Convention. The East African Community Income Tax Agreement (the EAC Agreement) is a multilateral treaty between Kenya, Tanzania, and Uganda, which was concluded in 1997 but which has never entered into force. If it were in force, it would apply in triangular cases in the same way as a series of bilateral conventions, with taxation potentially being allowed in the source state, the PE state and the residence state. Unlike in the CARICOM Convention (discussed below), the business profits article of the EAC treaty (Article 7) continues to apply to income which is dealt with in another article of the treaty, thus allowing the PE state to impose tax on the income. In addition, the articles dealing with dividends, interest and royalties provide that the source state and the residence state "may" tax the income; they are not restrictive, and thus do not prevent other states from imposing tax. This is also the case with respect to certain other categories of income. By contrast, for some categories of income exclusive taxing rights are allocated to one of the contracting states (e.g., income from shipping and air transport (Article 8)), in which case all the other states will be prevented from imposing tax, and there will be no double taxation. News articles in late 2010 suggested that negotiations were commencing for a new multilateral tax treaty between the EAC member states (which now include Kenya, Tanzania, Uganda, Rwanda and Burundi).


\textsuperscript{707} The full title of the treaty is: "Convention Between the Nordic Countries for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital." The discussion in this section is based on an unofficial translation from IBFD’s tax treaty database. The most recent version of the treaty was concluded in 1996, and was amended by protocols in 1997 and 2008.

\textsuperscript{708} The only additional article which was considered to be necessary to include in the treaty due to its multilateral nature is Article 26, which provides that no state may tax income derived by a resident of another contracting state unless taxation is specifically allowed under the convention (see: Hengsle, O., "The Nordic Multilateral Treaties – for the Avoidance of Double Taxation and on Mutual Assistance," \textit{56 Bulletin for International Fiscal Documentation} 8/9, (2002), pp. 371-376.)

\textsuperscript{709} To avoid making the treaty articles too complicated, the special provisions dealing with specific circumstances are included in a protocol to the treaty (see: Hengsle, O., "The Nordic Multilateral...”).

\textsuperscript{710} Note that this analysis ignores provisions which are specific to particular states; it considers only the general provisions of the treaty.

\textsuperscript{711} Nordic Convention, Article 11 (dealing with interest) and Article 12 (dealing with royalties).
may only be imposed in the residence state. The only exception to this is in situations where the income is attributable to a PE in one of the contracting states, in which case the business profits article applies and the PE state is entitled to impose tax on the income. In PE triangular cases involving interest and royalties, therefore, the source state is prevented from imposing tax under either Article 11 or Article 12, as applicable, and the PE state is entitled to impose tax on the income in accordance with the business profits article (Article 7). The residence state may also impose tax, but will be obliged to provide relief for tax imposed in the PE state (in accordance with Article 25). There will therefore be no unrelieved double taxation.

Dividends

The dividends article (Article 10) of the Nordic Convention, unlike the interest and royalties articles, allows source-based taxation in the absence of a PE. It provides that dividends paid by a resident of one contracting state to a resident of another contracting state may be taxed in the residence state and in the source state, but the tax imposed in the source state must not exceed 15% of the gross amount of the dividends. The dividend article also contains a provision dealing with dividends attributable to a PE (Article 10(2)), which reads as follows:

"If the beneficial owner of the dividends, being a resident of a Contracting State, has a permanent establishment or a fixed base in a Contracting State other than the State of which he is a resident, and the holding by virtue of which the dividends are paid is effectively connected with a business carried on through that permanent establishment, or with independent services carried on through that fixed base, as the case may be, dividends paid by a company which is a resident of a Contracting State to such beneficial owner may, notwithstanding the provisions of paragraphs 1 and 3 [dealing with taxation in the residence state and the source state, respectively], be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State in which the permanent establishment or fixed base is situated."

This provision allows the PE state to impose tax on dividends attributable to the PE in accordance with the business profits article (Article 7). This provision does not, however, prevent the source state from continuing to impose tax on the dividends in accordance with Article 10. This is because it does not provide that Article 7 applies to the dividends (i.e., instead of Article 10), but simply that the PE state may impose tax in accordance with Article 7. In addition, nothing in its wording ("notwithstanding the provisions of paragraphs 1 and 3") prevents the other paragraphs of Article 10 from applying in relation to dividends which are attributable to a PE. As a result, the PE state will be entitled to impose tax in accordance with Article 7 and the source state will be entitled to impose tax in accordance with Article 10. This result is effectively the same as that which arises under a series of bilateral tax treaties based on the OECD Model. Unless the PE state provides relief, either under domestic law or in accordance with non-discrimination principles, unrelieved double taxation may persist. There is, however, no question as to whether the source state is applying the appropriate treaty limitations since the limitation on the rate of source-based taxation (i.e., 15%) applies equally to residents of all the states which are party to the convention.

