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

PE triangular cases combined with reverse PE triangular cases

1.1. Introduction

The case discussed in this section is a combination of a typical PE triangular case and a reverse PE triangular case. It involves a person who is resident in one state ("State R1") and has a PE in a second state ("State PE1") who derives income from outside those two states. The income is paid by a resident of a third state ("State R2") and the payment originates from a PE which the payor has in a fourth state ("State PE2"); State R2 and State PE2 are referred to collectively as the “source states”. This situation is illustrated in the following diagram (in which “HO” denotes head office):

1.1.1. The existing treaty framework

Under the existing treaty framework, the applicable treaties in this case will be:

(i) the treaty between the recipient’s residence state and the payor’s residence state (the R1-R2 treaty);

(ii) the treaty between the recipient’s residence state and payor’s PE state (the R1-PE2 treaty); and

(iii) the treaty between the recipient's residence state and the recipient’s PE state (the R1-PE1 treaty).

Neither the treaty between the payor’s residence state and the payor’s PE state (the R2-PE2 treaty) nor the treaty between the two PE states (the PE1-PE2 treaty) will apply because, for the purposes both of these treaties, the income is not received by a resident of one of the contracting states.

In relation to virtually all categories of income, this situation gives rise to the same result as that which occurs in a typical PE triangular case under the existing treaty framework (as outlined in Chapter 2). This is because in most cases source-based taxation may only be imposed in one state, i.e., either the payor’s residence state or the payor’s PE state but not both. The main exception is interest, where both those states would generally be entitled to impose tax under Article 11 of their respective treaties with the residence state of the recipient of the income, giving rise to dual source-based taxation. Dual source-based taxation may also occur in relation to royalties if, as is commonly the case, Article 12 of the relevant treaties differs from the OECD Model and allows some limited rate of source-based taxation. Where there is dual source-based taxation, tax may be imposed in four separate states, which would result in a high likelihood of unrelieved double taxation. In addition, even where dual source-based taxation does not arise, this situation will give rise to the same issues as typical PE triangular cases; i.e., the application of the less appropriate treaty conditions in the source state and the potential for unrelieved double taxation if no relief is provided in the PE state. In addition, tax avoidance concerns may arise in

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1434 For a detailed overview of the application of tax treaties in typical PE triangular cases, refer to Chapter 2.
1435 For a detailed discussion of reverse PE triangular cases, refer to Chapter 12 (Section 12.2.).
1436 Refer to the analysis of reverse PE triangular cases in Chapter 12 (particularly Section 12.2.3.).
1437 Refer to the analysis of reverse PE triangular cases involving interest in Chapter 12 (Section 12.2.2.).
1438 The UN Model also allows source-based taxation of royalties. See: UN Income and Capital Model Convention (2001), Article 12(2). This is discussed in somewhat more detail in Chapter 12 (see Section 12.2.2.).
relation to claims for reduced source-based taxation under the treaties concluded by the recipient’s residence state with the two source states.1439

1.1.2. Application of proposed solutions

The relevant proposals for the situation discussed in this section are those which are aimed at dealing with typical PE triangular cases and reverse PE triangular cases.

Application of treaties between the PE state and third states 1440

It is proposed that where a resident of one state derives income which is attributable to a PE in a second state (for the purposes of the treaty between those two states), the person deriving the income should be entitled to claim the benefits of treaties concluded between the PE state and third states in relation to the income attributable to the PE. As a result, the state where the income arises (the source state) would be obliged to apply the conditions of its treaty with the PE state, and the PE state would be obliged to grant relief in accordance with the terms of that treaty. The proposed treaty provision to achieve this is as follows:

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

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

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

(3) Any income, capital gains or profits to which this Convention applies as a result of the preceding paragraphs shall be considered to be paid to, derived by and beneficially owned by a person who is a resident of the Contracting State where the permanent establishment … is located for the purposes of the application of this Convention under those paragraphs. "1441

Note that paragraphs 1(b) and 1(c) of this proposed provision (which are not reproduced above) are intended to deal with situations where treaties do not exist between all the contracting states. They are thus not relevant for the analysis conducted in this appendix, since it is assumed that there are treaties in place between all the states involved.

If this provision were included in all the relevant treaties, then in the situation discussed in this section the person deriving the income would generally be entitled to claim the benefit of the treaties concluded

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1439 In PE triangular cases, the primary tax avoidance concern is that a company resident in State R will claim a reduction in source-based taxation under the R-S treaty in relation to income which is exempt in State R (as a result of being attributable to a PE), and which is also not subject to tax in the PE state (which may be a tax haven). See, inter alia: Van Weeghel, S. "The Improper Use of Tax Treaties", (London, Kluwer Law International, 1998), pp. 124-126.

1440 This proposal is discussed in detail throughout Chapter 7 and Chapter 8.

1441 This provision is extracted from Chapter 8 (see Section 8.2.5.).
between State PE1 and the source states (State R2 and State PE2) in relation to the income attributable to the PE. The exclusion for situations where the PE state of the recipient of the income is prevented from imposing tax is also relevant for certain categories of income.

**Limited application of treaties between the residence state and third states**

It is proposed that in PE triangular cases, the application of tax treaties between the residence state of the person deriving the income and third states where income arises (source states) be restricted. It is proposed that a source state will not be required to apply the conditions of its treaty with the residence state in relation to income attributable to a PE in a third state if either:

3. The source state applies the conditions its treaty with the PE state in relation to that income; or
4. The source state does not apply the conditions of its treaty with the PE state, but the situation is one where the application of the conditions of the treaty with the residence state would be considered improper (in accordance with certain specified criteria).

The proposed provision is as follows:

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

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

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

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

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

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1442 This aspect of the proposed solutions is discussed in depth in Chapter 7 (see in particular Section 7.5.).
Where a Contracting State applies [Article 23A / Article 23B] under this paragraph, it shall be applied as though the other Contracting State has applied the other provisions of this Convention in relation to the income.\textsuperscript{1443}

In the situation discussed in this section, the effect of this provision would be to exclude the operation of the treaties between the residence state (State R1) and the two source states (State R2 and State PE2). However, these treaties will continue to require State R1 to provide relief under the terms of the treaty (under paragraph 3 of the provision set out above) in some circumstances. In accordance with the wording of this provision, no relief would be required in State R1 to the extent that the source states are prevented from imposing tax under their respective treaties with State PE1. Furthermore, where State R1 uses the credit method of relief (either under Article 23A(2) or under Article 23B), the credit in State R1 is specifically limited to the rate of tax that the source state could have imposed if it applied the terms of its treaty with State R1. State R1 will also not be required to provide any additional relief if it exempts the income under its treaty with the PE state. This is based on the general principles discussed in Chapter 3 but, if the residence state remains concerned about having to both exempt the income and grant a credit, then there are also certain measures (discussed in Chapter 3) which that state could take to ensure that it does not have a dual relief obligation.\textsuperscript{1444}

Limits on source-based taxation where payments originate from a PE

It is proposed that interest (and, where applicable, royalties) which originate from a PE located in a third state should not be considered to arise in the payor’s residence state for the purposes of treaties concluded between that state and third states. This would be achieved by changing the wording of Article 11(5) and, where applicable, the corresponding provision of Article 12. The proposed wording of Article 11(5) 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 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."\textsuperscript{1445}

As a result, interest or royalties paid in a reverse PE triangular situation (or in the situation discussed in this section) would not be considered to arise in the residence state of the payor for the purposes of the treaty between that state and the residence state of the recipient. As a result, the residence state of the payor would be prevented from imposing tax (this will be discussed in further detail below). This may be subject to certain conditions, for example that the PE state imposes source-based tax on the interest,\textsuperscript{1446} but it is assumed that any such conditions are satisfied for the purposes of the discussion below.

**Applicable treaties**

If these proposed provisions are incorporated into all the relevant treaties, the applicable treaties in the situation discussed in this section would be:

(i) the treaty between the recipient’s residence state and the payor’s residence state (the R1-R2 treaty) – State R2 will not be bound by the conditions of this treaty, but State R1 may have a relief obligation;

\textsuperscript{1443} This provision is extracted from Chapter 7 (Section 7.5.4.) where it is discussed in much greater depth.

\textsuperscript{1444} Please refer to Chapter 3 for a detailed discussion of the possibility of a dual relief obligation arising in the residence state in PE triangular cases (Section 3.3.). It was concluded in that chapter that a treaty exemption should be taken into account when determining the amount of tax imposed in the residence state in respect of certain income for the purposes of applying the credit relief provisions of the other applicable treaty. As a result, there will be no tax imposed on the income in the residence state for the purposes of those relief provisions and no credit will be required (in accordance with the terms of Article 23A(2) or Article 23B, as applicable).

\textsuperscript{1445} This provision has been taken from the 2010 OECD Commentary on Article 11, para. 30. It is discussed in much greater depth in Chapter 12 (Section 12.2.2.).

