Triangular cases: The application of bilateral tax treaties in multilateral situations
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Chapter 7
Extending treaty benefits to PEs

7.1. Introduction

The previous chapter introduced potential solutions to PE triangular cases and discussed two options for dealing with PE triangular cases; (i) resolving the overlap in tax treaty sourcing rules and thus preventing either the source state or the PE state from imposing tax on the income or (ii) by replacing the existing network of bilateral income tax treaties with one or more multilateral treaties. It was concluded that neither of these options provides a satisfactory solution to the issues arising in PE triangular cases. The discussion in this chapter will focus on resolving the issues in PE triangular cases by treating the PE concept more like a residence concept; broadly, by ensuring that double taxation relief is provided in the PE state and by ensuring that the source state applies the conditions of the PE-S treaty (rather than the conditions of the R-S treaty) in relation to income attributable to the PE. This means that PEs would effectively be entitled to treaty benefits. Extending treaty benefits to PEs would substantially resolve the hybrid nature of the PE concept in tax treaties, and would be consistent with the residence-like nature of PE taxation and the residence-supporting role of the PE concept in tax treaties (as discussed in Chapter 5), as well as the OECD's recent work on the attribution of profit to PEs (also discussed in Chapter 5).

This approach forms the basis for the vast majority of solutions which have been advocated for dealing with PE triangular cases (as will be seen below in Section 7.2.). If implemented, it would generally resolve the issues arising in PE triangular cases as follows:

1. The source state applies the conditions of the PE-S treaty instead of those contained in the R-S treaty in relation to income attributable to the PE. The source state is therefore applying the more appropriate treaty conditions (as discussed in Chapter 5);

2. The PE state is required to provide relief for tax imposed in the source state, using either the exemption method or the credit method. The provision of relief in the PE state would generally ensure, in conjunction with relief in the residence state, that there would be no unrelieved double taxation in PE triangular cases (as discussed in Chapter 5).

3. The residence state provides relief to the extent that such relief is required to prevent unrelieved double taxation. This may take the form of either exemption or credit relief, depending on the terms of the applicable treaties and the category of income involved.

Of the potential approaches identified in Chapter 6, treating the PE more like a resident enterprise of the PE state and effectively extending treaty benefits to PEs is considered to be the best approach for dealing with PE triangular cases. Allowing PEs to claim treaty benefits would represent a dramatic departure from the existing principles of treaty application, however given the hybrid nature of the PE concept, the implications of this approach would perhaps be less drastic than they may appear at first glance. Allowing PEs to claim treaty benefits would certainly represent less of a departure from the existing international tax framework than a solution based on the conclusion of multilateral treaties. It would also have less of an impact on the distribution of taxing rights than a solution which prevents either the PE state or the source state from imposing tax in PE triangular cases.

One of the main concerns with extending treaty benefits to PEs is the potential for tax avoidance and, in particular, the potential for treaty shopping through PEs. This may occur, for example, where the residence state exempts the income attributable to the PE and the PE state does not impose tax (or imposes very little tax) on the income arising in the source state. As was discussed in Chapter 5 (Section 5.2.6.), states face significant challenges in combating treaty shopping under existing principles and for this reason, they may be understandably reluctant to open up a further avenue for improper claims for treaty benefits. Treaty shopping through PEs is a legitimate concern, primarily because transactions between the PE and the rest of the enterprise have no legal consequences and because common patterns of PE taxation may make it easier to obtain treaty benefits through a PE without triggering any additional tax liability in the PE state or the residence state. It should be possible to address these concerns,

770 The OECD's 1992 report on PE triangular cases finds that "The majority of states are strongly opposed to such a solution (i.e., extending treaty benefits to PEs), above all because such states fear it might encourage 'treaty shopping'..." (OECD Committee on Fiscal Affairs, "Triangular Cases," para 39).
however, for example through the inclusion of a "subject to tax" requirement. In addition, the fact that taxpayers could not rely on legal arrangements to support a PE’s claim for treaty benefits, and the analysis required for determining the profits attributable to a PE may actually make gaining improper access to tax treaties through PEs less attractive for taxpayers than obtaining improper access to treaties through a legal entity. Further, the attribution of profits to PEs is based on an economic analysis and (at least under the AOA) depends on the "significant people functions" carried out by the PE. To the extent that the income is economically linked to the PE (and the PE state), it is difficult to see how the source state could legitimately object to the application of the PE-S treaty. The potential for improper access to treaties through PEs was discussed in detail in Chapter 5, and will be discussed further in Chapter 8 (Section 8.4.), which will outline specific provisions which could be included in treaties to address treaty shopping concerns. It will generally not be discussed further in this chapter.

It should also be noted that the approach discussed in this chapter encompasses a range of possible solutions, from simple measures allowing PEs to claim certain specific benefits under tax treaties (e.g., relief in the PE state or a limitation on source based taxation of passive income) through to comprehensive measures which would treat PEs in exactly the same way as resident persons for treaty purposes. The extent of the treaty benefits which should be available to PEs, along with potential implications of extending treaty benefits to PEs, will be discussed in Chapter 8 and Chapter 9.

Even if it is not accepted that the PE-S treaty should apply in relation to the income arising in PE triangular cases, it would still be desirable to apply the other aspects of this solution. That is, the PE state should be explicitly required to grant relief for tax imposed in the source state and a provision could be included in the R-S treaty to ensure that it doesn’t apply in circumstances which are considered abusive. This would only be a partial solution, since the source state would continue to apply the “incorrect” treaty provisions, but it would prevent unrelieved double taxation and would prevent improper use of the R-S treaty. This alternative “minimalist approach” would thus resolve many of the issues that arise in PE triangular cases and it is likely to be much simpler to gain acceptance of this approach and to implement it. The minimalist approach is considered to be the next best solution if the more comprehensive solution is not accepted.

This chapter will first outline the history of the idea that PEs should be entitled to treaty benefits before comparing the various ways in which this could be achieved. It will then go on to consider issues related to granting relief in the PE state under tax treaties and, finally, will discuss the exclusion of the R-S treaty in PE triangular cases.

7.2. Overview of existing treaty provisions and proposals

The suggestion that PEs should be entitled to treaty benefits has a long history, which will be outlined briefly in this section. Some of the items discussed here are provisions included in existing treaties, while others are merely expressions of the view that PEs should be entitled to treaty benefits. Still others comprise proposals for ways in which PE triangular cases could be resolved by effectively, in one way or another, extending either full or partial treaty benefits to PEs.

7.2.1. The 1964 France-Belgium treaty

The treaty between France and Belgium, concluded in 1964, contains a provision which allows (but does not require) the contracting states to apply the terms of the treaty in relation to income derived in certain PE triangular cases under the mutual agreement procedure. This provision, found in Article 24(2), reads as follows:

"Where the carrying out of certain provisions of this Convention would give rise to difficulties or doubts the competent authorities of both Contracting States shall consult together in order to apply such provisions in accordance with the spirit of the Convention. They may, in such special cases, by mutual agreement apply the rules laid down in this Convention to individuals or legal entities who are not resident in either of

771 Still in force, but modified by various protocols over the intervening years.
the Contracting States but who have in one of those States a permanent establishment certain income from which arises in the other State.\textsuperscript{772}

Thus, where a person who is not resident in either France or Belgium earns income from one of those states which is attributable to a PE in the other, it may be possible for the Belgium-France treaty to apply (i.e., where it operates as the PE-S treaty). This would presumably result in the source state applying the relevant conditions of the treaty in relation to the income (e.g., reduced rates of withholding tax on passive income) and the PE state granting relief for tax imposed in the source state in accordance with the relief provisions of the treaty.

7.2.2. \textit{IFA Cahiers "The Taxation of Enterprises with Permanent Establishments Abroad" (1973)}

The 1973 IFA Cahiers on the topic of the taxation of enterprises with permanent establishments abroad\textsuperscript{773} contained some brief comments regarding the extension of treaty benefits to PEs. The general reporter stopped short of suggesting that PEs should be entitled to treaty benefits in the same way as resident enterprises but did consider it "sufficiently important to call for close examination"\textsuperscript{774} The French reporter went further, however, contending that PEs ineligibility for treaty benefits is discriminatory\textsuperscript{775} and arguing that:

"As a general rule, the disparity of treatment [between a PE and a resident enterprise] is basically a result of the restrictive application of the agreements to "residents" of a Contracting State only (Article 1 of the draft convention), so much so that a French secondary establishment which has business dealings with a state other than that of the enterprise to which it belongs may not have recourse to the agreement signed between France and that other Country.

One can then ask oneself if the permanent establishment's lack of legal personality, (which is nevertheless considered fiscally as a separate enterprise), justifies a distortion which runs counter to the flow of the international business cycle and accordingly whether it is desirable that the choice between the creation of a strictly controlled subsidiary and that of a branch should be influenced by reasons of a purely fiscal nature in defiance at times of sound management."\textsuperscript{776}

These comments support the extension of treaty benefits to PEs on the basis that PEs are treated as separate taxpayers for domestic tax purposes and that the eligibility for treaty benefits should not turn merely on the legal form chosen to conduct business activities, and further, that the choice between operating through a subsidiary and through a branch should not be influenced by the availability (or non-availability) of treaty benefits. The French reporter does not suggest a specific approach for extending treaty benefits to PEs, but the general reporter states that the personal scope of the convention (in Article 1) would need to be expanded and goes on to suggest that the mutual agreement provision of the Belgium-France treaty (discussed above) may "point the way."\textsuperscript{777}

\textsuperscript{772} This is an unofficial translation from IBFD’s tax treaty database.
\textsuperscript{776} This quote is extracted from the English summary of the French report. See: Mouillan-Hogberg, N., “French Report” at p. II/146.
7.2.3. The 1989 France-Italy treaty

The PE non-discrimination article (Article 25(2)(b)) of the treaty between France and Italy, concluded in 1989, includes a specific provision which extends treaty benefits to PEs in relation to dividends, interest and royalty income. It reads as follows:

"Where a permanent establishment situated in a State receives dividends, interest or royalties arising in the other State and pertaining to property or rights effectively connected with its activities, such income may be taxed in the state in which it arises in accordance with the respective provisions of paragraph 2(b) of Article 10 [dividends], paragraph 2 of Article 11 [interest] and paragraph 2 of Article 12 [royalties]. The State in which the permanent establishment is situated shall eliminate double taxation in accordance with the provisions provided in paragraph 1(a) or paragraph 2 of Article 24 [the relief provisions], disregarding the last clause. This provision shall apply wherever the enterprise of which the permanent establishment is a part has its place of management."778

This provision grants partial treaty entitlement to PEs, regardless of the place where the entity to which the PE belongs is resident. Where a PE located in one of the contracting states (i.e., the PE state) earns dividends, interest or royalties which arise in the other contracting state (i.e., the source state), it requires the source state to apply the conditions of the interest, dividends and royalties articles of the treaty. These provisions specify a maximum rate of tax which the source state can impose.

Like the provision of the Belgium-France treaty, discussed above, this provision operates when the contracting states are in the position of the source state and the PE state (i.e., the PE-S treaty). However, unlike that provision, it imposes a definite obligation on the contracting states to apply the terms of the treaty in PE triangular cases. Notably, however, it only applies in cases involving passive income. In addition, there is no means of excluding the operation of the R-S treaty which means that the source state may be subject to multiple treaty conditions in respect of the same income; in this situation, it would only be able to meet its treaty obligations by applying the conditions that are most favourable to the taxpayer.

7.2.4. The Ruding report (1992)

The Ruding Report,779 a report prepared in 1992 for the European Commission, recommended (in an annex to the report780) that the OECD Model be expanded to allow PEs to claim treaty benefits. It stated that:

"The cause for many mutual agreement procedures arises from the fact that most treaty rights cannot be invoked by permanent establishments. On the other hand, in many countries taxation of permanent establishments approaches that of resident businesses.

Thus, a permanent establishment or fixed place of business should be considered a resident of the Member State in which it is situated for the application of the tax treaties

778 This is an unofficial translation from IBFD’s tax treaty database.

779 The Ruding Committee began work in January 1991 on three questions posed by the European Commission: (1) Do differences in business taxation among Member States cause major distortions in the functioning of the internal market, particularly with respect to investment decisions and competition? (2) In so far as such distortions do arise, are they likely to be alleviated or eliminated simply through the interplay of market forces and competition between national tax regimes, or is action at the Community level required? (3) What specific measures are required at the Community level to remove or mitigate these distortions? The Ruding Committee recommended a program of action to eliminate double taxation, harmonise corporation tax rates within a 30%-40% band and ensure the full transparency of the various "tax breaks" given by Member States to promote investment. See: Ruding, O., et al., "Report of the Committee of Independent Experts on Company Taxation" (Luxembourg: Office for Official Publications of the European Communities, 1992), at pp. 11-16.

780 The preface to the report states that: "Much of the rather more detailed background material considered by the Committee (but not necessarily endorsed by it) is contained in the annexes, which are referred to in the relevant chapters." (Emphasis added.) (Ruding, O., et al., "Report of the Committee…" at p. 6.)
Thus it suggests that, due to the similarity between the taxation of PEs and resident enterprises, the concept of residence for treaty purposes should be expanded to allow PEs to claim treaty benefits. This approach would mean that PEs would be treated as residents of the PE state for the purposes of the entire treaty.

