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

Fett, E.E.

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Chapter 8
Provisions extending treaty entitlement to PEs

8.1. Introduction
If it is accepted that treaty benefits should be extended to PEs, and once the basic approach has been determined, there are still a number of issues which must be addressed. Perhaps the most important of these is the exact mechanism by which the PE-S treaty will be made to apply, namely, whether the PE will be deemed to be a resident of the PE state or whether the person to whom the PE belongs will be made eligible to apply the treaty with respect to the income attributable to the PE. It is also important to consider the prerequisites that should be satisfied before a PE will be entitled to claim treaty benefits, and the extent to which specific provisions should be included in the treaty to prevent treaty shopping through PEs. These issues are the subject of this chapter.

8.2. Provisions extending treaty benefits to PEs
This chapter will proceed on the basis that treaty benefits are being extended to PEs directly under specific provisions included in the PE-S treaty, rather than indirectly by provisions included in the R-S treaty (as discussed in Chapter 7). This section will consider how such provisions should be structured in terms of the person who is intended to claim benefits under the provisions, the personal scope of the treaty, the definition which should apply for determining whether there is a treaty eligible PE, and the income to which the PE-S treaty should apply.

8.2.1. Person claiming treaty benefits in relation to PE income
The first issue to be addressed in designing a provision to extend treaty entitlement to PEs is determining who is intended to claim the benefit of the provision. That is, whether treaty benefits will be claimed by the PE itself, or by the entity to which the PE belongs. It is sometimes suggested that treaty benefits should be extended to PEs by expanding the definitions of "person" and/or "resident" (in Articles 3 and 4, respectively) in such a way that certain PEs would become treaty-eligible resident persons. This approach implies that it is the PE itself which claims the benefits of the treaty, rather than the entity to which it belongs. Allowing the PE to claim treaty benefits on its own account would be fully consistent with treating the PE as a separate, treaty-eligible entity, and would generally result in the treaty being applied to PEs in the same way as it applies to residents of the PE state. The problem with this approach is that PEs generally have no separate legal existence and are not treated as separate entities for tax purposes. As a result, the income which is attributable to the PE would generally be considered to be derived by the entity to which the PE belongs for the purposes of the domestic laws of the three states involved. Thus, even though tax may be calculated as though the PE is a separate taxable entity, the PE state, as well as the source state and the residence state, would generally impose any applicable tax liability on the entity to which the PE belongs. Treating the PE as a person for treaty purposes and allowing it to claim treaty benefits directly would result in a mismatch between the "person" claiming treaty benefits and the person upon whom tax is imposed under domestic law. This would clearly be problematic. To give an extreme example, one of the states involved may argue that it has no obligation

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875 See discussion in Section 8.2.3., below, regarding the situations in which a treaty-eligible PE should be considered to exist.
876 See, for example: Yong, S., "Triangular Treaty Cases…"; Langoth, B., "Treaty Entitlement….”
877 As will be seen in this chapter, certain modifications would almost certainly be necessary to deal with the fact that PEs typically lack separate legal existence.
878 Note that in some cases, PEs may be separate legal entities (even if they are not separate taxable entities). A good example is an entity which has elected to be fiscally transparent under the US check-the-box rules. This was discussed in Chapter 5 (Section 5.2.4.4.).
879 This is effectively the main issue that arises in relation to hybrid entities, such as partnerships, which are recognised as separate taxable entities in one state and are treated as flow-through entities in one or more other states. For discussion of the issues associated with hybrid entities, see, for example: Barenfeld, J., Taxation of Cross-Border Partnerships…. For a discussion of the attribution of income to persons for treaty purposes, and the problems
to reduce the tax it imposes on the entity deriving the income on the basis that that entity on which it is
imposing tax is not entitled to any treaty reduction. In addition, from a more administrative perspective,
the income would generally be included in the tax return(s) filed by the entity as a whole (to the extent tax
returns are required), and it would be that entity which would be responsible for dealing with any
controversies which arise in relation to the tax liability (or lack of tax liability), and to whom any other
administrative aspects of the tax laws of the three states would apply. These problems could potentially be
resolved by amendments to the domestic laws of the states involved, i.e., by treating PEs as separate
taxpayers for domestic law purposes. However, the treaty provisions should clearly be capable of being
effective without relying on such fundamental changes to the imposition of tax in the states involved.

These problems could be avoided relatively easily by structuring the provision in such a way that it is the
entity to which the PE belongs who is entitled to claim treaty benefits under the PE-S treaty in relation to
the income attributable to the PE. This approach could be implemented by including a specific article in
the PE-S treaty which requires the contracting states to apply the terms of the treaty in relation to income
derived by persons who are not resident in either of the contracting states but which is attributable to a
PE located in either of the contracting states. As will be discussed in the following section (Section 8.2.2.),
this approach would generally require a modification or exception to the personal scope of the treaty
established in Article 1.

Note that for ease of expression, this chapter will generally refer to a PE claiming treaty benefits, but it
should be borne in mind that such claims (i.e., treaty claims in relation to the income attributable to the
PE) should in actual fact, in accordance with this approach, be made by the entity to which the PE
belongs.

8.2.2. Personal scope of treaties

In general, the application of tax treaties is limited under Article 1 to "persons who are resident of one or
both of the contracting states." Where specific provisions are included in the PE-S treaty to extend treaty
benefits to PEs, and where it is intended that the benefit of such provisions will be claimed by the entity
to which the PE belongs (as discussed above), the person deriving the income is resident in State R and is
not resident in either of the contracting states. As a result, the personal scope of the treaty would, prima
facie, need to be expanded to encompass a non-resident carrying on business through a PE in one of the
contracting states.880

An alternative to expanding the scope of Article 1 is to create an exception to Article 1. There are several
existing provisions in the OECD Model which represent either express or implied exceptions to Article
1,881 such as the exchange of information article (Article 26882) and Article 10(5).883 It follows that it may
be possible for treaty entitlement to be extended to PEs without any amendments to the personal scope
of the treaty, by simply creating an exception to Article 1. This seems to be the better approach. The
circumstances in which the exception applies should of course be limited, since residents of a third state
should not fall within the personal scope of the treaty in a general sense, but only with respect to the
income arising in one contracting state and attributable to a PE in the other.

that may arise, see: Wheeler, J., "The Attribution of Income in the Netherlands and the United Kingdom" 3 World

880 If, on the other hand, treaty benefits are extended to PEs by expanding the definitions of "person" and "resident"
to include PEs, this would automatically enlarge the personal scope of the treaty, since it refers to those definitions.
However, as discussed above, this is not the preferred approach for extending treaty benefits to PEs.

881 Hattingh, P.J., “The Role and Function of…”

882 Which provides that its operation not restricted by Article 1.

883 Article 10(5) relates to the taxation in one contracting state of dividends paid by a resident of the other
contracting state, and which applies regardless of where the recipient of the dividends is resident (e.g., in reverse
triangular cases). This provision will be discussed in detail in Chapter 11, which deals with reverse triangular cases.
8.2.3. Applicable PE definition

If specific provisions are included in the PE-S treaty to extend treaty benefits to PEs, those provisions should only apply in circumstances where the income is attributable to a PE in the PE state for the purposes of the R-PE treaty. Otherwise, if the definition used for the purposes of determining whether the PE-S treaty applies is wider than the definition contained in the R-PE treaty:

(i) The source state could find itself applying the PE-S treaty in a situation where taxing rights remain with the residence state under the R-PE treaty and the PE state is prevented from imposing tax on the income884 and

(ii) The PE state could have an obligation to grant relief in relation to income which it is prevented from taxing under the R-PE treaty (although presumably in this case the PE state would have no relief obligation as a result of there being no tax payable in the PE state in relation to the income886).

Alternatively, if the definition used for the purposes of determining whether the PE-S treaty applies is narrower than the definition contained in the R-PE treaty:

(i) The source state may fail to apply the conditions of the PE-S treaty in circumstances where the income is attributable to a PE in the PE state for the purposes of the R-PE treaty (i.e., in a PE triangular case); and

(ii) The PE state may have no obligation to provide relief for tax imposed in the source state in situations where the income is taxable in the PE state in accordance with the provisions of the R-PE treaty, thus potentially leading to unrelieved double taxation.

If provisions are included in either the PE-S treaty to deal with PE triangular cases and no specific reference is made to the R-PE treaty, then the applicable PE definition will be that contained in the PE-S treaty. This follows from Article 5(1) (or the equivalent provision of the treaty) which provides that; "For the purposes of this convention, the term 'permanent establishment' means..." The PE definition contained in Article 5 therefore applies wherever the term "permanent establishment" is used in the treaty.887 This would be the case even though, in relation to provisions which are clearly intended to deal with triangular cases, it may seem more reasonable to apply the definition contained in the R-PE treaty. It may be possible to apply the R-PE treaty definition (without it being specifically referred to) where there

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884 Similarly, if the R-S treaty contains provisions which either set out circumstances where its conditions will not apply in PE triangular cases, those provisions should apply only if the income is attributable to a PE in the PE state for the purposes of the R-PE treaty. The discussion below therefore applies equally with respect to such provisions. It should also be noted that aside from differences in the wording of the relevant treaties, there may also be disagreements between the three states involved regarding the existence of a PE or the attribution of profit to the PE, based on the facts in a particular case. This will be discussed in Chapter 9.

885 Under Article 7 of the OECD Model, business profits can only be taxed in the residence state unless they are attributable to a PE in the other contracting state. If there is no PE in the "PE state" for the purposes of the R-PE treaty, then that state would be prevented from imposing any tax on the income. In this case the situation would effectively be bilateral rather than triangular.

886 This will depend on whether the result of the R-PE treaty (which prevents the PE state from imposing tax) is taken into account for the purposes of the relief provision contained in the PE-S treaty. This is effectively the same as the question of whether a dual relief obligation may arise in the residence state in PE triangular cases. Refer to discussion in Chapter 3 (see Section 3.3.), where I have argued that the result of one treaty should be taken into account for the purposes of applying the relief provisions of another applicable treaty.

887 A court in Denmark addressed this issue in a triangular case involving the taxation of employment income under Article 15(2) (Poseidon Personnel Services S.A. v. Ministry of Taxation, 18th Dept., Case No. B 2581/05, published in TFS 2006, 635). Article 15(2) allows a particular state to tax employment income which is paid to residents of the other contracting state and which is borne by a PE of the employer in the employment state. The question in this case was, broadly, whether the applicable PE definition for the purposes of applying the treaties between Denmark and the residence states of the employees (various states) was the definitions contained in those treaties, or the definition in the treaty between Denmark and the employer's residence state (Switzerland). It was found that the relevant definitions were those contained in the treaties with the employees' residence states. This meant that the income was not taxable in Denmark even though the employer had a PE in Denmark for the purposes of the treaty between Denmark and Switzerland. For further discussion see: Møll Pedersen, B., "Triangular Cases: Article 15 of the OECD Model, Income from Employment and the Definition of Terms," 47 European Taxation 2, (2007), pp. 90-92.
are materials showing that the contracting states intended the term "permanent establishment" to have a different meaning in the context of the provisions dealing with triangular cases than that set out in Article 5. However, where states are considering including provisions in their tax treaties to deal with PE triangular cases, the most straight-forward and the most certain approach would be to specify that the PE definition contained in the R-PE treaty applies for the purposes of those provisions. Thus, where provisions are included in the PE-S treaty to deal with PE triangular cases, those provisions should refer to the PE definition contained in the R-PE treaty for their operation.

Where, however, the enterprise to which the PE belongs is resident in a state which does not have a treaty with the PE state, then clearly a reference to the treaty definition of PE would not operate effectively. If the contracting states which to extend treaty benefits in situations where there is no R-PE treaty, e.g., in situations where there is a PE under the domestic law of one of the states, then the treaty provisions should refer to the criteria for the existence of a PE (or the equivalent threshold) under the domestic law of each of the contracting states.

8.2.4. Income to which the PE-S treaty should apply

In general terms, the PE-S treaty should apply to the income which is attributable to the PE for the purposes of the R-PE treaty. This section gives further consideration, however, to some potential limitations on the type of income to which the PE-S treaty would apply. It first discusses potentially limiting the application of the PE-S treaty to passive income, before going on to discuss income which the PE state is prevented from taxing and income which the PE state can tax, but not as a result of the existence of the PE. Depending on the category of income involved, the application of the R-S treaty instead of the PE-S treaty may have no practical impact since the source state is likely to be prevented from imposing tax (along with the PE state) under its treaty with the residence state (e.g., under Article 8). However, it could be very important if there were no R-S treaty or if there is a significant difference between the relevant terms of the two treaties.