713 Nordic Convention, Article 11(2) and Article 12(2). Unlike the current OECD Model, the Nordic Convention also contains a separate article dealing with independent personal services carried on through a fixed base (Article 14); where interest or royalties are effectively connected with such services, Article 14 will apply instead of Article 11 or Article 12 (Nordic Convention, Article 11(2) and Article 12(2)).
714 Nordic Convention, Article 10(1).
715 Nordic Convention, Article 10(3).
716 Unofficial translation from IBFD's tax treaty database.
717 Contra: Helminen, M., "Dividends, Interest and….”
718 Contra: Helminen, M., "Dividends, Interest and….”
**Income from immovable property**

In a bilateral treaty context, the definition of immovable property only applies where the property is located in one of the contracting states. As a result, the treaty article relating to income from immovable property (Article 6) does not apply if the property is located in a third state. In PE triangular cases therefore, income arising from property located in the source state is not considered to be income from immovable property for the purposes of the R-PE treaty and Article 6 of that treaty does not apply. This issue does not arise where all three states are party to the Nordic Convention because the definition of immovable property is applicable regardless of which state is applying the convention.  

Article 6(1) of the Nordic Convention provides that: "Income derived by a resident of a Contracting State from immovable property... situated in another Contracting State may be taxed in that other State." Therefore, the source state in a PE triangular case involving income from immovable property will be entitled to impose tax on the income in accordance with Article 6.

From the perspective of the PE state, the applicable article of the treaty is also Article 6 (unlike in a bilateral situation). This is because income is derived by a resident of one of the contracting states (i.e., the residence state) from immovable property (as defined) situated in another contracting state (i.e., the source state). This is reinforced by Article 6(4), which provides that paragraphs 1 and 2 of Article 6 also apply to the income from immovable property of an enterprise, and by Article 7(7), which provides that where the profit attributable to a PE includes items of income dealt with separately in other articles of the convention, then the provisions of those articles shall not be affected by the provisions of Article 7.

Article 6 does not deal with how the PE state should treat the income; it neither authorises nor forbids taxation of the income in the PE state. However, the Nordic Convention contains a specific provision, Article 26(1), which prevents taxation from being imposed in a contracting state other than the residence state unless such taxation is specifically authorised by the terms of the convention. Since Article 6 does not authorise the PE state to impose tax, the PE state is prevented from taxing the income.

In a PE triangular case where all three states involved are party to the Nordic Convention, income arising from immovable property located in one of the contracting states may therefore only be taxed in the state where the property is located (the source state) and the in residence state, even if the income is attributable to a PE in a third state. In addition, the residence state will be obliged to grant relief for tax imposed in the source state in accordance with Article 25. There will therefore be no unrelieved double taxation.

**Income from shipping and air transport**

Under the Nordic Convention, income from shipping and air transport is only taxable in the residence state of the person deriving the income (Article 8). In PE triangular cases, therefore, there will be no tax imposed in either the PE state or the source state and there will be no unrelieved double taxation.

**Capital gains**

The distribution of taxing rights in relation to capital gains under Article 13 of the Nordic Convention, as under bilateral treaties, depends upon the type of property from which the gain arises.

Where capital gains arise from the alienation of immovable property, Article 13(1) of the Nordic Convention allows tax to be imposed in the state where the property is located. Unlike in a bilateral case, where the gain would not be considered to arise from the alienation of immovable property for the purposes of the R-PE treaty, Article 13(1) will be the relevant article of the Nordic Convention regardless

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719 The definition of immovable property is contained in Article 3(1)(f), which reads as follows: "The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated; the term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources."

720 Unofficial translation from IBFD's tax treaty database.
of whether it is being applied by the source state, the PE state or the residence state. Article 13(1) allows the source state to impose tax on the income. The PE state is not authorised to impose tax on the income under Article 13(1) and will therefore be prevented from imposing tax under Article 26(1).

Under the Nordic Convention, gains derived from the alienation of shares in a company where the principal object of the company is to hold immovable property and where more than 75% of its net assets consists of immovable property may be taxed in the state where the property is located (Article 13(2)). In a PE triangular case, this article should apply when both the source state and the PE state apply the treaty. This will allow the source state (i.e., the state where the underlying property is located) to impose tax on the gain, but the PE state, since it is not specifically authorised to impose tax, will be prevented from imposing tax under Article 26(1).

Gains from the alienation of movable property forming part of the business property of a PE can be taxed in the state where the PE is located (Article 13(3)). This paragraph should arguably not apply, however, in relation to property which is covered by another paragraph of Article 13, on the basis that those paragraphs are more specific. Where Article 13(3) does apply, the gain will be taxable in the PE state and the residence state but the source state will be prevented from imposing tax under Article 26(1).