### 7.2.5. The OECD triangular cases report (1992)

The OECD's triangular cases report, published in 1992, contemplates a solution to PE triangular cases involving passive income whereby PEs would be treated as residents of the PE state for the purposes of the PE-S treaty. The report refers to the provision of the France-Italy treaty dealing with PE triangular cases as an example of how this solution might be implemented. In the final analysis, however, it recommends against extending treaty benefits to PEs on the basis that the majority of states are opposed to this type of solution. The report identifies two main reasons for this opposition. The first is the danger of treaty shopping, particularly in situations where the residence state uses the exemption method, i.e., residents of State R may establish PEs for the purpose of taking advantage of reduced source state taxation under the PE-S treaty. The second reason is that "...such a solution... departs too much from the principles underlying the Model Convention and current practices."

The final recommendation of the OECD's triangular cases report is much more limited; it effectively recommends only that the PE state should clearly be required to provide relief in PE triangular cases under the terms of the R-PE treaty (i.e., rather than implicitly under Article 24(3) of that treaty). It recommends changes to the OECD Commentary to this effect, primarily to Article 24, which were included in the Commentary as part of the 1992 update to the OECD Model. As mentioned elsewhere, I have not been able to identify any concluded treaties which incorporate the OECD commentary's suggested wording to explicitly require relief in the PE state.

### 7.2.6. Avery Jones proposal: Provisions included in all three treaties (1999)

Avery Jones proposes a solution to PE triangular cases whereby the residence state would transfer to the PE state the right to claim to be the "residence state" in relation to income attributable to the PE for the...

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782 OECD, "Triangular Cases," para. 43. The report deals only with PE triangular cases involving passive income; as discussed in Chapter 2, issues can also arise where other categories of income are involved. It may therefore be preferable, if treaty benefits are extended to PEs, for those treaty benefits to extend beyond passive income. This will be discussed in Chapter 8 (Section 8.2.4.).
783 OECD, "Triangular Cases," para. 43. The report also mentions that the PE state would endorse claims for treaty benefits by PEs; administrative aspects of extending treaty benefits to PEs will be discussed in Chapter 8 (see Section 8.3.3.).
784 OECD, "Triangular Cases," para. 45. This provision was discussed above (see Section 7.2.3.).
785 OECD, "Triangular Cases," para. 60. The potential for treaty shopping through PEs, if they were entitled to claim treaty benefits, was discussed in Chapter 5 (see Section 5.2.6.) and will be discussed further in Chapter 8 (see Section 8.4.).
786 OECD, "Triangular Cases," para. 44.
787 OECD, "Triangular Cases," para. 46.
788 OECD, "Triangular Cases," paras. 47-50 and para. 60.
789 These comments are now found in the OECD Commentary on Article 24, paras 58-72.
790 Section titled "Proposed Changes to the Commentary," paras 1-6.
purposes of treaties between the PE state and third states. He describes the proposed solution as follows:

"I suggest that what is required is not to treat the permanent establishment as if it were a resident of PE in all cases, but for HO [i.e., the State R] to transfer to PE [i.e., State PE] the right in certain circumstances to claim to be the taxpayer's residence state, instead of HO, in treaties with third states. This requires an addition to Article 4 to be contained in all relevant treaties between Source, HO, PE and Recipient [relevant for reverse triangular cases – see Chapter 12]. Article 4 would then say that, in addition to a treaty resident of a state being a person who is liable to tax in that state under internal law by reason of the listed criteria, a person would be a treaty resident of a state in which there was a permanent establishment under any other treaty containing a provision to that effect."

He goes on to say:

"Under the proposed solution, it is HO that decides whether to give PE the right to claim to be the taxpayer's residence state in its treaty with Source, and it will only do so if there is normal taxation in PE of income arising in a third state."

The transfer of residence may be limited to dividends, interest and royalties and may be limited to situations where the income is fully taxable in the PE state. In addition, the transfer of residence could be made conditional on the PE state giving relief for tax imposed in the source state. Where the right to claim to be the residence state is transferred to the PE state, the operation of the R-S treaty would be prevented by provisions included in that treaty. This would have the effect that the source state would be required to apply the conditions of the PE-S treaty instead of the conditions of the R-S treaty, and the PE state would be obliged to grant relief for tax imposed in the source state. This potential approach to extending treaty benefits to PEs will be discussed further in Section 7.3.3., below.

7.2.7. Zhai proposal: Indirect treaty entitlement for PEs (2009)

Zhai proposes a solution to PE triangular cases whereby the source state would be required, under a specific provision included in the R-S treaty, to apply the conditions of the PE-S treaty in relation to income attributable to a PE in the PE state. To address tax avoidance concerns, the conditions of the PE-S treaty would only apply if the income is taxed "normally" in the PE state; Zhai proposes that income would generally be considered to be taxed normally in the PE state unless the PE state exempts the income. The provision requiring the source state to apply the conditions of the PE-S treaty would also exclude the operation of the R-S treaty in the source state in relation to the income attributable to the PE, so that the source state would only be subject to the conditions of the PE-S treaty. Zhai's proposal would exclude the application of the R-S treaty even in situations where there is no PE-S treaty, meaning that in such cases the source state would be able to apply its domestic law without restriction. Zhai’s solution would not specifically require the PE state to grant relief for tax imposed in the source state, but instead relies on the PE state providing relief under the PE non-discrimination article (Article 24(3)) of the R-PE treaty.

792 Avery Jones, J.F., "The David R. Tillinghast Lecture…..” This solution is also mentioned very briefly in: Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems…..” Zhai also discusses this proposal, referring to unpublished work of J.F. Avery Jones (see: Zhai, G., "Triangular Cases…").
794 Avery Jones, J.F., "The David R. Tillinghast Lecture…..” at p. 31.
795 Avery Jones, J.F., "The David R. Tillinghast Lecture…..”
796 Avery Jones, J.F., "The David R. Tillinghast Lecture…..”
797 Referring to unpublished work by J.F., Avery Jones: Zhai, G., "Triangular Cases…..”
798 Zhai, G., "Triangular Cases…..”
799 Zhai, G., "Triangular Cases…..” Tax avoidance concerns will be discussed further in Chapter 8 (Section 8.4.).
7.2.8. Wheeler proposal: “The missing keystone of income tax treaties” (2011)\textsuperscript{800}

Wheeler proposes a new approach for determining treaty entitlement under which “…the imposition of a tax liability in respect of a specific item of income under domestic law constitutes the first step towards entitlement to the benefit of a treaty.”\textsuperscript{801} States which are asked to grant treaty benefits would then assess whether the tax liability in the other state is a sufficient basis upon which to grant such benefits. In making this assessment, source states would most likely take into consideration the strength of the connection between the income and the person deriving it, and the strength of the connection between that person and the residence state.\textsuperscript{802} Residence states, in considering whether to grant relief, would focus on the nature of the tax liability in the other state and on the connection between the income and the person claiming relief.\textsuperscript{803}

Although this approach is not specifically intended to address PE triangular cases, it could involve an extension of treaty benefits to PEs.\textsuperscript{804} After referring to the problem of the source state applying the “wrong” treaty conditions in PE triangular cases, Wheeler writes:

“The new approach could solve this problem by recognising the tax liability of the enterprise in respect of its permanent establishment as a liability imposed on it in a taxpaying capacity distinct from the taxpaying capacity of the entity as a whole. The permanent establishment would, in other words, be regarded as having a ‘treaty capacity’ and therefore be capable of claiming the benefit of the treaties concluded by the state in which it is situated.”\textsuperscript{805}

Wheeler then goes on to outline certain qualifications to the extension of treaty benefits in these circumstances. One of these qualifications is that the treaty benefits would be available “…only to the extent that the enterprise is liable to tax in the state of the permanent establishment in respect of income from worldwide sources derived through the permanent establishment.”\textsuperscript{806} Further, treaty benefits would only be available to PEs that met a higher threshold than the existing PE threshold.\textsuperscript{807} It is also proposed that the treaty entitlement of the PE would take priority over the treaty entitlement of the enterprise as a whole, meaning that the R-S treaty would not apply in a PE triangular case to the extent that the PE-S treaty applied.\textsuperscript{808} Whilst it is a very attractive approach, this method of extending treaty benefits to PEs will not be discussed extensively in this chapter since it requires a fundamental change in the way treaties operate, not only in triangular cases but also in bilateral situations, and is therefore outside the scope of the solutions being considered here.

7.2.9. Instances where treaty benefits have been claimed on behalf of a PE

There have been two cases where a resident of a third state has made a treaty claim on the basis of income arising in one contracting state and attributable to a PE in the other. The first of these cases involves an older treaty, the 1945 UK-US treaty, which did not contain a provision equivalent to Article 1 of the OECD Model, and the second involves the more recent US-Canada treaty. These two cases will be discussed in turn below.

7.2.9.1. Commerzbank\textsuperscript{809}

The Commerzbank case concerned the 1945 treaty between the UK and the US (since terminated). It involved a German bank and a Brazilian bank which operated through PEs in the UK and which derived

\textsuperscript{800} Wheeler, J.C., “The Missing Keystone….”
\textsuperscript{809} Inland Revenue Commissioners v. Commerzbank AG [1990] STC 285
interest income from US corporations. Under the 1945 UK-US treaty, the income would have been exempt in the UK if it had been derived by a treaty-eligible UK resident. The relevant treaty article, Article XV, provided that:

“Dividends and interest paid by a corporation of one Contracting Party shall be exempt from tax by the other Contracting Party except where the recipient is a citizen, resident, or corporation of that other Contracting Party. This exemption shall not apply if the corporation paying such dividend or interest is a resident of the other Contracting Party.”

The taxpayer argued that even though it was not a resident of either contracting state, this treaty provisions should prevent the UK from imposing tax on the income attributable to the UK branch. Importantly, the treaty did not contain an equivalent to Article 1 of the OECD Model, meaning that the treaty as a whole was not explicitly limited to residents of the contracting states. The court, in reaching its decision, noted that the other articles of the treaty were worded to apply only to residents of the contracting states and contrasted this to the article upon which the taxpayer was relying. This case establishes that in the absence of specific language included in the treaty itself there is no general principle that tax treaties apply only to residents of the two contracting states.810 This is an unusual outcome given that the UK was denied taxing rights over income of a UK-based business,811 although it does follow from quite an unusual treaty provision.

7.2.9.2. Crown Forrest Industries812

Crown Forrest Industries involved a company (“Norsk”) which was incorporated in the Bahamas but which conducted all its operations in the US.813 These operations in the US amounted to a “US trade or business” but the company’s income was exempt in the US under a reciprocal exemption between the US and the Bahamas applicable to shipping companies. The case concerned royalties which Norsk received from an associated company resident in Canada. Norsk claimed a reduction in Canadian withholding tax (from 25% to 10%) under the US-Canada treaty on the basis that the company was a resident of the US for the purposes of the treaty. This was said to result from the fact that the company’s place of management was in the US and that, since this led to the company having a “US trade or business”, it also led to the company being liable to tax in the US. Thus, the company argued that it was “liable to tax” in the US “by reason of” its “place of management” or an “other criterion of a similar nature.” This argument was rejected by the court, stating that:

“Although the fact that [the company’s] ‘place of management’ is located in the United States is one factor contributing to the finding that its trade or business is connected with the United States, it does not constitute the basis for Norsk’s tax liability in the first place.”814

The court also noted that the residence test sought to identify those taxpayers subject to worldwide taxation in one of the contracting states, and contrasted this to the source-based liability to tax imposed as a result of having a US trade or business. The company was therefore ultimately unsuccessful in its claim for treaty benefits.815 As Vann notes however:

“If the taxpayer had not had the benefit of the reciprocal exemption, would it have been so outrageous for it to claim treaty benefits? The United States would have been taxing

810 Vann, R., “Liable to Tax…” at p. 244 (Section 7.4.1.).
811 Vann, R., “Liable to Tax…” at p. 245 (Section 7.4.1.1.).
813 Crucially, the US determines corporate residence based solely on incorporation and thus, the place of management in the US did not make the Bahamian company resident there. The vast majority of countries do have a corporate residence test based on management and, if the activities of the Bahamian company were located in a state other than the US then it is quite likely that those activities would have made the company a local resident. For further discussion of the common corporate residence rules found in domestic laws, see Chapter 9 (Section 9.2.2.).
815 Although the court of first instance (the Federal Court Trial Division, 92 DTC 6305) and the Federal Court of Appeal (94 DTC 6107) decided otherwise.

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it on a net basis at the company rate on income that was sourced in Canada under the passive source rules for royalties and so would Canada at a 25% gross basis apart from the treaty. … In this kind of scenario, it is highly unlikely that the residence State of the taxpayer would have collected any tax even if it were not a tax haven and had treaties in standard form with both Canada and the United States.

It is not self-evident that the Canadian tax rate on royalties received by the US business should be determined by the treaty between Canada and a third country which very likely would collect no tax on the income, rather than the treaty with the country which would collect tax on the income and so can provide relief for third-country tax.816

### 7.2.10. Conclusions

The idea that PE triangular cases should be resolved by extending treaty benefits to PEs clearly has a long history. It has been advocated by numerous authors, including some not mentioned above,817 and has been implemented in two isolated cases; the Belgium-France and France-Italy treaties discussed above. However, there is still no widespread acceptance of this approach, presumably for the reasons identified in the OECD’s 1992 report on triangular cases, i.e., the potential for tax avoidance and the extensive departure from existing principles and practices which it would represent. As outlined in Chapter 5, however, it may be possible to address the tax avoidance concerns and, in addition, the extension of treaty benefits to PEs would be consistent with the residence-like nature and role of the PE concept. The following section will discuss and compare the various different approaches for extending treaty benefits to PEs.