8.2.4.1. Potential limitation to passive income

Virtually all the discussion on PE triangular cases focuses on situations involving dividends, interest and royalties. This perhaps follows from the focus of the OECD's triangular cases report in 1992 on those categories of income. As a consequence, however, many of the solutions which have been advocated for dealing with PE triangular cases are proposed to apply only to passive income. The issues arising in PE triangular cases are certainly most apparent in cases involving passive income, however treaties also vary in the extent to which they allow source based taxation in relation to other categories of income – a good example being capital gains. If the PE-S treaty and the R-S treaty both follow the OECD Model with respect to the category of income involved, the application of the PE-S treaty in the source state instead of the R-S treaty will have no impact on whether or not the source state is entitled to impose tax; however, to the extent that one or both of these treaties differs from the OECD Model, the source state should arguably apply the conditions of the PE-S treaty regardless of the category of income involved. Moreover, to the extent that taxation is allowed in the source state, triangular cases involving other categories of income may also result in tax being imposed in all three states. The PE state should therefore be required to grant exemption or credit relief in accordance with the terms of the PE-S treaty, i.e., in situations where the source state is entitled to impose tax, regardless of the category of income involved. Once it is accepted that PEs should be entitled to treaty benefits then there seems to be no

888 Article 31 of the Vienna Convention, dealing with the interpretation of treaties, provides that: "A special meaning will be given to a term if it is established that the parties so intended." (Article 31(4)). For further discussion see: Møll Pedersen, B., "Triangular Cases...".
889 For discussion of the attribution of profits to PEs, particularly focusing on the new "Authorized OECD Approach" (AOA), please refer to Chapter 5 (Section 5.2.5).
890 OECD, "Triangular Cases."
891 See, for example: Avery Jones, J.F., "The David R. Tillinghast Lecture..." at p 30; Langoth, B., "Treaty Entitlement..."; Zhai, G., "Triangular Cases..."; Yong, S., "Triangular Treaty Cases,...".
892 Refer to Chapter 2 for analysis of PE triangular cases involving various categories of income.
basis for limiting those benefits to passive income. Nevertheless, if the contracting states cannot reach agreement on extending full treaty benefits to PEs, then extending treaty benefits to PEs with respect to passive income would at least resolve PE triangular cases involving those categories of income.

8.2.4.2. Income which the PE state is prevented from taxing under the R-PE treaty

For many categories of income, the PE state will be entitled to impose tax as a result of the income being attributable to the PE. This is the case, for example, with respect to business profits, dividends, interest and royalties. In relation to other categories of income, however, the PE state may be prevented from imposing tax under the terms of the R-PE treaty despite the income being attributable to a PE in the PE state. One clear example of this is income from shipping, air transport and inland waterways transport, dealt with under Article 8.\(^{893}\) Under Article 8, such income may only be taxed in the state where the place of effective management of the enterprise is located.\(^{894}\) This means that in a PE triangular case the PE state will generally be prevented from imposing any tax under Article 8 of the R-PE treaty. A similar rule applies in relation to capital gains from the alienation of assets used in shipping, inland waterways transport and air transport and the PE state will be similarly prevented from imposing tax.\(^{895}\)

The application of the PE-S treaty in relation to the income attributable to the PE is premised on the R-PE treaty allocating either primary or exclusive taxing rights to the PE state. Where the PE state is prevented from imposing tax on certain income, then clearly the conditions of the PE-S treaty should not be applied to such income even if it is attributable to a PE in the PE state. Instead, the source state should continue to apply the conditions of the R-S treaty. This result could be achieved by providing that the PE-S treaty only applies to certain categories of income attributable to the PE. It would be better, however, to take a more general approach, ensuring that the PE-S treaty does not apply in situations where the PE state is prevented from imposing tax on the income under the terms of the R-PE treaty. This would be preferable because it will also be effective in situations where the R-PE treaty prevents the PE state from imposing tax on certain income which the PE state would normally be entitled to tax if the applicable treaty followed the OECD Model.

8.2.4.3. Income which the PE state can tax otherwise than under Article 7

The exclusion of income which the PE state is prevented from taxing under the R-PE treaty also raises the interesting question of whether the PE-S treaty should apply to income which is attributable to the PE and is taxable in the PE state under the R-PE treaty, but not as a result of the existence of the PE (i.e., not under the business profits article). This could occur, for example, where the income attributable to the PE includes income from immovable property which is located in the PE state but which, for some reason, is considered to be locally sourced income (and is consequently taxable) under the domestic laws of a third state.\(^{896}\) In this situation, the income would be taxable in the PE state under Article 6 of the R-PE treaty, but it would be taxable because it arises from immovable property located in the PE state, not because it is attributable to the PE. Arguably, the PE-S treaty should apply in this situation. If the key to the application of the PE-S treaty is the creation of a quasi-resident in the PE state as a result of the existence of the PE, and the transfer of primary taxing rights to the PE state under the R-PE treaty, then there seems to be no reason to exclude income taxable in the PE state otherwise than as a result of the existence of the PE. This approach would not result in the PE-S treaty applying to all income that is

\(^{893}\) Refer also to the discussion in Chapter 2 (Section 2.7.).

\(^{894}\) Article 8(1) provides that: "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is resident." Article 8(2) provides that: "Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated." This will usually be the residence state and in fact, it is common for treaties to allocate taxing rights by reference to the residence state, rather than the place of effective management. See: 2010 OECD Commentary on Article 8, para 2; Maisto, G., "Shipping, Inland Waterways..." at pp. 37-38.

\(^{895}\) Article 13(3). Refer also to the analysis in Chapter 2 (Section 2.8.3.)

\(^{896}\) This could occur, for example, where the source rules of that third state provide that any payment made by a resident of that state is considered to have a local source. This is perhaps an unusual source rule, particularly for income from immovable property, but not unheard of.
taxable in the PE state under the R-PE treaty, because it is still necessary for the income to be attributable to a PE in that state. Furthermore, in practical terms, there are unlikely to be many situations where a state can impose tax on income which is attributable to a PE other than as a result of the existence of the PE. Thus, there seems to be no reason to create a specific exclusion to prevent the application of the PE-S treaty to this type of income.

8.2.5. Proposed treaty provision extending treaty entitlement to PEs

A treaty provision extending treaty entitlement to PEs, by allowing the enterprise to claim the benefits of the PE-S treaty in relation to income attributable to the PE, could be worded as follows:

"(1) For the purposes of this Convention, notwithstanding the provisions of Article 1 (Persons Covered),

(a) where a person, who is not a resident of either of the Contracting States, has a permanent establishment in one of the Contracting States for the purposes of a convention between Contracting State where the permanent establishment is located and a third state, then this Convention shall apply to any income included in the profit attributable to the permanent establishment (for the purposes of the convention between the Contracting State where the permanent establishment is located and the state where the person is resident) as though that income were income of a resident of the Contracting State in which the permanent establishment is located. However, this Convention shall not apply to income which the Contracting State where the permanent establishment is located is prevented from taxing under the convention between that State and the person's residence state or between that State and a third state.

(b) where a person who is not a resident of either of the Contracting states, carries on business in State A through a [permanent establishment] (as defined under the laws of State A) and that person is not considered a resident of a third state for the purposes of a convention between State A and that third state, then this Convention shall apply to any income included in the profit attributable to the [permanent establishment] (under the domestic law of State A) as though that income were income of a resident of State A. However, the Convention shall not apply under this paragraph to income which State A is prevented from taxing under a convention with a third state.

(c) where a person who is not a resident of either of the Contracting states, carries on business in State B through a [permanent establishment] (as defined under the laws of State B) and that person is not considered a resident of a third state for the purposes of a convention between State B and that third state, then this Convention shall apply to any income included in the profit attributable to the [permanent establishment] (under the domestic law of State B) as though that income were income of a resident of State B. However, the Convention shall not apply under this paragraph to income which State B is prevented from taxing under a convention with a third state.

(2) This Article shall apply to capital gains and to profits in the same way as it applies to income.

(3) Any income, capital gains or profits to which this Convention applies as a result of paragraph 1 shall be considered to be paid to and derived by a person who is a resident of the Contracting State where the permanent establishment, [equivalent term in State A] or [equivalent term in State B] is located for the purposes of the application of this Convention under paragraph 1.

Paragraph 1(a) of this provision applies where the enterprise to whom the PE belongs is resident in a state which has concluded a treaty with the PE state. Paragraphs 1(b) and 1(c), on the other hand, apply in
cases where the enterprise is not resident in a state which has a treaty with the PE state, in keeping with the view that the residence state of the enterprise is not relevant to the extension of treaty benefits to the PE. However, where these paragraphs apply, treaty benefits should be available on the basis of the PE threshold of domestic law (or an equivalent domestic threshold) being satisfied. The wording of these provisions would therefore clearly have to be adapted to refer specifically to the domestic laws of each of the contracting states. Alternatively, the contracting states could exclude these paragraphs and extend treaty benefits only in situations where there is a treaty between the residence state and the PE state.

These provisions include wording to the effect that treaty benefits will not be available to the PE in relation to income which the PE state is prevented from taxing under a treaty. This may potentially occur, for example, in relation to income from shipping and air transport (under Article 8), where the distribution of taxing rights does not depend on the existence of a PE (see above).

Paragraph 2 of this proposed provision ensures that it applies to business profits and capital gains in the same way as it applies to other types of income. Paragraph 3 is included because the various articles of the OECD Model use varying terms to establish when they apply, as illustrated in the following table:

Table 8.1: Varying terms used in the OECD Model to establish when a particular article applies.

<table>
<thead>
<tr>
<th>Treaty article</th>
<th>Term used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 6</td>
<td>“derived by”</td>
</tr>
<tr>
<td>Article 7</td>
<td>“profits of”</td>
</tr>
<tr>
<td>Article 10</td>
<td>“paid … to”</td>
</tr>
<tr>
<td>Article 11</td>
<td>“paid to”</td>
</tr>
<tr>
<td>Article 12</td>
<td>“beneficially owned by”</td>
</tr>
<tr>
<td>Article 13</td>
<td>“derived by”, “gains from…”</td>
</tr>
<tr>
<td>Article 21</td>
<td>“income of”</td>
</tr>
</tbody>
</table>

Paragraph 3 is intended to ensure that the treaty applies as intended regardless of the exact term used in the relevant treaty article. For discussion of the beneficial ownership requirement, see Section 8.3.2., below.

8.3. Pre-requisites for availability of treaty benefits

Before an entity is eligible for reductions in source based taxation under a tax treaty, it must naturally satisfy the requirements of the treaty. The most common requirements are that the entity must be resident in one of the contracting states and, in relation to dividends, interest and royalties, that it must be the beneficial owner of the income. This section will address whether the availability of treaty benefits to PEs should be dependent on any prerequisites being satisfied in relation to residence or beneficial ownership. It will also discuss the certification of claims for treaty benefits by PEs.

8.3.1. Residence

8.3.1.1. Residence of the entity to which the PE belongs

The PE-S treaty should apply in PE triangular cases regardless of the residence state of the entity to which the PE belongs. It would not be appropriate to make treaty benefits for PEs dependent on the

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897 Note that Article 8 (which uses the term “profits from”) is not included in this table because, as mentioned above, income falling under Article 8 would generally not be taxable in the PE state and therefore the treaties between the PE state and third states would not generally apply.

898 In accordance with the residence definition contained in the treaty (in the OECD Model, Article 4).

899 See: OECD Model, Article 10 (2), Article 11(2) and Article 12(1).
residence state of the entity as a whole because it is likely that the income attributable to the PE will be either not taxed in the residence state at all (e.g., if it is exempt) or will be only minimally taxed (e.g., if the credit method of relief applies900). This is the case regardless of whether the residence state is a high or low taxing country or is, indeed, a tax haven. The state in which the entity as a whole is resident should therefore not have any influence on whether treaty benefits are available to the PE.