\textsuperscript{1446} Refer to Chapter 12 (Section 12.2.2.2.) for discussion of the reasons for imposing such limitations and the type of limitations that may be imposed.
(ii) the treaty between the recipient’s residence state and the payor’s PE state (the R1-PE2 treaty) – State PE2 will not be bound by the conditions of this treaty, but State R1 may have a relief obligation;

(iii) the treaty between the recipient’s PE state and the payor’s residence state (the PE1-R2 treaty) – State R2 must apply the conditions of this treaty in relation to the income attributable to the PE and State PE1 may be obliged to provide relief;

(iv) the treaty between the recipient’s PE state and the payor’s PE state (the PE1-PE2 treaty) – State PE2 must apply the conditions of this treaty in relation to the income attributable to the PE and State PE1 may be obliged to provide relief; and

(v) the treaty between the recipient’s residence state and recipient’s PE state (the R1-PE1 treaty) – there will be no change in the way this treaty applies.

The only treaty which will not apply in this case is the treaty between the payor’s residence state and the payor’s PE state. This treaty will not apply because the income is not received by a resident of either of the contracting states.

The following sections discuss the application of tax treaties in this situation, one where a PE triangular case is combined with a reverse PE triangular case, where different categories of income are involved. Each section deals firstly with the application of tax treaties under the existing framework, before going on to discuss the application of tax treaties on the basis that all the relevant treaties include the proposed provisions outlined above.

1.2. Business profits

Article 7 deals with business profits and allows the residence state of the person deriving the income to impose tax. It also allows the other contracting state to impose tax, but only in relation to profits which are attributable to a PE in that other state.\textsuperscript{1447} Article 7 (in paragraphs 1 and 2) provides as follows:

\begin{quote}
“1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article \textsuperscript{[23 A]} \textsuperscript{[23 B]}, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”\textsuperscript{1448}
\end{quote}

Thus, the source state may not impose any tax on business profits except to the extent they are attributable to a PE. For further discussion of the PE concept and the attribution of profit to PEs, refer to the discussion in Chapter 5 (Sections 5.2.3. and 5.2.4.).

This section deals with a situation where a person resident in State R1 derives income which is attributable to a PE in State PE1. The income is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. It is assumed that the recipient of the income does not have a PE in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

\begin{quote}
\textsuperscript{1447} The term “permanent establishment” is defined in Article 5.
\textsuperscript{1448} Article 7, paragraphs 1 and 2.
\end{quote}
For a more detailed discussion of PE triangular cases involving business profits, refer to Chapter 2 (Section 2.4). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving business profits, refer to Chapter 11 (Section 11.2).

1.2.1. Existing treaty framework

The payor's residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 7 will apply and, given that the income is not attributable to a PE in State R2, State R2 will be prevented from imposing tax.

The payor's PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 7 will apply and, given that the income is not attributable to a PE in State PE2, State PE2 will be prevented from imposing tax on the income.

The recipient's PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 7 will apply and State PE1 will be entitled to impose tax on the profit attributable to the PE.

The recipient's residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax, but will be obliged to provide relief (either exemption or credit) in accordance with Article 23A/23B of the R1-PE1 treaty.

Overview: Under the existing treaty framework, tax may only be imposed in State R1 and State PE1 and State R1 will be obliged to provide relief. There will be no unrelieved double taxation. This situation is effectively the same as a typical PE triangular case involving business profits, since both source states are prevented from imposing tax. In applying their treaties with State R1, however, the source states (State R2 and State PE2) are arguably not applying the appropriate treaty provisions and should instead apply the provisions of their treaties with State PE1.1449

1.2.2. Application of proposed solutions

The payor's residence state (State R2): Instead of being bound by the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty in relation to the income attributable to the PE. For the purposes of this treaty, Article 7 will apply and, given that the income is not attributable to a PE in State R2, State R2 would be prevented from imposing tax on the income. This outcome is the same as where the R1-R2 treaty applies. The outcome may differ, however, if the PE definitions differ between the two treaties. For example, if the PE threshold is lower in the PE1-R2 treaty than in the R1-R2 treaty, then a PE may exist for the purposes of the first treaty but not the second. Nevertheless, in most cases the application of the PE2-R2 treaty instead of the R1-R2 treaty will have no impact on State R2's ability to impose tax on the income.

The payor's PE state (State PE2): Instead of being bound by the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. In relation to business profits, Article 7 applies and given that the income is not attributable to a PE in State PE2, State PE2 would be prevented from imposing tax on the income. The application of the treaty with the PE state instead of the treaty with the

1449 The reasons for considering the conditions of the treaty between the source state and the PE state the appropriate treaty conditions for the source state to apply in PE triangular cases are discussed in depth in Chapter 5.
residence state will generally have no impact in State PE2 in relation to business profits, however, it may have an impact if the PE definitions differ between the two treaties.

The recipient’s PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 7 will apply and State PE1 will be entitled to impose tax on the profit attributable to the PE. State PE1 is also obliged to apply the conditions of its treaties with State R2 and State PE2, in particular the relief provisions. In relation to business profits, however, both of the source states are prevented from imposing tax and State PE1 therefore has no obligation to provide relief.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax on the income, but will have an obligation to provide relief (either exemption or credit) under the R1-PE1 treaty. State R1 does not have any obligation to provide relief under either the R1-R2 treaty or the R1-PE2 treaty, since both State R2 and State PE2 are prevented from imposing tax under their respective treaties with State PE1.

Overview: The proposed solutions would usually have little practical impact in this situation, since the distributive rules for business profits do not generally differ between treaties. Furthermore, because no tax can be imposed in the source states, no relief is required in the recipient’s PE state. One situation where a different outcome may arise is where the PE definition contained in one of the source states’ treaties with State R1 differs from that contained in its treaty with State PE1. As a result, the source state may be entitled to impose tax if it applies the conditions of its treaty with State R1 but not if it applies the conditions of its treaty with State PE1 or vice versa. In order for this to fit within the scenario discussed in this section, however, the PE in the source state would have to be a sub-PE of the PE in State PE1, which is unlikely to occur in practice; sub-PE triangular cases are discussed in Chapter 2 (Section 2.4.1.) and in Chapter 8 (Section 8.6.6.). Note that the proposals relating to reverse PE triangular cases are not relevant here, since those proposals deal only with situations involving interest and royalties.

1.3. Dividends

Dividends are dealt with in Article 10. Article 10 allows the state where the payor of dividends is resident (the source state) to impose tax, but limits the amount of the tax to a certain percentage of the gross amount of the dividends. Article 10 provides as follows (in paragraphs 1 and 2):

“1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

   b) 15 per cent of the gross amount of the dividends in all other cases.”

Thus, the rate of tax that may be imposed in the source state depends on recipient’s interest in the company paying the dividends.1450 The exact rates are a common point of negotiation, however, and often vary between treaties. The ownership thresholds also vary in many concluded treaties and some treaties may provide only a single maximum tax rate. Furthermore, if the dividends are attributable to a PE of the recipient which is located in the source state, then as a result of Article 10(3), Article 7 will apply instead of Article 10 and the source state may impose tax on the basis of the profit attributable to the PE.

1450 The application of this threshold (and other treaty thresholds) in situations where treaty benefits are claimed in relation to the income attributable to a PE are discussed in Chapter 8 (Section 8.6.2.).
This section deals with a situation where a person resident in State R1 receives dividends which are attributable to a PE located in State PE1. The dividends are paid by a resident of State R2 and the profits from which the dividends are paid originate in a PE located in State PE2. It is assumed that the recipient of the dividends does not have a PE in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For a detailed discussion of PE triangular cases involving dividends, refer to Chapter 2 (Section 2.5.1.). For a detailed discussion of reverse PE triangular cases involving dividends, refer to Chapter 11 (Section 11.2.1.).

1.3.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 10 will apply and State R2 will be entitled to impose tax on the dividends at a limited rate.

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. Article 10 of the treaty will not apply because the dividends are not paid by a resident of State PE2. Instead, Article 7 or Article 21 will apply (depending on whether the income is considered to be business profits) and State PE2 will be prevented from imposing tax on the dividends. State PE2 may also be prevented from imposing tax under Article 10(5) of the R2-PE2 treaty.1451

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty the dividends are attributable to a PE in State PE1 and therefore, as a result of Article 10(3), will fall under the distributive rule of Article 7 of the purpose of this treaty. Under Article 7, State PE1 will be entitled to impose tax on the basis of the profit attributable to the PE. State PE1 may also have an obligation to provide relief for the tax imposed in State R2 under the PE non-discrimination provision (Article 24(3)) of its treaty with State R1, however, the scope of this obligation is not completely clear.1452

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will be obliged to provide relief under both the R1-R2 treaty (using the credit method, regardless of the general relief method specified in the...
treaty\textsuperscript{1453}) and the R1-PE1 treaty (either credit or exemption). Unless relief is also provided in State PE1, State R1 may be unable to provide sufficient relief to prevent double taxation. Where State R1 provides relief using the exemption method under the R1-PE1 treaty, it should not be obliged to grant any additional credit relief under the R1-R2 treaty.\textsuperscript{1454}

\textit{Overview}: In this situation, tax may be imposed in State R2, State PE1 and State R1. State R1 will have an obligation to provide relief under its treaties with State R2 and State PE1, and State PE1 may also have an obligation to provide relief for tax imposed in State R2 (under Article 24(3) of the R1-PE2 treaty). This situation is effectively the same as a typical PE triangular case, since State PE2 is prevented from imposing tax, and gives rise to the same issues. These are namely, the application of the “wrong” treaty conditions in the source state (particularly State R2, but also State PE2) \textsuperscript{1455} and the potential for unrelieved double taxation if no relief is provided in State PE1.\textsuperscript{1456}

1.3.2. Application of proposed solutions

\textit{The payor’s residence state (State R2)}: Instead of being bound by the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of the PE1-R2 treaty, Article 10 applies and State R2 may impose tax on the dividends at a limited rate. This rate may differ from that specified in the R1-R2 treaty.