### 7.3. Approaches to extending treaty benefits to PEs

Where there are treaties in place between all the states involved in a PE triangular case, there are three possible bilateral tax treaties that can apply. Each of these treaties can bind only the contracting states in relation to that particular treaty; bilateral treaties cannot impose any obligations on a state which is not party to the treaty.818 This naturally limits the number of ways in which tax treaties can require the source state to apply the conditions of the PE-S treaty, exclude the operation of the R-S treaty in the source state, and require the PE state to grant relief. These aspects of extending treaty benefits to PEs can be achieved by provisions included in tax treaties as follows:

- **Application of the PE-S treaty conditions in the source state:** The source state is bound by both the R-S treaty and the PE-S treaty and could therefore be required to apply the conditions of the PE-S treaty under specific provisions included in either of those two treaties. The applicable treaty conditions in the source state cannot be affected by the terms of the R-PE treaty, which therefore cannot require the source state to apply the conditions of the PE-S treaty.

- **Non-application of the R-S treaty:** The operation of the R-S treaty can only be excluded by provisions included in that treaty. Neither the R-PE treaty nor the PE-S treaty can prevent the source state from being obliged to apply the conditions of the R-S treaty in relation to income derived by a person who is resident in State R.819

- **Relief in the PE state:** An explicit obligation for the PE state to provide relief could be included in either the R-PE treaty or in the PE-S treaty. The PE state is not party to the R-S treaty and it

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816 Vann, R., “Liable to Tax…” at pp. 248-249 (Section 7.4.1.3.).

817 García Prats, F.A., "Triangular Cases...”; Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at p. 102, (m.no. 30a); Vogel, K., "Tax Treaty Monitor...”; Langoth, B., "Treaty Entitlement...”; Yong, S., "Triangular Treaty Cases...”; and Vann, R., “Liable to Tax...” at pp. 248-250 (Section 7.4.1.3.) and p. 263-270 (Section 7.4.2.4.) (Vann writes: “In summary, a substantial argument can be mounted that a PE test is appropriate for granting treaty benefits in place of or in addition to a residence test for companies, although such an approach involves issues of overlapping treaties” at p. 269).

818 Article 34 of the Vienna Convention on the Law of Treaties (1964), which provides that: "A treaty does not create either obligations or rights for a third state without its consent.”

819 This point was made by Zhai, G., "Triangular Cases….”

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follows that the R-S treaty cannot require the PE state to grant relief for tax imposed in the source state.

In general, where specific provisions are included in the PE-S treaty to deal with PE triangular cases, it can be expected that these provisions would impose corresponding obligations on both the source state and the PE state. It is unlikely that a treaty would be concluded which, where it operated as the PE-S treaty, would either limit the tax imposed in the source state but not require relief in the PE state or, conversely, require relief in the PE state but without limiting the tax that can be imposed in the source state. There are therefore two primary ways of resolving the issues in PE triangular cases by way of measures included in the treaties between the three states involved, which are distinguished by the way in which the conditions of the PE-S treaty are made to apply. These two approaches are as follows:

1. The direct approach: The source state is required to apply the conditions of the PE-S treaty in relation to income attributable to a PE in the PE state and the PE state is required to grant relief (either exemption or credit) for tax imposed in the source state by provisions included directly in the PE-S treaty.

2. The indirect approach: The source state is required to apply the conditions of the PE-S treaty indirectly by provisions included in the R-S treaty. The PE state is required to provide relief for tax imposed in the source state (either exemption or credit) under specific provisions included in the R-PE treaty.820

It should be borne in mind that regardless of the approach taken, the exclusion of the provisions of the R-S treaty can only be achieved by specific provisions included in that treaty. In addition, any state could find itself in the position of the PE state, the source state, or the residence state in a PE triangular case and any treaty could therefore be the R-S treaty, the R-PE treaty or the PE-S treaty in a given situation. It follows that appropriately worded provisions would have to be included in every treaty for treaty benefits to be extended to PEs in all triangular cases. It is also important to note that the direct approach does not necessarily require the PE to be treated as a treaty eligible resident person; the person claiming treaty benefits in relation to the income attributable to the PE could still be person to which the PE belongs. This will be discussed further in Chapter 8 (Section 8.2.1.). For ease of expression, reference will continue to be made to a PE claiming treaty benefits even though this may not be strictly accurate.

The direct and indirect approaches to extending treaty benefits will each be discussed in turn below. The direct approach could also encompass a solution whereby the PE state and the source state can apply the conditions of the PE-S treaty in PE triangular cases under the mutual agreement procedure (as is the case in the Belgium-France treaty discussed above). Nevertheless, this potential solution will be discussed separately (see Section 7.3.4.). The approach proposed by Avery-Jones, which involves provisions included in all three treaties, will also be discussed separately below (see Section 7.3.3.). Furthermore, it may be possible to extend treaty benefits to PEs unilaterally under domestic laws; this will be discussed in Section 7.3.5., below.

The various approaches discussed in this section are, in general terms, not mutually exclusive. That is, if it is the treaty policy of a particular state that the PE-S treaty should apply to income attributable to a PE, then that state could seek to include terms in its treaties that operate to extend treaty benefits to PEs both indirectly where that treaty is operating as the R-S treaty and directly where that treaty is operating as the PE-S treaty. This may make PEs in more states eligible for treaty benefits in a shorter period of time, but it could be problematic in the sense that there may be inconsistencies between the provisions of various treaties. It would be preferable for states to agree on a single approach and apply it consistently in all treaties.

820 The indirect approach was proposed by Zhai (Zhai, G., "Triangular Cases...") who relied on the application of the PE non-discrimination provision (Article 24(3)) of the R-PE treaty to require the PE state to grant relief. However, as discussed in Chapter 4 (see Section 4.3.), many states do not accept that a relief obligation arises under Article 24(3), particularly with respect to treaty relief (as opposed to the relief available under their domestic laws). It is also problematic to rely on Article 24(3) to require the PE state to extend treaty relief to PEs because in situations where the source state doesn't apply the conditions of the PE-S treaty this effectively leads to an unbalanced application of the PE-S treaty. The better approach would be for the PE state to have an explicit obligation to grant relief for tax imposed in the source state. The relief obligation in the PE state will be discussed further in Section 7.4., below.
The remainder of this section will assess the various approaches for extending treaty benefits to PEs. However, it will not specifically consider issues related to the relief available in the PE state, which will be discussed in Section 7.4., below, or the exclusion of the R-S treaty, which will be discussed in Section 7.5., below.

7.3.1. Direct treaty entitlement

Direct treaty entitlement for PEs has a number of significant advantages over the other approaches identified above. Where the direct approach is employed, the provisions extending treaty benefits to PEs would be included in the PE-S treaty itself and would require both the PE state and the source state to apply the terms of the treaty. This would prevent any risk of an unbalanced application of the PE-S treaty which, as will be seen below, underlies the main disadvantage of the indirect approach.

If the PE-S treaty conditions are applied directly, however, the source state may be required to apply the conditions of the PE-S treaty in relation to income which is derived by a resident of a state which does not have a treaty with the source state (i.e., in situations where there is no R-S treaty). This may be considered inappropriate on the basis that residents of a state which does not have a treaty with the source state should not be entitled to treaty benefits, regardless of whether the income is attributable to a PE in a third state. However, once it is accepted that the appropriate treaty to apply in a PE triangular case is the PE-S treaty, then the existence of an R-S treaty is effectively irrelevant and the absence of an R-S treaty should not prevent the application of the PE-S treaty. 821

A significant advantage of the direct approach is that the direct application of the PE-S treaty allows the PE state and the source state to negotiate the extent to which treaty benefits should be available to PEs, e.g., whether such benefits should be limited to certain categories of income. As discussed in Chapter 5 (section 5.2.2.2.), one of the arguments for extending treaty benefits to PEs is that the split of tax revenues between the PE state and the source state should depend upon the bargain struck between them and reflected in the PE-S treaty, and the direct application of the PE-S treaty is the most certain way of ensuring that this is the case. The direct approach also means that the terms of the PE-S treaty can, where necessary, address any unusual circumstances in one or both of the contracting states which are relevant to the extension of treaty benefits to PEs. Furthermore, where treaty benefits are extended to PEs directly, the PE-S treaty can deal with any other specific consequences for the application of the PE-S treaty, such whether and how a limitation on benefits (LOB) provision contained in the treaty should apply in the context of a PE claiming treaty benefits. Finally, the operation of a direct extension of treaty benefits to PEs could potentially be simpler than an indirect extension of treaty benefits, in that there would be no need to consult multiple treaties to understand the operation of the PE-S treaty. 822 It may also simplify the provision of relief in the PE state, particularly where the PE state uses the credit method of relief (as will be seen in Section 7.4.1., below).

7.3.2. Indirect treaty entitlement

A significant advantage of the indirect approach is that the provisions of the R-S treaty requiring the source state to apply the PE-S treaty would presumably also exclude the operation of the R-S treaty in relation to the income attributable to the PE. This means that the source state will never be obliged to apply the conditions of two tax treaties simultaneously. By contrast, if treaty benefits are extended to PEs directly, then it is more likely that situations will arise where the source state is required to apply the conditions of both treaties. This impact of the application of multiple treaty conditions will depend upon the relative terms of the two treaties. To the extent that the terms of the treaties are the same in relation to the category or categories of income attributable to the PE, the application of multiple treaty

821 The OECD’s 1992 report on triangular cases also makes the point that in this case, the PE-S treaty is operating on the principle of reciprocity and implying that overall, the principle of reciprocity is not compromised by requiring the source state to apply the conditions of the PE-S treaty in situations where there is no R-S treaty. See: OECD Committee on Fiscal Affairs, “Triangular Cases,” para 44.

822 It should be noted, however, that specific terms would still need to be included in the R-S treaty to prevent the source state from being subject to multiple treaty restrictions; this will be discussed in Section 7.5.2., below.
conditions will have no impact on the amount of tax the source state is entitled to impose. However, it is common for treaties to differ with respect to the rate of source-based taxation which can be imposed on dividends, interest and royalties; where two treaties apply, the source state will only be able to fulfil its treaty obligations by applying the lower of the two rates. Clearly, this would be undesirable for the source state.

The primary disadvantage of the indirect approach is that the application of the PE-S treaty depends, firstly, upon the residence state having treaties with the source state and the PE state, and secondly, on the specific provisions contained within those treaties. This could lead to an unbalanced application of the PE-S treaty, whereby the terms of the PE-S treaty would be applied only in the source state or only in the PE state, in situations where either there is no R-PE treaty or no R-S treaty, or where one of those treaties does not contain specific provisions dealing with PE triangular cases. This is clearly undesirable and can potentially lead to adverse consequences, including unrelieved double taxation as will be seen below.

The unbalanced application of the PE-S treaty can lead to unrelieved double taxation regardless of whether it is the PE state or the source state that does not apply the PE-S treaty. If no relief is provided in the PE state, then the relief of double taxation will fall to the residence state, which may or may not be capable of providing sufficient relief (refer to the discussion in Chapter 3, Section 3.2.). Alternatively, if the source state is not required to apply the conditions of the PE-S treaty and the PE state is required to provide relief, but that relief is limited to that which would be available to residents of the PE state under the PE-S treaty, then unrelieved double taxation can persist to the extent that the source state imposes more tax than would be allowed under the conditions of the PE-S treaty. The potential for unrelieved double taxation in circumstances where there is an unbalanced application of the PE-S treaty is a clear disadvantage of the indirect approach.

Another disadvantage of the indirect approach is that the extent to which reductions in source based taxation under the PE-S treaty are available to the PE depends upon the agreement reached between the residence state and the source state, and embodied in the R-S treaty. So, for example, the R-S treaty may require the source state to apply the conditions of the PE-S treaty, but only with respect to passive income. This could potentially result in the split of tax revenues between the PE state and the source state being dependent upon the terms of the R-S treaty rather than those of PE-S treaty, which is arguably inappropriate.

The reliance on treaties concluded by the residence state also means that two PEs located in a particular state (the PE state), in what are effectively the same circumstances (e.g., both earning the same income, both exempt in their residence state, both taxable in the PE state), may be subject to different treaty conditions by virtue of the enterprises to which they belong being resident in different states. That is, treaty between the residence state of one of the enterprises and the source state may require the source state to apply the conditions of the PE-S treaty, while the treaty between the other enterprise's residence state and the source state does not.

The issues associated with the indirect approach to extending treaty benefits to PEs mean that the direct approach is to be preferred. However, if the full extension of treaty benefits to PEs is rejected, then it would still be desirable to require the PE state to provide relief for tax imposed in the source state. In circumstances where the PE-S treaty doesn’t apply, this could best be achieved by provisions included in the R-PE treaty (i.e., as suggested in the OECD's triangular cases report). The inclusion of provisions in the R-PE treaty to require the PE state to grant relief will be discussed further in Section 7.4.2., below.