Gains from the alienation of ships or aircraft operated in international traffic (and related assets\footnote{This rule applies to movable property pertaining to the operation of ships or aircraft operated in international traffic. The Nordic Convention also contains a specific paragraph (Article 13(5)) dealing with the alienation of containers used for the transport of goods or merchandise; gains from the alienation of such assets may only be taxed in the residence state.}) may be taxed only in the state of residence of the enterprise. Thus, in a PE triangular case involving such gains, neither the PE state nor the source state will be entitled to impose tax on the gain (under Article 13(4)). Similarly, gains from the alienation of any property not mentioned in the other paragraphs of Article 13\footnote{In addition to the paragraphs mentioned above, Article 13 of the Nordic Convention also contains a paragraph dealing with, broadly, gains derived by an individual who has become a resident of another Contracting State in relation to shares in a company which is resident in the individual's former residence state (Article 13(7)).} may only be taxed in the residence state (Article 13(6)), and thus, neither the source state nor the PE state will be entitled to impose any tax on the gain.

\textit{Other income}

Under the Nordic Convention, income not covered by any of the other articles of the convention ("other income") is taxable only in the state where the person deriving the income is resident (Article 22). However, where the income is attributable to a PE in one of the contracting states, then Article 7 applies instead of Article 22\footnote{Nordic Convention, Article 22(2).} and the profit attributable to the PE may be taxed in the PE state. The outcome in a PE triangular case involving such income is therefore the same as in a bilateral situation; i.e., tax may be imposed in the PE state and in the residence state, and the residence state must provide relief. No tax may be imposed in the source state.

\textit{Overview}

In situations involving interest, royalties, and income from immovable property the application of the Nordic Convention would resolve the issues which may arise from the application of bilateral tax treaties in PE triangular cases. In the case of interest and royalties, this is because the Nordic Convention prevents source based taxation in the absence of a PE. In the case of income from immovable property, the issue is resolved because a single definition of immovable property applies in relation to all the states applying the treaty; thus the income is also considered to be income from immovable property from the perspective of the PE state and the PE state is prevented from imposing tax on the income. The taxation of capital gains in PE triangular cases also benefits from the consistency in definitions and the consistent application of treaty provisions under the Nordic Convention. In the case of dividends, however, the Nordic Convention allows tax to be imposed in both the source state and the PE state (as well as the residence state) and thus may not prevent unrelieved double taxation. The extent to which unrelieved
double taxation occurs depends upon the extent to which the PE state provides relief for tax imposed in the source state (i.e., under domestic law or in accordance with the non-discrimination article of the treaty\(^{724}\)), as is the case in bilateral treaties. There is, however, no issue regarding the applicable conditions to apply in the source state since the source state will apply the same treaty conditions in relation to income derived by residents of the PE state and residents of the residence state.

### 6.5.1.2. The CARICOM Convention

There is also a multilateral treaty, known as the CARICOM Convention\(^{725}\) in place between the member states of the Caribbean Community\(^{726}\). The CARICOM Convention is quite unusual, in that it generally allocates exclusive taxing rights to the state of source, and does not allow any residual residence-based taxation\(^{727}\). As a result, any income arising in triangular cases where all the states involved are party to the CARICOM Convention can generally only be taxed in one state.

The interest article of the CARICOM Convention, for example, provides that: "Interest arising in a Member State and paid to a resident of another Member State shall be taxed only by the first-mentioned State."\(^{728}\) It goes on to limit the rate of tax that may be imposed to 15% of the gross amount of the interest.\(^{729}\) The source state in a PE triangular case involving interest would therefore be entitled to impose tax on the interest at a maximum rate of 15%. From the perspective of the PE state interest paid by a resident of one Member State to a resident of another Member State will be dealt with under the distributive rules applicable to interest (Article 12) even though the PE state is not one of those two states, for the following reasons:

1. For the purposes of the CARICOM Convention the term "Member State" includes all the states that are party to the treaty\(^{730}\). This stands in contrast to the operation of bilateral treaties containing similar wording; in a bilateral context the interest article of the R-PE treaty would not apply because the interest is not paid by a resident of one contracting state to a resident of the other contracting state.

2. In the CARICOM Convention, there is no exception to Article 12 for interest which is attributable to a PE of the recipient in the source state, i.e., Article 12 continues to apply and the business profits article (Article 8) does not apply. This is in contrast to terms of the OECD Model, which provide that interest attributable to a PE in the source state falls under Article 7.\(^{731}\)

3. For the purposes of the business profits article (Article 8) of the CARICOM Convention, the income is "dealt with" in another article of the treaty, i.e., Article 12, regardless of which Member State the payor of the interest is resident in.\(^{732}\) This means that Article 8, which would otherwise allow the PE state to impose tax, does not apply and the PE state will be prevented from imposing any tax on the income. Again, this would not be the case in a bilateral treaty context.

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\(^{724}\) Article 27(2) of the Nordic Convention, equivalent to Article 24(3) of the OECD Model

\(^{725}\) The full title of the treaty is: "Agreement Among the Member States of the Caribbean Community for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Profits or Gains and Capital Gains and for the Encouragement of Regional Trade and Investment." The treaty was concluded in 1994.