One possible exception is in situations where the enterprise to which the PE belongs is resident in the state where the income arises, i.e., where the income attributable to the PE includes income sourced in the residence state. This type of situation is effectively bilateral, with the PE-S treaty also operating as the R-PE treaty; the potential application of the R-PE treaty in circumstances where treaty benefits are extended to PEs under treaties with third states will be discussed in Chapter 9.

8.3.1.2. "Residence" at the level of the PE

In general, treaty benefits are only available to persons who are resident in one of the contracting states in accordance with Article 4 of the treaty. For a person to be a resident of a particular state, that person must be "liable to tax by reason of his domicile, residence, place of management or any other criterion of a similar nature."901 Article 4 also states that a person will not be resident in a particular state if they are "liable to tax in that State in respect only of income from sources in that State."902 The question arises as to whether these criteria can be adapted to PEs and, if so, whether PEs should be required to satisfy such criteria in order to be eligible for treaty benefits.

The first criterion which must be satisfied in order for a person to be resident in a particular state for treaty purposes is the requirement that the person be "liable to tax" in that state. For the purposes of Article 4(1), being liable to tax is an attribute of the person whose residence is being determined, not an attribute of the income in question.903 A PE can never be "liable to tax" in a technical sense since it is not a separate taxable entity, but this requirement could potentially be adapted to PEs, such that they would only be entitled to treaty benefits if the person to whom the PE belongs is liable to tax in the PE state in relation to the income attributable to the PE. This will be discussed further below in the context of preventing improper access to treaties through PEs.

The second sentence of Article 4(1) of the OECD Model provides that a person is not resident in a contracting state if they are only taxable in that state in respect of locally sourced income.904 As discussed in Chapter 5, the PE principle is something of a hybrid between the residence and source principles. If this type of criteria were adapted to PEs, it could be argued that all the income attributable to the PE is sourced in the PE state and thus, the PE is only taxable on locally sourced income. However, for the purposes of treaties between the residence state and a third state (i.e., the R-S treaty) the same income may be considered to be sourced in that third state (i.e., State S). Given the uncertainty in identifying a single geographical source for the income attributable to the PE, and the likelihood that this criterion would not provide any meaningful basis upon which to extend or deny treaty benefits, it would not be appropriate for PEs to be required to satisfy this type of condition in order to be entitled to treaty benefits.

A PE should not therefore be required to satisfy any additional "residence-type" criteria in order to be entitled to treaty benefits. Arguably, a resident enterprise is created in the PE state as a result of the PE being located there, as discussed in Chapter 5, and thus, the existence of a PE should be sufficient for the PE-S treaty to apply. The contracting states may, however, wish to include specific provisions in the treaty to prevent PEs from claiming treaty benefits in situations where such claims would be considered improper, e.g., a subject-to-tax clause. This will be discussed in Section 8.4., below.

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900 This is because if the residence state uses the credit method exclusively in its treaties, it would generally be obliged to provide credit relief both for the tax imposed in the PE state and the tax imposed in the source state. Even if the residence state is a high taxing country, there is likely to be minimal tax imposed after the provision of these credits. Refer to Chapter 3 for discussion of the residence state’s relief obligations in PE triangular cases.

901 OECD Model, Article 4(1).

902 OECD Model, Article 4(1).

903 Couzin, R., Corporate Residence… at p. 109 (Section 3.1.1.1.).

904 This provision will be discussed in greater detail in Chapter 10, dealing with dual-resident companies.
8.3.2. Beneficial ownership

In most tax treaties, source based taxation of dividends, interest and royalties is limited to a certain maximum rate of tax that can be imposed on the gross amount of the income, however, these limitations apply only if the beneficial owner of the income is resident in the other contracting state. The beneficial ownership concept is thus relevant for the availability of treaty benefits in relation to dividends, interest and royalties. It is also commonly used by source states to attack what they perceive to be improper claims for treaty benefits in relation to such income, i.e., by denying treaty benefits on the basis that the recipient of the income is not the beneficial owner.

If treaty benefits are extended to PEs, there are two beneficial ownership issues which should be addressed. The first is whether the entity to which the PE belongs should be required to be the beneficial owner of dividends, interest and/or royalties attributable to the PE, and the second is whether the PE itself should be required to satisfy some kind of beneficial ownership-type test. These two issues will be discussed in turn below.

8.3.2.1. Beneficial ownership by the entity as a whole

If treaty benefits are extended to PEs, the entity to which the PE belongs may formally make the claim for treaty benefits, but those benefits are available by virtue of the income being attributable to the PE. As discussed above, the availability of treaty benefits in relation to the income attributable to the PE should not depend upon the state of residence of the entity to which the PE belongs. This seems to suggest that the entity to which the PE belongs should also not be required to be the beneficial owner of the income, since it would not matter if the true beneficial owner were in fact resident in another state.

Beneficial ownership of the income may potentially be relevant, however, in situations where the income would not have been attributable to a PE in the PE state if the beneficial owner had received it directly, e.g., where a custodian, acting as an agent or nominee, receives income on behalf of another person and the income is attributable to a PE of the custodian, but is not attributable to a PE of the true beneficial owner of the income. It is, however, difficult to reconcile the receipt of income as an agent or nominee and the attribution of that income to a PE, since the receipt of income as an agent or nominee implies that the income is received simply on behalf of another person. It is therefore difficult to see how such income could have a sufficient connection to the activities of a PE. Nevertheless, the contracting states may wish to consider whether a specific exception to the availability of treaty benefits to PEs would be warranted to deal with these types of cases, i.e., where the income would not be attributable to a PE in the hands of the beneficial owner.

Another situation where identity of the beneficial owner may be relevant is in cases where that entity is resident in the source state. Where the income is beneficially owned by a resident of the source state, the situation is effectively bilateral, with the PE-S treaty also operating as the R-PE treaty; the potential application of the R-PE treaty in circumstances where treaty benefits are extended to PEs under treaties with third states will be discussed in Chapter 9.

8.3.2.2. Beneficial ownership at the level of the PE

The direct application of a beneficial ownership concept to PEs is not feasible because PEs are generally not separate legal entities. The question arises, however, as to whether the beneficial ownership concept can and should be adapted to PEs or whether there is some equivalent concept which could be applied. One of the main difficulties in adapting the beneficial ownership concept to PEs, in addition to PEs' lack

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905 OECD Model, Article 10(2) and Article 11(1). According to Article 12(1) of the OECD Model, royalties can only be taxed in the residence state. In practice, however, it is common for treaties to allow some limited rate of source based taxation of royalties.

906 The meaning of beneficial ownership and its role in addressing treaty shopping was discussed in Chapter 5 (see Section 5.2.6.1).

907 As discussed above, see Section 8.2.1.
of legal capacity, lies in the uncertainty surrounding the meaning of beneficial ownership and how it should be applied in the context of legal entities.\textsuperscript{908} This would make it extremely difficult to develop an equivalent concept for application to PEs. One instrument which attempts to do so is the EU Interest and Royalty Directive, discussed below.

The Interest and Royalty Directive\textsuperscript{909}

The EU Interest and Royalty Directive provides for an exemption from source-based taxation for cross-border interest and royalties payments between associated companies within the EU. It applies in situations involving both companies and PEs,\textsuperscript{910} and requires the state of the paying company or PE to exempt from tax any interest or royalty payments made to, and beneficially owned by, an associated company or PE.\textsuperscript{911} For the purposes of the Directive, a company is considered to be the beneficial owner of interest or royalties if “… it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person.”\textsuperscript{912} The directive also contains the following definition of beneficial ownership applicable to PEs:

“A permanent establishment shall be treated as the beneficial owner of interest or royalties:

(a) if the debt-claim, right or use of information in respect of which the interest or royalty payments arise is effectively connected with that permanent establishment; and

(b) if the interest or royalty payments represent income in respect of which that permanent establishment is subject in the Member State in which it is situated to one of the taxes mentioned in Article 3(a)(ii).”\textsuperscript{913}

Thus, in order for a PE to be the beneficial owner of interest or royalties for the purposes of the Interest and Royalties Directive, the asset giving rise to the interest or royalties must be “effectively connected” with the PE and the PE must be subject to tax on the income. This second requirement, that the income be subject to tax, does not correspond to any requirement which must be met in order for a company to

\textsuperscript{908} This was discussed in Chapter 5 (see Section 5.2.6.1.). For further discussion, see: Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions...} at pp. 561-562 (m.no. 7-9); Van Weeghel, S., \textit{The Improper Use...} at pp. 64-91; Oliver, J.D.B., Libin, J.B., Van Weeghel, S., & Du Toit, C., “Beneficial Ownership”; Martín Jiménez, A., "Beneficial Ownership..."; Du Toit, C., "The Evolution of..."; and Van Weeghel, S., “General Report” at pp. 50-52.


\textsuperscript{910} The PE definition contained in the Interest and Royalty Directive (Article 3, para (c)) is similar to that contained in Article 5(1) of the OECD Model, but there are some differences. For discussion see, inter alia: Terra, B.J.M., & Wattel, P.J., \textit{European Tax Law} at p. 619; and Distasos, M., & Russo, R, “The EC Interest...” at pp. 146-147.

\textsuperscript{911} Article 1, paragraph 1, of the Directive provides that: “Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State.” Article 1, paragraph 7, provides that: “This Article shall apply only if the company which is the payer, or the company whose permanent establishment is treated as the payer, of the interest or royalties is an associated company of the company which is the beneficial owner, or whose permanent establishment is treated as the beneficial owner, of that interest or those royalties.”

\textsuperscript{912} Interest and Royalty Directive, Article 1, para. 4. The scope of this provision differs somewhat from the likely meaning of beneficial ownership in a treaty context; refer to Chapter 5 (Section 5.2.6.1.) for a discussion of the beneficial ownership concept as it applies to companies for tax treaty purposes.

\textsuperscript{913} Interest and Royalty Directive, Article 1, para. 5.
be the beneficial owner of income, either in the Interest and Royalty Directive or for treaty purposes. It is submitted that if a subject to tax requirement is introduced, it should be considered separately from the beneficial ownership concept and the two should not be combined. The potential for the extension of treaty benefits to PEs to be dependent on the PE meeting a subject to tax requirement is therefore discussed separately below (see Section 8.4.2.), and is not considered further here.

The other requirement of the beneficial ownership definition is that the asset giving rise to the income must be “effectively connected” with the PE. This mirrors the language found in Article 11(4) and Article 12(3) of the OECD Model for determining the situations in which Article 7 applies to interest or royalties instead of Article 11 or Article 12, respectively. Article 11(4), for example, provides that:

“The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.” [Emphasis added.]

With respect to determining when a debt claim will be “effectively connected” with a PE, the OECD Commentary provides that:

“A debt-claim in respect of which interest is paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the ‘economic’ ownership of the debt-claim is allocated to that permanent establishment under the principles developed in the Committee’s report entitled Attribution of Profits to Permanent Establishments …”

For treaty purposes therefore, whether a debt claim or an asset giving rise to royalties is “effectively connected” with a PE is determined as part of the process for determining the profit attributable to a PE and is based on the same principles. Rather than adapting the concept of beneficial ownership applicable to companies in order to apply it to PEs, the Interest and Royalty Directive therefore effectively relies on the attribution of profit to the PE. Ultimately, this is the best approach. The concepts which are used to determine the profit attributable to the PE are well developed and effectively result in an allocation of income to the PE on an economic basis, linked to the activities it carries out, as outlined below.

**Reliance on the attribution of profit to the PE**

Under the Authorised OECD Approach ("AOA"), the attribution of profits to a PE is based on the calculation of profits (or losses) from all its activities, including transactions with third parties and transactions with other parts of the enterprise. The application of the AOA involves, firstly, a "functional and factual analysis," which is performed in order to hypothesise the PE as a distinct and separate enterprise and to "identify the economically significant activities and responsibilities undertaken by the PE". The outcome of the analysis in Step 1 of the AOA will be an allocation of assets, risks and capital to the PE based on the "significant people functions" performed by the PE. Passive income, such as dividends, interest and royalties, would generally be included in the profit attributable to a PE.