7.3.3. Provisions included in all three treaties (Avery-Jones proposal)

Avery Jones proposes a solution to PE triangular cases whereby the residence state would transfer to the PE state the right to claim to be the "residence state" in relation to income attributable to the PE for the purposes of treaties between the PE state and third states.823 This proposal has been outlined in further detail above (see Section 7.2.6.). This approach would ensure that the source state applies the conditions

823 Avery Jones, J.F., "The David R. Tillinghast Lecture...." This solution is also mentioned very briefly in: Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems...." Zhai also discusses this proposal, referring to unpublished work of J.F., Avery Jones (see: Zhai, G., "Triangular Cases...").
of the PE-S treaty instead of those contained in the R-S treaty, and would ensure that the PE state grants relief for tax imposed in the source state. It also addresses treaty shopping concerns by ensuring that the PE-S treaty only applies (instead of the R-S treaty) if the PE state taxes the income normally. However, there are certain problems with this approach. Firstly, this solution will not be effective unless there are treaties in place between all three of the contracting states and all three treaties contain specific provisions for dealing with PE triangular cases.\(^{824}\) If there is either no PE-S treaty or no R-PE treaty, or if either of those treaties does not contain the necessary provisions, then the transfer of residence under the R-PE treaty will have no effect. The fact that this proposed solution requires all three treaties to contain corresponding provisions may make it more difficult to implement in practice than the direct and indirect approaches, discussed above, which can be fully implemented with provisions included in only two treaties.

In addition, this proposed solution requires the residence state (presumably the tax authority of the residence state) to be involved in making the decision to transfer the "residence" claim to PE state, and makes the residence state responsible for determining whether the income is sufficiently taxed in the PE state. The residence state's obligations under this proposal seem to be greatly in excess of the normal obligations which a residence state may have to, e.g., certify the residence of locally resident companies. In addition, the residence state is not in the best position to assess the extent to which the income attributable to the PE is taxed in the PE state. In most cases it will presumably rely on the taxpayer to provide the information regarding the taxation of the income in the PE state, which the taxpayer could just as easily provide to the source state. It also appears that this approach would require the residence state to make a decision regarding whether to transfer residence, which would be a significant departure from the normal operation of tax treaties, whereby entitlement for treaty benefits arises independently, without requiring any decision by the tax authorities of the residence state, and where claims for treaty benefits are made by the persons who are entitled to such benefits.\(^{825}\) Under current treaty principles, the residence state does not claim to be the residence state in relation to income derived by its residents; rather, those resident persons claim to be resident in their residence state. It is therefore unclear exactly what the residence state is transferring to the PE state. Overall, this does not seem to be the best possible approach to dealing with PE triangular cases.

7.3.4. Mutual agreement

The treaty between France and Belgium, concluded in 1964, contains a provision which allows (but does not require) the contracting states to apply the terms of the treaty in relation to income derived in certain PE triangular cases under the mutual agreement procedure. The problem with this approach is that the PE-S treaty will only apply if the Contracting States agree to apply it. A provision like this would arguably be insufficient to prompt states to more generally apply the conditions of their treaties in relation to income derived through PEs in PE triangular cases, since by granting such benefits they would effectively be giving up their taxing rights despite not having any obligation to do so. The application of the provisions of the PE-S treaty in this situation may also result in the source state being subject to multiple treaty restrictions in respect of the same income, since it would generally have no means of excluding the operation of the R-S treaty in relation to the income attributable to the PE.

This approach minimises any concerns of treaty shopping through PEs, since the competent authorities of both contracting states must agree to apply the treaty in a each particular case, and would allow states to deal with PE triangular cases in situations which are clearly problematic and in which there is no suggestion of treaty shopping. However, due to the essentially optional nature of the application of the treaty to income derived by PEs and the impossibility of enforcing the provision in a uniform way, it is not a satisfactory approach for dealing with PE triangular cases more generally.

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824 Zhai, G., “Triangular Cases….”

825 Administrative aspects of extending treaty benefits to PEs will be discussed in Chapter 8 (see Section 8.3.3., which deals with how the claim for treaty benefits should be made and with certification requirements).
7.3.5. Domestic law

It is possible for states in the position of the source state to unilaterally apply the conditions of the PE-S treaty in relation to income attributable to a PE in the PE state and thus, to unilaterally extend treaty benefits to PEs. They could do this by enacting a provision in their domestic law to the effect that any income which is attributable to a foreign PE will be taxed as though it were derived by a treaty-eligible resident of the state where the PE is located (i.e., the PE state), in accordance with the provisions of its treaty with that state (i.e., PE-S treaty). As a result, the source state may, for example, unilaterally reduce the amount of withholding tax it imposes on dividends or interest paid to a foreign PE so that it is equal to the amount that would be imposed if the PE-S treaty applied. An advantage of this approach is that it could be implemented without specific provisions being included in tax treaties.

In practice, states are unlikely to extend treaty benefits to PEs unilaterally because any state that did so would, as a result, have virtually no negotiating power to convince other states to implement similar measures, either in their domestic law or in tax treaties. In effect, the source state would be giving up tax revenue with little chance of reciprocal measures in other states. One alternative may be for the extension of treaty benefits to PEs under domestic law to be dependent on a reciprocal (domestic law) application of the treaty in the other state. However, if both states agree to apply the treaty to PEs, then it would generally be preferable for the extension of treaty benefits to PEs to be included in the treaty itself (or in a protocol to the treaty). A domestic law extension of treaty benefits to PEs would also result in the source state being subject to the conditions of both the PE-S treaty and the R-S treaty. This is because the source state cannot unilaterally refuse to grant a reduction in source based taxation to residents of State R which is available under the R-S treaty on the basis that the income is attributable to a PE in another state. The source state is bound to apply the conditions of R-S treaty, and any unilateral provision which purported to deny treaty benefits would contravene that state’s obligations under international law. For these reasons, a treaty solution would be preferable to one relying on domestic laws.

Even if states do not unilaterally extend treaty reductions in source based taxation to PEs, they can clearly grant unilateral relief to PEs located within their borders. This would go a long way to resolving the issues arising in PE triangular cases, in that it would prevent unrelieved double taxation. Various states already extend their domestic relief measures to income which is derived by non-residents through PEs or in cases where an equivalent domestic law threshold is met. Where relief is granted under domestic law, it is important to ensure that the relief provided is compatible with the result arising under the applicable tax treaties. Unrelieved double taxation may still arise, for example, in states that only allow relief in

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827 If the source state is concerned about extending the benefits of the PE-S treaty to PEs in situations where the PE state either does not tax the income attributable to the PE, or imposes only a minimal amount of tax, the application of the PE-S treaty conditions could be made conditional on the PE state imposing a certain level of tax on the income. This type of anti-avoidance provision will be discussed in Chapter 8 (see Section 8.4.2.).

828 The benefits of the PE-S treaty should be made available only in situations where the recipient of the income has a PE in the PE state for the purposes of the R-S treaty. Otherwise, if the definition used for domestic law purposes is wider than that contained in the R-PE treaty, the source state may find itself granting treaty benefits in situations where the PE state is prevented from imposing tax on the income under the R-S treaty. Alternatively, if the definition used for domestic law purposes is narrower than the definition under the R-PE treaty, then the provision extending treaty benefits to PEs may be ineffective in certain situations, and may not allow the benefits of the PE-S treaty in relation to certain income which is attributable to a PE for the purposes of the R-PE treaty. To be effective, therefore, any domestic law provision extending treaty benefits to PEs should refer to the PE definition contained in the R-PE treaty. This will be discussed further in Chapter 8 (see Section 8.2.3.).

829 Vienna Convention on the Law of Treaties, Articles 26 and 27. Article 26 provides that: "Every treaty in force is binding upon the parties and must be performed by them in good faith." Article 27 provides that: "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."

830 For further discussion and an illustration of how relief in the PE state ensures that there is no unrelieved double taxation, refer to Chapter 3 (Section 3.2.2.2.).

831 This was discussed in Chapter 4. For examples of states that extend domestic relief provisions to non-residents deriving income through local PEs, see Section 4.2.2.1.
relation to income which is considered to be foreign source income under domestic sourcing rules.\textsuperscript{832} Where there is an overlap between the source rules of the PE state and those of the source state, the source state may impose tax on income which the PE state does not consider to be "foreign source income" and thus, the PE state may not provide relief under its domestic relief provisions.\textsuperscript{833} To overcome this potential problem, the limitation on double taxation relief in relation to domestic source income could be relaxed in the case of PEs, such that relief would be available for foreign tax imposed on a source basis in relation to income attributable to a PE regardless of whether the income is considered to have a foreign source under domestic law.\textsuperscript{834}

7.3.6. Conclusions

Extending treaty benefits to PEs directly under the terms of the PE-S treaty is clearly preferable to the other alternatives discussed above. It results in the PE being treated, as closely as possible, in the same way as a resident enterprise of the PE state and ensures neutral treatment of PEs located in a particular state (i.e., the PE state) and deriving income from another state (i.e., State S), regardless of the state where the person to which the PE belongs is resident. It also ensures that the split of tax revenue between the PE state and the source state in relation to income from cross-border activities is a product of the treaty conditions agreed between those two states, rather than with the residence state. Furthermore, in contrast to the indirect approach, the direct approach avoids the potential for unbalanced applications of the PE-S treaty, i.e., where the PE-S treaty is applied in only one of the contracting states. Thus, it would be preferable to apply the PE-S treaty to the income attributable to the PE directly rather than indirectly. The exact form and wording of the provisions will be discussed in Chapter 8.

If it is not accepted that the PE-S treaty should apply in relation to the income arising in PE triangular cases, then it would still be desirable to nevertheless apply the other aspects of this solution. That is, the PE state should be explicitly required to grant relief for tax imposed in the source state and a provision could be included in the R-S treaty to ensure that it doesn’t apply in circumstances which are considered abusive. This would only be a partial solution, since the source state would continue to apply the “incorrect” treaty provisions, but it would prevent unrelieved double taxation and would prevent improper use of the R-S treaty. The discussion in the remainder of this chapter will therefore address both situations where the source state does apply the conditions of the PE-S treaty and situations where it does not.

This minimalist approach would resolve many of the issues that arise in PE triangular cases and it is likely to be much simpler to gain acceptance of this approach and to implement it. However, a more comprehensive approach, under which a person deriving income in a PE triangular case would be entitled to invoke the provisions of the PE-S treaty, would nevertheless be a better approach. The minimalist approach is considered to be the next best solution if the more comprehensive solution is not accepted.

7.4. Double taxation relief in the PE state

As discussed in Chapter 4, the PE state may have an obligation under the non-discrimination article (Article 24(3)) of the R-PE treaty to provide relief for tax imposed in the source state. However, given the disagreement surrounding the obligation to provide relief and the difficulties with determining the amount of relief to be provided, it would be preferable for there to be an explicit treaty obligation for the PE state to provide relief. The PE state could potentially be required to grant relief either under a specific provision included in either the PE-S treaty or the R-PE treaty. The specific provisions which could be included in treaties to require the PE state to grant relief will be discussed in Chapter 8; the discussion in this section will focus on the limitations which should be imposed on the relief available in the PE state,

\textsuperscript{832} This is the case in the US, for example, under IRC Section 901. This was also the case in Australia prior to 2008 (former Section 160AF, Income Tax Assessment Act 1936 (repealed by the Tax Laws Amendment (2007 Measures No. 4) Act, 2007, with effect from income years starting after 1 July 2008)).

\textsuperscript{833} This issue can also arise in the residence state in bilateral situations, however in most bilateral situations the issue would be resolved by the residence state having a relief obligation under an applicable tax treaty.

\textsuperscript{834} Australia took this approach in reforms enacted in 2007 by the Tax Laws Amendment (2007 Measures No. 4) Act, 2007, with effect from income years starting after 1 July 2008.
and on certain additional issues which may arise if the PE state is required to grant relief under the R-PE treaty.

7.4.1. Limitations on relief

Regardless of whether the PE state is required to provide relief under provisions included in the PE-S treaty or in the R-PE treaty, it is important to consider the limitations on that relief. This is particularly relevant where the PE state uses the credit method. The limitations on the amount of relief to be provided in the PE state are complicated by the fact that if certain states begin to extend treaty benefits to PEs, then it is possible that the source state may apply the conditions of the R-S treaty, the PE-S treaty or both depending on the provisions (if any) included in each of the relevant treaties to deal with PE triangular cases. The aim of this section is therefore to determine the appropriate limitations to apply in relation to the relief in the PE state, taking into account that they must be capable of being applied regardless of the applicable treaty conditions in the source state.

7.4.1.1. Basic criteria for relief

The relief provisions of the OECD Model require the residence state to grant relief in relation to income which may be taxed in the other Contracting State "in accordance with the provisions of this Convention" 835 If the PE state is required to extend treaty relief to PEs (as a result of provisions included in either the R-PE treaty or the PE-S treaty), then such relief should only be required if the income may be taxed in the source state in accordance with the provisions of the PE-S treaty and in accordance with the terms of any applicable treaty between the source state and a third state (i.e., the R-S treaty). This will have the effect that no relief will be required in the PE state if either the R-S treaty or the PE-S treaty prevents the source state from imposing tax. It is possible to apply both these conditions regardless of which treaty conditions actually apply in the source state in a particular case with no ill-effect; if the source state is not required to apply the conditions of either the PE-S treaty or the R-S treaty, then nothing in the non-applicable treaty will prevent the source state from imposing tax and consequently, the condition in the relief article relating to that particular treaty will (correctly) have no effect. There is therefore no need to include specific wording to deal with each possible combination of applicable treaty conditions in the source state. 836

7.4.1.2. Limitations on the amount of credit relief

In situations where the PE state provides relief using the credit method (either generally or only in relation to passive income), the provision requiring relief should specify the applicable limitations on the amount of the credit available. This is the case regardless of whether the relief provision is included in the PE-S treaty or the R-PE treaty.