\textit{The payor’s PE state (State PE2)}: Instead of being bound by the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of applying this treaty, Article 10 does not apply because the dividends are not paid by a resident of State PE2. Instead, if the dividends are considered to be business profits, Article 7 will apply. If the dividends are not considered to be business profits, then Article 21 will apply. Regardless of whether Article 7 or Article 21 applies, however, State PE2 will be prevented from imposing tax on the dividends. If State PE2 is prevented from imposing tax as a result of Article 10(5) of the R2-PE2 treaty under the existing treaty framework, then the outcome in this case will not be any different (and Article 10(5) may also continue to prevent State PE2 from imposing tax). However, there is some uncertainty regarding the application of Article 10(5) in this situation and preventing State PE2 from imposing tax under the terms of the PE1-PE2 treaty makes the outcome clearer and more certain.

\textit{The recipient’s PE state (State PE1)}: State PE1 must continue to apply the R1-PE1 treaty. For the purposes of this treaty, Article 7 applies and State PE1 may impose tax on the profit attributable to the PE. State PE1 is also obliged to provide relief for tax imposed in State R2 under the relief provisions of the PE1-R2 treaty. Given that dividends are involved this would typically be credit relief regardless of the general

\textsuperscript{1453} Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).

\textsuperscript{1454} This was discussed in Chapter 3 (Section 3.3.), where it was concluded that the exemption under one treaty should be taken into account when determining the amount of tax imposed in the residence state in respect of the income for the purposes of applying the relief provisions of the treaty requiring credit relief. As a result, there will be no tax imposed on the income in the residence state for the purposes of that provision and no credit will be required (in accordance with the terms of Article 23A(2) or Article 23B, as applicable). Please see Chapter 3 for an in-depth discussion of this issue.

\textsuperscript{1455} That is, the source states apply the conditions of their treaties with the residence state of the recipient of the income (State R1) rather than the conditions of their treaties with the PE state (State PE1), despite the allocation of primary (or even exclusive) taxing rights to State PE1 under the R1-PE1 treaty. The reasons for considering this the “wrong” treaty are discussed in depth in Chapter 5.

\textsuperscript{1456} Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.
method of relief specified in the treaty. 1457 State PE1 does not have to provide relief under the PE1-PE2 treaty because State PE2 is prevented from imposing tax on the income under the terms of that treaty.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but is obliged to provide relief under the R1-PE1 treaty (either exemption or credit). To the extent that State R1 exempts the income under this treaty, no further relief would be required. If, however, State R1 uses the credit method of relief with respect to the income attributable to the PE, it will also have to provide a credit 1458 for tax imposed in State R2 under the terms of the R1-R2 treaty. 1459 State R1 will not be obliged to provide relief under the R1-PE2 treaty, since State PE2 is prevented from imposing tax under the terms of the PE1-PE2 treaty.

Overview: In this situation, the source states (State R2 and State PE2) no longer have to apply the conditions of their treaties with the residence state of the person receiving the dividends (State R1) and will instead be subject to the conditions of their respective treaties with the recipient’s PE state (State PE1). This means that they are now applying the more appropriate treaty conditions. In State PE2 this will generally have no impact since State PE2 will generally be prevented from imposing tax regardless of which treaty it applies. In State R2, however, the treaty with State PE1 may provide a different maximum rate of source-based taxation of dividends and this would have an impact on the amount of tax that State R2 could impose. In addition, State PE1 now has an explicit obligation to provide relief for tax imposed in State R2 under the terms of the PE1-R2 treaty. Relief will also be required in State R1. If State R1 uses the exemption method under the R1-PE1 treaty then it will simply exempt the income, however, if State R1 uses the credit method in relation to the income attributable to the PE then it will also be obliged to provide a credit for tax imposed in State R2. The combination of the relief in State PE1 and in State R1 will generally ensure that no unrelieved double taxation arises. Note that the proposals relating to reverse PE triangular cases are not relevant here, since those proposals deal only with situations involving interest and royalties.

1.4. Interest

Interest is dealt with in Article 11, which allows the state where interest arises to impose a limited rate of tax. Article 11 reads as follows (paragraphs 1 and 2):

“1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.”

Thus, where Article 11 applies, the source state is limited to imposing an amount of tax equal to 10% of the gross amount of the interest. This rate is a common point of negotiation, however, and often varies between concluded treaties. Furthermore, if the interest is attributable to a PE of the recipient which is located in the source state then, as a result of Article 11(4), Article 7 will apply instead of Article 11 and the source state may impose tax on the basis of the profit attributable to the PE. 1460

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1457 Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).
1458 Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 10 (or Article 11).
1459 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
1460 Article 11(4) provides that: “The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the
Whether interest arises in a particular state is determined in accordance with Article 11(5) which provides that:

“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 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.”

Thus, interest arises in a particular state if it is paid by a resident of that state or, in broad terms, is borne by a PE located in that state. It should be noted that where interest is paid by a resident of a contracting state for the purposes of a particular treaty and is borne by a PE, but that PE is not located in either of the contracting states, then the interest will continue to arise in the residence state of the payor for the purposes of Article 11.1461 Thus, the interest will arise in the residence state of the payor for the purposes of the treaty between that state and the residence state of the recipient, and will arise in the PE state of the payor for the purposes of the treaty between that state and the residence state of the recipient. As will be seen below, this may give rise to dual source-based taxation in reverse PE triangular cases.1462

This section deals with a situation where a resident of State R1 derives interest income which is attributable to a PE in State PE1. The interest is paid by a resident of State R2 and is borne by a PE located in State PE2. It is assumed that the recipient of the income does not have a PE in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram](image1)

For a detailed discussion of PE triangular cases involving interest, refer to Chapter 2 (Section 2.5.2.). For a detailed discussion of reverse PE triangular cases involving interest, refer to Chapter 11 (Section 11.2.2.).

1.4.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. Under Article 11(5) of this treaty, the interest will be considered to arise in State R2 since it is paid by a resident of that state.1463 This is the case notwithstanding the fact that the interest is borne by a PE of the payor located in a third state.1464 Article 11 of the treaty will therefore apply and State R2 will be entitled to impose a limited rate of tax on the interest.

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1461 See, inter alia, the 2010 OECD Commentary on Article 11, paras. 28 and 29. This is discussed in much greater depth in Chapter 12 (Section 12.2.2.1.).
1462 This is discussed in much greater depth in Chapter 12 (Section 12.2.2.1.).
1463 Article 11(5) provides that: “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 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.”
1464 The application of Article 11(5) in reverse PE triangular cases is discussed in detail in Chapter 12 (see Section 12.2.2.1.).
The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. Under Article 11(5) of this treaty, the interest will be considered to arise in State PE2 since it is borne by a PE located in that state. For the purposes of the R1-PE2 treaty, Article 11 will therefore apply and State PE2 will be entitled to impose a limited rate of tax on the interest.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of the R1-PE1 treaty, Article 7 will apply (since the interest is attributable to a PE located in State PE1) and State PE1 will be entitled to impose tax on the profit attributable to the PE. State PE1 may also have an obligation to provide relief for the tax imposed in the source states (State R2 and State PE2) under the non-discrimination article (Article 24(3)) of its treaty with State R1, however, the scope of this obligation is not completely clear. If State PE1 does grant relief under this provision, it would typically be credit relief given that the income involved is interest income. However, State PE1 may not be able to fully credit the tax imposed in both State R2 and State PE2.

The recipient’s residence state (State R1): State R1 must apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax, but must provide relief under each of the three applicable treaties. Under the R1-R2 treaty and the R1-PE2 treaty this is likely to be credit relief (regardless of the general method of relief specified in the treaty) and under the R1-PE1 treaty it may be either exemption relief or credit relief. Given that State R1 has an obligation to provide relief for tax imposed in three states it is unlikely to be able to provide sufficient relief to prevent unrelieved double taxation.

Overview: In this situation, tax may be imposed in all four states. For the purposes of the R1-R2 treaty the interest is considered to arise in State R2 and for the purposes of the R1-PE2 treaty the interest is considered to arise in State PE2. Both State R2 and State PE2 may therefore impose tax on the interest under Article 11 of their respective treaties with State R1. State PE1 may also impose tax on the basis of the profit attributable to the PE. Given that tax is imposed in four states, the relief granted in the residence state (and possibly in the PE state) is unlikely to be sufficient to prevent double taxation. In addition, the source states (State R2 and State PE2) should arguably apply the conditions of their treaties with the PE state of the recipient (State PE1) rather than the conditions of their treaties with the residence state of the recipient of the income (State R1) in relation to the income attributable to the PE.

1.4.2. Application of proposed solutions

The payor’s residence state (State R2): Under the proposed solution, State R2 must apply the conditions of the PE1-R2 treaty instead of the conditions of the R1-R2 treaty in relation to the income attributable to the PE in State PE1. Furthermore, Article 11(5) would be modified such that where interest income is borne by a PE in a third state (in this case, State PE2), the interest would not be considered to arise in the residence state of the payor. As a result, the interest would not be considered to arise in State R2 and Article 11 would not apply for the purposes of the PE2-R1 treaty. Instead Article 7 or Article 21 would apply.