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915 Similarly, Article 12(3) provides that: “The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”
916 OECD Commentary on Article 11, para 25.1. Similar language is contained in the OECD Commentary on Article 12 (para. 21.1.).
918 The AOA was discussed in greater detail in Chapter 5 (see Section 5.2.5.).
919 2010 OECD Commentary on Article 7, para 20.
only if the asset which gives rise to the income is economically owned by the PE.\textsuperscript{922} A PE will have "economic ownership" of an asset if it is entitled to the economic benefits of owning the asset and bears the corresponding economic burdens.\textsuperscript{923} Economic ownership of assets under the AOA generally depends upon "significant people functions."\textsuperscript{924} In general, the significant people functions relevant for determining economic ownership of intangible assets (including shares, debts, and intellectual property rights\textsuperscript{925}) will be those functions associated with active decision-making with regard to the assumption and management of risks.\textsuperscript{926} Therefore, assets giving rise to passive income will only be economically owned by a PE if active decision making with regard to whether to make the investment, and the ongoing management of the investment, is undertaken by personnel working in the PE. This is clearly a much higher standard than is required in order for income to be earned (and beneficially owned) by a subsidiary company, and this would typically be the case even where the AOA does not apply. Consequently, where income is attributable to the PE for treaty purposes, this connection to the activities of the PE should be sufficient to entitle the PE to claim reductions in source based taxation on dividends, interest and royalties under the PE-S treaty without the need for any additional beneficial ownership-type requirement to be satisfied.

\textbf{8.3.2.3. Proposed treaty provision regarding beneficial ownership}

A treaty provision to the effect that a PE is not required to satisfy the beneficial ownership requirement could be worded along the following lines:

\"(4) Any income to which [Article 10], [Article 11] or [Article 12] of this Convention applies as a result of paragraph 1 shall be considered to be beneficially owned by a person who is a resident of the Contracting State where the permanent establishment, [equivalent term in State A] or [equivalent term in State B] is located for the purposes of the application of this Convention under paragraph 1.\"

This provision deems the PE to satisfy the beneficial ownership requirements of the articles dealing with passive income. This provision is drafted as the fourth paragraph of the suggested provision outlined in Section 8.2.5., above, but alternatively, the third paragraph could simply be altered as follows:

\"(3) Any income, capital gains or profits to which this Convention applies as a result of paragraph 1 shall be considered to be paid to, derived by and beneficially owned by a person who is a resident of the Contracting State where the permanent establishment, [equivalent term in State A] or [equivalent term in State B] is located for the purposes of the application of this Convention under paragraph 1.\"

\textbf{8.3.3. Certification procedure}

Claims for treaty benefits must typically be supported by an endorsement from the residence state of the person claiming treaty benefits, usually in the form of a residence certificate.\textsuperscript{927} This endorsement serves to provide the source state with some assurance that the person claiming treaty benefits is in fact a resident of the other contracting state\textsuperscript{928} and, depending on the exact nature of the procedure in the residence state, also serves to notify the residence state that the person requesting the certificate is deriving income from the source state. Where a PE is claiming treaty benefits, the PE state should clearly

\textsuperscript{922} OECD, "2010 Report…," Part I, Section B-3(ii), para 19. This section does not address situations involving notional income from other parts of the enterprise; the application of treaties to notional payments between different parts of a single enterprise will be discussed in Section 8.5.2., below.

\textsuperscript{923} OECD, "2010 Report…," Part I, Section B-3(i), note 4.

\textsuperscript{924} OECD, "2010 Report…," Part I, Section D-2(iii)(a), para 72.

\textsuperscript{925} These types of intangible assets are not specifically mentioned in the OECD Report, but can be presumed to fall within the meaning of intangible property in accordance with general principles.

\textsuperscript{926} OECD, "2010 Report…," Part I, Section D-2(iii)(c), paras 85, 94, and 97.


\textsuperscript{928} Russo, R., "Administrative Aspects….”
be involved in this process, since the PE state is effectively functioning as the residence state with respect to that claim for treaty benefits.

One difficulty which may arise with requesting an endorsement of from the PE state is that the PE state may not have the appropriate knowledge of the situation to certify that a PE exists in that state, let alone that the income is attributable to that PE. Nevertheless, the PE state can certify that the taxpayer has represented to them that there is a PE in that state and that the income is attributable to that PE, giving assurance that the taxpayer is at least reporting the same facts and the same interpretation of those facts to both the PE state and the source state. If the taxpayer's representations turn out to be incorrect based on information that comes to light at a later date (e.g., when tax returns are filed, or when the tax authorities conduct an audit or examination), then the PE state should ideally provide this information to the source state.

It was proposed above that any claims for treaty benefits under the PE-S treaty should be made by the entity to which the PE belongs. Where the extension of treaty benefits to PEs under the PE-S treaty does not depend upon the state of residence of the entity to which the PE belongs (which it should not), there may be no need to involve the residence state in the endorsement process in order for the source state to be satisfied that there is a proper claim for treaty benefits. Nevertheless, involving the residence state would facilitate the application of the R-S treaty, particularly in cases where that treaty incorporates provisions dealing with PE triangular cases, e.g., excluding the operation of that treaty in certain circumstances, and would help to ensure that the taxpayer has presented the same facts, and the same interpretation of those facts, to all three of the states involved.

Requirements for residence certificates are not typically included in tax treaties, but rather, are part of the administrative mechanisms for the implementation of the treaty in each of the contracting states. Where states sign treaties which allow PEs to claim the benefits of the treaty, those states should ensure that they update their domestic administrative rules for the implementation of tax treaties to ensure that the endorsement procedure involves the PE state. A special procedure would usually be required since the PE state is not certifying as to the residence of a particular entity, but rather, is certifying that for the purposes of the R-PE treaty there is a PE in that state and the income in question is considered to be attributable to that PE. It may also be beneficial for states to specifically agree on the way in which such procedures should operate in the context of PEs claiming treaty benefits.

8.4. Preventing improper access to treaties through PEs

One of the primary concerns with extending treaty benefits to PEs is that it would give rise to opportunities for improper access to tax treaties, commonly referred to as treaty shopping. Treaty shopping through PEs is potentially more of a concern than treaty shopping through separate legal entities because transactions between the PE and the rest of the enterprise have no legal consequences for the entity as a whole and because common patterns of PE taxation may make it easier to obtain treaty benefits without triggering any additional tax liability in the PE state or in the residence state. However, this may be offset by the fact that the determination of the income attributable to a PE is based on an economic and factual analysis, rather than being based on legal ownership, and thus the income attributable to the PE will necessarily have a significant economic link to the PE state. These considerations were discussed in detail in Chapter 5 (Section 5.2.6.), where it was concluded that any differential between the risk of treaty shopping through PEs and through resident entities was not great enough to justify failing to extend treaty benefits to PEs, and that the risk could be further reduced by

929 OECD Committee on Fiscal Affairs, "Triangular Cases," paras 51 and 52.
930 The issue of controversies and disagreements regarding the existence of a PE and the attribution of income to PEs will be discussed below (see Section 8.6.1.).
931 Refer to Chapter 7 (Section 7.5.) for a discussion of the type of provisions which could be included in the R-S treaty to deal with PE triangular cases.
932 Treaty shopping is generally considered to occur where a person acts through or uses a legal entity in order to obtain treaty benefits that would not be available directly. The main forms of treaty shopping are "direct conduits" and "stepping-stone conduits"; these basic structures were outlined in Chapter 5 (see Section 5.2.6.1.).
933 These factors will be discussed in detail in this section, but an overview and a comparison to the common patterns for the taxation of separate entities was given in Chapter 5 (see Section 5.2.6.).
including specific provisions in tax treaties to prevent PEs from claiming treaty benefits in situations where such a claim would be considered improper. This section will discuss the types of specific provisions that could be included in tax treaties to address such concerns. These provisions are essentially optional. To the extent that a particular state considers that the attribution of income to a PE in the PE state is sufficient to guard against improper application of the PE-S treaty, there would be no need to include any specific anti-avoidance provisions in the treaty. The intention of this section is not to lay out the anti-avoidance provisions that should be included in the treaty, but rather to identify certain provisions which states could include in treaties for states that remain concerned about the potential for abuse.

8.4.1. Examples of potential treaty shopping structures involving PEs

In a practical sense, there are several ways in which the extension of treaty benefits to PEs may facilitate treaty shopping. Firstly, the income attributable to a PE may potentially be taxed more favourably in the PE state than it would be if it were derived by a resident of that state, e.g., where the PE state does not impose tax on the foreign income attributable to local PEs. Secondly, notional payments from the PE to the rest of the enterprise are not recognised for the purposes of applying tax treaties (other than for determining the income attributable to the PE) and consequently, no withholding tax can be imposed on such notional payments. This may facilitate the use of a PE to access treaty benefits either in place of a conduit company (a direct conduit) or in a base erosion scenario (a stepping stone conduit). These factors will be illustrated in the following three examples.

8.4.1.1. Example 1: PE State doesn’t tax foreign income attributable to the PE

If the PE state does not tax foreign income attributable to a local PE but does tax the foreign income of resident enterprises, the extension of treaty benefits to PEs may give rise to additional scope for treaty shopping, since the reduction in source-based taxation under the PE-S treaty could be obtained by deriving the income through a PE without attracting any additional tax liability in the PE state. In most cases, however, the PE state will impose tax on the worldwide income attributable to the PE or will at least tax the income attributable to a PE in the same way as the income of a resident enterprise, thus limiting concerns based on non-taxation in the PE state. Nevertheless, to demonstrate the use of a PE as a conduit in situations where the PE state does not tax the (foreign) income attributable to the PE, this example will compare three scenarios:

(i) A company resident in State R derives $100 of interest income from State S. The income is not attributable to a PE. Under the R-S treaty, State S is limited to imposing tax of 20% on the gross amount of the interest income, and State R is required to grant credit relief. The domestic interest withholding tax rate in State S is 20%. The corporate tax rate in State R is 30%. This situation is illustrated in the following diagram:

Figure 8.1.: Scenario (i) – Interest income received directly by resident of State R
(ii) A company resident in State R ("Parent") incorporates a wholly-owned subsidiary ("Sub") in State PE and that subsidiary derives interest income from sources in State S. The subsidiary is eligible for benefits under the PE-S treaty and is considered the beneficial owner of the interest income.934 The PE-S treaty limits the amount of tax State S may impose on the interest to 5% of the gross amount and thus, the WHT that the source state can impose is limited to 5%. The corporate tax rate in State PE is 30% and the PE state uses the credit method of relief under the PE-S treaty. The subsidiary pays the income as a dividend to its parent company, however, to remove the effects of dividend taxation (which will be illustrated in the following example) it is assumed that neither State PE nor State R imposes any tax on the dividend. This is illustrated in the following diagram.

Figure 8.2.: Scenario (ii) – Interest income received by a wholly-owned subsidiary in State PE.

(iii) A company resident in State R derives $100 interest income from sources in State S. The interest income is attributable to a PE established in State PE. The PE is entitled to treaty benefits under specific provisions included in the PE-S treaty and the PE-S treaty limits the amount of tax State S may impose on the interest to 5% of the gross amount. The PE state does not impose tax on income derived by PEs from third states, and thus the interest is excluded from the tax base in the PE state and the PE state is not required to grant relief. The residence state uses the exemption method of relief under the R-PE treaty and thus exempts the income attributable to the PE. This is illustrated in the following diagram.

Figure 8.3.: Scenario (iii) – Interest income received by a resident in State R but attributable to a PE in State PE.

934 It is further assumed that the subsidiary is not excluded from claiming treaty benefits by any specific provision of the PE-S treaty, e.g., an LOB provision.
These three scenarios are compared in the following table.