Clearly, any credit which the PE state is required to grant should be limited to the amount of tax paid in the source state and to the amount of tax in the PE state which is attributable to the income as is the case under the existing relief provisions of the OECD Model. 837 The relief provisions of the OECD Model also limit the credit to the amount of tax that may be imposed in accordance with the convention. 838 In a PE triangular case, the application of this type of limitation is more complicated because the source state may potentially apply the conditions of the R-S treaty, the PE-S treaty, no treaty or both treaties.

The OECD Commentary suggests that credit relief in the PE state should be limited to the lesser of:

835 2010 OECD Model, Article 23A(1). Similar wording is contained in Article 23A(2) (regarding the credit method for interest and dividends in situations where exemption is the primary method of relief) and Article 23B(1) (where the credit method is the primary method of relief).
836 Taking into account that even if the PE-S treaty does not require the source state to apply its conditions in PE triangular cases, the source state may be required to apply the PE-S treaty conditions as a result of provisions included in the R-S treaty, as discussed below.
837 2010 OECD Model, Article 23A(2) and Article 23B(1).
838 2010 OECD Model, Article 23A(2) and Article 23B(1).
1. The tax paid in the source state;
2. The amount of tax the source state may impose under the terms of the R-S treaty; and
3. the amount of tax the source state would have been entitled to impose under the terms of the PE-S treaty, if they applied.839

These limitations assume that the source state applies the conditions of the R-S treaty and does not apply the conditions of the PE-S treaty, but could be easily adapted to cover other situations. The amount of the credit should clearly be limited to the amount of tax that the source state may impose under any applicable treaty, i.e., the R-S treaty and/or the PE-S treaty. However, even if the source state is not required to apply the conditions of the PE-S treaty in relation to income attributable to the PE, the contracting states may wish to limit the amount of the credit in the PE state to the amount of tax that the source state could have imposed if it had applied the conditions of the PE-S treaty. If such a limitation is included, the states are effectively accepting that there will be unrelieved double taxation in certain. This supports the application of the conditions of the PE-S treaty in the source state.

7.4.2. Provisions included in the R-PE treaty

As discussed above, the issues associated with the indirect approach to extending treaty benefits to PEs mean that the direct approach is to be preferred. However, if the application of the conditions of the PE-S treaty in the source state is rejected, then it would still be desirable for the PE state to be required to provide relief for tax imposed in the source state. Where the PE-S treaty doesn’t apply in the source state, this could best be achieved by provisions included in the R-PE treaty, since otherwise the PE-S treaty would need to be made applicable solely for this purpose.

The main question to be addressed in relation to a provision of the R-PE treaty requiring relief in the PE state is whether it should require the PE state to provide relief directly, or whether it should link the relief available to PEs to the relief that would be available to residents of the PE state under the PE-S treaty. Thus there are two main alternatives for the operation of a provision of the R-PE treaty requiring the PE state to grant relief, namely:

1. A provision which requires the PE state to grant relief by reference to the relief available to residents of the PE state under the PE-S treaty; and
2. A provision which requires the PE state to grant relief directly, without reference to the PE-S treaty.

From a theoretical perspective, the preferred approach would be to link the relief to that available to a resident of the PE state under the PE-S treaty. This would put the PE, as closely as possible, in the same position as a resident of the PE state. However the practical implications of these two approaches should also be considered. As will be discussed below, the main difference between these two approaches becomes clear in situations where there is either no PE-S treaty or where the PE-S treaty requires the PE state to use a different method of relief (i.e., credit or exemption) than that which would apply under the R-PE treaty.

The OECD Commentary contains a suggested addition to the non-discrimination article which would oblige the PE state to provide double taxation relief to PEs. Although the provision is included in the non-discrimination article, it requires the PE state to provide relief directly, without reference to the relief that would be available to a resident of the PE state. This provision reads as follows:

839 2010 OECD Commentary on Article 24, para 70, which reads: "When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt claim in respect of which the dividends or interest are paid is effectively connected with the permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the state of which the enterprise is resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is resident in the first-mentioned Contracting State can claim under that state's convention with the third State." These limitations are discussed in detail in Chapter 4 (see Section 4.3.5.).
"When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt claim in respect of which the dividends or interest are paid is effectively connected with the permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the state of which the enterprise is resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is resident in the first-mentioned Contracting State can claim under that state's convention with the third State."

This provision will be discussed below, particularly in relation to the method of relief. It should be noted that this provision only requires the PE state to grant relief with respect to certain categories of income; the extent to which the treaty benefits available to PEs should be limited to certain categories of income will be discussed in Chapter 8 (Section 8.2.4.).

7.4.2.1. Method of relief

Where the PE state is required to grant relief by reference to the relief provisions of the PE-S treaty, the relief available to the PE will always be the same method of relief as that which would be available to a resident of the PE state under the PE-S treaty. This may be either the credit method or the exemption method depending on the terms of the PE-S treaty and the category of income involved.

If the relief provision doesn’t refer to the PE-S treaty then it must specify the method of relief available. It would preferable, in order to place the PE in the same position as a resident of the PE state, for the method of relief available to the PE to be the same as the method which would be available to a resident of the PE state under the PE-S treaty. Where the PE state uses the same primary method of relief (i.e., exemption or credit) in all its treaties then the R-PE treaty should clearly require the PE state to use that method of relief in relation to the income attributable to the PE, and this will not be an issue. This may also be the case in relation to passive income, such as dividends, interest, and royalties where the credit method typically applies regardless of the general method of relief used in the treaty. However, where the PE state does not use the same method of relief in all its treaties, the method of relief available to the PE may differ from that available to residents of the PE state. This is a potential disadvantage of a direct relief requirement, and suggests that it would be preferable for the PE relief provision to operate by reference to the relief provision of the PE-S treaty.

The suggested relief provision in the OECD Commentary requires the PE state to apply the credit method of relief regardless of the method of relief generally required by the PE-S treaty (or, indeed, the R-PE treaty). However, it also limits relief in the PE state to cases involving dividends and interest sourced in a third state and does not apply to other categories of income. Under the OECD Model, the credit method always applies in relation to dividends and interest, regardless of the method of relief applicable to other categories of income (see Article 23A and Article 23B). Therefore, assuming the applicable treaties follow the OECD Model, the method of relief will be the same as that which would be available to residents of the PE state. The Commentary does go on to say that, where the convention (presumably the R-S treaty) allows source-based taxation in relation to other categories of income, such as royalties, then the relief provision could be extended to cover those categories of income. Where other categories of income are involved, however, the credit method may not always be the appropriate method of relief. If a resident of the PE state would be entitled to exemption relief then arguably the PE should

840 2010 OECD Commentary on Article 24, para 70.
841 See: 2010 OECD Model, Article 23A and Article 23B.
842 Under the OECD Model, royalties may only be taxed in the residence state (under Article 12, except where they are attributable to a PE). This explains why royalties are not included in the relief provision suggested in the OECD Commentary. In reality, however, treaties commonly allow source-based taxation of royalties (limited to a certain percentage of the gross amount of the income) and thus even under a provision based explicitly on that suggested in the OECD Commentary, relief should also be available in relation to royalties.
843 2010 OECD Commentary on Article 24, para 70.
also be entitled to exemption relief, as this would place the PE as closely as possible in the same position as a resident enterprise.

7.4.2.2. Situations where there is no PE-S treaty

In situations where there is no PE-S treaty, the PE should arguably not be entitled to any relief for tax imposed in the source state. The lack of relief could result in unrelieved double taxation in certain situations, but in this case unrelieved double taxation could also occur if a resident of the PE state derives income from the source state. If relief were to be provided, the PE would potentially be in a more favourable position than a resident of the PE state, since residents of the PE state would not be entitled to any form of treaty relief (although unilateral relief may still be available). In addition, extending relief to PEs may enable enterprises to obtain relief when operating through a PE in circumstances where no relief would be available if they were operating through a locally resident enterprise in the PE state. The PE state could potentially consider this an improper use of the R-PE treaty. The extension of relief to PEs may also reduce the incentive for the source state and the PE state to negotiate a treaty, since enterprises would be able to obtain relief by operating through a PE. The preferred approach would therefore be to oblige the PE state to grant relief only where relief would be available to residents of the PE state under a treaty with the source state (or under the domestic law). This would serve to put the PE as closely as possible in the same position as a resident taxpayer. If the R-PE treaty requires the PE state to provide relief by reference to the relief available under the PE-S treaty then, in the absence of a PE-S treaty, the PE state will not be required to provide any relief. The relief in the PE state will automatically be limited to situations where there is a PE-S treaty. If, however, the R-PE treaty requires the PE state to provide relief directly, without reference to the PE-S treaty, then the contracting states may wish to include an exception for situations where there is no PE-S treaty. This again suggests that the better approach would be for the PE relief provision of the R-PE treaty to operate by reference to the relief provisions of the PE-S treaty.

7.4.2.3. Proposed relief provision

As discussed above, the PE state could be obliged to provide relief in PE triangular cases under the R-PE treaty either directly or by reference to the relief available to resident enterprises of the PE state under the PE-S treaty. If a relief obligation is included in the R-PE treaty, the better approach would be to link the relief to that available under the PE-S treaty, because this would ensure that the PE state uses the same method of relief as it would if the income were derived by a resident of the PE state and would prevent the PE state from being obliged to provide treaty relief in situations where there is no PE-S treaty.

A provision included in the R-PE treaty and requiring the PE state to grant relief for tax imposed in the source state in PE triangular cases could be worded along the following lines:

"(1) When an enterprise of a Contracting State receives income which is included in the profit attributable to a permanent establishment in the other Contracting State and that income may be taxed in a third state under an applicable tax treaty between the first-mentioned Contracting State and that third state, the state where the permanent establishment is located shall grant relief in respect of the tax paid on the income in the third state, provided such relief would be available if the income were derived by an enterprise of the Contracting State where the permanent establishment is located.

(2) If there is a convention between the Contracting State where the permanent establishment is located and the third state, the Contracting State where the permanent establishment is located shall apply the article of that convention which provides for the elimination of double taxation as though the permanent establishment were a resident of the State where it is located for the purposes of that convention. The Contracting State where the permanent establishment is located may apply that provision as though that convention had also been applied in the third state to the income attributable to the permanent establishment as though the permanent establishment were a resident of the State where it is
located and, where relevant, taking into account any limitation on the amount of tax imposed in the third state under any applicable convention between the Contracting State of the enterprise and that third state.

(3) If the Contracting State where the permanent establishment is located grants relief other than under paragraph 2, the relief shall be granted under the same conditions, including with respect to the method of relief, that would apply if the income were derived by an enterprise of that State."

This provision has a number of features which reflect the discussion earlier in this section regarding the situations in which relief should be provided, and the appropriate limitations on relief. Firstly, this provision operates by reference to the relief that would be available to a resident of the PE state, either under domestic law or under a treaty with the source state. It applies only where the source state is entitled to impose tax on the income in accordance with the R-S treaty, meaning that if the source state is prevented from imposing tax under the R-S treaty, then no relief is required in the PE state.844 Paragraph 2 deals with the extension of treaty relief to the PE, and requires the PE state to apply the relief provision of the PE-S treaty. However, it allows the PE state to provide relief as though the source state had also applied the terms of the PE-S treaty in relation to the income and taking into account any limitations under the R-S treaty. Where the exemption method applies, this means that no relief will be available if the source state would have been prevented from imposing tax if it had applied the PE-S treaty, or if it is prevented from imposing tax under the R-S treaty.

Where the credit method applies, the amount of relief would be limited to:

(i) the amount of tax actually imposed in the source state, by virtue of the reference to the terms of the PE-S treaty;

(ii) the amount of tax the source state could have imposed if it had applied the PE-S treaty; and

(iii) the amount of tax the source state can impose under the R-S treaty.

The suggested provision is worded in such a way that the second and third limitations are optional ("may"), which would allow the PE state, if it wished, to provide a credit in excess of the amount of tax that the source state could impose under the PE-S treaty. However, the third limitation is effectively not optional, and the reference to the terms of the R-S treaty could even be omitted, since relief is limited to the amount of tax imposed in the source state and the amount of tax imposed will already be limited by the terms of the R-S treaty; it is included in the suggested provision more for the avoidance of doubt.

Paragraph 3 deals with the extension of domestic relief provisions to a PE deriving income from a third state, and requires the PE state to grant relief under the same conditions and using the same method as would apply to residents of the PE state. This could apply, for example, in circumstances where there is no PE-S treaty.

7.5. Non-application of R-S treaty conditions in the source state

One of the main concerns arising in PE triangular cases under the current framework is the potential for improper access to the R-S treaty. States may therefore wish to exclude the operation of the R-S treaty in PE triangular cases as an anti-avoidance measure. In addition, if the source state applies the conditions of the PE-S treaty then it will in all likelihood seek to exclude the operation of the R-S treaty. As discussed above, the operation of the R-S treaty can only be excluded by provisions included in that treaty; neither the R-PE treaty nor the PE-S treaty can prevent the source state from being obliged to apply the conditions of the R-S treaty in relation to income derived by a person who is resident in State R.845 The following section will discuss the exclusion of the R-S treaty as an anti-avoidance measure, while the following section will go on to discuss the exclusion of the R-S treaty in circumstances where the source state applies the conditions of the PE-S treaty.