1465 The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

1466 Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.

1467 The reasons for considering the conditions of the treaty between the source state and the PE state the appropriate treaty conditions for the source state to apply in PE triangular cases are discussed in depth in Chapter 5. As mentioned above, it is proposed that interest (and, where applicable, royalties) which originate from a PE located in a third state should not be considered to arise in the payor’s residence state for the purposes of treaties concluded between that state and third states. This would generally result in the PE state (but not the residence state) of the payor being entitled to impose source based taxation on such payments. It would be achieved by changing the wording of Article 11(5) and, where applicable, the corresponding provision of Article 12. Refer to Section A1.2.1.2., above, and to Chapter 12 (Section 12.2.2.) for an in-depth discussion of this proposal.
apply, depending on whether the income is considered business profits, and State R2 would be prevented from imposing tax on the income (since it is not attributable to a PE of the recipient located in that state). Note that it is assumed that any conditions attached to the limitation on State R2's taxing rights are satisfied, e.g., there may be a provision to the effect that the income continues to arise in the residence state of the payor for the purposes of Article 11 if the PE state does not impose any tax on the interest.1469

The payor's PE state (State PE2): State PE2 must now apply the conditions of the PE1-PE2 treaty instead of the conditions of the R1-PE2 treaty. Under the modified version of Article 11(5) (as under the current version) the interest would arise in State PE2 for the purposes of the PE1-PE2 treaty. Article 11 of the treaty would therefore apply and State PE2 would be entitled to impose a limited rate of tax on the gross amount of the interest. This rate may differ from the rate that previously applied under Article 11 of the R1-PE2 treaty.

The recipient's PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty and must now also apply the PE1-R2 treaty and the PE1-PE2 treaty. For the purposes of the R1-PE1 treaty the interest income is attributable to a PE located in State PE1 and therefore, as a result of Article 11(3), the income will fall under the distributive rule of Article 7. Under Article 7, State PE1 is entitled to impose tax on the basis of the profit attributable to the PE. Under the PE1-PE2 treaty, State PE1 will be obliged to grant relief for tax imposed in State PE2. Given that the income is interest income, the credit method would generally apply irrespective of the general method of relief specified in the treaty.1470 State PE1 is not required to provide any relief under the PE1-R2 treaty because the terms of that treaty prevent State R2 from imposing any tax on the income.

The recipient's residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax on the income, but will have an obligation to grant relief under both the R1-PE1 treaty (using either the credit or exemption method) and the R1-PE2 treaty (using the credit method)1471 However, no relief will be required for tax imposed in State PE2 if State R1 exempts the income under the R1-PE1 treaty. State R1 will have no obligation to provide relief under the terms of the R1-PE2 treaty, since R2 is prevented from imposing tax under the PE1-R2 treaty.

Overview: The proposed modifications to Article 11(5) ensure that interest income which is borne by a PE is only considered to arise in one state for treaty purposes (i.e., the PE state of the payor, State PE2) and thus may not be subject to dual source-based taxation. Furthermore, the application of State PE1’s treaties with the source states (State R2 and State PE2) ensures that the source states are applying the appropriate treaty conditions to the income attributable to the PE. It also ensure that State PE1 provides relief for tax imposed on a source basis in State PE2; in relation to interest income this would typically be credit relief regardless of the general method of relief specified in the treaty. State R1 will also provide relief, either by exempting the income or by providing a credit for tax imposed in both State PE1 (as reduced by the credit for tax imposed in State PE2) and for the tax imposed in State PE2. The combination of the relief in State PE1 and State R1 should ensure that there is no unrelieved double taxation.

1.5. Royalties

Royalties are dealt with in Article 12, which allows tax to be imposed only in the residence state. Article 12 (paragraph 1) reads as follows:

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1469 For further discussion of the conditions that may be attached, refer to Chapter 12 (Section 12.2.2.2.).
1470 Where the treaty provides for the exemption method of relief under Article 23A, paragraph 2 nevertheless requires the residence state to grant relief using the credit method for income which may be taxed in the other contracting state under Article 11 (or Article 10).
1471 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
“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 which is located in the source state, then as a result of Article 12(2), Article 7 will apply instead of Article 12 and the source state may impose tax on the basis of the profit attributable to the PE. Thus, the OECD Model does not allow any source-based taxation of royalties except where they are attributable to a PE in the source state.

As outlined in Chapter 11 (see Section 11.2.2.), the UN Model and many concluded treaties do allow states to impose a limited rate of source-based taxation on royalties which arise in one contracting state and are paid to a resident of the other contracting state. In general, the rules for determining whether royalties arise in a particular state mirror the rules of Article 11(5) which apply in relation to interest.\textsuperscript{1472} To the extent that the applicable treaties do allow source-based taxation of royalties and determine where royalties arise under a provision equivalent to Article 11(5), the analysis in relation to royalties would be exactly the same as that outlined for interest above. The analysis below briefly considers both situations where the applicable treaties do allow source-based taxation of royalties under Article 12 and situations where they do not. Where source-based taxation of royalties is allowed, it is assumed that the relevant treaty contains a provision mirroring Article 11(5) for determining whether royalties arise in a particular state. Where Article 12 does not allow source-based taxation of royalties, the place where royalties arise becomes less important because if the royalties are not considered to arise in a particular state, then that state will nevertheless generally be prevented from imposing tax under either Article 7 or Article 21 of the treaty (depending on whether the income is considered to be business profits).\textsuperscript{1473} The result will therefore be the same regardless of whether the royalties are or are not considered to arise in the state applying the treaty.

This section deals with a situation where a person resident in State R1 derives royalties which are attributable to a PE located in State PE1. The royalties are paid by a resident of State R2 and originate in a PE of the payor located in State PE2. It is assumed that the royalties are not attributable to a PE of the recipient in either State R2 or State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram of PE triangular cases involving royalties]

For a detailed discussion of PE triangular cases involving royalties, refer to Chapter 2 (Section 2.5.3.). For a discussion of reverse PE triangular cases involving royalties, refer to Chapter 11 (Section 11.2.2.).

1.5.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State R2

\textsuperscript{1472} See, for example, Article 12(5) of the UN Model Treaty (2001), which 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."

will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.\textsuperscript{1474}

The payer’s PE state (State PE2): State PE2 must apply the R1-PE2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State PE2 will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.\textsuperscript{1475}

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 7 will apply and State PE1 may impose tax on the basis of the profit attributable to the PE. To the extent that either State R2 or State PE2 has imposed source-based taxation on the royalties, State PE1 may be required to provide relief in accordance with the non-discrimination provision (Article 24(3)) of the R1-PE1 treaty. However, the scope of the PE state’s obligation to provide relief under Article 24(3) is not completely clear.\textsuperscript{1476} If State PE1 does grant relief under this provision in relation to royalty income, it would typically be credit relief.

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-PE1 treaty, the R1-R2 treaty and the R1-PE2 treaty. State R1 may impose tax on the income. To the extent that State R2 and/or State PE2 is entitled to impose tax under their respective treaties with State R1, State R1 will be obliged to provide relief (generally using the credit method). State R2 will also be obliged to provide relief (credit or exemption) under the R1-PE1 treaty. To the extent that tax is imposed in State R2 and/or State PE2 as well as State PE1, State R1 will have an obligation to provide relief for tax imposed in more than one state and is unlikely to be able to provide sufficient relief to prevent unrelieved double taxation.\textsuperscript{1477}

Overview: The existence of dual source-based taxation of royalties in this situation will depend on the terms of the applicable treaties; it may be that neither of the source states (State R2 and State PE2) is entitled to impose tax, that only one of those states is entitled to impose tax or it may be that both those states are entitled to impose tax. Tax may also be imposed in State PE1 and State PE1 may have an obligation to provide relief for tax imposed in the source states (if applicable) under the non-discrimination provision of its treaty with State R1. State R1 may also impose tax and will have a clear obligation to provide relief for tax imposed in any of the other three states. Nevertheless, unrelieved double taxation may persist, particularly if tax is imposed in both of the source states. In addition, State R2 and State PE2 are arguably applying the wrong treaty conditions (i.e., the conditions of their treaties

\textsuperscript{1474} This assumes that the royalties are considered to arise in State R2 for the purposes of the treaty, i.e., as a result of being paid by a resident of State R2. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State R2, State R2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).

\textsuperscript{1475} This assumes that the royalties are considered to arise in State PE2 for the purposes of the treaty, i.e., as a result of originating from the PE. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State PE2, State PE2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).