Table 8.1: Example illustrating potential impact of non-taxation of foreign income in the PE state

<table>
<thead>
<tr>
<th></th>
<th>(i) Interest derived by resident of State R (no PE)</th>
<th>(ii) Interest derived by a subsidiary in State PE</th>
<th>(iii) Interest attributable to a PE in State PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income from State S</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>WHT collected in State S</td>
<td>20(^{935})</td>
<td>5(^{936})</td>
<td>5(^{937})</td>
</tr>
<tr>
<td>Tax collected in State PE</td>
<td>N/A(^{938})</td>
<td>25(^{939})</td>
<td>25(^{940})</td>
</tr>
<tr>
<td>Tax collected in State R</td>
<td>10(^{941})</td>
<td>10(^{942})</td>
<td>10(^{943})</td>
</tr>
<tr>
<td>Total tax imposed</td>
<td>30</td>
<td>30</td>
<td>5(^{944})</td>
</tr>
</tbody>
</table>

Where the PE in the above example (scenario iii) claims treaty benefits in the source state, the source state may view that claim as unacceptable, on the basis that if the income were derived directly by the entity to whom the PE belongs (without being attributable to a PE) then the source state would have been able to apply the higher rate applicable under the R-PE treaty and collect $20 instead of $5. The source state may also object to extending treaty benefits to the PE in this situation on the basis that it agreed to the reduced rate of source-based taxation under the PE-S treaty on the understanding that the income would be subject to a certain rate of tax in the PE state and, in relation to the PE, this has not occurred. The table above also demonstrates that it would not have been possible, given this particular set of facts, to obtain reduction in the overall tax liability using a conduit company established in the PE state, since the benefit of reduced taxation in the source state would be completely offset by the additional taxation imposed on the subsidiary in its state of residence (i.e., the "PE State").

In this example, there is an advantage to deriving the income through a PE rather than through a conduit company because if the income is attributable to the PE it is taxed more favourably in the PE state than it would be if derived by a locally resident company. However, the advantage that arises in the case of a PE

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\(^{935}\) The WHT is limited to 20% under the R-S treaty (20% x $100 = $20).

\(^{936}\) The WHT is limited to 5% under the PE-S treaty (5% x $100 = $5).

\(^{937}\) The WHT is limited to 5% under the PE-S treaty (5% x $100 = $5).

\(^{938}\) There is no link to the PE state in this case and thus no tax imposed.

\(^{939}\) State PE imposes tax at a rate of 30% (i.e., $100 x 30% = $30) but allows a credit for tax imposed in State S (i.e., $5). The net tax imposed in State PE is therefore $25 (i.e., $30 - $5). The subsidiary distributes its (net) profit to its parent company in the form of a dividend, however, to remove the effects of dividend taxation (which will be illustrated in the following example) it is assumed that neither State PE nor State R imposes any tax on the dividend.

\(^{940}\) It is assumed that State PE imposes no tax on the interest income arising in State S and attributable to the PE.

\(^{941}\) Tax is imposed on $100 at a rate of 30% (i.e., $100 x 30% = $30), but there is a credit available for the tax imposed in State S (i.e., $20) under the domestic law of State R. The net amount of tax imposed in State R is therefore $10 ($30 - $20 = $10).

\(^{942}\) The interest income received from State S is not received by a resident of State R and is thus not taxable in State R (assuming it is not taxed in the hands of the parent company under controlled foreign companies (CFC) rules in State R). The subsidiary distributes its profit to its parent company in the form of a dividend, however, to remove the effects of dividend taxation (which will be illustrated in the following example) it is assumed that neither State PE nor State R imposes any tax on the dividend.

\(^{943}\) The residence state uses the exemption method of relief under the R-PE treaty and thus exempts the income attributable to the PE. Note that if State R used the credit method of relief, the additional tax imposed in State R (i.e., $25) would completely offset the tax saving in the source state in this example.

\(^{944}\) Note that if State R used the credit method of relief, the additional tax imposed in State R (i.e., $25) would completely offset the tax saving in the source state in this example.
depends on the facts and assumptions made above. Clearly, if the PE state does not tax the PE more favourably than a resident enterprise (e.g., it uses the exemption method of relief and consequently would not impose any tax if the income were derived by a locally resident company) then there would be no advantage in deriving the income through a PE rather than a company.\footnote{With the possible exception of avoiding the dividend taxation that may be imposed in the case of a conduit company; dividend taxation is discussed in the following example.} Perhaps more importantly, however, if the residence state used the credit method of relief in relation to the income attributable to the PE, the additional tax imposed in the residence state would offset the benefit of the reduced taxation in the source state. These factors would tend to limit the situations in which there may be opportunities to reduce the overall tax burden in relation to certain income by deriving that income through a PE in order to claim treaty benefits. Nevertheless, the above example demonstrates that extending treaty benefits to PEs may create potential opportunities for treaty shopping in addition to those which currently exist in relation to legal entities. Although there is no general pattern of taxing the income attributable to PEs more favourably than the income of resident enterprises, the potential for such favourable taxation of PE income in the PE state may give rise to calls for limiting the availability of treaty benefits to PEs in certain situations.

\section*{8.4.1.2. Example 2: No tax on repatriations of income by the PE}

One consequence of the PE being simply part of a broader enterprise and not a separate legal entity is that the profit attributable to the PE belongs directly to the entity as a whole, and there is no need for any formal repatriation in order for the PE's profits to be utilised by other parts of the enterprise.\footnote{In the case of a PE, income may even be paid directly into a bank account in the entity's residence state and still be attributable to the PE. Conversely, the payment of a subsidiary's income directly into its parent company's bank account may, depending on the overall facts and circumstances, raise questions regarding whether the subsidiary is the true beneficial owner of the income for treaty purposes.} One of the factors which may tend to limit the opportunities for treaty shopping through separate entities (i.e., conduit entities) is that dividend payments are likely to trigger a tax liability\footnote{Withholding tax in the conduit state and/or tax in the residence state of the recipient. Note that dividend payments may not be required in the case in stepping-stone structures, where the conduit makes deductible (base eroding) payments to another entity.} which may outweigh the benefit of the reduced source-based taxation.\footnote{Note that dividend payments may not be required in the case in stepping-stone structures, where the conduit makes deductible (base eroding) payments to another entity. Structures involving base erosion will be illustrated in the following example.}

To demonstrate the way in which the non-taxation of repatriations from a PE to the rest of the enterprise may facilitate the use of a PE in place of a conduit company in a direct conduit structure, this example will compare three scenarios:

\begin{itemize}
  \item[(i)] A company resident in State R derives interest income of $200 from sources in State S. The income is not attributable to a PE. The domestic interest withholding tax rate in State S is 30%. The R-S treaty limits the tax that can be imposed on interest to 10%. The corporate tax rate in State R is 30% and State R provides credit relief under the R-S treaty. This is illustrated in the following diagram.
\end{itemize}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{scenario_i}
\caption{Scenario (i) – Interest received directly by a resident of State R}
\end{figure}
(ii) A company resident in State R ("Parent") incorporates a wholly-owned subsidiary ("Sub") in State PE and that subsidiary derives $200 interest income from sources in State S. Under the PE-S treaty, the WHT that the source state can impose on the interest is limited to 5%. The corporate tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income. The subsidiary uses its net profit to pay a dividend of $190 (i.e., $200 less the $10 (5%) withholding tax in State S). The domestic dividend WHT rate in the PE state is 30% but the tax State PE can impose is limited to 10% under the R-PE treaty. The corporate tax rate in State R is 30%. State R provides relief under both the R-S treaty and the R-PE treaty using the credit method. This is illustrated in the following diagram.

*Figure 8.5.: Scenario (ii) – Interest received by a wholly-owned subsidiary in State PE*

(iii) A company resident in State R derives a dividend of $200 from a controlled subsidiary which is resident in State S. The dividend income is attributable to a PE established in State PE. The residence state uses the exemption method under the R-PE treaty and thus exempts the income attributable to the PE. The PE is entitled to treaty benefits under specific provisions included in the PE-S treaty. The PE-S treaty limits the amount of tax State S may impose on the interest to 5% of the gross amount. The tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income. This is illustrated in the following diagram.

*Figure 8.6.: Scenario (iii) – Interest received by a resident of state R but attributable to a PE in State PE*
These three scenarios are compared in the table below.

Table 2: Example demonstrating the potential impact of non-taxation of repatriations from the PE to the rest of the enterprise

<table>
<thead>
<tr>
<th></th>
<th>(i) Interest derived by resident of State R (no PE)</th>
<th>(ii) Interest derived by a subsidiary resident in State PE</th>
<th>(iii) Interest attributable to a PE in State PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>WHT collected in State S</td>
<td>20&lt;sup&gt;949&lt;/sup&gt;</td>
<td>10&lt;sup&gt;950&lt;/sup&gt;</td>
<td>10&lt;sup&gt;951&lt;/sup&gt;</td>
</tr>
<tr>
<td>Tax collected in State PE</td>
<td>.952</td>
<td>.953</td>
<td>.954</td>
</tr>
<tr>
<td>WHT collected in State PE on distributions</td>
<td>N/A</td>
<td>18&lt;sup&gt;955&lt;/sup&gt;</td>
<td>N/A</td>
</tr>
<tr>
<td>Tax collected in State R</td>
<td>40&lt;sup&gt;956&lt;/sup&gt;</td>
<td>32&lt;sup&gt;957&lt;/sup&gt;</td>
<td>.958</td>
</tr>
<tr>
<td>Total tax imposed</td>
<td>60</td>
<td>60</td>
<td>10</td>
</tr>
</tbody>
</table>

In scenario (ii) in this example, where the dividend is received through a conduit company in "State PE," the benefit of the reduced withholding tax in the source state under the PE-S treaty is outweighed by the additional tax imposed on the dividend paid by the conduit company. Given that no withholding tax is imposed on any repatriations of income by a PE, the establishment of a PE to take advantage of the reduced withholding tax available under the PE-S treaty does not face this problem.<sup>959</sup> This demonstrates that it may be possible to reduce the total amount of tax imposed by deriving income through a treaty-eligible PE in a situation where it would not be possible to similarly reduce the amount of tax imposed by deriving the income through a treaty-eligible entity resident in the "PE state".

8.4.1.3. Example 3: Base erosion through notional payments

For the purposes of determining the profit attributable to a PE, the PE must be hypothesised as a distinct and separate enterprise, and notional payments made by the PE to other parts of the enterprise can be deducted from its profit. However, this recognition of notional payments does not go beyond the

<sup>949</sup> The WHT is limited to 10% under the R-S treaty: $200 x 10% = $20.

<sup>950</sup> The WHT is limited to 5% under the PE-S treaty: $200 x 5% = $10.

<sup>951</sup> The WHT is limited to 5% under the PE-S treaty: $200 x 5% = $10.

<sup>952</sup> There is no link between the PE state and the income and the PE state therefore imposes no tax.

<sup>953</sup> The corporate tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income.

<sup>954</sup> The corporate tax rate in State PE is 30% but, to isolate the effects of the taxation of profit repatriations, it is assumed that State PE does not impose tax on interest income.

<sup>955</sup> The company resident in State PE pays a dividend of $180 (i.e., $200 income less $20 withholding tax in State S) and State PE collects WHT at a rate of 10% ($180 x 10% = $18).

<sup>956</sup> State R imposes tax of 30%, but provides a credit for the tax imposed in the source state. It is assumed that State R grosses up with respect to the withholding tax for the purposes of determining the taxable income, and the tax liability is therefore: ($200 x 30%) - $20 = $40.

<sup>957</sup> State R imposes tax of 30% on the dividend paid by the subsidiary, but grants a credit for the tax imposed in the PE state ($18) and the source state ($10). It is assumed that the dividend is grossed up to determine the amount upon which tax is imposed, and the tax liability is therefore: ($200 x 30%) - $10-$18 = $32.

<sup>958</sup> State R exempts the profit attributable to the PE and there is therefore no tax imposed in State R.

<sup>959</sup> However, it should be noted that if, in the above example, State R used the credit method of relief with respect to the profit attributable to the PE instead of the exemption method, then the benefit of the reduced source-based taxation would be outweighed by the additional tax imposed in State R.
determination of the profit attributable to the PE, which means that the PE state is not entitled to impose any source based taxation (e.g., withholding taxes) on these notional payments. This non-recognition of notional payments may facilitate treaty shopping through PEs because the profit attributable to the PE, and thus taxable in the PE state, can be reduced by notional payments which do not attract any liability for withholding taxes. This stands in contrast to the situation involving a subsidiary company, since any payments made by the subsidiary company may attract withholding taxes.