844 This arises from the following wording in the first paragraph: "...and that income may be taxed in a third state under an applicable tax treaty between the first-mentioned Contracting State and that third state..."
845 This point was made by Zhai, G., "Triangular Cases...."
7.5.1. Excluding the application of the R-S treaty in tax avoidance situations

One of the primary concerns relating to PE triangular cases under the existing treaty framework is the potential for improper claims for treaty benefits. That is, the source state may be required to reduce the amount of tax it imposes as a result of the application of the R-S treaty in a situation where the income is exempt in the residence state by virtue of being attributable to a PE located in a third state, and where the PE state imposed no (or minimal) tax on the income. It should be noted that the main concern for the source state is not existing residents of State R establishing a PE in a third state and transferring income-generating assets to that PE, in which case there may be a reduction in the amount of tax collected in the residence state (e.g., due to exemption of the income) but no impact in the source state. The concern for the source state is, rather, situations where a person who is deriving income (or expecting to derive income) from the source state establishes a company, resident in State R, to derive the income from the source state and ensures that the income is attributable to a PE in a third state so that the benefit of reduced rates of taxation in the source state is not offset by a tax liability in the residence state. This results in the source state being able to impose less tax than it would be able to impose if the income were derived directly.

Clearly, this type of improper access to treaties could be addressed using the same approaches as are used to attack treaty shopping more generally, such as the beneficial ownership concept, general anti-avoidance rules and LOB provisions. These approaches were discussed in Chapter 5, and this section will not include any additional discussion of them. Instead, this section will focus on possible approaches for dealing specifically with improper access to tax treaties in PE triangular cases.

7.5.1.1. Specific provisions included in existing treaties

Various existing treaties contain provisions which are intended to counteract claims for treaty benefits in relation to income attributable to a PE in a third state in certain circumstances that are considered to be abusive. These provisions generally exclude the normal reductions in source based taxation under the treaty in certain situations where income is attributable to a PE located in a third state. Most of the existing provisions of this type are included in treaties concluded by the United States, and they are generally found in the LOB provision. Similar provisions are included in the Canada-France treaty (added to the 1975 treaty by protocol in 1995), the Canada-Belgium treaty (2002), the Canada-Lebanon treaty (2008) and the Netherlands-UK treaty (2008).

847 Who is most likely resident outside the three states involved in the triangular case.
848 Including the US treaties with: Austria (Article 16(4), 1996), Belgium (Article 21(6), 2006), Bulgaria (Article 21(5), included in 2007 treaty by protocol in 2008), Chile (Article 24(5), 2010), Denmark (Article 22(6), included in 1999 treaty by protocol in 2006), Finland (Article 16(5), included in 1989 treaty by protocol in 2006), France (Article 30(5), 1994), Germany (Article 28(5), included in 1989 treaty by protocol in 2006), Hungary (Article 22(6), treaty signed in 2010 but has not yet entered into force (as at 17 January 2012)), Iceland (Article 21(5), 2007), Ireland (Article 23(7), 1997), Luxembourg (Article 24(5), 1996), Malta (Article 22(5), 2008), the Netherlands (Article 12(8) and Article 13(6), included in 1992 treaty by protocol in 1993), New Zealand (Article 16(5), included in 1982 treaty by protocol in 2008), South Africa (Article 22(6), 1997), Sweden (Article 17(5), included in 1994 treaty by protocol in 2005), and Switzerland (Art 22(4), 1996).
849 Interestingly, the 2006 US Model convention does not contain a provision of this type, even though such provisions have been included in numerous US treaties since at least the mid-90s. They generally seem only to be included in treaties under which the other state uses the exemption method of relief (e.g., the 2001 protocol to the Australia-US treaty does not contain such a provision), and it may be that this is the reason for not including it in the US model.
850 The identification of treaties containing provisions of the type discussed in this section was based on a review of certain published articles and searches of the IBFD's tax treaty database carried out between [21 and 23 December 2010]. Due to the impossibility of reviewing all concluded treaties and the limitations of searching using key words, the list of both US and non-US treaties containing such provisions is likely to be incomplete.
A recent example of a provision excluding the operation of the R-S treaty in PE triangular situation which are considered to be abusive is that included in Article 22 (the LOB) of the Hungary-US treaty,\(^{851}\) signed in 2010, which reads as follows:

"6. Notwithstanding the preceding provisions of this Article [i.e., the LOB], where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the profits of the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and third state [that] is less than 60 percent of the general company tax applicable in the first-mentioned Contracting State. Any dividends, interest or royalties to which the provisions of this paragraph apply shall be subject to tax in the other Contracting State at a rate that shall not exceed 15 percent of the gross amount thereof. Any other income to which the provisions of this paragraph apply shall be subject to tax under the provisions of the domestic law of the other Contracting State, notwithstanding any other provision of the Convention. The provisions of this paragraph shall not apply if:

\[\text{a) In the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself; or}\
\[\text{b) In the case of any other income, the income derived from the other Contracting State is derived in connection with or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in third state (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are securities activities carried on by a registered securities dealer, or, in the case of an enterprise of the United States, are banking activities carried on by a bank, or, in the case of an enterprise of Hungary, are regulated financial services carried on by a financial institution).}"

The earliest provisions excluding the application of the R-S treaty in PE triangular cases were included in the US-Netherlands treaty in 1993.\(^{852}\) These provisions are included in the interest and royalties articles of the treaty, and thus applied only to those categories of income.\(^{853}\) By contrast, more recent provisions tend to apply to all categories of income,\(^{854}\) which is a better approach given that triangular situations can

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\(^{851}\) Note that as of April 2012, this treaty has not yet entered into force.

\(^{852}\) The provisions are worded to apply equally to both contracting states, but effectively apply only in relation to income arising in the US. They are included in the interest and the royalties articles (Article 12 and Article 13) of the treaty, and provide that if interest or royalties arising in one of the contracting states and beneficially owned by a resident of the other contracting state are attributable to a PE in a third state, and the income attributable to the PE is subject to an aggregate rate of tax in the residence state and the PE state of less than 60% of the general company tax rate in the residence state, then the provisions of the interest or royalties article (as applicable) do not apply to that income. Instead, the taxation in the source state is limited to 15% of the gross amount of the income. There is an exception for interest derived in connection with or incidental to the active conduct of a trade or business in the PE state, and for royalties received in relation to intangible property which has been produced or developed by the PE. If one of these exceptions applies, the treaty will apply in the normal way. (See: Turro, J., "U.S. and Dutch Negotiators…"; Specter, P. "’Triangular Problem’…."


\(^{854}\) This is also the case in the US treaties with Chile (Article 24(5)), Germany (Article 28(5)), Iceland (Article 21(5)), Ireland (Article 23(7)), Luxembourg (Article 24(5)), Malta (Article 22(5)), New Zealand (Article 16(5)), South Africa (Article 22(6)), and Switzerland (Art 22(4)). Similarly, the Canada-France treaty (Article 28(8)), and the Canada-Lebanon treaty (Article 27(4)) apply to all categories of income. The following US treaties limit this PE provision to interest and royalties: Austria (Article 16(4)), Belgium (Article 21(6)), Bulgaria (Article 21(5)), Denmark (Article 22(6)), France (Article 30(5)). Interestingly, the provisions included in the treaties with Finland (Article 16(5)) and Sweden (Article 17(5)) apply to insurance premiums, as well as interest and royalties. The relevant provision of the Netherlands-UK treaty (Article VII of the 2008 protocol) also applies only to interest and royalties. The relevant provision of the Belgium-Canada treaty (Article 27(5)) applies only to royalties.
also involve other categories of income (as discussed in Chapter 2). So, for example, a company resident in State R could derive "other income" from State S, which is attributable to a PE in State PE (which may be a tax haven), and which is exempt from tax in the residence state as a result of being attributable to the PE. In this case, State S would generally be prevented from imposing any tax under the "other income" article of the R-S treaty. Assuming that the source state would not be prevented from imposing tax if the income had not been attributable to the PE, this would clearly be just as much (if not more) of a concern for the source state than cases where interest or royalties are involved.

Treaties which exclude limitations on source based taxation for income which is attributable to a PE in a third state commonly contain exceptions for certain situations which are not considered to be abusive. The normal operation of the treaty is typically only excluded if the PE state does not impose sufficient tax on the income attributable to the PE. Thus, a reduction in source-based taxation available under the treaty is generally not excluded if the tax on the income attributable to the PE is subject to a combined rate of tax in the PE state and the residence state which is equal to at least 60% (or in some treaties 50%) of the amount of tax that would be payable in the residence state if the income was not attributable to the PE. One difficulty which may arise with applying a limitation of this kind is that the calculation of the taxable income may differ between the three states involved. The US overcomes this problem by relying on detailed calculation rules which are included in its domestic law.

In addition to exceptions for situations where income is sufficiently taxed, the normal reductions in source based taxation available under the treaty will virtually always continue to apply if the income is derived by the PE "in connection with or incidental to the active conduct of a trade or business" in the PE state. This may apply generally to all types of income or only to interest income, depending on the overall scope of the provision. It is also common for reductions in source based taxation to continue to apply in relation to royalties to the extent they are derived from "the use of, or the right to use, intangible property produced or developed by the permanent establishment itself." Less commonly, reductions in

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855 This is the case in the US treaties with: Austria (Article 16(4)), Belgium (Article 21(6)), Bulgaria (Article 21(5)), Chile (Article 24(5)), Denmark (Article 22(6)), Finland (Article 16(5)), France (Article 30(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Malta (Article 22(5)), New Zealand (Article 16(5)), Sweden (Article 17(5)), Switzerland (Art 22(4)). Similarly, the Netherlands-UK treaty (Article VII of the 2008 protocol), the Canada-France treaty (Article 28(8)), the Canada-Lebanon treaty (Article 27(4)) and the Canada-Belgium treaty (Article 27(5)) also apply a 60% threshold.

856 This is the case in the US treaties with: Ireland (Article 23(7)), Luxembourg (Article 24(5)), and South Africa (Article 22(6)).

857 In some cases, consideration is limited to the tax imposed in the source state, on the basis that the income is exempt in the residence state, but this should generally give the same result. This is the case in the US treaties with: Belgium (Article 21(6)), Bulgaria (Article 21(5)), Denmark (Article 22(6)), Finland (Article 16(5)), Luxembourg (Article 24(5)), and Sweden (Article 17(5)).

858 This is the case in the US treaties with: Austria (Article 16(4)), Chile (Article 24(5)), France (Article 30(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Ireland (Article 23(7)), Malta (Article 22(5)), the Netherlands (Article 12(8) and Art 13(6)), New Zealand (Article 16(5)), South Africa (Article 22(6)), and Switzerland (Art 22(4)). This is also the case in the Canada-France treaty (Article 28(8)), the Canada-Lebanon treaty (Article 27(4)) and the Canada-Belgium treaty (Article 27(5)).

859 See, for example, the US Technical Explanation (published in 2007) to Article 21 of the US-Belgium treaty, which states: "In general, the principles employed under Code section 954(b)(4) will be employed to determine whether the profits are subject to an effective rate of taxation that is above the specified threshold." Similar comments are included in the US technical explanation accompanying other treaties.

860 Such provisions are included in the US treaties with: Austria (interest only, Article 16(4)), Belgium (interest only, Article 21(6)), Bulgaria (interest only, Article 21(5)), Chile (Article 24(5)), Denmark (interest only, Article 22(6)), Finland (interest only, Article 16(5)), France (Article 30(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Ireland (Article 23(7)), Luxembourg (Article 24(5)), the Netherlands (interest only, Article 12(8)), New Zealand (Article 16(5)), Sweden (interest only, Article 17(5)), Switzerland (Art 22(4)). This is also the case in the Canada-France treaty (Article 28(8)), the Canada-Lebanon treaty (Article 27(4)) and the Canada-Belgium treaty (Article 27(5)). The provisions included in the Malta-US treaty (Article 22(5)) and the South Africa-US treaty (Article 22(6)) do not contain any exclusion for income derived by the PE in the active conduct of a trade or business. Neither does the provision contained in the Netherlands-UK treaty (Article VII of the 2008 protocol).

861 This is the case in the US treaties with: Austria (Article 16(4)), Belgium (Article 21(6)), Bulgaria (Article 21(5)), Chile (Article 24(5)), Denmark (Article 22(6)), Finland (Article 16(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Ireland (Article 23(7)), Luxembourg (Article 24(5)), Malta (Article 22(5)), the
source based taxation may continue to be available if the income which is attributable to the PE is taxed under controlled foreign companies (CFC) provisions in the source state, e.g., where the company deriving the income is controlled by residents of the source state.862

Many of these provisions excluding the normal reduction in source based taxation in PE triangular cases provide an alternative limitation on the rate of tax which the source state can impose on dividends, interest and/or royalties. In most cases, this alternative maximum rate is 15%.863 Where no such limitation applies, the source state will simply apply the relevant provisions of its domestic law, which may result in the income being subject to a very high rate of source-based taxation. The limitation of the source based taxation to 15% can soften the impact of the ordinary treaty rate (which may be 0%)864 being unavailable, at least with respect to the categories of income to which the 15% rate applies.

Finally, by referring to the exclusion of "tax benefits" these provisions generally preserve the operation of aspects of the treaty which are not "tax benefits", such as the provisions of the associated enterprises article (Article 9), the exchange of information article (Article 26), and the assistance in the collection of taxes article (Article 27).

Assessment of this approach

The inclusion of a specific provision in tax treaties to exclude treaty benefits in relation to income which is attributable to a PE in a third state has a number of advantages. It allows the states involved to specify the situations which they consider to give rise to improper claims for treaty benefits, and to prevent claims for treaty benefits in such cases. In comparison to an approach which is based, for example, on the application of domestic anti-avoidance measures or the suggestions of the OECD Commentary (discussed below), the inclusion of a specific provision in the treaty means that there is no need for the tax authority of the source state to identify the situation and challenge the claim for treaty benefits, a challenge which may or may not be successful. In addition, where treaty benefits are denied under a specific provision of the tax treaty, there is no question of whether or not the source state has met its treaty obligations by denying benefits.865 Specific provisions are also more transparent and give taxpayers greater certainty as to the way in which the treaty will apply in their particular circumstances.

