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

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Chapter 12
Reverse triangular cases

12.1. Introduction
Reverse triangular cases occur where a person who has a connection to two separate states pays an amount which forms part of the income of a resident of a third state. There are two types of reverse triangular cases, distinguished by the nature of the connection between the payor and the source states, namely, reverse PE triangular cases and reverse dual resident triangular cases. In a reverse PE triangular case, the payor is resident in one state and the payment originates from a PE in another state. In a reverse dual resident triangular case, the payor is resident in two states under their respective domestic laws and for treaty purposes and is therefore a dual resident. These situations stand in contrast to the situations discussed throughout the earlier chapters in that it is the payor, rather than the recipient of income who has a connection to more than one state. They are, in effect, a mirror image.

The main issue in reverse triangular cases is the potential for the income to be subject to source-based taxation in more than one state. In a reverse PE triangular case, both the residence state and the PE state of the payor may seek to impose source-based taxation. Similarly, in a reverse dual resident triangular case, both residence states of the payor may seek to impose tax on payments made by the dual resident. Both these situations may therefore lead to dual source-based taxation, at least in the absence of any applicable treaty limitation. As will be seen below, however, in both types of reverse triangular cases the person deriving the income will be entitled to claim the benefit of the treaties between its residence state and the two source states and consequently, dual source based taxation will generally only occur in relation to passive income, such as dividends, interest and royalties. The discussion in this chapter therefore focuses primarily on situations involving these types of income, although it will also outline the result of the application of tax treaties where other categories of income are involved.

Where source-based taxation is imposed in two states in accordance with the terms of the treaties between those states and the residence state of the recipient, the residence state of the recipient will generally be obliged to provide relief for tax imposed in both those states. This relief could take the form of either a credit or an exemption, but in the case of passive income it would usually be in the form of a credit even if the general method of relief used in the treaty is the exemption method. Where taxation is imposed on a source basis in two different states, however, the residence state of the person receiving the income may not be capable of providing sufficient relief and unrelieved double taxation may arise. The only way of preventing such unrelieved double taxation would be to limit the amount of tax imposed on a source basis. This could be done by limiting the amount of tax imposed in each of the source states to a sufficiently low amount, or by preventing one of the source states from imposing tax so

1277 In accordance with Article 23A / Article 23B of its treaties with each of the source states.
1278 Article 23A (dealing with the exemption method) requires the residence state to provide a credit in relation to income taxable in the other contracting state under Article 10 (dividends) or Article 11 (interest). In concluded treaties that (unlike the OECD Model) allow source-based taxation of royalties, this provision generally also refers to income taxable under Article 12 (i.e., royalties).
1279 For a discussion of situations where the residence state will and will not be able to provide sufficient relief for dual source-based taxation, refer to Chapter 3 (Section 3.2., which discusses relief in the residence state in PE triangular cases). In general, the residence state's ability to provide sufficient relief will depend on the effective rates of tax imposed in the source states relative to the effective rate of tax imposed in the residence state. Note that in reverse triangular cases, the relief in the PE state (discussed in Section 3.2.2.) will not be relevant.
that source-based taxation is imposed in only one state. If the residence state is capable of providing sufficient relief, then the case for preventing one of the source states from imposing tax may not be as strong and indeed, both states may have a legitimate claim to impose tax based on the link between the payment and their jurisdiction. Nevertheless, the risk of unrelieved double taxation suggests that dual source-based taxation should generally be prevented wherever possible, and this chapter will proceed on that basis.

**Scope and assumptions**

Reverse triangular cases can also give rise to double taxation if one or both of the source states fails to allow a deduction for business expenses, such as commissions or service fees, paid to a resident of a third state. Where such payments are taxable in the residence state of the recipient this can effectively lead to economic double taxation. This issue is not dealt with in this chapter for two reasons. Firstly, this issue can also arise in bilateral situations, e.g., where a resident of one state makes a payment to a resident of another state. Thus, although the quantum of the economic double taxation may be greater where there are two sources states, this is not an issue that is unique to reverse triangular cases. Secondly, the non-deductibility of business expenses gives rise to economic rather than juridical double taxation, which is outside the scope of the OECD Model, and also outside the scope of this study. This chapter therefore focuses solely on the potential unrelieved double taxation that may occur as a result of two states imposing source-based taxation where payments are made by a dual resident or by a person who is resident in one state but has a PE in a second state from which the payment originates.

The analysis in this chapter deals only with certain categories of income identified in the OECD Model, namely, business profits (Article 7), dividends (Article 10), interest (Article 11), royalties (Article 12), income from immovable property (Article 6), income from shipping, inland waterways transport and air transport (Article 8), capital gains (Article 13) and other income (Article 21). It does not discuss income from employment (Article 15), directors' fees (Article 16), income of artistes and sportsmen (Article 17, although Article 17 is discussed briefly in relation to business income), pensions (Article 18), government service (Article 19) or students (Article 20), which are outside the scope of this study.

Throughout this chapter it is assumed that bilateral tax treaties have been concluded between all the relevant states. It is further assumed that all these treaties follow the OECD Model except where specifically stated.

**Abbreviations**

In this chapter, the state where the recipient of the income is resident is referred to as “State R” in both reverse PE triangular cases and reverse dual resident triangular cases. In reverse PE triangular cases, the state where the payor of the income is resident is referred to as the “head office state” or “State HO” and the state where the PE from which the payment originates is located is referred to as the PE state or “State PE.” State HO and State PE are sometimes referred to collectively as the “source states.”

In reverse dual resident triangular cases, the two residence states of the payor are referred to either as “State A” and “State B” or, when discussing situations where the tie-breaker rule of the treaty between the two residence states has assigned residence to one state, as the winning residence state (“State W”) and the losing residence state (“State L”). These two states are also referred to collectively as the “source states” when discussing reverse dual resident triangular cases.

**12.2. Reverse PE triangular cases**

Reverse PE triangular cases occur where a person who is resident in one state (generally referred to as the "head office state" or "State HO") makes a payment which originates from a PE of the payor located in a second state (the "PE state" or "State PE") and which is received by a resident of a third state (the "recipient state" or "State R"). It is assumed that the recipient of the income does not have a PE in either State HO or State PE. This situation is illustrated in the following diagram.
Tax treatment in the absence of income tax treaties

In this situation it is assumed that both State HO and State PE view the income as locally sourced income under their respective domestic laws and that both states seek to impose tax on the recipient of the income, either by assessment or by withholding at source. It is also assumed that the recipient's residence state will seek to impose tax on the income on a residence basis. Thus, in the absence of any applicable tax treaties, tax could be imposed in State HO, State PE and State R. State R may provide double taxation relief under its domestic law, however for the purposes of the analysis below it will be assumed that no such unilateral relief is available.

Applicable treaties

In a reverse PE triangular case, the recipient of the income will be entitled to claim the benefit of the treaties which its residence state has concluded with each of the two source states. The applicable tax treaties in this case will therefore be:

(i) the treaty between the recipient's residence state and the head office state of the payor (the "R-HO treaty"); and
(ii) the treaty between recipient's residence state and the PE state of the payor (the "R-PE treaty").

For the purposes of both these treaties, the person receiving the income will be resident in State R and, as a result, may claim reductions in source based taxation in both State HO and State PE. The treaty between State HO and State PE (the "HO-PE treaty") will generally not apply because for the purposes of this treaty the recipient of the income is not resident in either of the contracting states.

The discussion of reverse PE triangular cases in this chapter deals firstly with situations involving dividends (in Section 12.2.1.), before moving on to deal with situations involving interest and royalties (in Section 12.2.2.) and finally, other categories of income (in Section 12.2.3.).

12.2.1. Dividends

In this situation the payor of the dividends, resident in State HO, has derived profits which are attributable to a PE in State PE, and has paid those profits out in the form of dividends to a resident of a third state, State R. A reverse PE triangular case involving dividends is illustrated in the following diagram.

Figure 12.2.: Reverse PE triangular case involving dividends
12.2.1.1. Application of tax treaties under the existing treaty framework

As will be seen below, the application of tax treaties will generally prevent dual source-based taxation of dividends in reverse PE triangular cases. Article 10 applies to dividends paid by a resident of one contracting state to a resident of the other contracting state, and allows the state of the payor to impose a limited rate of tax on the gross amount of the dividend.\textsuperscript{1280} Such tax is typically imposed by way of a withholding tax. In a reverse PE triangular case, therefore, the residence state of the payor will generally be entitled to impose tax on the dividends under Article 10 of its treaty with the residence state of the person receiving the dividends (i.e., the R-HO treaty). Article 10 will not apply, however, for the purposes of the treaty between the recipient’s residence state and the PE state (the R-PE treaty) because the dividend is not paid by a resident of State PE. Instead, the income will fall under either Article 7 or Article 21 of the treaty depending upon whether or not it is considered to be business profits.\textsuperscript{1281} Regardless of which of these two articles applies, the PE state will be prevented from imposing any tax on the dividends, since that the recipient of the income does not have a PE in the PE state.\textsuperscript{1282} Thus, source based taxation can only be imposed in State HO. State R may also impose tax but will be obliged to provide relief for tax imposed in State HO (under the R-HO treaty). There will therefore be no unrelieved double taxation.

Article 10 also contains a specific paragraph (Article 10(5)) which prevents a contracting state from imposing tax on dividends paid by a resident of the other contracting state, except in situations where those dividends are received by a resident of the state seeking to impose tax or are attributable to a PE in the first mentioned state.\textsuperscript{1283} Article 10(5) of the treaty between State HO and State PE may therefore also potentially prevent taxation in the PE state in a reverse PE triangular case.\textsuperscript{1284} However, given that the PE state will already be prevented from taxing the dividend under Article 7 or Article 21 of the treaty with the recipients residence state, it would generally not be necessary to apply Article 10(5) to prevent the PE state from imposing tax.\textsuperscript{1285} Article 10(5) will be discussed further in the context of reverse dual resident triangular cases (see Section 12.3.1.), and that discussion would also be relevant in reverse PE triangular cases if, for example, there is no treaty between the PE state and the residence state of the person receiving the income.

12.2.1.2. Policy considerations

One question which deserves to be raised in respect of reverse PE triangular cases involving dividends is whether the taxation of such income in the residence state of the payor, and not in the PE state, is appropriate or whether the PE state should be entitled to impose tax on dividends paid out of the profits attributable to the PE. It could be argued that if the PE is to be treated in the same way as a separate enterprise,\textsuperscript{1286} then the PE state should be entitled to impose tax on distributions of the PE’s profit.\textsuperscript{1287}

\textsuperscript{1280} Refer to Article 10(1) and Article 10(2) of the OECD Model.
\textsuperscript{1281} Avery Jones, J.F., et al., “Tax Treaty Problems….” Article 7, titled “Business Profits,” applies to “Profits of an enterprise of a Contracting State…” (Article 7(1)), and allows source based taxation only in relation to business profits which are attributable to a PE in the source state. Article 21, titled “Other Income,” applies to “Items of income… not dealt with in the foregoing articles of this Convention…” (Article 21(1)). Article 21 does not allow any source-based taxation, however if the income is attributable to a PE in the source state, Article 7 will apply instead of Article 21 as a result of Article 21(2).
\textsuperscript{1282} Avery Jones, J.F., et al., “Tax Treaty Problems….”
\textsuperscript{1283} Article 10(5) provides that: “Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other Contracting State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State.”
\textsuperscript{1284} Avery Jones, J.F., et al., “Tax Treaty Problems…”; Hattingh, P.J., “The Role and Function….”
\textsuperscript{1285} Avery Jones, J.F., et al., “Tax Treaty Problems…”; Hattingh, P.J., “The Role and Function….”
\textsuperscript{1286} As proposed in earlier chapters. Refer to Chapter 5 for discussion of the similarities between PEs and resident enterprises and for arguments supporting a more residence-like treatment of PEs. Refer also to Chapter 7 and Chapter 8, for discussion of the proposed extension of treaty benefits to PEs.
However, if this approach were accepted it would arguably entitle the PE state to impose tax on notional profit distributions (dividends) from the PE to the rest of the enterprise, rather than dividends paid by the enterprise as a whole. This would raise a number of serious difficulties, particularly in determining the timing and amount of any such notional distributions. Allowing the PE state to impose tax on (part of) the dividends paid by the company as a whole, e.g., as a proxy for imposing tax on notional dividends, would also require a determination of the timing and amount of the dividends which should be considered to be paid from the profit attributable to the PE. This is likely to be very difficult and, in many cases, arbitrary, since dividends are paid from the overall net profit of the company which is likely to have been derived over various periods and from various sources. In addition, the residence state arguably has the stronger claim to imposing source-based taxation on dividends given that, from a company law perspective, the declaration (and payment) of dividends is an integral activity of the company itself and of its management, and thus has a strong connection to the organisation and residence of the company as a whole, whether that be based on incorporation or, for example, on the place of effective management. Thus, it is appropriate that in reverse PE triangular cases involving dividends, source-based taxation may only be imposed in the residence state of the payor. Since this result generally arises under the existing treaty framework, there is no need for any changes to deal with reverse PE triangular cases involving dividends.