To demonstrate the way in which the non-taxation of notional payments from a PE to the rest of the enterprise may facilitate the use of a PE in base erosion structures (i.e., in place of a conduit in a "stepping-stone" structure\footnote{Briefly, in a stepping-stone conduit structure, a resident of one state ("ParentCo," resident in State A) establishes a company, which is resident in a second state ("SubCo," resident in State B), and transfers income-generating assets to that company in order to take advantage of the treaty between State B and a third state (State C) in respect of income arising from sources in State C. SubCo is fully taxable in State B but pays tax-deductible amounts (e.g., interest, service fees) to a related company, with the result that there is minimal residual tax payable in State B. The amounts paid by SubCo must not be subject to more than minimal tax in either State B (e.g., withholding tax) or the state where the recipient is resident, otherwise the additional tax liability may outweigh the benefit of the tax saving in State C. This was outlined in slightly more detail in Chapter 5 (see Section 5.2.6.).}), this example will compare three scenarios:

(i) A company resident in State R derives royalties of $100 from sources in State S. The income is not attributable to a PE in State S or in any other state. Under the R-S treaty, State S is entitled to impose tax at a maximum rate of 30\% on the gross amount of the income. State S imposes withholding tax at a rate of 30\% of the gross income under its domestic law. The tax rate in State R is 30\%, and State R provides relief using the credit method in accordance with the R-S treaty.

(ii) A company resident in State R incorporates a wholly-owned subsidiary in State PE and that subsidiary derives royalties of $100 from sources in State S. The company is eligible for benefits under the PE-S treaty, under which State S is prevented from imposing tax on the income. The corporate tax rate in State PE is 30\%. The subsidiary pays royalties of $90 to its parent company, and thus has net income of $10. State PE imposes a withholding tax on royalties of 20\% and the R-PE treaty allows source-based taxation of royalties up to a maximum rate of 20\%. State R taxes royalties at its general corporate tax rate of 30\%. Under the R-PE treaty, State R uses the credit method of relief in relation to royalty income. It is assumed that the subsidiary retains its net income and does not pay any dividends.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{example-diagram.png}
\caption{Scenario (i) – Royalties received directly by resident of State R}
\end{figure}
(iii) A company resident in State R derives royalties of $100 from sources in State S which is attributable to a PE established in State PE. The PE is entitled to treaty benefits under specific provisions included in the PE-S treaty. State S is prevented from imposing tax on the income under the PE-S treaty. The PE makes a notional royalty payment to the head office and, after deducting this payment, the profit attributable to the PE is $10. The tax rate in the PE state is 30%. State R uses the exemption method of relief under the R-PE treaty and therefore exempts the profit attributable to the PE. It is assumed that State R exempts foreign active business income under its domestic law (even the income is not attributable to a PE) and State R therefore exempts the income derived from State S.

Figure 8.9.: Scenario (iii) – Income received by resident in State R, but attributable to a PE in State PE

These three scenarios are compared in the table below.

Table 3: Example demonstrating the potential impact of base erosion through notional payments

<table>
<thead>
<tr>
<th></th>
<th>(i) Income derived by resident of State R (no PE)</th>
<th>(ii) Income derived by a subsidiary resident in State PE</th>
<th>(iii) Income attributable to a PE in State PE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business income</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Royalties paid</td>
<td>N/A</td>
<td>(90)</td>
<td>(90)</td>
</tr>
<tr>
<td>Net profit of Sub / PE</td>
<td>N/A</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>
This example demonstrates the use of a PE to obtain treaty benefits whilst avoiding tax in the PE state through base erosion, i.e., by making notional royalty payments to other parts of the enterprise. According to the AOA, such payments are recognised for determining the profit attributable to a PE, but are not recognised for other purposes of tax treaties and thus, the state where the PE is located is not entitled to impose any source-based taxation on such payments.\textsuperscript{971} It also shows that, given the facts specified above, if a company were used instead of a PE to gain access to treaty benefits then the reduction in source-based taxation would be outweighed by the additional tax imposed on the base eroding payments (i.e., the royalties). The potential for improper access to tax treaties through PEs could therefore potentially be reduced by taxing notional payments from the PE to the rest of the enterprise; this will be discussed in Chapter 9. It should also be noted that the conclusion in this example depends not only on the non-taxation of base eroding notional payments in the PE state, but also on the residence state using the exemption method, both in relation to the income attributable to the PE and under the R-S treaty. If State R used the credit method, then the residual tax imposed in the residence state may completely offset the tax advantage of deriving the income through a PE.\textsuperscript{972}

The remainder of this section will focus on specific anti-avoidance rules which could be included in tax treaties to prevent improper access to treaty benefits through PEs, focussing primarily on the three aspects of PE taxation identified above which may tend to facilitate such abuse. The OECD Commentary on Article 1 suggests various provisions which could be included in tax treaties to prevent treaty shopping and these provisions,\textsuperscript{973} and the way in which they could be adapted to prevent treaty shopping through PEs, form the basis of the following discussion. In addition, it is generally recognised that provisions of this type may potentially have a broad scope,\textsuperscript{974} and may prevent treaty benefits in situations which should

\begin{tabular}{|c|c|c|c|}
\hline
Tax collected in State S & 30\textsuperscript{961} & .962 & .963 \\
Tax collected in State PE & N/A & 3\textsuperscript{964} & 3\textsuperscript{965} \\
WHT collected in State PE & N/A & 18\textsuperscript{966} & 3\textsuperscript{967} \\
Tax collected in State R & .968 & 9\textsuperscript{969} & 3\textsuperscript{970} \\
\hline
Total tax imposed & 30 & 30 & 3 \\
\hline
\end{tabular}

\textsuperscript{961} In accordance with the R-S treaty, State S imposes tax of $30 (30\% x $100 = $30).
\textsuperscript{962} State S is prevented from imposing tax under the PE-S treaty.
\textsuperscript{963} State S is prevented from imposing tax under the PE-S treaty.
\textsuperscript{964} The company's net profit is $10, i.e., $100 of income less $90 of royalties paid to the parent company. State PE imposes tax at a rate of 30\% on the net profit and the tax imposed is therefore: $10 x 30\% = $3.
\textsuperscript{965} The profit attributable to the PE is $10, i.e., $100 of income less $90 of notional royalties paid to the HO. The PE state imposes tax at a rate of 30\% on the net profit and the tax imposed is therefore: $10 x 30\% = $3.
\textsuperscript{966} State PE imposes withholding tax at a rate of 20\% on the royalties of $90: $90 x 20\% = $18.
\textsuperscript{967} State PE is not entitled to collect any withholding tax on notional royalty payments made by the PE.
\textsuperscript{968} State R imposes tax of $30 (i.e., $100 x 30\%), but grants a credit of $30 for tax imposed in State S. It therefore imposes no tax after the provision of relief.
\textsuperscript{969} State R imposes tax at a rate of 30\% on the royalty income of $90, but allows a credit for tax imposed in State PE ($18). The tax imposed is therefore: ($90 x 30\%) - $18 = $9.
\textsuperscript{970} State R exempts the profit attributable to the PE (i.e., $10) under the R-PE treaty and exempts the other income (i.e., $90) under the R-S treaty. There is therefore no tax imposed in State R.
\textsuperscript{972} State R would impose tax of $30 (30\% x ($90 + $10)) and would grant a credit of $3 (for the tax imposed in the PE state), leaving net tax imposed of $27. The overall tax burden would therefore be $30, which is equal to the amount of tax imposed in the other two scenarios.
\textsuperscript{973} OECD Model on Article 1, paras. 13-26. The following section will not discuss, however, the suggested provisions relating to the "look-through approach" (paras 13 and 14) or those relating to entities which are taxed under preferential tax regimes (paras 21-21.2 and paras 21.5-26), since these approaches would not be suitable for dealing with improper claims for treaty benefits through PEs.
\textsuperscript{974} De Broe, L., International Tax Planning..., at pp. 727-728 (Part 3, Chapter 7, Section 7.2.1.3., para. 505).
not be considered abusive. Thus, they should be accompanied by a some kind of safe harbour provision; such provisions will also be discussed below.

8.4.2. Subject to tax provisions

A subject to tax requirement could be included in the PE-S treaty to address concerns that PEs may claim treaty benefits in a situation where their income is not appropriately taxed in the PE state. The OECD Commentary on Article 1 includes a suggested subject to tax provision, worded along the following lines:

"Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned state under the ordinary rules of its tax law."  

To adapt this type of provision to prevent improper access to treaties through PEs, the paragraphs regarding the control of the company would not be relevant since the PE will always be part of an enterprise resident outside the PE state, and would naturally be under the control of that enterprise. In relation to PEs, the important aspect of a subject-to-tax requirement would be the taxation of the income attributable to the PE in the PE state. Thus, a provision could be included in the PE-S treaty which provides that any exemptions or reductions available to a PE under the treaty will only apply if the income in question is subject to tax in the PE state under the ordinary rules of that state's tax law. Such a provision could be worded as follows:

"Where income arising in a Contracting State is included in the income attributable to a permanent establishment located in the other Contracting State to which the Convention is applied under this Article, any provision of this convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law."

One issue which would need to be considered if such a provision is included in the treaty is what exactly is meant by the term “subject to tax”. Clearly if the PE has an overall loss, the fact that it does not actually pay any tax should not prevent the PE-S treaty from applying. Similarly, if the PE has sufficient foreign tax credits to offset the tax liability in the PE state then the income should still be considered to be subject to tax. However, things may get more difficult in other circumstances, e.g., would income be considered subject to tax if it is brought within the taxing net but is subsequently exempted? What if the PE is exempt as a result of conducting charitable activities? Clearly, the contracting states should determine the exact scope of any subject to tax provision which they include in a particular treaty.

Even if the phrase “subject to tax” can be adequately defined, a better approach may be to draft a provision that compares the tax imposed in the PE state to the tax that would be imposed if the income were derived by a resident person. Arguably, treaty benefits should only be denied if the PE’s income is taxed more favourably than it would be if derived by a resident enterprise carrying on the same activities, and requiring PEs to satisfy additional requirements would place them at a disadvantage compared to

975 OECD Commentary on Article 1, para 19; De Broe, L., *International Tax Planning…*, at pp. 726-730 (Part 3, Chapter 7, Sections 7.2.1.2.-7.2.1.5., paras. 504 to 508).

976 This has been proposed by Zhai, who suggests that the income should be considered to be “taxed normally” in the PE state (and thus the benefits of the PE-S treaty should be available) as long as the PE state does not exempt the income. Zhai, G., "Triangular Cases….”

977 OECD Commentary on Article 1, para 15.
resident enterprises. Moreover, linking the denial of treaty benefits to the favourable taxation of the PEs' income gets to the heart of the concern that the non-taxation of PE income may facilitate improper claims for treaty benefits in a way that the availability of treaty benefits to resident entities does not. Thus, it would be preferable for a "subject-to-tax" provision applicable to PEs to operate by reference to the tax that would be imposed on a resident enterprise deriving the same income as the PE in the same circumstances, rather than simply requiring that the PEs' income is taxed in the PE state. Such a provision could be worded as follows:

"Where this Convention applies under this article to income arising in a Contracting State and included in the income attributable to a permanent establishment located in the other Contracting State, any provision of this Convention conferring an exemption from tax, or a reduction of tax shall apply only to income that is subject to tax in the last-mentioned State which is equivalent to the tax that would be imposed in that state if the income were derived by a resident of that State in the same circumstances as the permanent establishment."

This assumes, of course, that tax is imposed on the income attributable to a PE in the same way that tax is imposed on income derived by resident persons, such that a comparison can reasonably be made. This may be relatively straightforward in the case of passive income, but in the case of business income the PE state may, for example, use a different tax base for PEs than for resident enterprises. Clearly states would need to take into account the way in which they impose tax on PEs when drafting a subject-to-tax provision which operates by reference to the tax that would be imposed on a resident enterprise, and must consider the extent to which such a comparison could be made. Where there would be difficulties in making the comparison the provision suggested above would need to be modified or, if a modification cannot resolve the issue, the contracting states may need to take a different approach.

8.4.3. Denial of treaty benefits in base erosion situations

The OECD Commentary contains a suggested provision, referred to as the "channel approach," which could be included in tax treaties to deal with stepping-stone structures, i.e., where the taxable income of a conduit entity is reduced to a minimal level by base eroding deductible payments. The suggested provision is worded as follows:

"Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more person who are not residents of that other Contracting State

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on material goods and possessions)."\textsuperscript{978}

A base erosion test is also included in the suggested Limitation on Benefits (LOB) provision contained in the OECD Model Commentary, in combination with an ownership test. This test provides that treaty benefits will only be available if, broadly:

\textsuperscript{978} OECD Commentary on Article 1, para 17.
(i) On at least half the days of the fiscal year, persons that are qualified persons under certain provisions of the LOB own at least 50% of the aggregate vote and value of the shares or other beneficial interests in the entity\(^{979}\) (the "ownership test"), and

(ii) That less than 50% of the entity's gross income is paid or accrued to persons who are not resident in either of the contracting states in the form of payments that are deductible for income tax purposes (excluding arm's length payments in the ordinary course of business for services or tangible property) (the "base erosion test").\(^{980}\)

Both these requirements must be met in order for the benefits of the treaty to be available under this paragraph of the LOB.