One argument against combatting tax avoidance (including improper access to treaties) through specific provisions is that specific provisions can generally only apply in the case of tax avoidance strategies that have already been identified. This is particularly relevant in the case of tax treaties, since treaties cannot easily be amended and are generally in force for a long period of time before being renegotiated.866

862 This is the case in the Austria-US treaty (Article 16(4)), the France-US treaty (Article 30(5)), the Canada-France treaty (Article 28(8)), the Canada-Lebanon treaty (Article 27(4)) and the Canada-Belgium treaty (Article 27(5)).

863 This is the case with respect to dividends, interest and royalties unless otherwise indicated in the US treaties with: Belgium (interest and royalties only, Article 21(6)), Bulgaria (interest and royalties only, Article 21(5)), Chile (Article 24(5)), Denmark (interest and royalties only, Article 22(6)), Finland (interest and royalties only, Article 16(5)), France (Article 30(5)), Germany (Article 28(5)), Hungary (Article 22(6)), Iceland (Article 21(5)), Ireland (Article 23(7)), Luxembourg (Article 24(5)), Malta (Article 22(5)), the Netherlands (interest and royalties only, Article 12(8) and Art 13(6)), New Zealand (Article 16(5)), South Africa (interest and royalties only, Article 22(6)), Sweden (interest and royalties only, Article 17(5)), Switzerland (Art 22(4)). This is also the case in the Canada-France treaty (Article 28(8)). In the Canada-Lebanon treaty (Article 27(4)), the applicable rate is 25%. No such limitation applies under the Canada-Belgium treaty (Article 27(5)) or the Netherlands-UK treaty (Article VII of the 2008 protocol).

864 This is the case in, e.g., the Germany-US treaty with respect to interest (Article 11), royalties (Article 12) and certain dividends (Article 10).

865 For discussion of the extent to which the application of domestic anti-avoidance measures in a treaty context may contravene international law, see: Arnold, B.J., & Weeghel, S., "The Relationship Between….”

866 For example, in OECD countries tax treaties generally remain unchanged for an average of 15 years (see: Sasseville, J., "The Role of Tax Treaties…” at p. 247).
7.5.1.2. Application of a specific anti-avoidance rule under domestic law

If the source state considers a claim for treaty benefits under the R-S treaty to be improper, it may potentially counteract the claim through the application of anti-avoidance rules contained in its domestic law. States may therefore be tempted to include a provision in their domestic law along the lines of the provisions which are included in some tax treaties (discussed above) to exclude the operation of the R-S treaty in PE triangular cases which they consider to be abusive. However, where the effect of a domestic anti-avoidance rule is to deny treaty benefits in situations in which they would otherwise be available, it is questionable whether the state denying treaty benefits has met its obligations under international law.\(^{867}\) If the rule implemented under domestic law does not depend on the taxpayer having a tax avoidance motive or does not seek to deny treaty benefits by re-characterizing the facts of the situation, it is not clear that it would fit within the OECD commentary’s approach, which allows states to apply domestic anti-avoidance rules in certain circumstances, and by denying treaty benefits, the source state would arguably fail to meet its treaty obligations. It would therefore generally not be sufficient to rely on domestic anti-avoidance measures to prevent improper application of the R-S treaty in PE triangular cases.

7.5.1.3. Treat profit as not attributable to the PE

The OECD Commentary on Article 21 (dealing with other income) notes that states which apply the exemption method may be concerned about assets which give rise to "other income" being attached to a PE in the other contracting state in order to obtain more favourable tax treatment (i.e., in bilateral situations).\(^{868}\) The concern here arises from the fact that if the residence state uses the exemption method, then income attached to a PE in the source state will only be taxed in the source state. Taxpayers may have an incentive to set up this type of structure because, to the extent that the tax rate in the source state is lower than that in the residence state, it will result in the income being subject to a lower rate of tax than it would be if it were not attributable to a PE. The OECD Commentary suggests that states which are concerned about this type of abuse may take the view that the transaction is artificial, and therefore, that the assets are not effectively connected to the PE.\(^{869}\) Although these comments deal with bilateral situations, the OECD triangular cases report suggests that this approach could also be applied to deal with PE triangular cases.\(^{870}\) That is, where the income is attributable to a PE located in a third state (rather than in the source state as outlined in the OECD Commentary), the residence state (or potentially the source state) could take the position that the income is not properly attributable to the PE.

One serious problem with this approach, regardless of whether the situation is bilateral or multilateral, is that (as the OECD points out elsewhere) it may be "extremely difficult, not to say impossible, to apply" and it disregards states that exempt income attributable to PEs under domestic law.\(^{871}\) It is also not really appropriate for dealing with the source state’s concern about being required to apply the conditions of the R-S treaty, since the source state will be required to apply the conditions of the R-S treaty regardless of whether the profit is attributable to the PE. As a result, the source state has no real incentive to argue that the profit is not attributable to the PE since it will have no impact on the tax which the source state can impose. It is also difficult to see how the source state could reject an attribution of profit to the PE under the R-PE treaty which has been accepted by both the PE state and the residence state. The application of this approach in PE triangular cases may therefore discourage taxpayers who are considering establishing triangular structures to gain access to the R-S treaty, but it is not appropriate as a general approach for dealing with particular cases of improper access to the R-S treaty.

\(^{867}\) This section contains only a very brief discussion of this issue, which was discussed in greater detail in Chapter 5. For further discussion, see, inter alia: De Broe, L., *International Tax Planning*… at pp. 377-460, Part 3, Chapter 4; Arnold, B.J., & Van Weeghel, S., “The Relationship between….”

\(^{868}\) 2010 OECD Commentary on Article 21, para 6.

\(^{869}\) 2010 OECD Commentary on Article 21, para 6. The OECD Commentary also suggests that states could strengthen their position by adding a condition to Article 21(2) providing that it does not apply (and thus the other income article continues to apply, instead of the business profits article) “in cases where the arrangements were primarily made for the purposes of taking advantage of this provision.” (2010 OECD Commentary on Article 21, para 6. In relation to PE triangular cases, this provision would need to be included in the R-PE treaty.)

\(^{870}\) OECD Committee on Fiscal Affairs, “Triangular Cases”, para 23.

\(^{871}\) OECD Committee on Fiscal Affairs, “Triangular Cases,” para 23.
7.5.1.4. Conclusions

The best approach for dealing with improper access to the R-S treaty in PE triangular cases is to include a specific provision in tax treaties along the lines of the provision currently included in various US treaties. This approach has a number of advantages, as outlined above, particularly the relative ease of application by tax authorities and greater certainty for taxpayers. Furthermore, where the source state denies treaty benefits under a specific provision included in the treaty there can be no question regarding whether the source state has met (or failed to meet) its treaty obligations.

7.5.2. Excluding the R-S treaty where the PE-S treaty may apply in the source state

If treaty benefits are extended to PEs, then in addition to dealing with treaty shopping concerns, the exclusion of the normal provisions of the R-S treaty in relation to income attributable to a PE in a third state would serve to prevent the source state from being subject to multiple treaty restrictions with respect to the same income. The exclusion of the R-S treaty where the source state applies the PE-S treaty will be the focus of this section.

7.5.2.1. Situations where there is no PE-S treaty or the PE-S treaty doesn't apply

The provision excluding the operation of the R-S treaty must take into account the possibility that the source state will not apply the conditions of the PE-S treaty, either because there is no treaty in force between the PE state and the source state or because there are no specific provisions requiring the source state to apply it. In these circumstances, the question arises as to whether the source state should revert to applying the conditions of the R-S treaty to the income. If the source state doesn't apply the conditions of the R-S treaty, then the source state will not apply the conditions of any treaty and will simply apply its domestic law, which may provide for a high rate of taxation. In this case, insufficient relief may be available in the PE state and/or the residence state and there may be unrelieved double taxation. However, if the source state does apply the conditions of the R-S treaty, then the situation is effectively the same as it is under the current treaty framework, with the same potential for tax avoidance. One alternative would be to make the non-application of the R-S treaty dependent on the application of the PE-S treaty in the source state, i.e., such that the source state will always apply either the PE-S treaty or the R-S treaty. However, if the PE state is a tax haven then there is unlikely to be any PE-S treaty, so the application of the R-S treaty (in the absence of a PE-S treaty) may disproportionately occur in tax avoidance situations.

7.5.2.2. Proposed approach

In order to deal with situations where there is either no PE-S treaty or the PE-S treaty does not apply, the best approach may be to combine a provision excluding the operation of the R-S treaty in cases where the PE-S treaty applies, with a provision along the lines of those included in existing treaties which excludes its operation in certain specified situations where access to the treaty is considered improper. This would allow the R-S treaty to continue to apply in situations where the source state doesn't apply the conditions of the PE-S treaty and the application of the R-S treaty is not considered improper.

Thus, ideally, the R-S treaty would include provisions to the effect that its conditions do not apply in relation to income attributable to a PE in a third state if either:

1. The source state applies the conditions of the PE-S treaty in relation to that income (either indirectly as a result of provisions included in the R-S treaty, or directly under the PE-S treaty); or

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872 Zhai suggests that this may be the proper outcome, in that the taxation in the source state would then reflect that state's ordinary tax policy towards persons resident in the PE state (see: Zhai, G., "Triangular Cases...").
873 It is important that the conditions of the R-S treaty are excluded if, and only if, there is a PE in the PE state for the purposes of the R-PE treaty. The provisions excluding the operation of the R-S treaty should therefore refer to the PE definition contained in the R-PE treaty for their operation.
2. The source state does not apply the conditions of the PE-S treaty, but the situation is one where the application of the conditions of the R-S treaty would be considered improper according to certain specified criteria set out in the provision (i.e., similar to the provisions included in certain existing treaties, discussed above).

There would thus be three alternative scenarios. First, the source state may apply the PE-S treaty, in which case the R-S treaty would be excluded. Second, the source state may not apply the PE-S treaty but the situation may fall within those situations considered to be abusive, in which case the operation of the R-S treaty would be excluded and the source state would not apply the conditions of any treaty (although may still be subject to some alternative maximum rate, e.g., 15%, under the R-S treaty). Finally, the source state may not apply the conditions of the PE-S treaty and the application of the R-S treaty may not be considered abusive, in which case the source state would simply continue to apply the conditions of the R-S treaty. A suggested treaty provision to this effect will be set out below (see Section 7.5.4.).

7.5.3. Relief in the residence state if source state doesn’t apply R-S treaty

If the operation of the R-S treaty is completely excluded in relation to income which is attributable to a PE in a third state, then the residence state will not have any obligation to provide relief for tax imposed in the source state. If the residence state exempts the income attributable to the PE, then this outcome is appropriate; no further relief is required in the residence state. However, if the residence state uses the credit method of relief with respect to the income attributable to the PE, then the residence state should still be obliged to provide relief for tax imposed in the source state and the relief provisions of the R-S treaty should continue to operate.

Provided the application of the R-S treaty is not excluded in its entirety, a relief obligation may continue to arise under the terms of the R-S treaty, even though the source state is not required to apply its conditions in relation to the income. In accordance with the existing wording of exemption relief article of the OECD Model, Article 23A, relief is required in the residence state to the extent that the source state may impose tax on the income in accordance with the terms of the treaty. Where the R-S treaty places no restriction on the source state’s ability to impose tax, the residence state would arguably continue to have an obligation to exempt the income. Similarly, in accordance with the existing wording of the credit relief provisions of Article 23A and 23B of the OECD Model, the credit relief in the residence state is limited to the amount of tax which the source state is entitled to impose under the terms of the R-S treaty. Where the R-S treaty does not limit the amount of tax imposed in the source state, then arguably any tax imposed in the source state is imposed in accordance with the terms of the treaty and the residence state should be obliged to grant relief. The residence state may not be satisfied with this interpretation, however, particularly in abusive situations. The residence state may therefore may wish to limit its relief obligation to situations where the source state would be entitled to impose tax in accordance with the terms of the treaty and, if it uses the credit method, to limit the amount of relief to the amount of tax that the source state could impose if it were required to apply the conditions of the R-S treaty. These limitations seem to be reasonable, but could potentially give rise to unrelieved double taxation in some cases. This is demonstrated in the following example.

Example

A company resident in State R earns interest income of $100 in a PE triangular case. The company’s only income and the company has no expenses. State S applies the PE-S treaty and imposes tax at a rate of 20% (i.e., $20). State PE imposes tax at a rate of 30% and provides a credit for tax imposed in the source state; the tax paid in the PE state is therefore $10 ($30 tax less $20 credit). The tax rate in the residence state is 30%. The residence state provides relief using the credit method under both the R-PE treaty and the R-S treaty, but the relief provided under the R-S treaty is limited to 10% of the gross amount of the income (i.e., the maximum rate of tax allowed under the R-S treaty). This is illustrated in the following diagram.
Figure 7.1: Example demonstrating the potential impact of limiting relief in State R to R-S treaty rate in situations where State S applies the PE-S treaty

Table 2: Example demonstrating the potential impact of limiting the relief in State R to the R-S treaty rate in situations where State S applies the PE-S treaty

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from PE triangular case</td>
<td>100</td>
</tr>
<tr>
<td>Tax in State S (20%)</td>
<td>20</td>
</tr>
<tr>
<td>Tax in State PE (30%, less $20 credit relief)</td>
<td>10</td>
</tr>
<tr>
<td>Tax in State R (30%)</td>
<td>30</td>
</tr>
<tr>
<td>Credit in State R for tax imposed in State S (limited to R-S treaty rate)</td>
<td>(10)</td>
</tr>
<tr>
<td>Credit in State R for tax imposed in State PE</td>
<td>(10)</td>
</tr>
<tr>
<td>Tax in State R after credit</td>
<td>10</td>
</tr>
<tr>
<td>Unrelieved double taxation (excess credit)</td>
<td>10</td>
</tr>
</tbody>
</table>

In this example, the residence state only credits $10 of the $20 tax imposed in the source state, and there is $10 of unrelieved double taxation.