### 12.2.2. Interest and royalties

In a reverse PE triangular case involving interest or royalties, a person who is resident in State HO makes a payment of interest or royalties which originate from a PE in State PE, and the interest or royalties form part of the income of a resident of a third state, State R. A reverse PE triangular case involving interest or royalties is illustrated in the following diagram.

**Figure 12.3.: Reverse PE triangular case involving interest**

![Diagram showing reverse PE triangular case involving interest](image)

Article 11 allows interest "arising" in a particular state (and paid to a resident of the other contracting state) to be taxed in the state where it arises. However, the amount of tax that can be imposed in the source state is limited to a certain specified percentage of the gross amount of the income; the rate is 10% in the OECD Model but commonly varies between concluded treaties. Such tax is typically imposed by way of a withholding tax on the gross amount of the income. Whether interest "arises" in a particular state is determined in accordance with Article 11(5). Under Article 11(5), interest will be considered to arise in a particular state if (i) it is paid by a resident of that state or (ii) if the payment originates from a PE located in that state. The interpretation and application of this provision will be the main focus of the discussion below.

Royalties are dealt with in Article 12 of the OECD Model. Under Article 12, a contracting state cannot impose any tax on royalties arising in that state and beneficially owned by a resident of the other contracting state unless those royalties are attributable to a PE of the recipient in the state where the royalties arise (in which case Article 7 applies). In the UN Model treaty, however, as well as in many

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1287 This was discussed in greater detail in Chapter 9 (see Section 9.3.2.4.).
1288 For a more detailed discussion, see Chapter 9 (Section 9.3.2.4.).
1289 Refer to Article 11(1) and Article 11(2) of the OECD Model.
1290 Article 12(1) provides that: “Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.” If, however, the royalties are attributable to a PE of the recipient in the source state, then Article 7 will apply instead of Article 12 as a result of Article 12(3).
concluded treaties, royalties are taxable on a source basis in a similar way to dividends and interest.\textsuperscript{1291} That is, royalties "arising" in a particular state and paid to a resident of the other contracting state may be taxed in the state where they arise with the amount of tax being limited to a certain percentage of the gross amount of the income.

There is no guidance in the OECD Model regarding when royalties will be considered to arise in a particular state. This is not particularly strange since it will generally make no difference whether the royalties arise in the non-residence state (in which case Article 12 applies) or whether they are considered to arise elsewhere (in which case Article 7 or Article 21 will apply).\textsuperscript{1292} In either case the non-residence state will be prevented from imposing tax unless the royalties are attributable to a local PE. Nevertheless, where Article 12 (or its equivalent) does allow source based taxation of royalties, it is important to determine whether royalties arise in a particular state because that will govern whether that state can impose taxation under Article 12, or whether it is prevented from imposing taxation under Article 7 or Article 21.\textsuperscript{1293} The approach taken in the UN Model for determining where royalties arise is similar to that taken by Article 11(5) of the OECD Model in relation to interest. That is, royalties will be considered to arise in a particular state if they are paid by a resident of that state or are connected with a PE of the payor located in that state.\textsuperscript{1294} The discussion below will focus on primarily on interest payments and the interpretation of Article 11(5) in the context of reverse dual resident triangular cases. However, it should be borne in mind that this discussion will apply equally to royalties if the treaties which State R has concluded with State HO and State PE both allow source based taxation of royalties and determine where royalties arise on the basis of a provision similar to Article 11(5).\textsuperscript{1295} For treaties that don’t contain a provision equivalent to Article 11(5), similar principles may be applied but it is difficult to generalize and the place where royalties should be considered to arise may need to be determined on a case-by-case basis. For the purposes of the discussion below, it will be assumed that wherever a particular treaty allows source-based taxation of royalties, the determination of where royalties arise will be based on the principles of Article 11(5).

\textbf{12.2.2.1. Application of Article 11(5)}

Article 11(5), which determines whether interest "arises" in a particular state for the purposes of Article 11, provides as follows:

"Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

Thus, there are two basic rules for determining where interest income "arises" for the purposes of Article 11. Interest will arise in a particular state if (i) it is paid by a resident of that state or (ii) if it is connected with a PE of the payor which is located in that state (i.e., the payor of the interest has a PE in that state in connection with which the indebtedness on the interest is paid was incurred, and such interest is borne by such permanent establishment). In a reverse PE triangular case, this results in the interest being considered to arise in two different states for the purposes of the two applicable treaties. For the

\textsuperscript{1291} UN Income and Capital Model Convention (2001), Article 12(2).
\textsuperscript{1292} Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions...}, at p. 776, (m.no. 20).
\textsuperscript{1293} Vogel, K., Engelschalk, M., & Görl, M., \textit{Klaus Vogel on Double Tax Conventions...}, at p. 776, (m.no. 20).
\textsuperscript{1294} Article 12(5) of the UN Model Treaty (2001) provides that: "Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."
\textsuperscript{1295} If one or both of these treaties prevent source based taxation of royalties, then no dual source-based taxation will arise. Thus, the potential for unrelieved double taxation arises only where both the applicable treaties allow source-based taxation of royalties.
purposes of the treaty between the residence state of the person receiving the income and the PE state
(the R-PE treaty), the interest will be considered to arise in the PE state in accordance with the second
sentence of Article 11(5), since it is connected with a PE of the payor located in that state. It is not
necessary for the payor to be resident in one of the contracting states in order for this rule to apply
(“whether he is a resident of a Contracting State or not”). As a result of the interest arising in the PE
state, Article 11 of the R-PE treaty will apply and will allow the PE state to impose tax on the income,
albeit at a limited rate.

In the context of the treaty between the residence state of the payor of the interest and the residence state
of the recipient (i.e., the R-HO treaty), the interest will be considered to arise in the residence state of the
payor in accordance with Article 11(5), because it is paid by a resident of that state. This is the case
notwithstanding that the interest payment is connected with a PE of the payor, because the PE is not
located in either of the contracting states and thus, the rule deeming the interest to arise in the state where
the PE is located does not apply. In this respect, the OECD Commentary provides that:

"Paragraph 5 provides no solution for the case, which it excludes from its provisions,
where both the beneficiary and the payee are indeed residents of the Contracting States,
but the loan was borrowed for the requirements of a permanent establishment owned
by the payor in a third state and the interest is borne by that establishment. As
paragraph 5 now stands, therefore, only its first sentence will apply in such a case...
The Contracting State of the payor's residence does not, therefore, have to relinquish its
tax at the source in favour of the third State in which is situated the permanent
establishment for the account of which the loan was effected and by which the interest
is borne."1298

Thus, for the purposes of the treaty between the payor's residence state and the recipients residence state,
the interest is considered to arise in the payor's residence state (State HO), and that state may impose
source based taxation under Article 11 of that treaty. Prior to the 2005 update, the OECD Commentary
contained comments suggesting that Article 11(5) of the treaty between the PE state and the residence
state of the payor (the HO-PE treaty) could potentially prevent the residence state of the payor (State
HO) from imposing tax.1299 The commentary implied that Article 11(5) of the HO-PE treaty would deem
the interest to arise in the PE state, and that the residence state of the payor would therefore be prevented
from imposing tax. However, the HO-PE treaty does not apply to the income derived in this situation,
since the recipient of the income is not resident in either of the contracting states, and it is therefore
difficult to see how Article 11(5) of that treaty could apply.1301 Even if the HO-PE treaty did apply, the
determination of the place where the interest arises for the purposes of that treaty would have no impact
on where the interest should be considered to arise for the purposes of applying other treaties, i.e., the R-
HO treaty and the R-PE treaty, which must be determined under Article 11(5) of those other treaties.1302

1296 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions... at p. 752, (m.no. 95); Avery Jones,
1297 2010 OECD Commentary on Article 11, paras 28-31; Avery Jones, J.F., et al., "Tax Treaty Problems..."; Avery
Jones, J.F., & Bobbett, C., "Triangular Treaty Problems..."; Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on
Double Tax Conventions... at p. 752, (m.no. 95); Lombardi, M., "Triangular Situations..."; Pereira Ribeiro, R., "Dual
Source Situations..." at pp. 183-184.
1298 2010 OECD Commentary on Article 11, paras 28 and 29.
1299 2003 OECD Commentary on Article 11, paras 28-30, which stated that: "The risk of double taxation just
referred to can only be fully avoided through a bilateral convention containing a similar provision to that in
paragraph 5 [i.e., Article 11(5)], between the Contracting State of which the payer of the interest is a resident and the
third State in which the permanent establishment paying the interest is situated..." (at para 29). See also: Avery Jones,
J.F., et al., "Tax Treaty Problems...."
1300 Avery Jones, J.F., et al., "Tax Treaty Problems...."
1301 Avery Jones, J.F., et al., "Tax Treaty Problems..."; Hattingh, P.J., "The Role and Function...."; Pereira Ribeiro,
R., "Dual Source Situations...," at pp. 183-184.
1302 Avery Jones, J.F., et al., "Tax Treaty Problems..."; Hattingh, P.J., "The Role and Function...."
The comments contained in the OECD Commentary were therefore clearly wrong and, as indicated above, were removed in the 2005 update.

The overall result in a reverse PE triangular case involving interest is that source-based taxation may be imposed in both the residence state of the payor (State HO) and the PE state (State PE) under Article 11 of their respective treaties with the residence state of the recipient. State R may also impose tax but will be obliged to provide relief for the tax imposed in both State HO and State PE under its treaties with those states. Given that the income is interest income, State R will generally use the credit method of relief regardless of the general method of relief used in the treaty. Depending on the rates of tax imposed in each of the source states relative to the amount of tax imposed in the residence state, the expenses (if any) associated with the interest, and the applicable credit limitations, the residence state may not be able to fully relieve the double taxation.

12.2.2.2. Potential solutions

To resolve reverse PE triangular cases, either the PE state or the residence state of the payor should be prevented from imposing source-based taxation. Of these two states, it seems more appropriate to prevent taxation in the residence state since the interest must have a significant economic connection to the activities of the PE (and thus the PE state) in order to be borne by the PE. This is further supported by the fact that the terms of Article 11(5) give priority to the PE state in bilateral situations. Thus, the potential solutions discussed in this section will focus on ways in which the residence state of the payor could be prevented from imposing source-based taxation on the payment of interest in reverse PE triangular cases.