\(^{726}\) Namely, Antigua and Barbuda, Jamaica, Bahamas, Montserrat, Barbados, St. Kitts and Nevis, Belize, Saint Lucia, Dominica, St. Vincent and the Grenadines, Grenada, Suriname, Guyana, and Trinidad and Tobago.

\(^{727}\) Article 5 states: "Irrespective of the nationality or State of residence of a person, income of whatever name accruing to or derived by such person shall be taxable only by the Member State in which the income arises, except for the cases specified in this Agreement." For discussion, see: Bierlaagh, H.M.M., "The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation?" 54 Bulletin for International Fiscal Documentation 3, (2000), pp. 99-110.

\(^{728}\) Article 12(1) of the CARICOM Convention.

\(^{729}\) Article 12(2) of the CARICOM Convention.

\(^{730}\) Article 3(1)(e) and Schedule II of the CARICOM Convention.

\(^{731}\) OECD Model, Article 11(4)

\(^{732}\) Article 8 of the CARICOM Convention provides that: "Where business profits includes items of income which are dealt with separately in other Articles of this Agreement, the provisions of those Articles shall, except as otherwise provided therein, supersede the provisions of this Article."
Under the CARICOM Convention, the PE state must therefore apply the interest article of the treaty and, as a result, the PE state is prevented from imposing tax, i.e., because the interest article states that tax may be imposed only in the source state. The residence state is also prevented from imposing tax on the income as a result of the interest article of the treaty. Similar rules apply in relation to dividends and royalties.733

A similar outcome (i.e., taxation only in the source state) also arises in relation to income from immovable property (which can only be taxed in the state where the property is located),734 capital gains (except those arising from the alienation of ships or aircraft),735 and management fees,736 as well as various other types of income.737 Income from shipping and air transport may only be taxed in the residence state of the person deriving the income,738 as can capital gains derived from the alienation of ships and aircraft in international traffic.739 Any income which is not covered by a specific provision will be taxable only in the state in which it arises.740

In essence, the CARICOM Convention resolves PE triangular cases by preventing the PE state (and generally also the residence state741) from imposing tax on income which, despite being business profits, is dealt with under another article of the treaty. As a result, income arising in PE triangular cases can only be taxed in one state (generally the source state) and there can be no unrelieved double taxation. This approach is unlikely to be adopted more widely, however, even in multilateral treaties, because states are unlikely to be willing to sacrifice their legitimate taxing rights to such an extent. In addition, this approach would involve drastic changes to the distribution of taxing rights under existing treaties, i.e., in purely bilateral situations, which would not be warranted simply for dealing with PE triangular cases. It may also present opportunities for tax avoidance, in that residents of a particular contracting state would be able to avoid tax by shifting their income to other contracting states which impose less or no tax on the income.742

6.5.1.3. The Andean Convention

The Andean Convention,743 concluded between Bolivia, Colombia, Ecuador and Peru, is similar to the CARICOM Convention in that it allocates exclusive taxing rights to the source state. Article 3 provides

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733 See Article 10 and Article 13 of the CARICOM Convention. Under Article 10, dividends can be taxed only in the state of residence of the payor and, under Article 13, royalties can be taxed in the state where the intangible property giving rise to the royalties is used.

734 Article 6 of the CARICOM Convention provides that: "Income from immovable property shall be taxable only in the Member State in which such property is situated."

735 See Article 7 of the CARICOM Convention. Article 7(1) provides that gains arising from the alienation of real property located in one of the member states shall be taxable only in that state. Article 7(2) defines real property to include shares in a company (or interests in a partnership, trust or estate), the assets of which consist wholly or principally of immovable property. In addition, capital gains arising from other property may only be taxed in the Member State in which the gains arise (Article 7(4)). Article 7(3) deals with gains from the alienation of ships or aircraft operated in international traffic.

736 Article 14 of the CARICOM Convention.

737 e.g., salaries and wages (Article 15 of the CARICOM Convention).

738 Article 9 of the CARICOM Convention.

739 Article 7(3) of the CARICOM Convention.

740 Article 5 of the CARICOM Convention states that: "Irrespective of the nationality or State of residence of a person, income of whatever name accruing to or derived by such person shall be taxable only by the Member State in which the income arises, except for the cases specified in this Agreement."

741 Except in the case of income from shipping and air transport, or capital gains derived from the alienation of shipping or air transport assets.

