

Emily Fett

Triangular Cases

The Application
of Bilateral
Income
Tax Treaties
in Multilateral
Situations

Triangular Cases: The Application of Bilateral Income Tax Treaties in Multilateral Situations

Why this book?

Bilateral income tax treaties do not always operate effectively in situations where more than two states are involved. These situations are known as “triangular cases” and they typically arise where a person who is resident in two states for tax purposes (a dual resident), or a person who is resident in one state and has a permanent establishment (PE) in another, has dealings with a resident of a third state. This thesis explores the issues presented by the application of bilateral tax treaties in PE triangular cases, dual resident triangular cases and reverse triangular cases, and outlines potential solutions.

The main focus of this book is PE triangular cases: situations where a person which is resident in one state (the residence state) earns income from sources in a second state (the source state) that is attributable to a PE of the recipient in a third state (the PE state). Such situations give rise to numerous issues. Key among these is the fact that the source state is not required to apply the conditions of the treaty between the PE state and the source state, even though the treaty between the residence state and the PE state will allocate the prior (and perhaps exclusive) taxing rights to the PE state. This book argues that this approach should be reconsidered. It argues that residence concepts do not always provide a strong foundation on which to base eligibility for treaty benefits, that the PE concept and, in particular, the attribution of income to the PE, represents a sufficiently strong connection to the PE state to support a treaty claim, and that treaty-shopping concerns can be sufficiently addressed.

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Introduction

1.1. Introduction

Bilateral income tax treaties do not always operate effectively in situations where more than two countries are involved. These situations are known as “triangular cases” and they typically arise where a person who is resident in two states for tax purposes (a dual resident), or a person who is resident in one state and has a permanent establishment (PE) in another, has dealings with a resident of a third state.

There are four basic categories of triangular cases that will be discussed in this thesis. They are (i) PE triangular cases, (ii) dual resident triangular cases, (iii) reverse PE triangular cases and (iv) reverse dual resident triangular cases. This chapter contains a brief introduction to the issues that can arise in these situations, which will be discussed in depth in later chapters. This discussion is based on the assumption that all the relevant states have concluded treaties based on the OECD Model Tax Convention on Income and on Capital¹ (the “OECD Model”). Further assumptions will be set out below.

1.2. Background and outline of triangular cases

1.2.1. PE triangular cases²

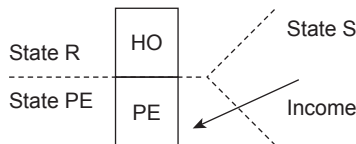
PE triangular cases arise where a person who is resident in one state (the “residence state” or “State R”) earns income from sources in a second state

1. All references to the OECD Model are to the OECD Model (2010) unless otherwise specified.

2. For general literature on PE triangular cases, refer to: B.J. Arnold & J. Sasseville, *Source Rules for Taxing Business Profits under Tax Treaties* in B.J. Arnold, J. Sasseville & E.M. Zolt, *The Taxation of Business Profits under Tax Treaties* (Canadian Tax Foundation 2003); J.F. Avery Jones, *The David R. Tillinghast Lecture: Are Tax Treaties Necessary?*, 53 *Tax Law Review* 1, pp. 1-38 (1999); J.F. Avery Jones & C. Bobbett, *Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London*, 53 *Bull. Intl. Fiscal Docn.* 1, pp. 16-20 (1999), *Journals IBFD*; F.A. García Prats, *Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties*, *Intertax* 11, pp. 473-491 (1994); M. Gusmeroli,

(the “source state” or “State S”) and that income is attributable to a PE of the recipient in a third state (the “PE state” or “State PE”). These situations are also known as “typical” triangular cases, particularly when they involve dividends or interest.³ A PE triangular case is illustrated in the following diagram (in which “HO” denotes the head office of the entity):

Figure 1.1.: A PE triangular case



In a PE triangular case, tax may be imposed under the domestic laws of all three states involved. The source state would generally impose tax on a source basis, e.g., due to the residence of the payor, particularly where passive income such as dividends and interest is involved. In the PE state, it is the business activities carried on there by the person deriving the income and the link between the income and those business activities which is likely

Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part I, 45 Eur. Taxn. 1, pp. 2-13 (2005), Journals IBFD; H.E. Kostense, *The Saint-Gobain Case and the Application of Tax Treaties. Evolution or Revolution?*, 9 EC Tax Review 4, pp. 220-232 (2000); B. Kusters, *Triangular Cases in Tax Treaties*, 15 Asia-Pac. Tax Bull. 6, pp. 372-377 (2009), Journals IBFD; A.J. Martín Jiménez, F.J. García Prats & J.M. Calderón Carrero, *Triangular Cases, Tax Treaties and EC Law: The Saint-Gobain Decision of the ECJ*, 55 Bull. Intl. Fiscal Docn. 6, pp. 241-253 (2001), Journals IBFD; OECD Committee on Fiscal Affairs, *Triangular Cases*, in *Model Tax Convention: Four Related Studies* (OECD 1992) (hereinafter, the OECD Triangular Cases Report); F.P.G. Pötgens, *The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case*, 48 Eur. Taxn. 4, pp. 210-215 (2008), Journals IBFD; A. Rust, *Situs Principle v. Permanent Establishment Principle in International Tax Law*, 56 Bull. Intl. Fiscal Docn. 1, pp. 15-18 (2002), Journals IBFD; P. Spector, “*Triangular Problem*” Settled in *US-Netherlands Treaty Protocol*, 47 Bull. Intl. Fiscal Docn. 12, pp. 698-700 (1993), Journals IBFD; F.P. Sutter & U. Zehetner (eds.), *Triangular Tax Cases* (Linde Verlag 2004); J. Turro, *U.S. and Dutch Negotiators Settle “Triangular Problem” in Protocol*, 7 Tax Notes International 13, pp. 775-777 (1993); E. van der Stoel, *Dutch Supreme Court Denies Tax Credit for Cross-Border Withholding*, 25 Tax Notes International p. 1268 (2002); K. van Raad, *Issues in the Application of Tax Treaty Non-Discrimination Clauses*, 42 Bull. Intl. Fiscal Docn. 8/9, pp. 347-351 (1988), Journals IBFD; K. van Raad, *The 1992 OECD Model Treaty: Triangular Cases*, 33 Eur. Taxn. 9, pp. 298-301 (1993), Journals IBFD; R. Vann, “*Liable to Tax*” and *Company Residence under Tax Treaties* in G. Maisto (ed.), *Residence of Companies under Tax Treaties and EC Law* pp. 197-271 (IBFD 2006); K. Vogel, *Tax Treaty Monitor: Tax Treaty News*, 57 Bull. Intl. Fiscal Docn. 6, pp. 235-236 (2003), Journals IBFD; S. Yong, *Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place*, 64 Bull. Intl. Taxn. 3, pp. 152-164 (2010), Journals IBFD; G. Zhai, *Triangular Cases Involving Income Attributable to PEs*, 53 Tax Notes International 12, pp. 1105-1123 (2009).

3. Inter alia: OECD Triangular Cases Report, *supra* n. 2.

to trigger tax. Finally, in the residence state, tax is likely to be imposed on the basis of the residence of the person deriving the income. The residence state may provide double taxation relief unilaterally under its domestic law, and in many cases will do so, but even then the relief may not be sufficient and unrelieved double taxation may arise. This brings us to the application of tax treaties, the main focus of this thesis. In a PE triangular case, there are two applicable tax treaties:

- the treaty between the residence state and the source state (the “R-S treaty”); and
- the treaty between the residence state and the PE state (the “R-PE treaty”).