The best way to prevent the payor's residence state (State HO) from imposing tax would be through provisions included in the treaty between that state and the residence state of the recipient (the R-HO treaty). It may also be possible for State HO to be prevented from imposing tax by including specific provisions in the HO-PE treaty, but this is likely to give rise to uncertainty regarding whether the recipient of the income, a resident of a third state, would be entitled to claim the benefits of those provisions given the limitation of the personal scope of the treaty under Article 1. It would also require anyone trying to determine how much tax can be imposed in the residence state of the payor (State HO) to consult multiple treaties, and gives rise to the possibility that the provisions of the two treaties would somehow fail to interact properly. Given these considerations, the best approach is clearly to deal with reverse PE triangular cases under provisions included in the R-HO treaty.

One way of preventing State HO from imposing tax in reverse PE triangular cases is by altering the wording of Article 11(5) to the effect that interest (or royalties) which are connected with a PE would be considered to arise in the PE state even if the PE state is not one of the contracting states. As a result, the distributive rule of Article 11 would not apply. Instead, Article 7 or Article 21 would apply and the payor's residence state would be prevented from imposing tax (assuming the

1304 Avery Jones, J.F., et al., "Tax Treaty Problems…”; Jakobson, C., "Payment of Interest…” at p. 84; Hattingh, P.J., "The Role and Function…”
1305 Refer to: OECD Model, Article 23A(2) and Article 23B.
1306 Refer to: OECD Model, Article 23A(2) and Article 23B.
1307 For a discussion of situations where the residence state will and will not be able to provide sufficient relief for dual source-based taxation, refer to Chapter 3 (Section 3.2., which discusses relief in the residence state in PE triangular cases). In general, the residence state's ability to provide sufficient relief will depend on the effective rates of tax imposed in the source states relative to the effective rate of tax imposed in the residence state. Note that in reverse triangular cases, the relief in the PE state (discussed in Section 3.2.2.) will not be relevant.
1308 See: Hattingh, P.J., "The Role and Function…”
recipient does not have a PE in that state). This could be achieved by adopting the alternative wording for the second sentence of Article 11(5) suggested in the OECD Commentary, which reads as follows:

"Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."[1310] [Emphasis added.]

This type of provision is routinely included in tax treaties concluded by Australia, and has also been included in some treaties concluded by various other states.[1311] The problem with this approach, and the reason why this alternative wording is not included in the OECD Model, is that preventing the payor's residence state from imposing tax may lead to the income escaping source-based taxation altogether (i.e., if the PE state does not impose tax), which could potentially create opportunities for tax avoidance.[1312] This issue could be dealt with by limiting the circumstances in which the residence state would be prevented from imposing tax.[1313] Avery Jones (et al.) write:

"It seems to us that the alternative wording given by the Commentary provides the best solution, although it could be improved by a variation to the effect that the payer's residence state only gives up its right to tax if the permanent establishment state exercises its right to tax the interest, because otherwise the source state gives up its right to tax in favour of the residence state, which would not have to credit any source tax imposed by either the payer's residence state or the permanent establishment state. This solution could be limited to cases where there are treaties between all three states in order to prevent the problem of permanent establishments in tax havens imposing a small charge to tax. Possibly there could also be a requirement that the permanent establishment state must not charge substantially less than the rate of tax which the payer's residence state would have charged."[1314]

These suggested limitations on the situations in which the payor's residence state would be prevented from imposing tax would address the concern that the residence state would give up taxing rights unnecessarily or that tax avoidance opportunities would be created. Another alternative would be for the payor's residence state to reduce the amount of withholding tax that it imposes by the amount imposed in the PE state, although this would perhaps be unnecessarily complicated. Ultimately, the exact wording of the provision would depend on the situations in which the contracting states would be willing to give up their source-based taxing rights in relation to interest payments connected to a PE in a third state. But, more generally, it should be possible to overcome the objections to preventing the residence state of the payor from imposing source-based taxation in reverse PE triangular cases.

12.2.2.3. Applicable PE definition for the purposes of Article 11(5)

For the purposes of Article 11(5), the applicable permanent establishment definition is that contained in Article 5 of the treaty which is currently being applied.[1315] As Article 11(5) of the OECD Model is currently worded, the paragraph referring to PEs applies only where the PE is located in one of the contracting states and the existing wording of the PE definition can generally apply without any

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[1315] This follows from Article 5(1) (or the equivalent provision of the applicable tax treaties) 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. This issue was also addressed in a case in Denmark 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 TFJ 2006, 635). For further discussion, see Chapter 8 (Section 8.2.3.).
significant problems.\textsuperscript{1316} If, however, the alterative wording of Article 11(5) (discussed above) is included in a particular treaty then it may require a determination of whether a PE exists in a third state. Where this occurs, it may be problematic to apply the PE definition of Article 5 because that definition is worded to apply bilaterally, and in several places makes reference to the contracting states.\textsuperscript{1317} Article 5(5), for example, dealing with agency PEs, refers to a person acting on behalf of an enterprise who "... has and habitually exercises, in a Contracting State an authority to conclude contracts..." [emphasis added]. Similar references can be found in Article 5(6), dealing with agents of independent status, and Article 5(7), dealing with companies that control or are controlled by a company in the other contracting state. Due to the way in which these paragraphs are worded, they may not be applicable in situations where Article 5 is being applied to determine whether a PE exists in a third state. This issue could be mitigated by a provision along the lines of that included in Article 5 (or its equivalent) of many Australian treaties, which reads as follows:

"The principles set forth in the preceding paragraphs of this Article shall be applied in determining for the purposes of paragraph 7 of Article 11 [equivalent to Article 11(5) of the OECD Model] and paragraph 5 of Article 12 [a similar provision applicable to royalties] whether there is a permanent establishment outside both Contracting States, and whether an enterprise, not being an enterprise of a Contracting State, has a permanent establishment in a Contracting State."\textsuperscript{1318}

This wording allows the PE definition to apply properly in situations where the definition is being applied to determine whether there is a PE in a third state, and thus resolves the difficulty in applying those parts of Article 5 that refer to the contracting states.\textsuperscript{1319} Alternatively, Article 5 could be amended such that the paragraphs referred to above use the phrase "in a State" rather than "in a Contracting State," which would provide an even clearer solution. This should also not give rise to any particular issues in applying the other articles of the treaty, since those that refer to the existence of a PE also generally make reference to the relevant contracting state.\textsuperscript{1320}

A separate issue is whether this is the appropriate PE definition to apply. Arguably, the more appropriate definition would be that contained in the treaty between the residence state of the payor (State HO) and the PE state (the HO-PE treaty), since it is the existence of a PE under this treaty which governs whether the "PE state" is entitled to impose tax on business income under Article 7 (and also whether it can impose tax on certain other categories of income on a net basis under Article 7 rather than under Article 10, Article 11, Article 12 or Article 21). If the PE definitions differ between the HO-PE treaty and either the R-HO treaty or the R-PE treaty, then it would not make sense for the PE state to be entitled to impose tax or for State HO to be prevented from imposing tax in situations where there is no PE for the purposes of the HO-PE treaty. Similarly, situations could arise where the PE state and the residence state of the payor (State HO) are either both prevented from imposing tax or are both entitled to impose tax under Article 11 as a result of inconsistent PE definitions. The better approach would therefore be for the R-HO treaty and the R-PE treaty to refer to the existence of a PE for the purposes of the HO-PE treaty in determining whether income is considered to be connected to a PE outside the payor's residence state. Taking this into account, it is proposed that Article 11(5) be modified as follows:

"Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident, for the purposes of the treaty between the State of which he is resident and that other State, a permanent establishment in connection with which the indebtedness on which the

\textsuperscript{1316} Although if the payment is made by a resident of a third state, the PE definition under the treaty between the PE state and the state where the recipient of the income is resident may differ from that contained in the treaty between the residence state and the PE state of the payor. Thus, a PE could exist for the purposes of one of those treaties but not for the other. This was discussed in more detail in Chapter 8 (Section 8.2.3.) and is also discussed briefly below.

\textsuperscript{1317} Avery Jones, J.F., et al., “Tax Treaty Problems.....”

\textsuperscript{1318} This provision is taken from the Australia-New Zealand treaty of 2009 (Article 5(11)). See: Avery Jones, J.F., et al., “Tax Treaty Problems.....”

\textsuperscript{1319} Avery Jones, J.F., et al., “Tax Treaty Problems.....”

\textsuperscript{1320} See: OECD Model, Article 7(1), (2) and (3), Article 10(4) and (5), Article 11(4) and (5), Article 12(3), Article 13(2), Article 15(2), Article 21(2), Article 22(2), and Article 24(3),
interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.”

This provision, in combination with provisions preserving the residence state of the payor’s right to impose tax in situations where insufficient tax is imposed in the PE state, would ensure that interest would not be subject to dual source-based taxation in reverse PE triangular cases whilst also guarding against tax avoidance. In addition, it would ensure that the existence of a PE for the purposes of the treaty between the residence state of the payor and the purported PE state would be controlling, preventing possible mismatches between the application of different treaties.

12.2.3. Other categories of income

This section briefly outlines the effect of the application of tax treaties in reverse PE triangular cases involving categories of income other than those discussed above. As will be seen in the table below, dual-source based taxation will generally not occur in these cases and there will be no unrelieved double taxation.

Table 1: Application of tax treaties in reverse PE triangular cases

<table>
<thead>
<tr>
<th>Category of income and diagram</th>
<th>Application of the R-HO treaty</th>
<th>Application of the R-PE treaty</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business profits</strong>&lt;br&gt;Figure 12.1.: Reverse PE triangular case involving business profits</td>
<td>Article 7 applies and State HO is prevented from imposing tax.</td>
<td>Article 7 applies and State PE is prevented from imposing tax</td>
<td>It is assumed that the recipient of the income does not have a PE in either of the source states. Both those states will therefore be prevented from imposing tax under Article 7 of their respective treaties with State R. There is no need for relief in State R. If the income is attributable to a PE in one of the source states, then the state where the PE is located would be entitled to impose tax on the profit attributable to the PE under Article 7. State R would be obliged to provide relief (either credit or exemption) in accordance with the treaty. There would be no unrelieved double taxation.</td>
</tr>
<tr>
<td><strong>Income from immovable property</strong>&lt;br&gt;(property located in State PE)&lt;br&gt;Figure 12.2.: Reverse PE triangular case involving income from immovable property</td>
<td>Article 7 or Article 21 applies and State HO will be prevented from imposing tax on the income.</td>
<td>Article 6 applies and State PE may impose tax on the income without limitation. State R will be obliged to grant relief (credit or exemption) in accordance with Article 23A/B.</td>
<td>For the purposes of the R-HO treaty, the immovable property is located in a third state and, as a result, Article 6 will not apply. The income will fall under the distributive rule of either Article 7 or Article 21 (depending on whether it is considered to be business profits); regardless of which article applies, State HO will be prevented from imposing tax. Note that it is assumed that the property is located in State PE; this is the most likely since, for example, the payor of the income may lease the...</td>
</tr>
<tr>
<td>Category of income and diagram</td>
<td>Application of the R-HO treaty</td>
<td>Application of the R-PE treaty</td>
<td>Comments</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>--------------------------------</td>
<td>--------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td><img src="image1.png" alt="Diagram" /></td>
<td>Article 8 applies and State HO is prevented from imposing tax on the income.</td>
<td>Article 8 applies and State PE is prevented from imposing tax on the income.</td>
<td>Under Article 8, tax can only be imposed in the state where the place of effective management (&quot;POEM&quot;) is located. Given that the recipient of the income is resident in State R, it can be assumed that the POEM is located in State R. Both State HO and State PE will therefore be prevented from imposing any tax on the income under their respective treaties with State R and State R will have no obligation to provide relief.</td>
</tr>
<tr>
<td>Income from shipping, inland waterways transport and air transport</td>
<td><img src="image2.png" alt="Diagram" /></td>
<td><img src="image3.png" alt="Diagram" /></td>
<td></td>
</tr>
<tr>
<td><img src="image4.png" alt="Diagram" /></td>
<td>Article 13(5) applies and State HO is prevented from imposing tax on the capital gain.</td>
<td>Article 13(1) applies and State PE may impose tax on the capital gain.</td>
<td>Under Article 13(1) State PE will be entitled to impose tax on any capital gains arising from the alienation of immovable property located in that state.</td>
</tr>
<tr>
<td><img src="image5.png" alt="Diagram" /></td>
<td>N/A</td>
<td>N/A</td>
<td>For the purposes of this analysis it is assumed that the recipient of the income does not have a PE in either State HO or State PE. Article 13(2) will therefore never apply. If the recipient of the income did have a PE in one of those states, the state where the PE was located would be entitled to impose tax on any capital gains arising from the alienation of movable property which forms part of the business property of a PE.</td>
</tr>
</tbody>
</table>