\textsuperscript{1476} The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

\textsuperscript{1477} Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations.
with State R1) and should instead apply the conditions of their respective treaties with State PE1 in relation to the income attributable to the PE located in that state.\textsuperscript{1478}

\subsection*{1.5.2. Application of proposed solutions}

\textit{The payor’s residence state (State R2):} Instead of applying the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State R2 will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.\textsuperscript{1479}

\textit{The payor’s PE state (State PE2):} Similarly, instead of applying the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty Article 12 will generally apply and, depending on the terms of Article 12, State PE2 will either be prevented from imposing tax (if the treaty follows the OECD Model) or will be entitled to impose tax on the royalties at a limited rate.\textsuperscript{1480}

\textit{The recipient’s PE state (State PE1):} State PE1 will continue to apply the conditions of the R1-PE1 treaty and will continue to be entitled to impose tax on the profit attributable to the PE in accordance with Article 7. However, State PE1 must now also apply the conditions of the PE1-R2 treaty and the PE1-PE2 treaty. To the extent that State PE2 is entitled to impose tax on the income in accordance with the PE1-PE2 treaty, State PE1 will now have an explicit obligation to grant relief. State R2 will be prevented from imposing tax under the PE1-R2 treaty and therefore, State PE1 will not have any relief obligation under that treaty.

\textit{The recipient’s residence state (State R1):} State R1 will continue to apply the conditions of the R1-PE1 treaty, the R1-R2 treaty and the R1-PE2 treaty. Under the R1-PE2 treaty, State R1 will continue to have an obligation to provide relief using either the exemption or credit method in relation to the profit attributable to the PE. If State R1 uses the credit method of relief under the R1-PE1 treaty, and if State PE2 is entitled to impose tax under the PE1-PE2 treaty, then State R1 may also have an obligation to provide relief for tax imposed in State PE2 under the R1-PE2 treaty.\textsuperscript{1481} State R1 will not have any relief obligation under the R1-R2 treaty because State R2 will be prevented from imposing tax under the terms of the PE1-R2 treaty.

\textit{Overview:} The proposed modification to Article 12 will ensure that the royalties will only be considered to arise, and thus may only be taxable, in one of the source states (State PE2). Depending on the terms of Article 12 of the PE1-PE2 treaty, State PE2 may be prevented from imposing tax or may be entitled to impose tax at a limited rate. State R2 will be prevented from imposing any source-based taxation on the royalties. Thus, there will be no dual source-based taxation of the royalties. In addition, due to the

\textsuperscript{1478} For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.

\textsuperscript{1479} This assumes that the royalties are considered to arise in State R2 for the purposes of the treaty, i.e., as a result of being paid by a resident of State R2. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State R2, State R2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).

\textsuperscript{1480} This assumes that the royalties are considered to arise in State PE2 for the purposes of the treaty, i.e., as a result of originating from the PE in State PE2. This could occur under general principles or as a result of the application of a specific provision mirroring Article 11(5). If Article 12 does not allow any source based taxation of royalties, it may not contain a provision specifying where royalties are considered to arise. If this is the case and if, for some reason, the royalties are not considered to arise in State PE2, State PE2 would still be prevented from imposing tax either under Article 7 or under Article 21 (depending on whether the royalties are considered to be business profits for the purposes of the treaty).

\textsuperscript{1481} It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of the treaty (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
application of the treaties between the recipient’s PE state (State PE1) and the source states, the source states are now applying the more appropriate treaty provisions and State PE1 will have an explicit relief obligation in situations where State PE2 is entitled to impose tax. State R1 will also have an obligation to provide relief for tax imposed on the profit attributable to the PE in State PE1 and, where it uses the credit method with respect to the profit attributable to the PE, will also have an obligation to provide relief for tax imposed in State PE2 to the extent that it imposes source-based taxation on the royalty. This ensures that double taxation can generally be prevented.

1.6. Income from immovable property

Income from immovable property is dealt with in Article 6, which allows the state where the property is located to impose tax on the income. Article 6 (paragraph 1) provides as follows:

“Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

Immovable property is defined in Article 6(2) by reference to the domestic law of the state where the property is located.\(^{1482}\) The definition in Article 6(2) also lists certain things, such as property accessory to immovable property and livestock, which are always considered to be immovable property for the purposes of the treaty.

Where immovable property is located in a third state for the purposes of a particular treaty, there is some debate regarding the appropriate treaty article to apply.\(^{1483}\) This was discussed in detail in Chapter 2 (Section 2.6.) where it was concluded that the income may fall under the distributive rule of either Article 7 or Article 21. Article 7 may apply either because the income is considered to be business profits or because is attributable to a PE (i.e., as a result of Article 21(2)). The income will generally fall under Article 21 only if it is not considered to be business profits and is not attributable to a PE. For a detailed discussion, please refer to Chapter 2 (Section 2.6.).

This section deals with a situation where a person resident in State R1 derives income from immovable property which is attributable to a PE located in State PE1. The income is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. It is assumed that the recipient of the income does not have a PE in either State R2 or State PE2. As mentioned above, the application of tax treaties in relation to income from immovable property depends on the location of the property. For the purposes of the analysis below, it is assumed that the immovable property is located in the PE state of the payor (i.e., State PE2); this may occur, for example, where the payor leases business premises in that state through which it carries on its enterprise, thus giving rise to the PE in that state. This situation is illustrated in the following diagram (in which “HO” denotes head office):

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\(^{1482}\) Article 6(2) provides that: “The term ‘immovable property’ shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.”

For a detailed discussion of PE triangular cases involving income from immovable property, refer to Chapter 2 (Section 2.6.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving income from immovable property, refer to Chapter 11 (particularly Section 11.2.3).

1.6.1. Existing treaty framework

The payer’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. Article 6 does not apply because the immovable property is not located in State R2; instead, Article 7 or Article 21 applies (depending on whether the income is considered to be business profits)\textsuperscript{1484} and State R2 is prevented from imposing tax on the income.

The payer’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 6 will apply and, given that the immovable property is located in State PE2, State PE2 will be entitled to impose tax on the income.

The recipient’s PE state (State PE1): State PE1 will be subject to the conditions of the R1-PE1 treaty. The income will fall under Article 7 of the treaty (either directly because it is considered to be business profits, or indirectly as a result of Article 21(2)) and State PE1 will be entitled to impose tax on the profit attributable to the PE. State PE1 may also have an obligation to provide relief for tax imposed in State PE2 (i.e., the state where the property is located) under the non-discrimination provision (Article 24(3)) of its treaty with State R1.\textsuperscript{1485}

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will have an obligation to provide relief (either exemption or credit) under both the R1-PE2 treaty and the R1-PE1 treaty.\textsuperscript{1486} State R1 will not have a relief obligation under the R1-R2 treaty because the terms of the treaty do not allow State R2 to impose any tax on the income.

Overview: In this situation, tax is imposed in the state where the property is located (State PE2), State PE1 and State R1. State R1 will have a clear obligation to provide relief for tax imposed in both State PE1 and State PE2, but is unlikely to be able to provide sufficient relief in the absence of relief in the PE state (refer to discussion in Chapter 3). State PE1 may have an obligation to provide relief under Article 24(3), but the scope of this relief obligation is subject to debate. Unless State PE1 does provide relief, unrelieved double taxation is likely to arise. In addition, the source states (State R2 and State PE2) are

\textsuperscript{1484} Please refer to Chapter 2 for an in-depth discussion of the application of the tax treaties to income from immovable property located in a third state (Section 2.6.).

\textsuperscript{1485} The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

\textsuperscript{1486} Refer to Chapter 3 (Section 3.2.) for an analysis of the residence states capacity to provide sufficient relief to prevent unrelieved double taxation in PE triangular situations where the PE state does not provide any relief. Broadly, this will depend on the relative tax rates in the states involved and, where the residence state uses the credit method, will also depend on the applicable credit limitations. Chapter 3 also discusses the residence state’s potential option to grant dual relief (see Section 3.3.).
arguably applying the wrong treaty conditions, given the allocation of primary taxing rights to State PE1 under the R1-PE1 treaty.

Note that if the immovable property were instead located in State R2 (rather than in State PE2) then State R2 would be entitled to impose tax under Article 6 of its treaty with State R1 and State PE2 would be prevented from imposing tax under Article 7 or Article 21 of its treaty with State R1. If the immovable property were located in either State PE1 or State R1, then both State R2 and State PE2 would be prevented from imposing tax under their respective treaties with State R1.

1.6.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty, however this is unlikely to have any practical impact in State R2. State R2 will still be prevented from imposing tax, now under either Article 7 or Article 21 of the PE1-R2 treaty (instead of the R1-R2 treaty).

The payor’s PE state (State PE2): Instead of applying the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. Again, Article 6 will apply and State PE2 will be entitled to impose tax on the income. The definition of immovable property in Article 6 refers to the domestic law of the state where the property is located and thus, there is unlikely to be any difference in the results of the application of the two treaties. As a result the application of the PE1-PE2 treaty instead of the R1-PE2 treaty is unlikely to have any practical impact in State PE2.

The recipient’s PE state (State PE1): State PE1 will continue to apply the R1-PE1 treaty and will continue to be entitled to impose tax on the profits attributable to the PE under Article 7. However, State PE1 will now have an explicit obligation to provide relief (either exemption or credit) under the terms of the PE1-PE2 treaty.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will continue to have an obligation to provide relief under the R1-PE1 treaty. If State R1 provides relief using the credit method, it will also have an obligation to provide relief under the R1-PE2 treaty (using either the credit or exemption method).