742 See: Bierlaagh, H.M.M., "The CARICOM….

the general rule that income of any kind is taxable only in the member country where it's "source of production"\(^{744}\) is located, except as otherwise provided in the treaty. The "source of production" is defined in general terms to be any activity, right or asset that generates or may generate income (Article 2).\(^{745}\) The other articles of the treaty effectively prescribe more specific source rules for particular categories of income,\(^{746}\) including:

- Income from immovable property (Article 4) – taxable in the member state where the property is located;
- Income from the right to exploit natural resources (Article 5) – taxable in the member state whose natural resources are being exploited;
- Business profits (Article 6) – taxable in the member state where the business activities were carried out (without the requirement for there to be a PE in that state\(^{747}\));
- Income derived by transport enterprises (Article 7) – taxable in the member state where the person deriving the income is domiciled (this term is defined in Article 2 and is effectively a residence concept);
- Royalties (Article 8) – taxable in the member state where the intangible is used;
- Interest (Article 10) – taxable only in the member state where the payment is charged or recorded;
- Dividends and other income from shares (Article 11) – taxable only in the member state where the company making the distribution is domiciled (i.e., where it has its place of incorporation or place of effective management);
- Capital gains (Article 12) – taxable only in the member state where the property is located at the time of alienation, with exceptions for capital gains relating to transport assets (which are taxable in the member state where the owner is domiciled) and capital gains relating to bonds, shares and other securities (which are taxable only in the member state where they were issued);

Unlike the CARICOM Convention, the Andean Convention does not contain a specific rule for dealing with overlaps between the business profits article and the other articles of the convention. In PE triangular cases, this makes it difficult to determine which state would ultimately be entitled to impose tax under the treaty; the PE state on the basis of the business profits article, or the source state based on, e.g., the interest or dividends article of the treaty. This could result in two states imposing tax based on differing interpretations of the treaty. It may be that the articles dealing with specific types of income, such as dividends, interest, royalties, and immovable property take precedence over what may be considered the more general article dealing with business profits,\(^{748}\) however this is not entirely clear from the wording of the treaty. The treaty also contains no mutual agreement procedure and thus no specific mechanism to resolve inconsistencies in the way it is applied in different states.

In more general terms, assuming that the overlap between different treaty provisions can be resolved, the approach taken in the Andean Convention gives rise to the same issues as those arising with respect to the CARICOM Convention. That is, although allowing taxation in only one state (the state that is

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\(^{744}\) "Fuenta productora." The English equivalent used here is based on an unofficial translation of the treaty from IBFD's tax treaty database.

\(^{745}\) Article 2, para. f, which reads as follows: "La expresión ‘fuente productora’ se refiere a la actividad, derecho o bien que genere o pueda generar una renta." The English version used here is based on an unofficial translation of the treaty from IBFD's tax treaty database.

\(^{746}\) Jogarajan, S., "A Multilateral Tax Treaty..." at pp. 326-327. The business profits article of 2004 treaty is substantially the same as the corresponding article of the 1971 treaty.

\(^{748}\) Conversely, Atchabahian suggests that income from business activities dedicated to the exploitation of natural resources would be dealt with under the business profits article rather than the specific article applicable to income from natural resources, but does not suggest any specific reason for taking this approach and not deal with this issue when discussing other categories of income. See: Atchabahian, A., "The Andean Subregion..." at p. 326.
considered to be the source of the income) may prevent issues from arising in PE triangular cases, this approach would drastically alter the distribution of taxing rights between different states and is unlikely to be widely accepted. As mentioned above in relation to the CARICOM Convention, it also raises to tax avoidance concerns.

6.5.1.4. The EU Parent-Subsidiary Directive

Although it is not a multilateral treaty, the EU Parent-Subsidiary Directive\(^ {749} \) effectively applies multilaterally (through its implementation in EU Member States) and contains certain provisions which could be adapted to deal with in PE triangular cases in a multilateral treaty context. The aim of the Parent-Subsidiary Directive is to remove any tax obstacles to distributing profits between parent and subsidiary companies\(^ {750} \) resident in EU Member States.\(^ {751} \) These aims are achieved by exempting profit distributions (e.g., dividends) from tax in the subsidiary’s residence state (i.e., the source state), and either exempting the income or allowing an indirect credit (i.e., for taxes imposed on the underlying profit which is being distributed) in the parent company’s residence state.\(^ {752} \) The Directive also applies in situations where the profit distribution is attributable to a permanent establishment\(^ {753} \) of the parent company which is located in a Member State other than the state where the subsidiary is resident and requires the PE state to grant relief.\(^ {754} \) Thus, in a PE triangular situation where all three states are EU Member States the outcome will, in principle, be as follows:

1. The source state (the member state where the subsidiary is resident) is prevented from imposing any tax on the profit distribution;
2. The PE state is required to either exempt the income or grant an indirect tax credit (note that no direct credit is required because no withholding tax is allowed); and
3. The residence state is required to either exempt the income or grant an indirect tax credit.

The overall result is that the will be no unrelieved double taxation and indeed, there is a good chance that the profit distribution will not be taxed in any of the three states.\(^ {755} \) There is also no question of whether the source state is applying the appropriate limitation, since the source state does not impose any tax regardless of whether the dividend is paid directly to the parent company or whether it is attributable to a PE in another Member State, and regardless of the state of residence (provided it is within the EU).