The treaty between the PE state and the source state (the “PE-S treaty”) will generally not apply because PEs are not “persons” for treaty purposes and are thus not entitled to treaty benefits.⁴ The source state will therefore be bound to apply the conditions of the R-S treaty and, at least in the case of passive income, will generally be entitled to impose tax under the terms of the treaty. Where interest income is involved, for example, the source state would apply the conditions of the interest article (article 10) and, given the income is paid by a resident of that state, would be entitled to impose tax at a limited rate (e.g., 10%) based on the gross amount of the income. The PE state, on the other hand, will be required to apply the conditions of the R-PE treaty. Under the business profits article of this treaty (article 7) the PE state will generally be entitled to impose tax on the profit attributable to the PE, including any income which may be considered to be sourced in a third state. Finally, the residence state must apply the conditions of both the R-S treaty and the R-PE treaty and will have an obligation to provide relief under both these treaties (under the relief article: article 23A or article 23B). This relief may or may not be sufficient to prevent unrelieved double taxation. Thus, depending on the category of income, the domestic law of the states involved, and the terms of the applicable tax treaties, tax may be imposed on the income in the source state, the PE state and the residence state. Conversely, PE triangular cases can also give rise to opportunities for tax avoidance, since the source state may be required to apply the terms of the R-S treaty in circumstances where the residence state exempts the income and where the PE state also does not impose any tax. The following sections give a more detailed overview of the issues that may arise in PE triangular cases, while also introducing some of the potential solutions examined in more detail throughout the remainder of this thesis.

4. This is discussed further in section 2.3.

1.2.1.1. The residence state's obligation to provide relief

In PE triangular cases, the residence state may have an obligation to provide relief for tax imposed in the source state under the terms of the R-S treaty, and may also have an obligation to grant relief for tax imposed in the PE state under the terms of the R-PE treaty. This gives rise to two main issues. The first is the extent to which the residence state is capable of fully relieving double taxation. Where source-based taxation has been imposed in both the source state and the PE state, the residence state may not be able to provide sufficient relief.⁵ As will be seen in chapter 3, the residence state's ability to provide sufficient relief will depend on a number of factors, including the relative tax rates of the three states involved (after the application of any relevant treaty limitations), whether the PE state grants relief for tax imposed in the source state, and, if the residence state grants relief using the credit method, the way in which the credit is calculated.

The residence state's obligations under the R-PE treaty and the R-S treaty may also potentially require the residence state to grant dual relief. That is, if one treaty (e.g., the R-PE treaty) requires the residence state to exempt the income and another treaty (e.g., the R-S treaty) requires the residence state to grant relief using the credit method, then the residence state may only be able to meet its treaty obligations by both exempting the income and allowing a credit.⁶ This would clearly be problematic. As will be discussed in chapter 3, however, the residence state may not have a dual relief obligation for a number of reasons. For states that remain concerned about the risk of being obliged to grant dual relief, chapter 3 will also identify some potential solutions.

1.2.1.2. The PE state and the non-discrimination principle

To the extent that the PE state imposes tax on income arising in a PE triangular case, that state should be obliged to grant relief for tax imposed in the source state. This would serve both to ensure that double taxation can be prevented and to ensure that there is an equitable distribution of taxing rights between the PE state and the residence state.⁷ The PE state may grant

5. Inter alia: OECD Triangular Cases Report, *supra* n. 2, at para. 40. This will be discussed in detail in section 3.2.

6. Inter alia: Pötgens, *supra* n. 2; Van Raad, *The 1992 OECD Model ...*, *supra* n. 2; Zhai, *supra* n. 2. This issue is discussed in detail in section 3.3.

7. OECD Triangular Cases Report, *supra* n. 2, at paras. 18 and 40. Refer also to: García Prats, *supra* n. 2; Van Raad, *The 1992 OECD Model ...*, *supra* n. 2. This will be discussed further in chapter 3.

relief unilaterally under its domestic law,⁸ but given that PEs are generally not eligible for treaty benefits, the PE state will not have any obligation to provide relief under the PE-S treaty. The PE state may, however, have an obligation to provide relief under the non-discrimination article of the treaty between the PE state and the residence state.⁹