[No diagram]
<table>
<thead>
<tr>
<th>Category of income and diagram</th>
<th>Application of the R-HO treaty</th>
<th>Application of the R-PE treaty</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>gains derived from the alienation of movable property forming part of the business property of the PE under Article 13(2) of its treaty with State R. State R would be obliged to provide relief in accordance with the terms of the treaty. The other source state would be prevented from imposing tax under Article 13(5) of its treaty with State R.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated movable property</td>
<td>Article 13(3) applies and State HO is prevented from imposing tax.</td>
<td>Article 13(3) applies and State HO is prevented from imposing tax.</td>
<td>Under Article 13(3), tax can only be imposed in the state where the place of effective management is located. Given that the recipient of the income is resident in State R, it can be assumed that the place of effective management is located in State R. State HO and State PE will therefore both be prevented from imposing any tax on the capital gain under their respective treaties with State R.</td>
</tr>
<tr>
<td>Figure 12.5.: Reverse PE triangular case involving capital gains dealt with under Article 13(3)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (underlying property located in State PE)</td>
<td>Article 13(5) applies and State HO is prevented from imposing tax on the capital gain. State R is obliged to provide relief (credit or exemption) in accordance with Article 23A/B of the treaty.</td>
<td>Article 13(4) applies and State PE may impose tax on the capital gain. State R would have a corresponding obligation to provide relief. State PE would be prevented from imposing tax.</td>
<td></td>
</tr>
<tr>
<td>The state where the underlying property is located may impose tax in accordance with Article 13(4) of its treaty with State R. If the underlying property were located in State HO, Article 13(4) of the R-HO treaty would apply and State HO would be entitled to impose tax. State R would have a corresponding obligation to provide relief. State PE would be prevented from imposing tax. If the underlying property were located in State R, then both State HO and State PE would be prevented from imposing tax under Article 13(5) of their respective treaties with State R.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Figure 12.6.: Reverse PE triangular case involving capital gains dealt with under Article 13(4)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Category of income and diagram</td>
<td>Application of the R-HO treaty</td>
<td>Application of the R-PE treaty</td>
<td>Comments</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-------------------------------</td>
<td>-------------------------------</td>
<td>----------</td>
</tr>
<tr>
<td><strong>Other capital gains</strong></td>
<td>Article 13(5) applies and State HO is prevented from imposing tax.</td>
<td>Article 13(5) applies and State HO is prevented from imposing tax.</td>
<td>Article 13(5) provides that any capital gains not referred to in other paragraphs of Article 13 can only be taxed in the residence state. Both State HO and State PE will therefore be prevented from imposing tax under Article 13(5) of their respective treaties with State R. State R has no obligation to provide relief.</td>
</tr>
<tr>
<td><strong>Other income</strong></td>
<td>Article 21 applies and State HO is prevented from imposing tax.</td>
<td>Article 21 applies and State HO is prevented from imposing tax.</td>
<td>Given that the recipient of the income does not have a PE in either State HO or State PE, both those states are prevented from imposing tax under their respective treaties with State R. State R therefore has no obligation to provide relief.</td>
</tr>
</tbody>
</table>

This table illustrates that there will be no dual source-based taxation in reverse PE triangular cases involving these categories of income. In some cases either the PE state or the HO state is entitled to impose source-based taxation under its treaty with State R, however this will not give rise to unrelieved double taxation because State R will generally be capable of providing sufficient relief (either credit or exemption). No particular issues arise in the scenarios considered in this section.

### 12.2.4. Conclusions

The issues that arise in reverse PE triangular cases arise because two states assert source-based taxing rights. However, provided that tax treaties have been concluded between all three states involved and that those treaties follow the OECD Model, reverse PE triangular cases will only give rise to potential unrelieved double taxation in the case of interest. For all other categories of income, only one of the source states (i.e., State HO or State PE), or neither of them, is entitled to impose tax on the income or gain under the applicable treaties with the residence state of the recipient of the income. In the case of interest, double taxation will only occur if tax is imposed in both the PE state and the HO state and the recipient’s residence state is unable to provide sufficient relief. This could also occur in relation to
royalties if the applicable treaties differ from the OECD Model and allow source based taxation of royalties, as is the case in many concluded treaties.

Double source-based taxation of interest in reverse PE triangular cases could be prevented by adopting the alternate wording of Article 11(5) contained in the OECD Commentary, which would prevent the interest from being considered to arise in the payor’s residence state even where the PE to which the payment is connected is located in a third state. This approach could be improved, however, by limiting the circumstances in which the payor’s residence state is prevented from imposing tax to those where the PE state imposes source based taxation on the interest. Additional caveats could also be included if the residence state remains concerned about tax avoidance or about unnecessarily giving up its taxing rights. A similar approach could be taken to prevent double source-based taxation of royalties. The provision could be improved by altering the wording such that the PE definition contained in the treaty between the residence state and the (potential) PE state would be determinative of whether the amount originates from a PE.

12.3. Reverse dual resident triangular cases

Reverse dual resident triangular cases arise where a person who is resident in two states ("State A" and "State B") pays an amount of income to a resident of a third state ("State R"). In such cases, both residence states of the payor may consider the income to be locally sourced and may thus seek to impose source-based taxation. A reverse dual resident triangular situation is illustrated in the following diagram:

Figure 12.9.: Reverse dual resident triangular case

For the purposes of the analysis below it is assumed that both the payor’s residence states would seek to impose source-based taxation on the income in the absence of any treaty limitation. It is further assumed that the residence state of the recipient of the income would impose tax on a residence basis. The recipient’s residence state may provide unilateral relief in the form of an exemption or a credit for the tax imposed in the residence states of the payor, however for the purposes of the analysis below it will be assumed that this is not the case.

In a reverse dual resident triangular case, the recipient of the income will be entitled to claim the benefit of the treaties concluded between that person’s residence state (State R) and the two residence states of the payor (States A and B). The applicable treaties will therefore be the treaty between State R and State A (the A-R treaty) and the treaty between State R and State B (the B-R treaty). The treaty between the two residence states will not apply because the person receiving the income is not resident in either of the contracting states for the purposes of that treaty.

Note that this section does not deal with situations where the payment originates from a PE located in the losing residence state; such situations are discussed in Section 12.4., below. It is therefore assumed for the purposes of the analysis in this section that there is no PE in either of the residence states of the payor.

12.3.1. Application of tax treaties under the existing treaty framework

For most categories of the income dealt with in this study, the distributive rules of tax treaties do not allow source-based taxation on the basis of the residence of the payor and thus, as will be seen below, one
(or even both) of the payor's residence states will be prevented from imposing tax in a reverse dual-resident triangular case. In the case of dividends, interest and royalties, however, the distributive rules of tax treaties generally allow source based taxation in a particular state if the income is paid by a resident of that state.\textsuperscript{1321} Thus, as will be seen below, such income may be subject to dual source based taxation when paid by a dual resident. Under its treaties with the two source states the residence state of the recipient will be obliged to provide relief, generally using the credit method where passive income is involved. However, given that source-based taxation has been imposed in two states the residence state of the person receiving the income may be unable to provide sufficient relief and unrelieved double taxation may occur.\textsuperscript{1322}

The following table briefly outlines the effect of the application of tax treaties in reverse dual resident triangular cases involving various categories of income. For the purposes of this analysis, it is assumed that the payor remains resident in both its residence states for the purposes of the treaties between those states and the residence state of the recipient, despite any application of the residence tie-breaker rule of the treaty between the two residence states. It is further assumed that the recipient of the income does not have a PE in either of the residence states of the payor.

\textit{Table 2: Application of tax treaties in reverse dual resident triangular cases}

<table>
<thead>
<tr>
<th>Category of income and diagram</th>
<th>Application of the A-R treaty</th>
<th>Application of the B-R treaty</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business profits &lt;br/&gt;\textit{Figure 12.10.: Reverse dual resident triangular case involving business profits}</td>
<td>Article 7 applies and State A is prevented from imposing tax.</td>
<td>Article 7 applies and State B is prevented from imposing tax.</td>
<td>Both the source states are prevented from imposing tax. There is no need for relief in State R. &lt;br/&gt;If the income is attributable to a PE of the recipient in one of the source states, then the state where the PE is located would be entitled to impose tax on the profit attributable to the PE under Article 7. State R would be obliged to provide relief (either credit or exemption) in accordance with the treaty. There would be no unrelieved double taxation.</td>
</tr>
<tr>
<td>Dividends &lt;br/&gt;\textit{Figure 12.11.: Reverse dual resident triangular case involving dividends}</td>
<td>Article 10 applies and State A is entitled to impose a limited rate of tax on the dividends. &lt;br/&gt;State R is obliged to provide relief using the credit method in accordance with either Article 23A or Article 23B.</td>
<td>Article 10 applies and State B is entitled to impose a limited rate of tax on the dividends.</td>
<td>This analysis ignores the potential effect of the application of the residence tie-breaker rule of the treaty between the two residence states and any consequent application of Article 10(5) of that treaty, both of which will be discussed in detail below. &lt;br/&gt;Both the payor’s residence states are entitled to impose tax on the dividends and thus there is dual source-based taxation. State R may therefore not be able to provide sufficient relief to prevent unrelieved double taxation.</td>
</tr>
</tbody>
</table>