Overview: The main impact of the proposed solution in this case is the explicit obligation imposed on the PE state to provide relief for tax imposed in the state where the property is located. Although the source states (State R2 and State PE2) are now applying the more appropriate treaty conditions, this is likely to have little practical impact since the terms of Article 6 are less likely to differ between treaties than, for example, the maximum rates of tax that can be imposed on passive income. There is also no concern with dual source-based taxation in this case, since tax cannot be imposed in a state other than the state where the immovable property is located in the absence of a PE. As a result, the proposals relating to reverse PE triangular cases are not relevant here.

1.7. Income from shipping and air transport

Article 8 deals with income from shipping, inland waterways transport and air transport and provides (in paragraphs 1 and 2) that:

“1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

1487 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

Thus, under Article 8, income from shipping, inland waterways transport and air transport may only be taxed in the state where the enterprise’s place of effective management is located.\textsuperscript{1488}

This section deals with a situation where a person resident in State R1 derives income from shipping, inland waterways transport and/or air transport which is attributable to a PE in State PE1. The place of effective management of the person deriving the income is located in that person’s residence state, State R1. The income is paid by a resident of State R2 and originates from a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the recipient of the income):

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{diagram.png}
\caption{Diagram illustrating the tax treaty framework involving income from shipping, inland waterways transport and air transport.}
\end{figure}

For a more detailed discussion of typical PE triangular cases involving income from shipping, inland waterways transport and air transport, refer to Chapter 2 (Section 2.7.). For further discussion of reverse PE triangular cases, including a brief overview of the outcome of reverse PE triangular cases involving income covered by Article 8, refer to Chapter 11 (Section 11.2.3.).

\textbf{1.7.1. Existing treaty framework}

\textit{The payor’s residence state (State R2)}: State R2 will apply the conditions of the R1-R2 treaty. Article 8 will apply and, given that the place of effective management is located in State R1, State R2 will not be entitled to impose any tax on the income.

\textit{The payor’s PE state (State PE2)}: State PE2 will apply the conditions of the R1-PE2 treaty. Again, Article 8 of the treaty will apply and State PE2 will be prevented from imposing any tax on the income.

\textit{The recipient’s PE state (State PE1)}: State PE1 must apply the conditions of the R1-PE1 treaty. Article 8 will also apply for the purposes of this treaty and State PE1 will not be entitled to impose any tax on the income.

\textit{The recipient’s residence state (State R1)}: State R1 must apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. There will be no limitation on State R1’s ability to impose tax, and since no other state may impose tax on the income, State R1 will have no obligation to provide relief.

\textit{Overview}: In this situation, tax may only be imposed in State R1; all the other states involved will be prevented from imposing tax under Article 8 of their respective treaties with State R1. For this category of income, the fact that income is paid by a resident of a particular state or is attributable to a PE located in that state does not have any impact on the allocation of taxing rights under tax treaties.

\textbf{1.7.2. Application of proposed solutions}

\textsuperscript{1488} The place of effective management will generally be in the residence state of the enterprise, and this is assumed to be the case for the purposes of the discussion below. For further discussion of the location of the place of effective management in the context of applying tax treaties in PE triangular cases involving income from shipping, inland waterways transport and air transport, please refer to Chapter 2 (Section 2.7.).
It is not proposed that the benefits of treaties concluded between the PE state and third states should be available in situations where the PE state is prevented from imposing tax under the conditions of the R-PE treaty, as is the case with respect to income from shipping, inland waterways transport and air transport under Article 8. This is discussed in Chapter 8 (Section 8.6.5.). Furthermore, no changes are proposed with respect to reverse PE triangular cases involving this category of income, since no dual source-based taxation arises under the existing treaty framework. There are therefore no changes proposed in relation to the situation discussed above.

1.8. Capital gains from the alienation of immovable property

Capital gains derived from the alienation of immovable property are dealt with in Article 13(1), which provides as follows:

“Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.”

Thus, Article 13(1) applies where a resident of one state derives capital gains from the alienation of immovable property located in the other contracting state, and allows the state where the property is located to impose tax on the gain. The reference to Article 6 in Article 13(1) is a reference to the definition of immovable property, which in turn refers to the domestic law of the state where the property is located, as well as containing a list of certain property which is always considered to be immovable property for the purposes of the treaty.1489

This section deals with a situation where a person resident in State R1 derives a capital gain from the alienation of immovable property and that capital gain is attributable to a PE of the recipient located in State PE1. The amount giving rise to the gain is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. It is further assumed for the immovable property from which the gain arises is located in State PE2. This situation is illustrated in the diagram below (in which “HO” denotes head office):

For further discussion of Article 13(1) and of typical PE triangular cases involving capital gains from the alienation of immovable property, refer to Chapter 2 (Section 2.8.1.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains from the alienation of immovable property, refer to Chapter 11 (Section 11.2.3.).

1.8.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State R2 will be prevented from imposing tax on the capital gain.1490

1489 For further discussion of the definition of immovable property and the application of tax treaties in PE triangular cases involving capital gains from immovable property, please refer to Chapter 2 (particularly Section 2.8.1.).

1490 Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other
The payor's PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(1) applies and state PE2 will be entitled to impose tax on the capital gain.

The recipient's PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 13(1) will not apply because the property is not located in either of the contracting states. Instead, Article 13(5) will apply (since none of the other paragraphs of Article 13 apply) and State PE1 will be prevented from imposing tax on the capital gain.

The recipient's residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will be required to provide relief (either exemption or credit) under the R1-PE2 treaty. State R1 will have no relief obligation under the R1-R2 treaty or the R1-PE1 treaty, since both State R2 and State PE1 are prevented from imposing any tax on the gain under their treaties with State R1.

Overview: In this situation, tax may be imposed in the state where the immovable property is located and in the residence state of the person deriving the capital gain, and the residence state is obliged to provide relief (either exemption or credit, depending on the terms of the treaty). There is therefore no unrelieved double taxation; this is to be expected since the existence of a PE in a particular state does not have any influence on that state’s ability to impose tax, either on the basis of the profit attributable to the PE or on a source basis. The residence of the payor also gives no source-based taxing rights under tax treaties.

Note that if the property were instead located in State R2 or State PE1, then a similar result would arise. The state where the property is located would be entitled to impose tax, as would State R1, but the other two states would be prevented from imposing any tax.

1.8.2. Application of proposed solutions

There are no changes proposed in relation to the situation discussed in this section. As mentioned above, it is not proposed that treaties concluded between the PE state and third states in PE triangular cases should apply in situations where the PE state is prevented from imposing tax under the terms of the treaty between that state and the residence state. Furthermore, no dual source-based taxation arises in relation to this category of capital gains and there are consequently no applicable changes proposed with respect to reverse PE triangular cases involving capital gains from the alienation of immovable property.

1.9. Capital gains from the alienation of movable property of a PE

Article 13(2) deals with capital gains from the alienation of movable property forming part of the business property of a PE. It provides that:

“Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.”

This section discusses a situation where a person resident in State R1 derives a capital gain from the alienation of movable property which forms part of the business property of a PE located in State PE1. The amount giving rise to the gain is paid by a resident of State R2 and the payment originates from a PE.
in State PE2. Note that for the purposes of the analysis below it is not relevant where the property is actually located, only that it is attributable to the PE located in State PE1. This situation is illustrated in the following diagram (in which “HO” denotes head office):

For further discussion of Article 13(2) and of typical PE triangular cases involving capital gains from the alienation of movable property forming part of the business property of a PE, refer to Chapter 2 (Section 2.8.2.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with under Article 13(2), refer to Chapter 11 (Section 11.2.3.).

1.9.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(2) will not apply because the gain does not arise from the alienation of movable property of a PE located in state R2. Since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State R2 will be prevented from imposing any tax on the gain.1492

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(2) will not apply because the gain does not arise from the alienation of movable property of a PE located in state PE2. Since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State PE2 will be prevented from imposing any tax on the gain.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty Article 13(2) will apply and State PE1 will be entitled to impose tax on the gain.

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-PE1 treaty, the R1-PE2 treaty, and the R1-R2 treaty. State R1 may impose tax on the gain but will be obliged to provide relief (either exemption or credit) under the R1-PE1 treaty. State R1 will have no obligation to provide relief under either the R1-R2 treaty or the R1-PE2 treaty, since both State R2 and State PE2 are prevented from imposing tax on the gain.

Overview: Tax may be imposed in State R1 and in State PE1, and State R1 must provide relief. There is no dual source-based taxation and no unrelieved double taxation, however State R2 and State PE2 are nevertheless still applying the wrong treaty conditions.1493

1.9.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty, Article 13(2) will not apply because the capital gain does not arise from the alienation of movable property forming part of the business property

1492 Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other paragraphs of Article 13 deal with capital gains arising from the alienation of immovable property (para 1), capital gains from the alienation of ships or aircraft in international traffic (and associated assets) (para 3), and capital gains from the alienation of shares deriving more than 50% of their value from immovable property (para. 4).

1493 For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.
of a PE located in State R2. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State R2 will be prevented from imposing any tax on the gain.

The payor's PE state (State PE2): Instead of applying the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty, Article 13(2) will not apply. Instead, since none of the other paragraphs of Article 13 apply, Article 13(5) will apply and State PE2 will continue to be prevented from imposing any tax on the gain.