One interesting aspect of the EU Parent-Subsidiary Directive is the wording of the relief provision, which could potentially be adapted for use in a multilateral treaty dealing with PE triangular cases. This provision reads as follows:

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\(^ {750} \) The term "company of a Member State" is defined in Article 2(1) of the Directive. Broadly, a company must meet all three of the following requirements to be within the scope of the directive: (i) It must take one of the forms listed in the Annex to the Directive, (ii) it must be considered a resident of a Member State for tax purposes according to domestic laws (and not considered resident outside the EU under an applicable tax treaty) and (iii) it must be subject to one of the taxes listed in the Directive. Under Article 3(1) of the Directive, a company will be considered a "parent company" if it has a minimum holding of 10% in the capital of a company of another Member State (the 10% limit applies as of 1 January 2009; this percentage has been gradually reduced). See: Helminen, M., \textit{EU Tax Law…} at pp. 143-148 (Chapter 3, Section 3.1.2.3. and Section 3.1.2.5.).

\(^ {751} \) Helminen, M., \textit{EU Tax Law…} at pp. 137 (Chapter 3, Section 3.1.1.).

\(^ {752} \) Helminen, M., \textit{EU Tax Law…} at pp. 137 (Chapter 3, Section 3.1.1.).

\(^ {753} \) The PE definition in Article 2(2) of the Parent-Subsidiary Directive is similar to the basic PE definition in Article 5(1) of the OECD Model. However, it contains an additional requirement that the PE be subject to tax in the state where it is located.

\(^ {754} \) Helminen, M., \textit{EU Tax Law…} at pp. 139-142 (Chapter 3, Section 3.1.2.2.); Terra, B.J.M., & Wattel, P.J., \textit{European Tax Law} at p. 482. This was not addressed prior to the 2003 changes to the directive.

\(^ {755} \) In practice, the exemption method is more commonly applied (See: Helminen, M., \textit{EU Tax Law} at p. 151 (Chapter 3, Section 3.1.3.1.2.).
“Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the State of the parent company and the state of its permanent establishment shall, except when the subsidiary is liquidated, either:

- refrain from taxing such profits, or
- tax such profits while authorising the parent company and the permanent establishment to deduct from the amount of tax due that fraction of the corporation tax related to those profits and paid by the subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary meet the requirements profited for in Articles 2 and 3, up to the limit of the amount of the corresponding tax due.”

If a provision along these lines were included in a multilateral treaty, it would impose relief obligations on both the residence state of the person deriving the income and the PE state. Note that the provision of an indirect credit is outside the scope of this study, but a provision along these lines could provide for a direct foreign tax credit in circumstances where the source state is entitled to impose tax on the income (e.g., withholding tax).

### 6.5.2. Possible multilateral treaty solutions

As mentioned above, where a multilateral treaty is in place between all the states involved in a PE triangular case there is no need to alter the treaty conditions which are applicable in the source state. The main issue which must be dealt with in a multilateral treaty context is therefore the prevention of unrelieved double taxation. Double taxation in PE triangular cases could be prevented in a multilateral treaty by:

1. Allowing all three states involved to impose tax on the income (in the same way as they would be allowed to under bilateral treaties, e.g., with respect to dividends and interest) and requiring the PE state to provide relief for tax imposed in the source state. The residence state would also be required to provide relief for tax imposed in the source state and the PE state;
2. Preventing the residence state from imposing tax on the income and requiring the PE state to grant relief for tax imposed in the source state. In this case, the income may be taxed in the source state and the PE state, and the PE state would grant relief. The previous approach would also effectively operate in this way in circumstances where the residence state uses the exemption method;
3. Preventing the source state from imposing tax on the income, in which case the income may be taxed in the PE state and the residence state, with the residence state granting relief for tax imposed in the source state. There would be no need for the PE state to provide any relief;
4. Preventing the PE state from imposing tax on the income, in which case the source state and the residence state may tax the income and the residence state would be obliged to provide relief for tax imposed in the source state; or
5. Allowing only one state to impose tax. This is the approach taken in the CARICOM Convention discussed above and in the Nordic Convention in relation to interest and royalties; in both these cases it is the source state that is entitled to impose tax (with some exceptions in the CARICOM Convention), but it could also be the PE state or the residence state which is entitled to impose tax.

These approaches mirror the options available for resolving the issues arising in PE triangular cases under bilateral tax treaties. Therefore, many of the considerations which are relevant for determining which is

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757 This was the solution identified by Schuch, who suggested a draft provision which could potentially be included in multilateral treaties to deal with PE triangular cases (see Schuch, J., "The Methods for…").
the best approach under a multilateral treaty are the same as those for determining which is the best approach under bilateral treaties.

As discussed above (in Section 6.4.), preventing either the PE state or the source state from imposing tax on income derived in PE triangular situations (i.e., options 3 and 4 above) may lead to opportunities for tax avoidance and, in addition, neither the PE state nor the source state is likely to accept such a limitation on its taxing rights. The approach taken in the CARICOM Convention (i.e., option 5 above) also gives rise to a number of problems (as discussed previously), and is not considered to be a viable option, although it may be used with respect to certain categories of income if the contracting states are willing to accept the restriction on their taxing rights (as is the case in the Nordic Convention with respect to interest and royalties).