\textsuperscript{1321} OECD Model, Article 10 and Article 11. In the UN Model (Article 12) and in many concluded treaties, this is also the case with respect to royalties. <br/>\textsuperscript{1322} For a discussion of situations where the residence state will and will not be able to provide sufficient relief for dual source-based taxation, refer to Chapter 3 (Section 3.2., which discusses relief in the residence state in PE triangular cases). In general, the residence state’s ability to provide sufficient relief will depend on the effective rates of tax imposed in the source states relative to the effective rate of tax imposed in the residence state. Note that in reverse triangular cases, the relief in the PE state (discussed in Section 3.2.2.) will not be relevant.
| **Interest** | Article 11 applies and State A is entitled to impose a limited rate of tax on the interest. State R is obliged to provide relief using the credit method in accordance with either Article 23A or Article 23B. | Article 11 applies and State B is entitled to impose a limited rate of tax on the interest. State R is obliged to provide relief using the credit method in accordance with either Article 23A or Article 23B. | This analysis ignores the potential effect of the application of the residence tie-breaker rule of the treaty between the two residence states, which will be discussed in detail below. Both the payor’s residence states are entitled to impose tax on the interest and thus there is dual source-based taxation. State R may therefore not be able to provide sufficient relief to prevent unrelieved double taxation. |
| **Royalties** | Article 12 applies and State A is prevented from imposing tax. | Article 12 applies and State B is prevented from imposing tax. | As will be discussed below, many concluded treaties depart from the OECD Model and do allow a limited rate of source based taxation. Where this is the case in both the A-R treaty and the B-R treaty then both those states may be entitled to impose tax and dual source-based taxation may arise. This analysis ignores the potential effect of the application of the residence tie-breaker rule of the treaty between the two residence states, which will be discussed in detail below. |
| **Income from immovable property – Property located in State A** | Article 6 applies and State A may impose tax on the income without limitation. State R will be obliged to grant relief (credit or exemption) in accordance with Article 23A/B. | Article 7 or Article 21 applies and State B will be prevented from imposing tax on the income. | For the purposes of the B-R treaty, the immovable property is located in a third state and, as a result, Article 6 will not apply. The income will fall under the distributive rule of either Article 7 or Article 21 (depending on whether it is considered to be business profits); regardless of which article applies, State B will be prevented from imposing tax. Note that if the property were instead located in State B, State B would be entitled to impose tax and State A would be prevented from imposing tax. If the property were located in State R, then both source states would be prevented from imposing tax. |
| **Income from shipping, inland waterways transport and air transport** | Article 8 applies and State A is prevented from imposing tax on the income. | Article 8 applies and State B is prevented from imposing tax on the income. | Under Article 8, tax can only be imposed in the state where the place of effective management (“POEM”) is located. Given that the recipient of the income is resident in State R, it can be assumed that the POEM is located in State R. Both source states will therefore be prevented from imposing tax. |
| Capital gains arising from the alienation of immovable property - Property located in State A | Article 13(1) applies and State A may impose tax on the capital gain. State R is obliged to provide relief (credit or exemption) in accordance with Article 23A/B of the treaty. | Article 13(5) applies and State B is prevented from imposing tax on the capital gain. Under Article 13(1) State A will be entitled to impose tax on any capital gains arising from the alienation of immovable property located in that state. Note that if the property were instead located in State B, State B would be entitled to impose tax and State A would be prevented from imposing tax. If the property were located in State R then both source states would be prevented from imposing tax. |
| Capital gains arising from the alienation of movable property which forms part of the business property of a PE. [No diagram] | N/A | N/A | For the purposes of this analysis it is assumed that the recipient of the income does not have a PE in either of the residence states of the payor. Article 13(2) will therefore never apply. If the recipient of the income did have a PE in one of those states, the state where the PE was located would be entitled to impose tax on any capital gains derived from the alienation of movable property forming part of the business property of the PE under Article 13(2) of its treaty with State R. State R would be obliged to provide relief in accordance with the terms of the treaty. The other source state would be prevented from imposing tax under Article 13(5) of its treaty with State R. |
| Capital gains arising from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated movable property | Article 13(3) applies and State A is prevented from imposing tax. | Article 13(3) applies and State B is prevented from imposing tax. Under Article 13(3), tax can only be imposed in the state where the place of effective management (“POEM”) is located. Given that the recipient of the income is resident in State R, it can be assumed that the POEM is located in State R. Both the source states will therefore be prevented from imposing tax. |
| Figure 12.17.: Reverse dual resident triangular case involving capital gains dealt with under Article 13(3) | Capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property – underlying property located in State A | Article 13(4) applies and State A may impose tax on the capital gain. State R is obliged to provide relief (credit or exemption) in accordance with Article 23A/B of the treaty. The state where the underlying property is located may impose tax in accordance with Article 13(4) of its treaty with State R. If the underlying property were instead located in State B, State B would be entitled to impose tax and State A would be prevented from imposing tax. If the underlying property were located in State R then both residence states of the payor would be prevented from imposing tax. |
| Figure 12.18.: Reverse dual resident triangular case involving capital gains dealt with under Article 13(4) | Article 13(5) applies and State B is prevented from imposing tax on the capital gain. |
| Figure 12.19.: Reverse dual resident triangular case involving capital gains dealt with under Article 13(5) | Article 13(5) provides that any capital gains not referred to in other paragraphs of Article 13 can only be taxed in the residence state. Both source states will therefore be prevented from imposing tax under Article 13(5) of their respective treaties with State R. State R has no obligation to provide relief. |
| Figure 12.20.: Reverse dual resident triangular case involving other income | Other capital gains |
| | Article 21 applies and State A is prevented from imposing tax. |
| | Article 21 applies and State B is prevented from imposing tax. Given that the recipient of the income does not have a PE in either of the source states, both those states are prevented from imposing tax under their respective treaties with State R. State R therefore has no obligation to |
This table illustrates that although reverse dual-resident triangular cases may give rise to dual source-based taxation in relation to dividends, interest and royalties, this will not occur for other categories of income. This is because the distributive rules of tax treaties in relation to these types of income do not allow source-based taxation to be imposed on the basis of the income being paid by a resident enterprise. In these cases, there will generally be no unrelieved double taxation and no particular issues will ordinarily arise. The remainder of this chapter will provide a more in-depth analysis of reverse dual-resident triangular cases involving dividends, interest and royalties, and will suggest ways in which dual source-based taxation could be prevented in such cases.

### 12.3.2. Situations where the tie-breaker rule does not effectively allocate residence

For treaty purposes, residence is determined by reference to residence under domestic laws in accordance with Article 4 (or its equivalent)\(^{1323}\) and, as a result, a person who is resident in two states under their respective domestic laws will generally also be a dual resident for treaty purposes. Where this occurs, the tie-breaker rules of the treaty between the two residence states will apply and will allocate the residence of the dual resident person to one state for the purposes of that treaty.\(^{1324}\) However, the tie-breaker rules may not always be successful in allocating the residence of a dual resident to one state for treaty purposes, e.g., where a company is managed from multiple states and the "place of effective management" cannot be determined.

In a reverse dual resident triangular case where the residence tie-breaker rule of the treaty between the two residence states of the dual-resident payor (the A-B treaty) does not effectively allocate that person’s residence to one state for the purposes of the treaty, there will be nothing to prevent dual source-based taxation of passive income. The dual resident payor will continue to be resident in both of its residence states (State A and State B) for the purposes of the treaties between each of those states and the residence state of the recipient of the income. As a result, both those states would generally be entitled to impose source-based taxation on passive income paid by the dual resident. In the case of dividends for example, Article 10 allows dividends paid by a resident of one contracting state to a resident of the other contracting state to be taxed in the residence state of the payor. For the purposes of both the A-R treaty and the B-R treaty, any dividends paid by the dual resident would be considered to be paid by a resident of one of the contracting states, and State A or State B, respectively, would be entitled to impose tax in accordance with Article 10 of the treaty (at a limited rate). Similarly, any interest paid by the dual resident would be considered to "arise" in State A for the purposes of the A-R treaty (under Article 11(5)), and would be considered to "arise" in State B for the purposes of the B-R treaty (again, under Article 11(5)). Thus, under both treaties, Article 11 would apply and both State A and State B would both be entitled to impose tax on the income at the rate allowed by their respective treaties with State R. This may also occur in relation to royalties to the extent that both the A-R treaty and the B-R treaty allow source-based taxation of such income under Article 12.

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\(^{1323}\) Article 4(1) provides that: "For the purposes of this Convention, the term 'resident of a Contracting State’ means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of sources in that State or capital situated therein."

\(^{1324}\) For a detailed overview of the tax treaty tie-breaker rules and their interpretation, see Chapter 10 (Section 10.3.).
Where both residence states of the dual-resident payor impose tax on the income, the residence state of the person receiving the income (State R) will generally be obliged to grant relief for tax imposed in both those states. However, depending on the relative rates of tax imposed, it may be unable to provide sufficient relief and, as a result, unrelieved double taxation may occur. This issue was discussed in detail in Chapter 3 in the context of PE triangular cases. The simplest solution would be to prevent one state from imposing source-based taxation, however, it is not clear in this case which state should be prevented from imposing tax on the income. The remainder of this section discusses two possible approaches for ensuring that payments are not subject to dual-source-based taxation in situations where there is no allocation of residence of the dual-resident payor.

12.3.2.1. Split the right to tax between the two residence states of the payor

One possibility is that taxing rights could be split equally between the two states. That is, each state could be entitled to impose only 50% of the tax that it would otherwise impose.\(^\text{1325}\) This could be achieved by including a specific provision in the treaty between the two residence states of the payor, or under the treaty between each of the residence states of the payor and the residence state of the recipient. The main advantage of having the provision operate under the treaty between the two residence states of the payor is that the terms of that treaty would then specify the consequences of the contracting states being unable to determine the residence of a dual resident, e.g., under the mutual agreement procedure. However, the better approach seems to be for the provision to operate under the treaties with the residence state of the recipient of the income, since there would be no question of this treaty applying to the income. Such a provision could be worded as follows:

“When dividends are paid to a resident of a Contracting State by a company which is resident in the other Contracting State and is also resident in a third State for the purposes of a convention between the last mentioned Contracting State and the third State, and is not deemed to be resident in only one of those States for the purposes of that convention, then the tax imposed in the Contracting State of which the payor is resident shall not exceed 50% of the tax that may be imposed under [paragraph 2 of Article 10].”

Similar provisions could be included for interest and, if applicable, royalties (i.e., in situations where the treaty allows source-based taxation of royalties). One essential aspect of this provision is that it must be applied taking into account the application of the tie-breaker provisions of the treaty between the two residence states. That is, it should only be applied in situations where the application of the tie-breaker has been unsuccessful, and not in situations where payor of dividends is simply resident in two states under Article 4(1). This is achieved by limiting the application of the provision to situations where the payor is not deemed to be resident in one state for the purposes of the treaty between the two residence states. It must also be included in the source state’s treaties with both the residence states in order for it to be effective, although even if it were included in only one of these treaties it would at least reduce the amount of source-based taxation imposed in one state.

One issue which could arise in relation to such a provision is the potential for tax avoidance. A company that is resident in a state with relatively high rates of withholding tax could, for example, become resident in another contracting state which imposed no withholding tax or lower rates of withholding tax, in order to reduce by half the applicable withholding tax rate in the first residence state. The potential for this type of abuse is limited, of course, by the fact that the reduced withholding tax rate is only applicable in situations where the tie-breaker provision of the treaty between the two residence states does not effectively assign residence to one state for the purposes of the treaty. It is also limited by the potential

\(^\text{1325}\) This is similar to the approach taken in some early model treaties which, instead of including a residence tie-breaker provision, split taxing rights between the two residence states of a dual-resident in certain cases. Vann writes: “Dual residence of individuals is the subject of special mention in the resolutions [see below], though perhaps confusingly to modern eyes, one of the solutions during this period [the mid-1920s] was a splitting of taxing rights between both countries of fiscal domicile on the basis of time spent in each country or by agreement between the competent authorities rather than a tie-breaker.” Vann, R., “‘Liable to Tax’...,” at p. 214 (Section 7.3.1.2.). See also: League of Nations, “Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee” (Geneva, League of Nations, 1925), Document F.212.
residence-based tax liability in the second residence state on any income derived. Nevertheless, the potential for abuse should be considered if states are contemplating including a provision such as that outlined above in their treaty.

12.3.2.2. Allow tax in the state to which the payment is more closely connected

Another alternative, at least with respect to interest and royalties, would be to seek to identify the state to which the payment is more closely connected in order to determine which state should be entitled to impose source-based taxation. This would essentially involve trying to identify a PE in one of the two residence states of the payor that bears the payment, which would in turn require a notional application of the treaty between the two residence states of the payor to determine firstly whether a PE could be considered to exist and secondly, whether the payment could be considered to originate from the PE.

As discussed in Chapter 10, where the tie-breaker provision of the treaty between the two residence states does not effectively allocate residence to one state for the purposes of the treaty, both states are likely to apply the treaty as though the person involved is a local resident for treaty purposes and is not resident in the other contracting state. In general, one of the residence states (say, State A) will only grant relief for tax imposed in the other residence state (State B) if it considers the tax imposed in that state to have been imposed in accordance with the provisions of the treaty. In many cases, this will require a consideration of whether the income is attributable to a PE in State B. However, from State B’s perspective, it is not imposing tax because the income is attributable to a local PE but instead, because the income is derived by a resident enterprise. Thus, there will be no agreement between the two residence states of the payor as to the existence of a PE in one of those states.