Both the "channelling" provision and the LOB test refer to the ownership of the entity which is claiming treaty benefits; the general channelling provision cannot apply to deny treaty benefits unless the company claiming treaty benefits is controlled by persons who are not resident in that company's residence state, while satisfying the LOB provision (in order to be entitled to treaty benefits) requires that "qualified persons" own at least 50% of the shares in the entity. Clearly these ownership tests are not relevant and could not reasonably be applied in the case of a PE, since a PE will always be part of an enterprise resident outside the PE state, and thus under the control of a non-resident enterprise. The focus of an equivalent provision for PEs should therefore be on the base erosion aspect of the test, rather than on ownership. Such a provision could be worded as follows:

"Where income arising in a Contracting State is included in the income attributable to a permanent establishment located in the other Contracting State to which the Convention applies under this Article, any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of the gross income attributable to the PE is paid or accrued to persons who are not resident in either of the contracting states in the form of payments that are deductible, including notional payments to other parts of the enterprise to which the PE belongs, but excluding arm's length payments in the ordinary course of business for services or tangible property."\(^9\)

This suggested provision is based on the provision found in the OECD Commentary LOB, in that it excludes arm's length payments in the ordinary course of business for services or tangible property. A provision excluding such payments seems preferable since it would be less likely to result in the denial of treaty benefits in non-abusive situations. It is worded to be included in the provision extending treaty benefits to PEs, but could also be included in a separate treaty article (in which case the reference to "this Article" would have to be changed to refer to the article under which treaty benefits are extended to PEs.)

Where a treaty contains an anti-base erosion provision applicable to resident enterprises, then an equivalent provision should clearly apply where treaty benefits are claimed in relation to the income attributable to a PE. However, if there is no such provision then, as an alternative to considering all payments made by the PE, the anti-base erosion principle could focus solely on notional payments made by the PE to the rest of the enterprise. Such notional payments are the primary reason why PEs may give rise to greater base erosion concerns than resident enterprises, and it therefore seems reasonable to focus an anti-avoidance provision on situations involving these payments. In addition, a broader test would require PEs to satisfy more stringent requirements than resident enterprises which would arguably not be justified by the differences between PEs and resident enterprises.

A provision focusing on base-eroding notional payments could be worded as follows:

"Where income arising in a Contracting State is included in the income attributable to a permanent establishment located in the other Contracting State to which the

\(^{979}\) The actual wording of this part of the test requires that "on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph a), b) or d) or subdivision c)(i) of this paragraph [i.e., the LOB] own, directly or indirectly, at least 50 per cent of the aggregate vote and value of the shares or other beneficial interests in the person [i.e., the person claiming treaty benefits]" (OECD Commentary on Article 1, para 20, clause 1(e)(i)). A person is a "qualified person," and thus entitled to treaty benefits, if they meet certain tests contained in the LOB.

\(^{980}\) OECD Commentary on Article 1, para 20, clause 2(e). The equivalent paragraph of the US Model LOB is very similar (see: 2006 US Model Convention, Article 22, para 2(e)).
Convention applies under this Article, any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of the gross income attributable to the PE is considered to be paid or accrued to other parts of the enterprise to which the permanent establishment belongs for the purposes of determining the profit attributable to the permanent establishment in the form of payments that are deductible (excluding arm's length payments in the ordinary course of business for services or tangible property).”

More generally, under the provisions suggested in the OECD Commentary, treaty benefits are denied regardless of whether the payments are made to related or unrelated parties. However, in cases of treaty shopping through base erosion, an important factor is that the company to which the conduit pays deductible items is controlled by the treaty shoppers.981 Thus the contracting states may wish to limit the scope of the provision, such that it only considers payments made to related parties. An equivalent provision applicable to PEs (assuming it is not limited to notional payments) would presumably consider payments made to related parties of the entity to which the PE belongs, and to other parts of the enterprise.

8.4.4. Denial of treaty benefits where there is a tax avoidance motive

The OECD Commentary suggests a provision which would deny reductions in source based taxation of certain types of income where a tax avoidance motive exists.982 The types of income to which the provision would apply are dividends (Article 10), interest (Article 11), royalties (Article 12) and other income (Article 21), and the provision is intended to be included separately in each of those articles. The suggested wording of the provision, using the example of dividends, is as follows:

"The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment."983

The wording of the provision can be relatively simple, but, as De Broe has noted, "it has the inherent difficulty of obliging the tax authorities of the source state to determine the taxpayers intentions".984 It can thus create uncertainty in the application of the treaty and lead to protracted disputes between taxpayers and tax authorities. Nevertheless, this approach could be adapted to limit improper claims for treaty benefits by PEs. Such a provision could be worded as follows, again using the example of dividends:

"The provisions of this Convention shall not apply under this Article if it was the main purpose or one of the main purposes of any person concerned with the creation of the permanent establishment or any actions which cause the dividends to be included in the profit attributable to the permanent establishment to take advantage of this Article by means of that creation or attribution."

Alternatively, the provision could be worded more generally to apply to all categories of income, not only dividends, interest and royalties, as follows:

981 OECD Commentary on Article 1, para 19; De Broe, L., International Tax Planning… at pp. 727-728 (Part 3, Chapter 7, Section 5.2.1.3., para. 505).
982 OECD Commentary on Article 1, para 21.4. This provision is similar to provisions which have been included for many years in UK treaties (see: De Broe, L., International Tax Planning… at Chapter 7, p. 731 (Part 3, Chapter 7, Section 5.2.1.7., para. 511).
983 OECD Commentary on Article 1, para 21.4. That paragraph contains alternative wording for inclusion in the various treaty articles as follows: "The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: "shares or other rights"; Article 11: "debt-claim"; Articles 12 and 21: "rights"] in respect of which the [Article 10: "dividends": Article 11: "interest"; Article 12: "royalties"; Article 21: "income"] is paid to take advantage of this Article by means of that creation or assignment."
984 De Broe, L., International Tax Planning… at p. 731 (Part 3, Chapter 7, Section 5.2.1.7., para.. 511).
The provisions of this Convention shall not apply under this Article in relation to any item of income if it was the main purpose or one of the main purposes of any person concerned with the creation of the permanent establishment or any actions which cause that income to be included in the profit attributable to the permanent establishment to take advantage of this Article by means of that creation or attribution.

Of course the exact wording of this type provision would have to be determined by the contracting states, who may wish to give further consideration to the types of activities or actions which would be considered in determining whether treaty benefits should be denied.

8.4.5. Limitation on benefits provisions

Some treaties do not allow residents of the contracting states to benefit from treaty reductions in source based taxation unless they also satisfy a limitation on benefits (LOB) provision. If the PE-S treaty contains an LOB, the question arises as to whether the terms of the LOB should be required to be satisfied before a PE can claim treaty benefits, or perhaps more realistically, whether any of the typical provisions of LOBs could be adapted to apply to PEs.

If the terms of an LOB are applied, the first question is whether they should be applied in relation to the PE itself or in relation to the entity to which the PE belongs. Arguably, the LOB should be applied in relation to the PE itself (if at all), since the entity to which the PE belongs is not resident in either of the contracting states. As discussed above, claims for treaty benefits in relation to the income attributable to a PE should not depend on the residence of the entity as a whole. As will be seen below, however, the majority of the tests contained in LOB provisions do not have any relevance or cannot be reasonably applied in the context of a PE.

As discussed in Chapter 4, LOB articles are contained in virtually all the treaties concluded by the United States and the United States is one of the contracting states in the majority of treaties containing an LOB article. The Commentary to the OECD Model Convention also contains suggested wording for an LOB provision, and its provisions are similar to those of the US Model treaty. The discussion in this section will focus on the wording of the LOB provision contained in the OECD Commentary and the ways in which it could be adapted to apply in situations where PEs are entitled to treaty benefits.

Stock exchange listing test

Under the suggested LOB contained in the OECD Model, a company is a "qualified person," and thus not excluded from entitlement to treaty benefits if the principal class of its shares is listed on a recognised stock exchange and is regularly traded on one or more recognised stock exchanges. Clearly,
this cannot be reasonably by applied in relation to a PE claiming treaty benefits since a PE is not a separate legal entity and thus cannot be listed. Further, the listing of the entity to which the PE belongs is arguably not relevant for the application of the PE-S treaty in relation to the income attributable to the PE, since a listed company is also capable of engaging in tax planning.991

Ownership and base erosion test

The ownership and base erosion test was discussed above, in Section 8.4.3., and will not be discussed further here. It was concluded above that while the application of an ownership test is not feasible, PEs could be subject to a base erosion test constructed along the lines of that included in the LOB provision suggested by the OECD Model Commentary.

Active business test

The LOB provision in outlined in the OECD Commentary provides that treaty benefits will be available in relation to a particular item of income derived by a resident of one of the contracting states if the person deriving that income is "actively carrying on business" in their residence state and the income is "derived in connection with, or is incidental to, that business."992 Unlike the other tests contained in the LOB, this test is applied in relation to particular items of income for which treaty benefits are claimed, rather than the person deriving the income. Thus, if this requirement is satisfied, treaty benefits are available in relation to the item of income in question regardless of whether or not the person deriving it is a "qualified person" under any other paragraph of the LOB.

The active business test could potentially be adapted to apply to PEs by including a provision to the effect that a PE will be entitled to treaty benefits with respect to a particular item of income if the PE is actively carrying on business in the PE state and derives the income in connection with or incidental to the conduct of that business. The basic definition of a PE in Article 5 of the OECD Model is "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and therefore, in order for a PE to exist under this basic definition, there must be business activities carried on in the PE state. Nevertheless, the question may arise in some cases as to whether the PE's activities in the PE state, if considered independently from the activities carried on by the rest of the enterprise, would be sufficient to constitute actively carrying on business. In addition, under Article 5(5), an agency PE will exist where a person is acting on behalf of an enterprise and has and habitually exercises the authority to conclude contracts. This provision does not refer to business activities and the activities of a particular agency PE may not be considered to amount to carrying on business. Depending on the exact nature of their activities, therefore, certain PEs may be considered to be actively carrying on business. The other requirement of the active business test is that the income is "derived in connection with, or is incidental to, that business." Where a PE is considered to be actively carrying on business, it would be difficult to argue that any income which is considered to be attributable to the PE would not be "derived in connection with, or incidental to" the business carried on by the PE.

More broadly, the active business test is intended to allow claims for treaty benefits in situations where the person deriving the income has a sufficient link to their residence state by virtue of conducting business activities there (and where the income has a sufficient link to those business activities). In the case of a PE, however, this type of requirement does not seem to add any particular value. By definition, PEs will usually be carrying on business activities in the PE state, even if they may not amount to a complete business when considered independently of the activities conducted by the entity as a whole.

991 Closely held companies may potentially be subject to less oversight and thus more likely to engage in aggressive tax planning, but clearly tax avoidance concerns would still exist with respect to listed companies.

992 The LOB article of the US Model Convention provides that the benefits under the convention will be available with respect to an item of income derived in connection with (or incidental to) the active conduct of a trade or business in the residence state (referred to herein as the "active trade or business test") (see: 2006 US Model Convention, Article 22, para 3(a)). The active conduct of a trade or business is a detailed US domestic law concept, and the consideration of the circumstances in which there may be a "trade or business" and in which income may be derived in connection with (or incidental to) that trade or business are beyond the scope of this study. For a discussion of these issues in the US context, see: 2006 US Model Technical Explanation, pp. 69-72
Furthermore, the income attributable to a PE clearly has a strong link to the PE state, given the way in which the profit attributable to a PE is determined,\(^{993}\) and this link should be sufficient to enable the PE to claim treaty benefits (subject to any other specific provisions limiting the availability of treaty benefits to PEs). Taking into account the difficulties in applying an active business test, requiring PEs to meet such a test in order to be entitled to treaty benefits does not seem to be appropriate.