The recipient's PE state (State PE1): State PE1 will continue to be bound by the conditions of the R1-PE1 treaty and will continue to be entitled to impose tax under Article 13(2) of that treaty. State PE1 must also apply the conditions of the PE1-R2 treaty and the PE1-PE2 treaty. Given that both State R2 and State PE2 are prevented from imposing tax under these treaties, however, State PE1 will have no relief obligation.

The recipient's residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax and will continue to have an obligation to provide relief under the R1-PE2 treaty (using either the exemption or credit method). State R1 will not have any obligation to provide relief under the R1-R2 treaty or the R1-PE2 treaty because both State R2 and State PE2 are prevented from imposing tax under their respective treaties with State PE1.1494

Overview: In this situation, the application of the treaties between the PE state of the person deriving the capital gain and third states has no practical impact on the ability of each state to impose tax, and no impact on the overall outcome. This is because there is no difference between the conditions of those states’ treaties with State R1 and their treaties with State PE1. In practice, there could potentially be differences between the terms of these treaties, in which case the application of the latter treaties may have an impact on the source state’s ability to impose tax in this situation. Note that the proposals relating to reverse PE triangular cases are not relevant here, since those proposals deal only with situations involving interest and royalties.

1.10. Capital gains from the alienation of ships and aircraft in international traffic

Article 13(3) deals with capital gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport and associated assets. It provides that:

“Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.”

This section deals with a situation where a person resident in State R1 derives a capital gain from the alienation of ships or aircraft operated in international traffic, and that capital gain is attributable to a PE located in State PE1. The place of effective management of the person deriving the capital gain is located in State R1. The amount giving rise to the capital gain is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office and “POEM” denotes the place of effective management of the person deriving the capital gain):

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1494 It is proposed that the residence state will continue to have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
For further discussion of Article 13(3) and of typical PE triangular cases involving capital gains from the alienation of ships or aircraft operated in international traffic, refer to Chapter 2 (Section 2.8.3.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with in Article 13(3), refer to Chapter 11 (Section 11.2.3).

1.10.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R1, State R2 will be prevented from imposing any tax on the capital gain.

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R1, State PE2 will be prevented from imposing any tax on the gain.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 13(3) will apply and, since the place of effective management of the enterprise deriving the gain is located in State R1, State PE1 will be prevented from imposing any tax on the gain. The fact that the gain is attributable to a PE in State PE1 has no impact on the application of the treaty.

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. None of these treaties will impose any restriction on State R1’s ability to impose tax and State R1 will have no obligation to provide relief.

Overview: In this situation, tax may only be imposed in State R1. State R2, State PE2 and State PE1 will all be prevented from imposing tax under their respective treaties with State R1.

1.10.2. Application of proposed solutions

There are no proposed changes that would have any impact on the situation discussed in this section. As mentioned above, it is not proposed that treaties concluded between the PE state and third states should apply in situations where the PE state is prevented from imposing tax under its treaty with the residence state.1495 Furthermore, no dual source-based taxation arises in relation to this category of capital gains and there are no applicable changes proposed with respect to reverse PE triangular cases involving capital gains of the type dealt with in Article 13(3).

1.11. Capital gains from the alienation of shares in a real estate company

Article 13(4) deals with capital gains from the alienation of shares which derive their value from immovable property. It provides as follows:

1495 Refer to Section A1.2.1.2. above and, for a more in-depth discussion of the application of the PE state’s treaties with third states in PE triangular cases, refer to Chapter 8 (Section 8.2.3.).
“Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.”

Such gains may therefore be taxed in the state where the underlying immovable property is located. The OECD Model does not contain any other specific provision dealing with shares, but some concluded treaties also allow source based taxation of gains arising from:

3. The alienation of shares in a company having more than 50% of its assets located in the source state;\textsuperscript{1496} and/or

4. The alienation of shares where the person disposing of those shares has a "substantial participation" (i.e., a shareholding of more than a certain specified percentage) in the company whose shares are being alienated.\textsuperscript{1497}

In general, these provisions allow the source state (i.e., the state where the underlying property is located) to impose tax on the gains in the same way as Article 13(4) allows taxation of gains arising from shares in a real estate company. For the purposes of the discussion below, however, it will be assumed that all the relevant treaties follow the OECD Model.

This section deals with a situation where a person resident in State R1 derives a capital gain from the alienation of shares which derive more than 50% of their value from immovable property, and that capital gain is attributable to a PE located in State PE1. The amount giving rise to the capital gain is paid by a resident of State R2 and originates in a PE of the payor located in State PE2. For the purposes of the discussion below, it is assumed that the underlying immovable property is located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

Note that the place where the shares are registered is not relevant for the purposes of the discussion below.

For additional discussion of PE triangular cases involving capital gains arising from the alienation of shares deriving more than 50% of their value from immovable property (and similar cases), refer to Chapter 2 (Section 2.8.4.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with under Article 13(4), refer to Chapter 11 (Section 11.2.3.).

1.11.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. Article 13(4) of the treaty will not apply because the underlying property is not located in State R2. Instead, since none of the other paragraphs of Article 13 apply, the capital gain will fall under Article 13(5) and State R2 will be prevented from imposing tax.\textsuperscript{1498} Note that if the underlying property were instead located in State R2, then Article 13(4) would apply and State R2 would be entitled to impose tax.


\textsuperscript{1497} See, for example the reservations of France, Chile, Sweden and Korea in the OECD Commentary to Article 13 of the OECD Model.

\textsuperscript{1498} Article 13(5) provides that: “Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.” The other
The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(4) will apply and State PE2 will be entitled to impose tax. Note that if the property were located in another state, such as State R2, then Article 13(5) would apply instead of Article 13(4) and State PE2 would be prevented from imposing tax.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, Article 13(4) will apply and State PE1 will be entitled to impose tax on the gain. State PE1 may have an obligation to provide relief for tax imposed in State PE2 (i.e., the state where the underlying property is located) under the non-discrimination article (Article 24(3)) of the R1-PE1 treaty.\(^\text{1499}\)

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will be obliged to provide relief (either exemption or credit) under both the R1-PE2 treaty and the R1-PE1 treaty.

Overview: In this situation, tax may be imposed in State PE2, State PE1 and State R1. State R1 will be obliged to provide relief under both the R1-PE2 treaty and the R1-PE1 treaty but may not be able to provide sufficient relief to prevent unrelieved double taxation in the absence of relief in State PE1. State PE1 may have an obligation to provide relief under the non-discrimination article (Article 24(3)) of the R1-PE1 treaty. Furthermore, State R2 and State PE2 are arguably applying the wrong treaty conditions and should instead apply the conditions of their respective treaties with State PE1.\(^\text{1500}\)

1.11.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty, Article 13(5) will apply and State R2 will continue to be prevented from imposing tax.

The payor’s PE state (State PE2): Instead of applying the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty, Article 13(4) will apply and State PE2 will continue to be entitled to impose tax on the gain.

The recipient’s PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty and must now also apply the conditions of the PE1-PE2 treaty. As under the existing framework, Article 13(2) of the R1-PE2 treaty is likely to apply and State PE1 is likely to be entitled to impose tax on the gain. Now, however, State PE1 will have a direct obligation to provide relief (exemption or credit) under the terms of the PE1-PE2 treaty. State PE1 will not have any relief obligation under the PE1-R2 treaty since State R2 is prevented from imposing tax.

The recipient’s residence state (State R1): State R1 must continue to apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 will continue to have a relief obligation under the R1-PE1 treaty (either exemption or credit) but now, will only have a relief obligation under the R1-PE2 treaty if it uses the credit method under the R1-PE1 treaty.\(^\text{1501}\) State R1 will not have any relief obligation

1499 The PE state’s potential relief obligation under Article 24(3) is discussed in depth in Chapter 4. Article 24(3) requires that the tax imposed on the PE in the PE state be “not less favorably levied” than the tax imposed on a resident enterprise carrying on the same activities. It is quite clear that this requires the PE state to extend the benefit of any domestic relief provisions to the PE. It is less clear however, whether this also requires the PE state to extend to the PE any relief that would be available to local residents under the PE-S treaty. For detailed discussion of these issues, please refer to Chapter 4 (particularly Section 4.3.).

1500 For an in-depth discussion of the appropriate treaty conditions to apply in the source state in PE triangular cases, please refer to Chapter 5.

1501 It is proposed that the residence state will have an obligation for tax imposed in the source state(s) in PE triangular cases under a specific provision of its treaties with those states (refer to Section A1.2.1.2., above). The residence state will not have a relief obligation if it is required to exempt the income under its treaty with the PE.
under the R1-R2 treaty because State R2 is prevented from imposing tax under the terms of the PE1-R2 treaty.

Overview: In this situation, tax may be imposed in State PE2 (the state where the underlying property is located), State PE1 and State R1. Both State R1 and State PE1 will have an obligation to provide relief, with State PE1 now having an explicit relief obligation under the terms of the PE1-PE2 treaty. The application of the terms of the treaties concluded between State PE1 and the source states (State R2 and State PE2) has little impact on the ability of each of the states to impose tax provided all the relevant treaties follow the OECD Model. It is possible, however, that the terms of the treaties between State PE1 and the source states differ from the terms of the treaties concluded between State R1 and the source states, in which case the application of the State PE1’s treaties could have a significant impact. The explicit obligation for the PE state to provide relief may also have a significant impact if that state does not consider itself bound to provide relief under Article 24(3) of the R1-PE1 treaty. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

1.12. Capital gains from the alienation of other property

Article 13(5) deals with capital gains arising from the alienation of property not dealt with in the other paragraphs of Article 13 (referred to herein as “other property”). It provides that:

“Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.”