The preferred approach would be to allow all three states to impose tax, but to require both the residence state and the PE state to provide relief (i.e., option 1 above). This effectively treats the PE more like a resident of the PE state and resembles the bilateral treaty option which will be discussed in Chapter 7. A significant advantage of this approach is that, if it were adopted, the distribution of taxing rights under the multilateral treaty would resemble, as closely as possible, the distribution of taxing rights under the OECD Model and existing bilateral treaties.

6.5.3. Advantages of a multilateral treaty

A multilateral treaty has a number of advantages for dealing with PE triangular cases. Perhaps most importantly, the same conditions would generally apply in the source state regardless of whether the income is derived by a resident of the PE state or of the residence state and thus, a major complication and issue which usually arises in triangular cases is simply not relevant in a multilateral treaty context (i.e., the applicable treaty conditions in the source state). This also limits concerns regarding the potential for treaty shopping. Treaty shopping concerns can also be mitigated by the fact that in a multilateral treaty context, all the states involved know which other states may be involved in situations to which the specific treaty provisions dealing with triangular cases will apply. More specifically, where all three states are parties to the multilateral treaty, the PE state will presumably not be a tax haven. Where a multilateral treaty is concluded between a limited number of states, it should also be possible for the contracting states, when drafting the provisions applicable to PE triangular cases, to take into account the way each of those states would treat triangular cases under their domestic law, e.g., whether they impose tax on the worldwide income of PEs, at least as their domestic law stands at the time the treaty is negotiated.

Another advantage of a multilateral treaty solution is that a multilateral treaty will contain definitions which are applicable with respect to all of the states involved, preventing any issues that may arise in situations involving bilateral treaties where there are inconsistent definitions between the various treaties. The clearest example is that in a multilateral treaty there will be a single PE definition which will apply with respect to all the states involved and thus, there will be no concern that there may be a PE under the definition contained in the R-PE treaty but not under the definition contained in the R-S treaty and/or the PE-S treaty (or vice versa). However, even in a multilateral context it is possible for disagreements to arise between the taxpayer and the contracting states, or between the contracting states themselves, regarding whether there is a PE in the PE state and whether the income in question is attributable to the PE, particularly in borderline cases. This issue will be discussed in Chapter 9 (Section 9.2.1.).

Another aspect of multilateral treaties which is advantageous for resolving the issues which arise in PE triangular cases is that there will be no question of the applicable treaties not containing corresponding provisions. As will be seen in Chapter 7, bilateral treaty solutions to PE triangular cases generally rely on more than one treaty containing specific provisions and issues can arise if one or more of the relevant

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758 Schuch, J., “The Methods for….”
759 Although it should be noted that even countries which are not generally considered to be tax havens and which have comprehensive income tax systems can have features in their tax law which would enable the avoidance of tax.
760 This issue will be discussed in the context of a solution based on terms included in bilateral treaties in Chapter 8 (see Section 8.2.3.).
treaties do not contain the required provisions. This issue will simply not arise in the context of a multilateral treaty.

6.5.4. Practical limitations

Despite the advantages of multilateral treaties for dealing with triangular cases, the practical difficulties involved in concluding and maintaining such treaties make this solution problematic. The primary obstacle to concluding multilateral treaties is likely to be the difficulty of getting multiple states to agree to the terms of the treaty. Even in the case of bilateral treaties, negotiations can stretch on for years before two states are able to reach agreement on the terms of a treaty and the difficulty of reaching agreement increases substantially where more states are involved. It would also be more difficult to renegotiate and amend a multilateral treaty, given that any changes would likely require the unanimous agreement of all the contracting states.

A multilateral treaty will also be less flexible in dealing with the particular circumstances of the countries involved and the differences between their tax systems. Of course, special provisions and/or exclusions could be included to deal with specific issues, but such provisions would increase the complexity of the treaty and may cancel out the benefit of the simplification which a multilateral treaty might be expected to achieve. It has been suggested that national tax systems would have to be harmonized to a much greater extent before a multilateral treaty would be feasible. The conclusion of a multilateral treaty may be more feasible for small groups of countries which are in similar circumstances. However, if the treaty is concluded between a small group of countries then the benefit with respect to triangular cases will be reduced, because this benefit only exists in situations where all three of the states involved are party to the treaty. If the PE triangular situation involves a state which is not a party to the treaty, then the multilateral treaty will effectively operate as a bilateral treaty between the two states involved which are party to it, and will therefore not offer any advantages over a bilateral treaty. A multilateral treaty could still contain specific provisions to deal with triangular situations involving third states, but such provisions could only operate in the same way as provisions included in bilateral treaties. Given the difficulties involved in concluding multilateral treaties, they would generally not provide enough of an advantage over bilateral treaties to make pursuing them worthwhile.