In some cases, it may be easy to identify one state to which the payment is clearly connected. However, even in this situation, it would be very challenging to draft a provision to prevent the other state from imposing tax on the payment. One possible wording of the provision, for inclusion in the interest article (Article 11), is as follows:

“Where, however, the person paying the interest is resident in a Contracting State and in a third state for the purposes of a convention between those two states, and is not deemed to be resident in one State for the purposes of that convention, the interest will not be considered to arise in the Contracting State of which that person is resident if that person would have had a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest would have been borne by such permanent establishment, if the person had been deemed to be a resident of the Contracting State of which they are resident for the purposes of the treaty between that State and the third State.”

A similar provision could be included in the article applicable to royalties (Article 12) if the treaty differs from the OECD Model in allowing source based taxation of royalties. This provision, applied under the treaty between the residence state of the person receiving the income (State R) and one of the residence states of the payor, State A (i.e., the R-A treaty), would prevent State A from imposing tax if the interest would have been considered to have originated from a PE in the other residence state (State B) if the residence of the payor had been assigned to State A for the purposes of applying the A-B treaty. This would clearly be a very difficult provision to interpret and apply, since it would require a hypothetical determination of whether a PE exists and whether income could be considered to originate from that PE. This may give rise to significant uncertainty even in relatively simple cases and therefore cannot be recommended. In any case, the potential for dual source-based taxation in reverse dual resident triangular cases again highlights the importance of an effective allocation of residence under the treaty between the two residence states (as was discussed in Chapter 10).1326

1326 See Section 10.4.1.
### 12.3.3. Situations where the tie-breaker rule does effectively allocate residence of the payor

In a reverse dual-resident triangular case, where a person is resident in two states under their respective domestic laws, that person will generally also be resident in both those states for the purposes of the treaties which each of them have concluded with the third state where the recipient of the income is resident (State R).1327 This would clearly be undesirable since it will result in dual source based taxation of passive income in the same way as in situations where the tie-breaker rule does not effectively allocate residence. This could be avoided by preventing the dual resident from being resident in the state to which residence is not assigned (the losing residence state or "State L") for the purposes of treaties between that state and third states. This would result in State L generally being prevented from imposing tax on passive income (except where the income originates from a PE of the payor or is attributable to a local PE of the recipient). Note that this section does not deal with situations where the payment originates from a PE located in the losing residence state; such situations are discussed in Section 12.4., below. It is therefore assumed for the purposes of this analysis that there is no PE in the losing residence state.

As discussed in Chapter 11, the only argument for not applying the treaty between the losing residence state and third states is that the dual-resident is not resident in the losing residence state under the second sentence of Article 4(1).1328 The second sentence of Article 4(1) provides that a person will not be resident in a particular state if they are "liable to tax in that State in respect only of sources in that State." It is argued that the effect of the restrictions imposed under the treaty between the two residence states is that the dual resident will be taxable in the losing residence state only on income from sources in that state, and should therefore not be resident in that state for the purposes of treaties it has concluded with third states.1329 This interpretation was discussed in detail in Chapter 11, where it was concluded that it is highly uncertain that a dual resident should be denied residence in the losing residence state on this basis.1330

If the dual resident continues to be resident in the losing residence state for the purposes of the treaty between State L and the residence state of the recipient of the income (State R) (the L-R treaty), then they will continue to be resident in both residence states for the purposes of the treaties between those states and State R. As a result, both of the payor’s residence states will be entitled to impose tax on interest paid by the dual resident under Article 11 of their respective treaties with State R. This may also be the case with respect to royalties under Article 12. In the case of dividends, however, a solution may potentially be found in Article 10(5) of the treaty between the two residence states, as will be discussed below.

If, on the other hand, the application of the tie-breaker rule of the treaty between the two residence states results in the dual resident being denied residence for the purpose of the R-L treaty, then any passive income paid by the dual resident would not be paid by a resident of State L for the purposes of the R-L treaty. As a result, State L would generally be prevented from imposing tax on the dividends, interest or royalties paid by the dual resident. That is, for the purposes of Article 10, Article 11, or Article 12 (as applicable) the income would not be paid by a resident of one state to a resident of the other contracting state and thus, these articles would not apply. The income would then fall under the distributive rules of Article 7 or Article 21, depending on whether it is considered to be business income, and the losing residence state would be prevented from imposing tax (since it is assumed that the recipient of the income does not have a PE in that state).

For the purposes of the treaty between the winning residence state ("State W") and the residence state of the person receiving the income (the W-R treaty), any amounts paid by the dual resident would be paid by a resident of State W. Therefore, where the dual resident pays a dividend, Article 10 of the R-W treaty would apply and State W would be entitled to impose source-based taxation. Similarly, if the dual resident

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1328 2010 OECD Commentary on Article 4, para 8.2.; Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems…"; Avery Jones, J.F., "The Interaction Between…,” at pp. 137-138 (Chapter 6, Section 6.4.1.);
1329 2010 OECD Commentary on Article 4, para 8.2.; Avery Jones, J.F., & Bobbett, C., "Triangular Treaty Problems…"; Avery Jones, J.F. "The Interaction Between…,” at pp. 137-138 (Chapter 6, Section 6.4.1.);
1330 Refer to Section 11.2.
pays interest or royalties, Article 11 or Article 12 of the treaty would apply, and State W may be entitled to impose tax. The residence state of the person receiving the income (State R) would also be entitled to impose tax, but would be obliged to provide relief for the tax imposed in State W. Given that the losing residence state is prevented from imposing tax, source based taxation can be imposed in only one state (the winning residence state) and there would therefore be no unrelieved double taxation. This how the denial of residence under the R-L treaty could resolve reverse PE triangular cases. This will be discussed below (see Section 12.3.4.), however, the following section will first discuss the potential application of Article 10(5) to prevent dual source-based taxation of dividends.

12.3.4. Dividends and the application of Article 10(5)

Article 10(5) generally prevents a contracting state from imposing tax on dividends paid by a resident of the other contracting state, unless the dividend is received by a local resident or is attributable to a local PE of a resident of the other state. Article 10(5) reads as follows:

"Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other Contracting State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State."

In a reverse dual resident triangular case where the tie-breaker rule of the treaty between the two residence states assigns residence to one state for the purposes of that treaty, this provision of the treaty between the two residence states may prevent the losing residence state from imposing source-based taxation on the dividend. For the purposes of applying that treaty, the dividend is indeed paid by a resident of the other state (the winning residence state) and it is not paid to a resident of a losing residence state or attributable to a PE located there. However, the application of this provision in such cases is not so straightforward, as will be discussed below.

The application of Article 10(5) in relation to dividends paid by a dual resident company has been dealt with in two court decisions, one in Canada (Hunter Douglas Ltd. v. The Queen) and one in the Netherlands (Case 27 252). In both cases it was found that Article 10(5) of the treaty between the two residence states will prevent the losing residence state from imposing tax on dividends distributed to residents of third states. These decisions will be discussed below where relevant.

12.3.4.1. Requirement for profits or income derived in the losing residence state

One of the difficulties in applying Article 10(5) in this reverse dual resident triangular cases is that it is stated to apply only where the company paying the dividends "derives profits or income" from the state which is seeking to impose tax (i.e., the losing residence state). Article 10(5) thus assumes that the state seeking to impose tax on the dividends is doing so because the dividends are paid out of income derived from sources in that state. However, if the company is resident in the losing residence state simply by virtue of being incorporated there, the company may not in fact derive any profit or income from that state. Rather than seeking to impose tax on the dividends as a result of the activities of the company, tax is being imposed because the company is considered to be a local resident under domestic law, e.g., as a result of incorporation. In this case, it would be difficult to apply Article 10(5) to prevent the losing


1332 Case 27 252, BNB 1992/379, 2 September 1992, decided by the Supreme Court of the Netherlands (the Hoge Raad).
residence state from imposing tax on dividends paid by the company unless the company also derives at least some income from that state.\textsuperscript{1333} 

\textit{Case 27 252}, decided in the Netherlands, involved a company incorporated in the Netherlands and effectively managed from Ireland, which distributed dividends to its parent company incorporated in the United States.\textsuperscript{1334} For the purposes of the Ireland-Netherlands treaty the company was treated as a resident in Ireland, and it derived no income from the Netherlands. The issue in the case was whether the Netherlands was prevented from imposing dividend withholding tax under Article 8(9) of the Ireland-Netherlands treaty,\textsuperscript{1335} which is the equivalent of Article 10(5) of the OECD Model and is worded in virtually the same way.\textsuperscript{1336} The court decided that this provision did prevent the Netherlands from imposing source based taxation on the dividends, and in particular, that it applied notwithstanding that the company derived no income or profits from the Netherlands.\textsuperscript{1337} In applying the Ireland-Netherlands treaty, the Court considered the OECD Commentaries to be of great importance, and referred particularly to comments that Article 10(5) prohibited "extraterritorial taxation" of dividends.\textsuperscript{1338} The Court argued that if the prohibition on source based taxation of dividends applied in situations where the company derives profit or income from sources in the state seeking to impose tax, then it should apply even more so if the company derives no income or profit from that state.\textsuperscript{1339} The Court referred to the wording of the last line of the provision, which states that taxation will be prevented "...even if the dividends paid or the undistributed profits consist wholly or parts of profits or income arising in such other state."\textsuperscript{1340} This wording seems to anticipate that the provision will apply, not only in situations where the tax is imposed on the basis that the profits from which the dividend is paid have a local source, but also where tax is imposed on another basis.

In the \textit{Hunter Douglas} case,\textsuperscript{1341} decided in Canada, a company that was resident in both Canada and the Netherlands under their respective domestic laws paid a dividend to residents of third states.\textsuperscript{1342} Under the Canada-Netherlands treaty\textsuperscript{1343} the company was resident only in the Netherlands and the case concerned the application of withholding tax in Canada (i.e., in the losing residence state). The court found that Canada was prevented from imposing tax on the dividends under Article IV(5) of the Canada-Netherlands treaty, a provision which was equivalent to Article 10(5) of the OECD Model and which was

\begin{footnotes}
  \item 1333 Avery Jones, J.F., et al., "Tax Treaty Problems...."
  \item 1334 Case 27 252, BNB 1992/379, 2 September 1992. This overview of the facts of the case is drawn from: Smit, P.M., "Taxation of Dividends...."
  \item 1335 The treaty in force at the relevant time was the Ireland-Netherlands treaty concluded in 1969. This treaty remains in force today.
  \item 1336 Article 8(9) of the Ireland-Netherlands treaty provides that: "Where a company which is a resident of one of the States derives profits or income from the other State, that other State may not impose any tax on the dividends paid by the company to persons who are not residents of that other State, or subject the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising from such other State."
  \item 1337 Smit, P.M., "Taxation of Dividends...."
  \item 1338 Smit, P.M., "Taxation of Dividends...." The OECD Commentary (of 1963) stated that: "Paragraph 5 [i.e., Article 10(5)] adopts a provision already contained in a number of Conventions. It rules out extraterritorial taxation of dividends and further provides that non-resident companies are not to be subjected to special taxes on undistributed profits." [emphasis added] (at para 42 of the Commentary on Article 10). A similar comment is contained in para 34 of the 2010 OECD Commentary on Article 10, although it refers specifically to situations where tax is imposed because the profits from which the dividend is paid is sourced in the state seeking to impose tax. The Commentary does not contain any discussion of the application of Article 10(5) in situations where a dual-resident pays a dividend to residents of a third state.
  \item 1339 Smit, P.M., "Taxation of Dividends...." See also: Avery Jones, J.F., et al., "Tax Treaty Problems...."
  \item 1340 Smit, P.M., "Taxation of Dividends...."
  \item 1342 For a more detailed overview of the facts of the case, refer to either the IBFD Tax Treaty Case Law database or to: Creus, J., & De Jong, D., "Dividends Paid by...."
  \item 1343 The treaty in force at the time was that concluded between Canada and the Netherlands in 1957. This treaty is no longer in force, having been replaced by a new treaty in 1986.
\end{footnotes}
worded along similar lines. However, the court did not directly address the question of whether provisions like Article 10(5) will apply where no profits or income are derived in the state seeking to impose tax, which was not necessary since the company did in fact derive income from Canada during the relevant period.