To ensure that double taxation is prevented, the residence state should provide relief for the total amount of tax imposed in the source state, regardless of the amount of tax the source state could have imposed if it applied the conditions of the R-S treaty (but limited of course to the amount of tax imposed in the residence state). This may, however, be unacceptable to certain states. States that wish to limit the amount of relief they provide should include specific wording in the relief provisions of the treaty to this effect. This wording should provide that where the source state is not required to apply the conditions of the treaty with respect to income attributable to a PE in a third state, then relief is only available to the extent that the source state could have imposed tax, had it applied the conditions of the R-S treaty. It should also specify that, where the credit method applies, that amount of the credit is limited to the amount of tax that the source state could have imposed if it had applied the conditions of the R-S treaty in relation to the income.
7.5.4. Conclusions and proposed treaty provision

The exclusion of the conditions of the R-S treaty in the source state in PE triangular cases may serve either to prevent improper access to the R-S treaty or to prevent the source state from being subject to multiple treaty conditions in cases where it applies the conditions of the PE-S treaty in relation to the income attributable to the PE. It is proposed that treaties should include a specific provision to the effect that the source state is not required to apply the conditions of the treaty in relation to income attributable to a PE in a third state if either:

1. The source state applies the conditions of the PE-S treaty in relation to that income (either indirectly as a result of provisions included in the R-S treaty, or directly under the PE-S treaty); or

2. The source state does not apply the conditions of the PE-S treaty, but the situation is one where the application of the conditions of the R-S treaty would be considered improper.

A provision excluding the application of the R-S treaty in the above circumstances could be worded along the following lines:

"(1) Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third state for the purposes of a convention between the Contracting State of the enterprise and that third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the profits of the permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and third state that is less than [60] percent of the general company tax rate applicable in the first-mentioned Contracting State. Any dividends, interest or royalties to which the provisions of this paragraph apply shall be subject to tax in the other Contracting State at a rate that shall not exceed [15] percent of the gross amount thereof. Any other income to which the provisions of this paragraph apply shall be subject to tax under the provisions of the domestic law of the other Contracting State, notwithstanding any other provision of the Convention. The provisions of this paragraph shall not apply if:

a) In the case of royalties, the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself; or

b) In the case of any other income, the income derived from the other Contracting State is derived in connection with or is incidental to, the active conduct of a business carried on by the permanent establishment in the third state (other than the business of making, managing or simply holding investments for the enterprise’s own account).

(2) Where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third state for the purposes of a convention between the Contracting State of the enterprise and that third state, the tax benefits which would otherwise be available under the other provisions of this Convention will not apply to that income if the other Contracting State applies the conditions of a convention between that State and the third state in relation to that income.

(3) This article shall apply to capital gains and profits in the same way as it applies to income."

Paragraph 1 of this provision is based on the wording of the provision of the US-Hungary treaty which was discussed above, with minor modifications. One of these modifications clarifies that the provision applies if a PE exists for the purposes of the R-PE treaty, the importance of which will be discussed in Chapter 8 (see Section 8.2.3.). The other modification simplifies the exception for the active conduct of a trade or business; the exact wording of this exception would of course have to be determined by the contracting states. The contracting states should also determine the appropriate rate of tax that is required.
in the PE state for the R-S treaty conditions to continue to apply, and the appropriate tax rate to apply to passive income where the source state doesn't apply the normal conditions of the treaty. Paragraph 2 excludes the operation of the R-S treaty if the source state applies the conditions of the PE-S treaty in relation to the income attributable to the PE. Paragraph 3 is included for the avoidance of doubt, and ensures that the provision applies equally to capital gains and to profits.

Where the residence state exempts the income attributable to the PE, there will be no need for relief in the residence state. However, where the residence state uses the credit method in relation to the income attributable to the PE, unrelieved double taxation may persist unless the residence state continues to grant relief in accordance with the provisions of the R-S treaty. To preserve the operation of the relief provisions of the R-S treaty in the residence state, treaties could include the following paragraph (in addition to those outlined above):

"(4) Where the tax benefits which would otherwise be available under the other provisions of this Convention do not apply as a result of paragraph 1 or paragraph 2, the Contracting State where the person deriving the income is resident shall continue to apply [Article 23A/Article 23B]. However, that State shall not apply [Article 23A/Article 23B] if the other Contracting State is prevented from imposing tax on the income under the terms of a convention with a third state. Where a Contracting State applies [Article 23A / Article 23B] under this paragraph, it shall be applied as though the other Contracting State has applied the other provisions of this Convention in relation to the income."

This provision requires the residence state to continue applying the relief provisions of the treaty, but allows it to apply those provisions as though the source state had also applied the conditions of the treaty. This means, for example, that the residence state will not be obliged to provide relief in relation to income which the source state would have been prevented from taxing if the R-S treaty had applied. It also means that, in relation to dividends and interest, the residence state will not be obliged to provide credit relief for any tax in excess of the amount the source state could have imposed under the R-S treaty. This limitation is included because it is expected that few states would be willing to grant relief in excess of that which they would be obliged to grant under a normal application of the R-S treaty. In doing so, however, states are accepting the potential for unrelieved double taxation. The limitation on the amount of relief, particularly credit relief, could be excluded if the contracting states are willing to grant relief for the entire amount of tax imposed in the source state.

This provision also does not require the residence state to apply the relief provisions of the R-S treaty if the source state is prevented from imposing tax on the income under the terms of the PE-S treaty. In many cases where the source state is prevented from imposing tax under the PE-S treaty, it would also have been prevented from imposing tax under the conditions of the R-S treaty, had they applied. This may occur, for example, in relation to business profits which are not attributable to a PE in the source state. In this case, this additional limitation would not be required since the residence state applies the relief provisions as though the source state had applied the terms of the R-S treaty. However, there may be situations where the source state is prevented from imposing tax under the PE-S treaty but would have been entitled to impose tax under the terms of the R-S treaty; this may occur, for example, where the PE definition differs between the two treaties. In this case, the residence state should not be obliged to provide relief (e.g., an exemption) under the R-S treaty and specific wording is required to achieve this outcome.

When considering the provision outlined above it is also important to keep in mind the interaction between this provision and the relief provisions of the R-PE treaty. Where State R exempts the income attributable to the PE in accordance with the terms of the R-PE treaty, then no further relief would be provided and the provision above would have no practical impact (as outlined in Chapter 3). Where State R uses the credit method under the R-PE treaty, then the relief provision of the R-S treaty may require State R to either exempt the income or provide a credit for tax imposed in State S. For the reasons discussed in Chapter 3 (Section 3.3.), State R would not be required to both exempt the income and grant credit relief. The possible outcomes are summarised in the following table:
<table>
<thead>
<tr>
<th>R-PE treaty method</th>
<th>R-S treaty method</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exemption</td>
<td>Exemption</td>
<td>State R exempts the income.</td>
</tr>
<tr>
<td>Exemption</td>
<td>Credit</td>
<td>State R exempts the income (no credit is required).</td>
</tr>
<tr>
<td>Credit</td>
<td>Exemption</td>
<td>State R exempts the income (no credit is required)</td>
</tr>
<tr>
<td>Credit</td>
<td>Credit</td>
<td>State R grants a credit for tax imposed in State S and for tax imposed in State PE (net of any relief provided in that state for tax imposed in State S).</td>
</tr>
</tbody>
</table>

States may wish to allow the method provided for in the R-PE treaty to govern the method of relief in State R. In practical terms, this would mean that the residence state would either provide no relief under the R-S treaty (where the income is already exempt under the R-PE treaty), or would use the credit method of relief under the R-S treaty regardless of the general method of relief specified in that treaty. This could be achieved by altering the wording of the proposed provision set out above.

7.7. Conclusions

Issues arise in PE triangular cases because PEs are treated partially, but only partially, in the same way as persons who are resident in the PE state for treaty purposes. Extending treaty benefits to PEs would involve a requirement for the source state to apply the conditions of the PE-S treaty in relation to the income attributable to the PE, and a requirement for the PE state to provide relief, in accordance with the PE-S treaty, for tax imposed in the source state. This ensures that the source state applies the appropriate treaty conditions and that unrelieved double taxation can generally be prevented. In addition, the source state should not be subject to the conditions of multiple treaties in relation to the same item of income and thus, where it applies the conditions of the PE-S treaty, the source state should not be required to apply the conditions of the R-S treaty.

There are two primary ways of extending treaty benefits to PEs under provisions included in the bilateral tax treaties. These are as follows:

1. The direct approach: The source state is required to apply the conditions of the PE-S treaty in relation to income attributable to a PE in the PE state and the PE state is required to grant relief (either exemption or credit) for tax imposed in the source state by provisions included directly in the PE-S treaty.

2. The indirect approach: The source state is required to apply the conditions of the PE-S treaty indirectly by provisions included in the R-S treaty. The PE state is required to provide relief for tax imposed in the source state (either exemption or credit) under specific provisions included in the R-PE treaty.

The operation of the R-S treaty can only be excluded by the terms of that treaty and so, irrespective of whether treaty benefits are extended to PEs directly or indirectly, specific provisions would need to be included in the R-S treaty to ensure that the source state is not subject to multiple treaty conditions in respect to the income attributable to the PE.

Regardless of whether treaty benefits are extended to PEs directly or indirectly, the source state applies the conditions of the PE-S treaty to income attributable to the PE instead of the conditions of the R-S treaty, and the PE state is obliged to grant relief for tax imposed in the source state. However, the direct

874 Note that where passive income is involved (dividends, interest or royalties), State R would generally be obliged to grant relief under the R-S treaty using the credit method, regardless of the general method of relief provided in the treaty. Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 or Article 11. Article 12 is usually also mentioned if the treaty allows source-based taxation of royalties under Article 12.
approach is preferable for a number of reasons. Perhaps the most important of these is that, unlike the indirect approach, the direct approach can never result in an unbalanced application of the PE-S treaty, i.e., where only one of the contracting state applies the treaty to the income attributable to the PE. It also avoids the need to consult multiple treaties to understand the operation of the PE-S treaty, and would allow the PE-S treaty to deal with any unusual circumstances in one or both of the contracting states, as well as any other consequences for the application of the PE-S treaty which arise from extending treaty benefits to PEs.

It is also be possible for states to effectively extend treaty benefits to PEs unilaterally under their domestic law. It would be appropriate for states to extend their unilateral relief measures to PEs, and a number of states do this already, but it seems highly unlikely that any state would unilaterally apply the conditions of its tax treaties to income derived by PEs located in treaty-partner states. This is because any state that implemented such a provision would, as a result, have virtually no negotiating power to convince other states to implement reciprocal measures, and because the operation of the R-S treaty could not be excluded under domestic law, resulting in the application of multiple treaty conditions in the source state.

PE triangular cases also give rise to concerns regarding improper access to the R-S treaty, particularly in situations where the PE state and the residence state impose no (or minimal) tax on the income. The best way to address this issue would be to include specific provisions in tax treaties, along the lines of those included in many US tax treaties, which exclude the operation of the treaty in certain specified circumstances where their application would be considered improper. This approach has a number of advantages, as outlined above, including relative ease of application by tax authorities and greater certainty for taxpayers. Furthermore, where the source state denies treaty benefits under a specific provision included in the treaty there can be no question regarding whether the source state has met (or failed to meet) its treaty obligations. This provision should be coupled with a provision excluding the operation of the R-S treaty in circumstances where the source state applies the conditions of the PE-S treaty, to ensure that the source state is not subject to multiple treaty conditions in respect of the same income. Thus, the source state should only continue to apply the conditions of the R-S treaty in PE triangular cases where it does not apply the conditions of the PE-S treaty and where the application of the R-S treaty is not considered to be improper.

This chapter has proposed a solution to PE triangular cases whereby treaty benefits would be extended to PEs by provisions included in the PE-S treaty. This leads inevitably to further issues associated with how such a solution should operate, including whether PEs should be treated for resident persons for the purpose of the entire treaty or simply entitled to certain specified benefits under the treaty, how tax avoidance concerns can best be addressed, and whether notional payments from the PE to its head office should be recognised for treaty purposes. These issues, among others, will be addressed in the following two chapters (Chapter 8 and Chapter 9).

It should also be noted that various aspects of this solution could be implemented even if the overall application of the PE-S treaty is not accepted. That is, even if the source state does not apply the conditions of the PE-S treaty, the PE state should nevertheless have an explicit obligation to grant relief for tax imposed in the source state (under a specific provision of the R-PE treaty) and a specific provision should be included in tax treaties to ensure that the R-S treaty does not apply in situations that are considered to be abusive. Whilst not presenting a comprehensive solution, these measures would go a long way towards resolving the issues that arise in PE triangular cases.