Thus, capital gains from the alienation of other property may only be taxed in the residence state of the person deriving the gain.

This section deals with a situation where a person who is resident in State R1 derives a capital gain from the alienation of other property, and that gain is attributable to a PE in State PE1. The amount giving rise to the capital gain is paid by a person resident in State R2 and originates in a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):

![Diagram showing capital gains from the alienation of other property](image)

Note that in most cases, capital gains attributable to the PE in State PE1 (and not arising from the alienation of immovable property) would fall under Article 13(2), which deals with capital gains from the alienation of movable property forming part of the business property of a PE. Thus, it is unlikely that Article 13(5) would ever apply for the purposes of the R1-PE1 treaty in a PE triangular case. Nevertheless, for completeness, this section discusses a situation where that is the case.

For discussion of typical PE triangular cases involving capital gains from the alienation of other property, refer to Chapter 2 (Section 2.8.5.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving capital gains dealt with under Article 13(5), refer to Chapter 11 (Section 11.2.3.).

1.12.1. Existing treaty framework

state or if the source state is prevented from imposing tax under its treaty with the PE state (the PE-S treaty). This proposal is discussed in much greater depth in Chapter 7 (Section 7.5.4.).
The payor’s residence state (State R2): State R2 must apply the conditions of the R1-R2 treaty. For the purposes of this treaty, Article 13(5) applies and State R2 will be prevented from imposing tax on the gain.

The payor’s PE state (State PE2): State PE2 must apply the conditions of the R1-PE2 treaty. For the purposes of this treaty, Article 13(5) applies and State PE2 will be prevented from imposing tax on the gain.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of the discussion in this section it is assumed that Article 13(5) applies, in which case State PE1 will be prevented from imposing tax on the gain. However, it should be recognised that in many cases where the capital gain is attributable to the PE, the capital gain will have arisen from the alienation of movable property forming part of the business property of the PE, in which case Article 13(2) would apply and State PE1 would be entitled to impose tax (refer to Section 1.9, above).

The recipient’s residence state (State R1): State R1 must apply the conditions of the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax and will have no obligation to provide relief since State R2, State PE2 and State PE1 are each prevented from imposing tax under their respective treaties with State R1.

Overview: In this situation, tax may only be imposed in State R1. There will be no need for relief in State PE1 and no unrelieved double taxation.

1.12.2. Application of proposed solutions

None of the proposed changes would have any impact on the application of tax treaties in this situation. Since the PE state (State PE1) is prevented from imposing tax on the capital gain under its treaty with State R1, the treaties between State PE1 and the source states (State R2 and State PE2) would not apply. In addition, dual source-based taxation of capital gains falling under Article 13(5) is prevented under the existing framework and thus no changes are proposed in relation to reverse PE triangular cases involving such gains.

1.13. Other income

Article 21, titled “other income,” applies to any income not dealt with elsewhere in the treaty. It provides that:

“1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.”

Thus, Article 21 does not allow any taxation of other income outside the residence state unless the income is attributable to a local PE, in which case Article 7 applies.

This section deals with a situation where a resident of State R1 derives “other income” which is attributable to a PE in State PE1. The income is paid by a resident of State R1 and originates in a PE of the payor located in State PE2. This situation is illustrated in the following diagram (in which “HO” denotes head office):
For a discussion of typical PE triangular cases involving other income, refer to Chapter 2 (Section 2.9.). For more detailed discussion of reverse PE triangular cases, including a brief overview of the outcome in reverse PE triangular cases involving other income, refer to Chapter 11 (Section 11.2.3.).

1.13.1. Existing treaty framework

The payor’s residence state (State R2): State R2 must apply the R1-R2 treaty. For the purposes of this treaty Article 21 applies and, since the income is not attributable to a PE of the recipient in State R2, State R2 is prevented from imposing any tax on the income.

The payor’s PE state (State PE2): State PE2 must apply the R1-PE2 treaty. For the purposes of this treaty Article 21 applies and, since the income is not attributable to a PE of the recipient in State PE2, State PE2 is prevented from imposing any tax on the income.

The recipient’s PE state (State PE1): State PE1 must apply the conditions of the R1-PE1 treaty. For the purposes of this treaty, the income is attributable to a PE located in State PE1 and therefore, as a result of Article 21(2), the income will fall under the distributive rule of Article 7. Under Article 7, State PE1 will be entitled to impose tax on the profit attributable to the PE.

The recipient’s residence state (State R1): State R1 must apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R1 may impose tax but will have an obligation to provide relief (either exemption or credit) under the R1-PE1 treaty. State R1 will not have any relief obligation under the R1-R2 treaty or the R1-PE2 treaty, since these treaties prevent State R2 and State PE2, respectively, from imposing any tax on the income.

Overview: The outcome in this case is that tax may be imposed in State R1 and in State PE1, and State R1 will be obliged to provide relief. Both State R2 and State PE2 will be prevented from imposing tax on the income.

1.13.2. Application of proposed solutions

The payor’s residence state (State R2): Instead of applying the conditions of the R1-R2 treaty, State R2 must now apply the conditions of the PE1-R2 treaty. For the purposes of this treaty, Article 21 will apply and, given that the income is not attributable to a PE of the recipient in State R2, State R2 will be prevented from imposing any tax on the income.

The payor’s PE state (State PE2): Instead of applying the conditions of the R1-PE2 treaty, State PE2 must now apply the conditions of the PE1-PE2 treaty. For the purposes of this treaty, Article 21 will apply and, given that the income is not attributable to a PE in State PE2, State PE2 will be prevented from imposing any tax on the income.

The recipient’s PE state (State PE1): State PE1 must continue to apply the conditions of the R1-PE1 treaty and will still be entitled to impose tax on the profit attributable to the PE in accordance with Article 7 of the treaty. State PE1 must also apply the PE1-R2 treaty and the PE1-PE2 treaty, however since these treaties prevent State R2 and State PE2 (respectively) from imposing any tax on the income, State PE2 will not have any relief obligation.

The recipient’s residence state (State R1): State R1 must continue to apply the R1-R2 treaty, the R1-PE2 treaty and the R1-PE1 treaty. State R2 may impose tax but will be obliged to provide relief in accordance with the terms of the R1-PE1 treaty (either exemption or credit). State R1 will not have any relief obligation.
under either the R1-R2 treaty or the R1-PE2 treaty, since both State R2 and State PE2 are prevented from imposing any tax under their treaties with State PE1.

**Overview:** In practical terms, the final outcome in this situation is no different after the application of the proposed solution. That is, State R1 and State PE1 may impose tax, with State R1 obliged to provide relief, and both of the source states are prevented from imposing tax. However, this is a consequence of the assumption that all the relevant treaties follow the OECD Model. The source states are now applying the more appropriate treaty conditions and if terms of the relevant treaties did differ (for example, if one or both of these treaties did not contain Article 21), then a very different result could occur. Note that the proposals relating to reverse PE triangular cases do not apply here, since those proposals deal only with situations involving interest and royalties.

1.14. Conclusions

This section has discussed a situation where a typical PE triangular case is combined with a reverse PE triangular case. The analysis above illustrates that the issues arising in this situation are generally the same as those arising in the basic triangular cases which it comprises. Reverse PE triangular cases only give rise to dual source-based taxation in relation to interest income (and royalties where the applicable treaties differ from the OECD Model) and thus, dual source based taxation may only occur here where interest and royalties are involved. In all other cases, the outcome in this situation is essentially the same as the outcome in a typical PE triangular case (outlined in detail in Chapter 2).

The application of the proposed solutions in this situation ensures that the source states apply the appropriate treaty conditions, and ensure that both the PE state and the residence state of the person receiving the income provide appropriate relief to prevent unrelieved double taxation. Importantly, the provisions of the treaties concluded between the PE state and the source states do not apply in situations where the PE state is prevented from imposing tax on the income under its treaty with the residence state. In such cases, the source states should continue to apply the conditions of their respective treaties with the residence state. In addition, although the source states are no longer bound by the conditions of their treaties with the residence state of the person deriving the income, the residence state may still have an obligation to grant relief in accordance with these treaties. The residence state will not have any relief obligation in situations where it exempts the income under its treaty with the PE state or where the source state in question is prevented from imposing tax under its treaty with the PE state. In other cases, however, the provision of relief in the residence state is important for preventing unrelieved double taxation.

This situation has also demonstrated the application of the proposed solution for reverse PE triangular cases involving interest. Under this proposed solution, interest which originates in a PE in a third state is not considered to arise in the residence state of the payor (subject to certain conditions) under Article 11(5). As a result, the residence state of the payor is not entitled to impose tax under Article 11 and is prevented from imposing tax under either Article 7 or Article 21. Source based taxation may therefore only be imposed in the PE state of the payor and there will no longer be any dual source based taxation.

One of the key points of the discussion in this section is to test the interaction of these two solutions and, as can be seen above, this presents no special problems. The residence state of the payor of the interest simply applies the modified Article 11(5) of its treaty with the PE state and is prevented from imposing tax under the terms of that treaty.