In general, the prevention of dual source-based taxation of dividends paid by a dual resident company under Article 10(5) in situations where no income is derived from the losing residence state is clearly a reasonable outcome, but it is still somewhat difficult to reconcile with the wording of the provision. This difficulty could be remedied by rewording Article 10(5) to remove this requirement. It is not necessary to the purpose of Article 10(5) for it to apply only where the company derives profit or income from the state seeking to impose tax, and indeed, some concluded treaties already omit this requirement. Article 10(5) could, for example, be reworded as follows:

"A Contracting State may not impose any tax on dividends paid by a resident of the other Contracting State, except insofar as such dividends are paid to a resident of the first-mentioned Contracting State or insofar as the dividends are attributable to a permanent establishment situated in that State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State."

This wording achieves the same aim without the unnecessary requirement that the company derive income or profits from the non-residence state before the provision can apply, and would more clearly apply in cases where a dual resident company pays dividends to residents of third states.

12.3.4.2. Personal scope of the treaty

Another difficulty with applying Article 10(5) of the treaty between the two residence states is that the person upon whom tax is being imposed, the recipient of the dividends, is not resident in either of the contracting states and thus does not fall within the personal scope of the treaty under Article 1. As a

1344 The provision was worded as follows: "Where a company which is resident in one of the States derives profits or income from sources within the other State, that other State shall not impose any form of taxation on dividends paid by the company to persons not resident in that other State, or any tax in the nature of an undistributed profits tax on undistributed profits of the company, by reason of fact that those dividends or undistributed profits represent, in whole or in part, profits or income so derived." This wording is very similar to that of Article 10(5) of the OECD Model, except that it provides that no tax can be imposed "by reason of" the dividends representing profit derived from sources in the state seeking to impose tax. This suggests that the provision, Article IV(5), may only prevent tax which is imposed on the basis that the profits are sourced in that state. However, the court found that there was no such limitation based partly on the wording of other tax treaties concluded by Canada which used the wording "even if" instead of "by reason of" and on testimony from a person involved in the negotiation of Canada's tax treaties to the effect that the different wording did not represent any change in policy by the Government of Canada (see para 34 of the court decision). In any case, this issue will not arise under treaty provisions which follow Article 10(5) of the OECD Model, which provides that no tax can be imposed "... even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State." [emphasis added].

1345 Avery Jones, J.F., et al., "Tax Treaty Problems...."
1347 One of these states is the US. The Article 10(7) of the US model treaty (equivalent to Article 10(5) of the OECD Model) reads as follows: "A Contracting State may not impose any tax on dividends paid by a resident of the other State, except insofar as the dividends are paid to a resident of the first-mentioned State or the dividends are attributable to a permanent establishment, nor may it impose tax on a corporation's undistributed profits, except as provided in paragraph 8, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State." Paragraph 8 of that article preserves the operation of the US branch profits tax.

1348 This is similar to the wording used in Article 10(7) of the US Model treaty, reproduced in the previous note.
The result is that the recipient of the dividends may potentially be unable to claim the benefit of Article 10(5). However, Article 10(5) is not stated to apply only to dividends paid to residents of the contracting states, but in other situations. "Dividends paid by" a resident of the other contracting state, which indicates that its application may not be constrained by Article 1. Hattingh writes that "... the very terms of Art. 10(5) imply an exception to Art. 1 in the treaty..." In a somewhat similar vein, Vogel writes that:

"The inclusion of residents of third States in the 'protective scope' of Art. 10(5) results from the rule, though merely as a secondary effect. The rule's basic purpose is to draw the line between the taxing powers of the two contracting States in regard to the residents of each of them.

This, on the other hand, does not imply that residents of third States are barred from invoking the rule's more far-reaching protective effect, just because the treaty concerned has effect only in the relationship between the two contracting States and hence only to the benefit of their own taxable entities. The fact is that when concluding the treaty, the contracting States, rather than entering into international commitments as representatives of their residents or nationals, are doing so on their own behalf. The treaty becomes an integral part of their domestic law. Therefore, anyone may invoke it who is subject to such domestic law of account of no matter what point of attachment."

Thus, Vogel argues that residents of third states can claim the benefit of Article 10(5) as a result of the treaty becoming part of the domestic law of the contracting states (which commonly occurs through specific domestic legislation or through constitutional law). He argues that since any tax imposed contravenes the terms of the treaty and, since the treaty is an "integral part" of domestic law, the imposition of tax also contravenes the domestic law of the state seeking to impose tax and can thus be challenged by the person upon whom tax is being imposed.

The court in Hunter Douglas had no problem applying the Canada-Netherlands treaty in relation to dividends paid to residents of third states. However, in this case the tax was imposed on the company paying the dividend rather than the recipients of the dividends (resident in third states) and thus, the person who was being assessed to tax was clearly within the scope of the treaty. Whether this will be the case in other situations depends on the law of the state seeking to impose tax; that is, whether it will seek to collect the tax from the recipients of the dividend or from a withholding agent who has, for example, failed to withhold tax. In most cases, however, it can be expected that the tax would be imposed on the recipient of the dividends and indeed, this is what is anticipated under the distributive rules of Article 10. In addition, the Canada-Netherlands treaty did not contain any equivalent to Article 1 of the OECD Model, and the personal scope of the treaty was therefore not specifically limited to residents of the contracting states. Nevertheless, the court expressed the view that the wording of the Article IV(5) of the treaty (equivalent to Article 10(5)) made it clear that shareholders resident in third states could benefit from the provision, on the basis that it does not limit the application of the provision to situations where the dividends are received by residents of the contracting states. In support of its decision, the court also referred to the purpose of tax treaties, namely, the avoidance of double taxation.

1350 Hattingh, P.J., "The Role and Function..." Hattingh goes on to note that "... since its earliest appearance in bilateral tax treaties, Art. 10(5) has been an implied exception to Art. 1." Also describing Article 10(5) as an implied exception to Article 1, see: Avery Jones, J.F., et al., "Tax Treaty Problems..."
1351 Vogel, K., Engelschalk, M., & Görl, M., Klaus Vogel on Double Tax Conventions..., at pp. 694-695, (m.no. 258).
1352 Elsewhere, Vogel writes: "Under the theory of 'moderate dualism,' which seems to be generally accepted nowadays, international and domestic law are two spheres which exist separate of each other (save some exceptions). To exercise their intended influence on domestic law, treaties therefore have to be implemented by the domestic legislator. Thus, they receive the force of domestic law." (Vogel, K., "The Domestic Law Perspective," at p. 3, (Chapter 1, section 1.1.))
1353 Sasseville, J., "A Tax Treaty Perspective...," at pp. 39-40 (Chapter 3, Section 3.2.).
1354 Hunter Douglas Ltd. v. Her Majesty the Queen, 1979, at para. 33.
1355 Hunter Douglas Ltd. v. Her Majesty the Queen, 1979, at para. 28.
In the case decided in the Netherlands, *Case 27252*, the relevant treaty (the Ireland-Netherlands treaty) also contained no equivalent to Article 1 of the OECD Model and the decision therefore does not specifically address this issue. Nevertheless, Smit writes that "...from the wording used by the Supreme Court, it appears justified to assume that its decision is also valid for treaties which do not have such a provision" (i.e., Article 1).

In general, it seems that Article 10(5) of the treaty between the two residence states should apply to prevent the losing residence state from imposing tax on dividends paid to residents of third states by dual resident companies. Nevertheless, various authors have suggested that the application of Article 10(5) in this situation should be put beyond doubt by making it an express exception to Article 1. This could be achieved by specific wording included at the end of Article 10(5).

### 12.3.4.3. Conclusions

As it is currently worded, the issues associated with applying Article 10(5) in relation to dividends paid by a dual resident to a person resident in a third state mean that it is difficult for taxpayers to achieve certainty that, on the basis of this provision, they will not be subject to dual source-based taxation. It is also difficult for a withholding agents who does not withhold tax in reliance on Article 10(5) to be confident that they have met their withholding obligations. These issues could be alleviated by rewording Article 10(5) to clarify its application in the case of dividends paid by dual resident companies to residents of third states. However, it would be better to establish a more comprehensive approach which would prevent dual source based taxation in reverse dual resident triangular cases not only in relation to dividends, but also in relation to interest and royalties. This will be discussed in the following section.

### 12.3.5. Potential solutions

The best way of resolving reverse dual resident triangular cases would be to make the allocation of residence under the treaty between the two residence states effective for the purposes of treaties with third states, i.e., by preventing the dual resident from being resident in the losing residence state for the purposes of such treaties. In this case, the dividends, interest or royalties would be paid by a person who is not resident of that state (State L) for the purposes of the R-L treaty and, as a result, State L would be prevented from imposing source-based taxation.

As discussed in Chapter 11, there are two main ways of achieving this outcome: the first is for states to incorporate a provision in their domestic law which prevents a dual resident from being resident for domestic purposes when that state is the losing residence state, and the second is for specific provisions to be included in tax treaties. These two options will be discussed in turn below.

#### 12.3.5.1. Domestic law

States could incorporate a provision into domestic law to the effect that a person whose residence is assigned to another state under a tax treaty tie-breaker provision ceases to be a resident under domestic law. If incorporated into the domestic law of the losing residence state, such a provision would prevent the dual-resident payor being resident in that state for the purposes of its treaty with the state where the person receiving the income is resident. As a result, the losing residence state would generally be prevented from imposing source based taxation on passive income paid by the dual resident to residents of third states. As discussed in Chapter 11, this is a simple and effective approach for dealing with dual residence under tax treaties, but it has the disadvantage that it does not resolve the treaty issues in the

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1356 Smit, P.M., "Taxation of Dividends...."
1357 Smit, P.M., "Taxation of Dividends...."
1358 Avery Jones, J.F., & Bobbett, C. "Triangular Treaty Problems...."  
1359 Avery Jones, J.F., et al., "Tax Treaty Problems....”; Hattingh, P.J., "The Role and Function....”
1360 Again, this assumes that the payment does not originate from a PE located in the losing residence state. Situations where the payment does originate from a PE in the losing residence state are discussed in Section 12.4., below.
1361 Refer to Section 11.3, for a more in depth discussion of these options.
state implementing the provision.\textsuperscript{1362} In the context of reverse dual resident triangular cases, for example, residents of the state implementing the provision may still be subject to dual source-based taxation when they receive passive income from persons who are dual resident in other states. In fact, reverse dual resident triangular cases clearly provide a disincentive for states to implement this type of provision in their domestic law, since it would effectively result in the state unilaterally giving up its source-based taxing rights when it is in the position of the losing residence state. Perhaps more importantly, the impact of such a provision a domestic context would likely be far greater than its impact in a treaty context and thus, domestic considerations are likely to take precedence over treaty considerations in deciding whether to implement such a provision.\textsuperscript{1363}

12.3.5.2. Treaty provisions

A specific provision included in tax treaties could deny treaty benefits by direct reference to the allocation of residence under treaties concluded with third states. This was also discussed in Chapter 11, in the context of denying treaty benefits to dual residents receiving income from a third state, but would be equally effective in preventing dual source-based taxation in reverse dual resident triangular cases. In Chapter 11 it was proposed that such a provision could be worded as follows (for inclusion in Article 4):

"Notwithstanding the other paragraphs of this Article, a person will not be a resident of a Contracting State if that person is, under a tax treaty concluded between that State and a third State, resident in the third State and not in the first-mentioned State."