### 8.4.6. Safe harbour provisions

The OECD Commentary suggests a number of safe harbour provisions which could be included in tax treaties to counteract the potential denial of treaty benefits under a specific anti-avoidance provision in bona fide situations. A number of these provisions could be adapted to allow claims for treaty benefits in relation to the income attributable to a PE in situations where such claims would be considered legitimate but which nonetheless trigger a denial of treaty benefits under a specific anti-abuse provision included in the treaty. The safe harbour provisions suggested in the OECD Commentary, and the way in which they could be adapted to apply to PEs, are outlined below.

**General bona fide provision:**

A general bona fide provision allows the provisions of the treaty to continue to apply where the circumstances leading to the claim for treaty benefits are motivated by sound business reasons and not driven by the treaty claim. The suggested provision in the OECD Commentary is worded as follows:

"The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as a primary purpose the obtaining of any benefits under this Convention."\(^{994}\)

This could clearly be adapted to situations where PEs are entitled to treaty benefits. Such a provision could be worded as follows:

"The provision of this Convention shall not apply under this Article\(^{995}\) where the person to which the permanent establishment belongs establishes that the principal purpose of the permanent establishment, the conduct of its business and, if applicable, that the acquisition or maintenance by it of property from which the income in question is derived, are motivated by sound business reasons and do not have as a primary purpose the obtaining of any benefits under this Convention."

The LOB provision suggested in the OECD Commentary includes a similar provision which gives the contracting states the discretion to allow treaty benefits in situations where the specific terms of the LOB may not be satisfied. This provision is worded as follows:

"A resident of a Contracting state that is neither a qualified person pursuant to ... or entitled to benefits under... shall, nevertheless, be granted benefits of the Convention if the competent authority of the other Contracting State determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention".\(^{996}\)

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\(^{993}\) For discussion of the separate enterprise approach for determining the profit attributable to a PE, see Chapter 5 (Section 5.2.5).

\(^{994}\) OECD Commentary on Article 1, para 19(a).

\(^{995}\) This provision is designed to be included in the article of the treaty which extends treaty benefits to PEs.

\(^{996}\) OECD Commentary on Article 1, para 20 (5).
A similar provision could be included in tax treaties to allow treaty benefits to be extended to PEs at the source states discretion, even if the PE would otherwise be denied treaty benefits as a result of a specific anti-abuse provision. Such a provision could be worded as follows:

"A person deriving income through a permanent establishment established in one of the Contracting States which would be entitled to benefits paragraph 1 of this Article but is not entitled to benefits as a result of the application of [paragraph X or Y] of this Article, shall, nevertheless, be granted benefits of the Convention under this Article if the competent authority of the other Contracting State determines that the establishment, acquisition or maintenance of the permanent establishment and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention."

There is clearly an overlap between this provision and the general bona fide provision discussed above, and a general provision allowing PEs to claim treaty benefits in bona fide situations could be modelled on either of these two suggested provisions.

**Activity provision**

An activity provision allows a claim for treaty benefits in circumstances where the person claiming treaty benefits engages in substantial activities in their residence state. The suggested provision in the OECD Commentary is as follows:

"The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed in the other Contracting State is with respect to income that is connected with such operations."

This type of provision could also be adapted to apply in the context of PEs. Such a provision could be worded as follows:

"[Paragraphs X and Y shall not apply where the permanent establishment is engaged in substantive business operations in the Contracting State in which it is located and the relief from taxation claimed in the other Contracting State is with respect to income that is connected with such operations."

Typically, where a PE exists under Article 5(1), the PE will exist as a result of business activities carried on through a fixed place of business, which would in most cases presumably amount to substantial business activities. This is the idea behind the PE concept, i.e., the PE state is entitled to impose tax on the income attributable to the PE because the entity carries on a sufficient level of business activities in that state to justify taxation. In this case, the first part of the test would be satisfied, and presumably all the income attributable to the PE would be connected with those business operations, with the result that the safe harbour rule would apply. In the context of PEs, this provision may therefore substantially reduce the situations in which treaty benefits are denied under specific anti-avoidance rules (e.g., it may allow treaty benefits to be claimed even in base erosion situations or in situations where the PE is not taxed in the PE state on foreign source income). This impact on the effectiveness of the anti-abuse rules should be taken into account by the contracting states if they are considering including such a provision in their treaty. However, to the extent that substantial business activities are carried on in the PE state,

997 The paragraphs denying treaty benefits. This provision is worded on the basis that it would be included in the article of the treaty which extends treaty benefits to PEs, and which includes the specific provisions denying treaty benefits in certain cases.

998 OECD Commentary on Article 1, para 19(b).

999 The paragraphs denying treaty benefits. This provision is worded on the basis that it would be included in the article of the treaty which extends treaty benefits to PEs, and which includes the specific provisions denying treaty benefits in certain cases.

1000 In the case of agency PEs, under Article 5(5), this may not necessarily be the case. The different types of PEs are discussed in Chapter 5 (see Section 5.2.4.).
and to the extent that the income in question has a sufficient connection to those business activities to be attributable to the PE, then it seems somewhat unreasonable to deny treaty benefits.

**Amount of tax provision**

An amount of tax provision allows a claim for treaty benefits where the reduction in tax is less than the tax imposed in the residence state. The suggested provision in the OECD Commentary is as follows:

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."\(^{1001}\)

This provision operates on the premise that if the tax imposed in the residence state is greater than the reduction in tax available in the source state under the treaty, then the company has clearly not been established to take advantage of the treaty since the benefit of applying the treaty is outweighed by the tax imposed in the residence state. This test could also be applied to PEs, substituting the PE state for the residence state. Such a provision could be worded as follows:

"\[Paragraphs X and Y\] shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of in which the permanent establishment is located."\(^{1002}\)

**Stock exchange provision**

A stock exchange provision allows a claim for treaty benefits by an entity which is listed on a stock exchange in its residence state. The suggested provision in the OECD Commentary is as follows:

"The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned – directly or indirectly through one or more companies each of which is a resident of the first-mentioned state – by a company which is a resident of the first-mentioned state and the principal class of whose shares is so registered."\(^{1003}\)

This test is clearly not relevant to PEs, since a PE is not a separate legal entity. It would also not make sense to include a safe harbour which is based on the entity to which the PE belongs being a listed company (or a subsidiary of a listed company) since there is no reason to believe that a public company could not establish a PE in order to claim what may be considered improper treaty benefits in the source state.

**Alternative relief provision**

An alternative relief provision allows a claim for treaty benefits

"In cases where an anti-abuse clause refers to non-residents of the Contracting State, it could be provided that the term shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation that is not less than the relief from taxation claimed under this Convention."\(^{1004}\)

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\(^{1001}\) OECD Commentary on Article 1, para 19(c).

\(^{1002}\) The paragraphs denying treaty benefits. This provision is worded on the basis that it would be included in the article of the treaty which extends treaty benefits to PEs, and which includes the specific provisions denying treaty benefits in certain cases.

\(^{1003}\) OECD Commentary on Article 1, para 19(d).

\(^{1004}\) OECD Commentary on Article 1, para 19(e).
This type of safe harbour would be very useful in allowing the PE-S treaty to apply in a PE triangular case in circumstances where the person deriving the income would be entitled to an equivalent reduction in source based taxation under the R-S treaty if the income were not attributable to the PE. Such a provision could be worded as follows:

"[Paragraphs X and Y] shall not apply if the person to which the permanent establishment belongs would be entitled to relief which from taxation (if the income were not attributable to a permanent establishment), under a treaty between a third state and the Contracting State from which relief from taxation is claimed, and that relief is not less than the relief from taxation claimed under this Convention."

This assumes, of course that the R-S treaty contains specific provisions excluding its application in the source state in PE triangular cases. If this is not the case, i.e., if the source state is subject to the conditions of both the R-S treaty and the PE-S treaty, then the source state can only satisfy its treaty obligations by applying the conditions which are most favourable to the taxpayer. In such cases, this type of safe harbour provision would have no operation, since either the R-S treaty conditions will be less favourable, or the source state will apply those conditions rather than the conditions of the PE-S treaty. It could, nevertheless, be included in the PE-S treaty with no adverse consequences.

8.4.7. Conclusions

The potential risks of treaty shopping if treaty benefits were extended to PEs were discussed in detail Chapter 5 (Section 5.2.6.). This section has not dealt with these general considerations, but has focussed on specific provisions which could be included in tax treaties to prevent improper claims for treaty benefits by PEs. These provisions could be used to address the potentially increased risk of treaty shopping which may exist in relation to PEs due to the non-recognition of notional payments for purposes other than profit attribution, and the potential for favourable taxation of the PEs income in comparison to the income of residents of the PE state.

Where a treaty contains specific anti-avoidance provisions applicable to resident persons, those provisions should be adapted so that an equivalent provision can be applied to PEs claiming treaty benefits. However, where the treaty does not contain any such provisions applicable to resident persons, then arguably, the PE should only be denied treaty benefits in situations where the PEs income is taxed more favourably than that of resident persons, since it is in these situations that the extension of treaty benefits to PEs may facilitate treaty shopping. The treaty could, for example, include a subject-to-tax provision which compares the tax imposed on the income attributable to the PE to the tax that would be imposed on a resident of the PE state deriving the same income. It could also include a base erosion test focussing on notional payments from the PE to the rest of the enterprise.

The exact provisions to be included in the treaty should be a matter for negotiation between the contracting states and should deal with their concerns regarding the potential for improper access to the treaty through PEs. If the treaty does include specific provisions denying treaty benefits in certain circumstances, it should also include savings provisions to prevent denial of treaty benefits in bona fide situations. The specific savings provisions to be included in a particular treaty would depend on the nature of the anti-abuse provisions included in the treaty and would also be a matter for negotiation between the contracting states.

8.5. Conclusions

Clearly, the way in which specific provisions extending treaty benefits to PEs are drafted must be carefully considered, taking into account their impact on the application of the various treaty articles both in PE triangular cases and in other situations involving PEs. This chapter has generally referred to claims for
treaty benefits by PEs, but in practice, such claims should be made by the entity to which the PE belongs, since this is the entity which would generally be taxable in relation to the income attributable to the PE under the domestic laws of the states involved. This would require an exception to Article 1 for non-residents operating through a PE in one of the contracting states in relation to any income attributable to that PE and derived from sources in the other contracting state. In addition, the operation of the provision extending treaty benefits to PEs should depend on the existence of a PE for the purposes of the R-PE treaty. This would require a specific provision to ensure that the PE definition contained in the R-PE treaty applies for determining whether there is a treaty-eligible PE in the PE state for the purposes of the PE-S treaty. In general, neither the PE nor the entity to which the PE belongs should be required to satisfy any conditions with respect to residence or beneficial ownership; rather, the entitlement to treaty benefits should be based on the existence of a PE under the R-PE treaty and the attribution of profit to that PE. However, the availability of treaty benefits may still be subject to the requirements of a specific provision aimed at preventing improper claims for treaty benefits (i.e., treaty shopping).

One of the main concerns with extending treaty benefits to PEs is that doing so would facilitate treaty shopping. As discussed in detail in Chapter 5, and briefly in this chapter, there are some aspects of the taxation of PEs which may result in opportunities for treaty shopping through PEs that would not exist in the case of separate legal entities. However, this may be offset by the fact that the determination of the income attributable to a PE is based on an economic and factual analysis, rather than being based on legal ownership, and thus the income attributable to the PE will always have a significant economic link to the PE state. Nevertheless, the contracting states may which to include specific provisions in the treaty to prevent claims for treaty benefits in certain circumstances where such claims may be considered to be improper. Such provisions could take the form of a subject-to-tax requirement, a base erosion test, or a provision denying treaty benefits where there is a tax avoidance motive. However, where the treaty does not contain equivalent provisions applicable to resident enterprises claiming treaty benefits, the provision applicable to PEs should only deny treaty benefits in situations where, for example, the PE is taxed more favourably than a resident enterprise or makes excessive notional payments to other parts of the enterprise. Any such provision should also be accompanied by safe harbour provisions to prevent the denial of treaty benefits in non-abusive situations.