Multilateral treaties would also alter the distribution of taxing rights as currently agreed between states and embodied in their bilateral tax treaties. Currently, different tax treaties contain different provisions, e.g., different maximum rates of source based taxation on passive income, whereas in a multilateral treaty the provisions would generally be standardized. The conclusion of a multilateral treaty could therefore substantially alter the global distribution of tax revenues in relation to cross-border income, which would

761 Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings…"; Schön, W., "International Tax Coordination….
763 McIntyre, M.J., "Options for Greater….
764 Schön, W., "International Tax Coordination….
765 Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings….
766 Schön states that "a multinational agreement is only recommendable for a small group of countries with converging economic situations and a common political background (like the Nordic states of Europe)." (Schön, W., "International Tax Coordination….") Similarly, Mattsson states that: "The countries involved must have an attitude towards international tax issues which makes it possible to find common solutions to those rules which should be part of a tax treaty. And such solutions are probably possible only if the tax systems do not show basic differences." (Mattsson, N., "Multilateral Tax Treaties – A Model for the Future?" bound in International Studies in Taxation: Law and Economics: Liber amicorum Leif Mutén, (The Hague, Kluwer Law International, 1999), pp. 243-258 at p. 256).
767 Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings….
768 See: Arnold, B.J., Sasseville, J., & Zolt, M., "Summary of the Proceedings…."; McIntyre, M.J., "Options for Greater…."; Schön, W., "International Tax Coordination…."; Avery Jones, J.F., "The David R. Tillinghast Lecture…." (who states: "Indeed, there seems no obvious advantage in having multilateral tax treaties." (at p. 6)).
769 Although specific provisions could still be included to deal with special issues arising between particular states, as in the Nordic Convention, discussed above in Section 6.5.1.1.
clearly be unrelated to PE triangular cases and would be in excess of what is required for dealing with the issues arising in PE triangular cases. Importantly, the main impact of this change in the distribution of taxing rights would be felt in purely bilateral situations, given that such situations are vastly more common than triangular cases.

6.6. Conclusions

The issues arising in PE triangular cases are the result of a number of interrelated factors, including the overlap in treaty sourcing rules (such that the income effectively has a dual source for treaty purposes) and the bilateral nature of tax treaties. Chief among these factors though, is the hybrid nature of the PE concept. Although the PE concept is generally considered to be a source-based concept, the taxation of PEs exhibits a number of features of residence-based taxation and may be more appropriately thought of as a quasi-residence based concept. The hybrid nature of the PE concept leads directly to the issues arising in PE triangular cases because, whilst the state where a PE is located is entitled to impose tax on the worldwide income attributable to the PE, a PE is generally not eligible for treaty benefits. This means that the PE state has no direct obligation to grant relief for tax imposed in the source state and the source state is not required to apply the conditions of its treaty with the PE state in relation to the income attributable to the PE.

One of the simplest solutions to the issues arising in PE triangular cases would be to resolve the hybrid nature of the PE concept by treating it purely as a source concept and to then resolve the overlap in the tax treaty sourcing rules. This could be done either by preventing the source state from imposing tax on the income (i.e., resolving the overlap in favour of the PE state) or by preventing the PE state from imposing tax on the income (i.e., resolving the overlap in favour of the source state). In either case, the situation would effectively become bilateral and, as a result, there would generally be no unrelieved double taxation, no need for relief in the PE state, and no issue would arise regarding the appropriate treaty conditions to apply in the source state. Neither of these approaches is viable, however, due to the potential for tax avoidance. In particular, if the PE state is prevented from imposing tax on income which is attributable to a local PE but which is sourced in a third state (i.e., the source state), enterprises could avoid paying residence-based taxes by shifting their residence to a state which exempts the income attributable to PEs, while continuing to conduct all their activities in what is now the PE state. Alternatively, if tax treaties prevent source states from imposing taxation on income which is attributable to PEs in a third state (i.e., not the source state or the residence state), then enterprises could avoid source based taxation by ensuring that income is attributable to a PE in a third state. It would be extremely difficult to formulate effective anti-avoidance provisions to deal with these concerns. Perhaps more importantly, states are unlikely to be willing to accept such extensive restrictions on their taxing rights.

Multilateral treaties could also resolve the issues arising in PE triangular cases, and there are a number of ways in which this could be achieved. However, the difficulty inherent in concluding and updating multilateral treaties means that, unless there are other strong motivating factors, this solution is unlikely to be implemented in practice. The standardisation of distributive rules under a multilateral treaty could also substantially alter the global distribution of taxing rights, which would largely be felt in bilateral situations and would be unwarranted if the intention is simply to deal with PE triangular cases.

We will now turn, in Chapter 7, to potential solutions to the issues arising in PE triangular cases that involve treating the PE more like a resident enterprise of the PE state. For various reasons (which will be discussed further in Chapter 7), this is the preferred approach for dealing with PE triangular cases. However, it does give rise to a number of issues which must be addressed, not least the extent to which a PE should be treated in the same way as a resident person for treaty purposes and means by which such a solution should be implemented. These issues will be discussed in Chapter 7, Chapter 8 and Chapter 9.