This provision operates where the treaty in which it is included is the treaty between the losing residence state and the source state, and would be a clear and direct approach for excluding dual residents from treaty benefits. There would be no need to adapt the wording of the provision to deal with reverse dual resident triangular cases, since it is the denial of residence itself that prevents the losing residence state from imposing source based taxation. The main disadvantage of this approach is the extended period of time that it would take to implement, since it will only be effective in relation to those treaties that actually include the provision.

12.3.5.3. Conclusions

States should be encouraged to include provisions in their domestic law to the effect that a person will not be resident in that state if their residence is assigned to another state under a tax treaty. A better approach, however, would be to include a specific provision in tax treaties to deny treaty benefits to dual-residents whose residence is assigned to a third state under a tax treaty between the state that would otherwise be their residence state and that third state. This would resolve both situations where a dual resident receives income from a third state and those where a dual resident makes a payment that forms part of the income of a resident of a third state. If, however, there is no effective allocation of residence for the purposes of the treaty between the two residence states then neither of these approaches can be effective and the best alternative would be to split the source based taxing rights evenly between the two residence states of the payor.

12.4. Interaction between reverse dual resident and reverse PE triangular cases

There may be situations where a dual resident will be considered to have a PE in the losing residence state for the purposes of the treaty between the two residence states. Where the dual resident in this scenario pays dividends, interest or royalties to a resident of a third state, the result is a combination of a reverse dual resident triangular case and a reverse PE triangular case. This is illustrated in the following diagram.

\textsuperscript{1362} Refer to Section 11.3.1. for a more in depth discussion of this point.

\textsuperscript{1363} Refer to Section 11.3.1. for a more in depth discussion of this point.
This discussion below addresses such cases involving dividends, interest and royalties since these are the categories of income for which issues have been identified. It first sets out the result in such cases under the existing treaty framework, before going on to discuss the application of the proposals outlined above. As will be seen below, no changes to these proposals are required to deal with such situations.

### 12.4.1. Dividends

**Existing treaty framework**

Under the existing treaty framework, both State W and State L would generally be entitled to impose tax on the dividends under their respective treaties with State R. The existence of a PE in State L has no particular impact here, since the existence of a PE does not have any impact on whether a particular state is entitled to impose source-based taxation on dividends. State L may, however, be prevented from imposing any tax either (i) because the dual-resident is not considered to be resident in State L for the purposes of the L-R treaty as a result of the second sentence of Article 4(1), or (ii) as a result of Article 10(5) of the W-L treaty. If the dual-resident is not treated as a resident of State L for the purposes of the R-L treaty, the dividends would not fall under the distributive rule of Article 10 (since they are not paid by a resident) and would instead fall under either Article 7 or Article 21, depending on whether they are considered to be business profits. As a result, State L would be prevented from imposing tax on the dividends (assuming that the recipient of the dividends does not have a PE in that state). Alternatively, if the dual-resident continues to be resident in State L for the purposes of the R-L treaty, State L may nevertheless still be prevented from imposing tax under Article 10(5) of the W-L treaty. This may be difficult to apply, however, since the person benefiting from the reduction in tax is not resident in either of the contracting states (as discussed above).

**Proposed solutions**

Under the solutions proposed above, the L-R treaty would contain a specific provision having the effect that the dual-resident would no longer be considered a resident of State L for the purposes of that treaty, i.e., as a result of the allocation of residence to State W under the W-L treaty. As a result, State L would be prevented from imposing tax on the dividends under the same analysis as that outlined above. The dividends would remain taxable in State W under Article 10 of the W-R treaty, and State R would continue to have an obligation to provide relief. The advantage of the proposed solution in this case is the increased certainty that State L will be prevented from imposing tax on the dividends.

### 12.4.2. Interest

**Existing treaty framework**

Under the existing treaty framework, both State W and State L are likely to be entitled to impose tax on interest paid by the dual resident to a resident of a third state under their respective treaties with that state. Unlike in the case of dividends, the losing residence state would generally be entitled to impose source-based taxation under Article 11 even if the dual-resident is not considered to be a resident for the purposes of the L-R treaty, since the interest will originate from a PE of the payor located in that state.
Thus, there will be dual source-based taxation and the residence state of the recipient of the income may not be capable of providing sufficient relief to prevent unrelieved double taxation.

Proposed solutions

Under the proposed solution, the dual-resident payor would not be considered to be a resident of State L for the purposes of the R-L treaty as a result of a specific treaty provision. However, State L would still be entitled to impose source-based taxation on the interest under Article 11 as a result of the interest originating from a PE in State L. State W, on the other hand, would be prevented from imposing tax on the interest as a result of the amended wording of Article 11(5). Under the proposed alternative wording of Article 11(5), any interest which originates from a PE can only be taxed on a source basis in the PE state, even if that state is not one of the two contracting states. Therefore, as a result of Article 11 of the W-R treaty, State W would be prevented from imposing any tax on the interest. Thus, the interest would only be taxable on a source basis in State L. The residence state of the recipient of the income will be obliged to provide relief and no unrelieved double taxation will arise.

12.4.2. Royalties

As mentioned above, Article 12 of the OECD Model does not allow any source-based taxation of royalties, but many treaties differ from the OECD Model and allow source-based taxation of royalties where they arise in a contracting state. If both the W-R treaty and the L-R treaty follow this approach, then the analysis of the application of the treaties to royalties will be the same as that outlined above for interest. If, on the other hand, both these treaties follow the OECD Model, then both State W and State L will be prevented from imposing any tax under Article 12 of their respective treaties with State R.

Interestingly, if the W-R treaty would generally allow source-based taxation of royalties but prevents State W from imposing tax on royalties which originate from a PE located in a third state, a situation may arise where State W is prevented from imposing tax in circumstances where State L is prevented from imposing tax under the R-L treaty, i.e., where the R-L treaty follows the OECD Model. This may not be acceptable to State W, given that it is presumably agreeing to refrain from taxing the royalties in order to prevent dual source-based taxation. This illustrates one situation where the contracting states (i.e., State W and State R) may want to introduce some limitation on the circumstances in which the residence state of the payor would be prevented from imposing tax as a result of the royalties arising from a PE located in a third state (as discussed above).

12.5. Summary and conclusions

Reverse triangular cases can potentially result in dual source-based taxation of passive income. In reverse PE triangular cases, both the residence state of the payor and the PE state may be entitled to impose source-based taxation on payments of interest and royalties under their respective treaties with the residence state of the person receiving the income. Similarly, in reverse dual resident triangular cases, both residence states of the payor may be entitled to impose source-based taxation on payments of interest and royalties under their respective treaties with the residence state of the person receiving the income. This dual source-based taxation is problematic because it can lead to unrelieved double taxation if the residence state of the person receiving the income does not provide sufficient relief. This risk of unrelieved double taxation be resolved by preventing one of the source states from imposing tax on the income.

Reverse PE triangular cases

In reverse PE triangular cases, the residence state of the payor could be prevented from imposing tax by altering the wording of Article 11(5) to the effect that interest (or royalties) which are connected with a PE would be considered to arise in the PE state even if the PE is located in a third state. As a result, the interest would not be considered to arise in the payor's residence state for the purposes of applying the treaty between the payor's residence state and the recipient's residence state (the R-HO treaty), and thus
the distributive rule of Article 11 would not apply. Instead, article 7 or Article 21 would apply and the payor's residence state would be prevented from imposing tax (assuming the recipient does not have a PE in that state). This could be achieved by adopting alternative wording for the second sentence of Article 11(5), similar to that suggested in the OECD Commentary. The proposed provision is as follows:

"Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident, for the purposes of the treaty between the State of which he is resident and that other State, a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

Concerns that preventing the payor's residence state imposing tax may lead to the income escaping source-based taxation altogether (i.e., if the PE state doesn't impose tax), could be dealt with by limiting the circumstances in which the residence state would be prevented from imposing tax, e.g., such that the residence state would only be prevented from imposing tax if tax is imposed in the PE state. The exact wording of the provision would ultimately depend on the situations in which the contracting states would be willing to give up their source-based taxing rights in relation to interest payments connected to a PE in a third state, which would in turn depend on their level of concern regarding the potential for interest income to escape source-based taxation.

Reverse dual resident triangular cases

In reverse dual resident triangular cases, dual source based taxation of passive income may occur if the income is considered to be paid by a resident of each of the dual resident's residence states for the purposes of their respective treaties with the residence state of the recipient of the income. This can potentially give rise to unrelieved double taxation in situations where the residence state of the recipient of the income cannot grant sufficient relief. Where the tie-breaker provision of the treaty between the two residence states does not effectively allocate residence to one state, taxing rights should be split between the two residence states of the payor, such that each state may impose only 50% of the tax that it may otherwise have imposed under its treaty with the residence state of the person deriving the income. In situations where residence is assigned to one state under the treaty between the two residence states, however, the losing residence state should be prevented from imposing any source-based taxation. In the case of dividends, dual source-based taxation may be prevented by Article 10(5) of the treaty between the two residence states of the company paying the dividend. Article 10(5) prevents a particular state from imposing tax on dividends paid by a resident of the other contracting state unless they are paid to a local resident or attributable to a local PE of the person receiving the dividends. However, the application of Article 10(5) in the case of a dual resident paying dividends to residents of third states is somewhat unclear, since the person receiving the dividends (and thus the person upon whom tax is generally being imposed) is not a resident of either of the contracting states and thus does not fall within the personal scope of the treaty under Article 1. In addition, because of the way in which Article 10(5) is worded, it may not apply where the dual resident does not earn any income or profits from the losing residence state. Despite these issues, there is a strong argument that Article 10(5) could be used to prevent dual source based taxation of dividends in reverse dual resident triangular situations. It's application could be clarified by removing the reference to the derivation of profits or income from the non-residence state, and by making it an express exception to Article 1.

In a more general sense, dual source based taxation will not occur if the dual resident is not considered a resident of the losing residence state for the purposes of treaties which that state has concluded with third states. This may occur as a result of the application of the second sentence of Article 4(1), which denies residence to an entity which is taxable in the potential residence state only on income from sources in that state. Instead of relying on the second sentence of Article 4(1), however, the dual resident should be more explicitly prevented from being resident in the losing residence state for the purposes of treaties concluded between that state and third states. This could be achieved by provisions included in domestic laws which prevent a dual resident from being resident for domestic purposes when the state implementing the provision is the losing residence state. States should be encouraged to implement such
provisions. However, the impact of this type of provision in a domestic context would likely be far greater than its impact in a treaty context and thus, domestic considerations are likely to take precedence over treaty considerations in deciding whether to implement such a provision.

An alternative approach would be to include a specific provision in tax treaties to deny treaty benefits to dual-residents whose residence is assigned to a third state under a tax treaty between the state that would otherwise be their residence state and that third state. This would resolve both situations where a dual resident receives income from a third state and those where a dual resident makes a payment that forms part of the income of a resident of a third state. In Chapter 11 it was proposed that such a provision could be worded as follows (for inclusion in Article 4):

"Notwithstanding the other paragraphs of this Article, a person will not be a resident of a Contracting State if that person is, under a tax treaty concluded between that State and a third State, resident in the third State and not in the first-mentioned State."

There would be no need to alter the wording of this provision to deal with reverse dual resident triangular cases, since it is the denial of residence itself that prevents the losing residence state from imposing source-based taxation. The main disadvantage of this approach is the extended period of time that it would take to implement, since it will only be effective in relation to those treaties that actually include the provision, making it more appropriate as a long term rather than short term solution.