The PE non-discrimination article (article 24(3)) of the R-PE treaty generally requires the PE state to tax the PE “not less favourably” than a resident enterprise of the PE state.¹⁰ Consequently, to the extent that relief would be available to a resident of the PE state carrying on the same activities as the PE, equivalent relief should, *prima facie*, be available to the PE. The scope of this relief obligation is, however, subject to much debate; it is quite clear that the PE state is required to extend domestic relief measures to PEs, but there is no general consensus regarding whether the PE state is required to grant relief equivalent to that available to residents under the PE-S treaty.¹¹ Where the PE state does grant relief and does so using the credit method, issues may also arise with respect to the amount of the credit which must be granted and the appropriate limitations to apply. The PE state’s potential obligation to grant relief in PE triangular cases will be discussed in depth in chapter 4.

1.2.1.3. Limitation of the source state’s taxing rights

In accordance with the existing treaty framework, the taxation of income in the source state in a PE triangular case must satisfy the conditions of the R-S treaty. The source state is not required to apply the conditions of the PE-S treaty even though the R-PE treaty will allocate the prior (and perhaps exclusive) right to tax the income to the PE state. It has therefore been suggested by various authors that the applicable treaty conditions in the source

8. See section 4.2.2.1.

9. Inter alia: OECD Triangular Cases Report, *supra* n. 2, at paras. 30-32. This will be discussed in detail in section 4.3.

10. Article 24(3) provides that: “The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.”

11. Para. 67 *OECD Commentary on Article 24*; J.F. Avery Jones et al., *The Non-Discrimination Article in Tax Treaties*, 31 *Eur. Taxn.* 10, pp. 310-347 (1991), *Journals IBFD*; Avery Jones & Bobbett, *supra* n. 2; J. Friedhelm, *Discriminatory Tax Treatment of German Permanent Establishments – The Rebirth of an Old Problem*, 31 *Tax Management International Journal* 13, pp. 613-617 (2002); Gusmeroli, *supra* n. 2; K. van Raad, *Nondiscrimination in International Tax Law*, Series on International Taxation, vol. 6, p. 151 (Kluwer 1986); Van Raad, *The 1992 OECD Model ...*, *supra* n. 2; Zhai, *supra* n. 2.

state should be those contained in the PE-S treaty, instead of those contained in the R-S treaty.¹² Chapter 5 will assess this position, taking into consideration the role of the residence concept in tax treaties, the reasons why states enter into tax treaties and agree to reduced rates of source-based taxation, the nature of PEs and their treatment under domestic tax laws and tax treaties, and the separate entity approach for determining the profit attributable to PEs (particularly under the new Authorised OECD Approach (AOA)). It will also consider the extent to which extending treaty benefits to PEs may potentially facilitate improper use of tax treaties, taking into account the ways in which states seek to combat treaty shopping under existing principles, the lack of legal effect of internal transactions, the economic basis for the attribution of income to PEs under the AOA, and the impact of the way in which the income attributable to PEs is generally taxed.

PE triangular cases can also give rise to concerns regarding the improper use of treaties under the existing treaty framework. That is, a resident of State R may claim the benefits the R-S treaty in the source state in relation to income which is exempt from taxation in the residence state as a result of it being attributable to a PE in a third state, and which is either not taxed or is subject to only minimal tax in the PE state.¹³ In this situation, the source state may consider the application of the conditions of the R-S treaty to be abusive. This will be discussed further in chapter 8, along with ways in which this type of abuse could be prevented.

1.2.1.4. Underlying causes of the issues arising in PE triangular cases

There are three primary factors underlying all the issues arising in PE triangular cases. The first is the overlap between the implicit source rules contained in tax treaties. That is, for the purposes of the R-PE treaty the income attributable to the PE is effectively considered to have its source in the PE state as a result of the PE's activities there, whereas for the purposes of the R-S treaty, the income is effectively considered to have its source in State S. As a result, both the source state and the PE state may be entitled

12. Refer to, inter alia: Arnold & Sasseville, *supra* n. 2, at p. 118; Avery Jones & Bobbett, *supra* n. 2; Avery Jones, *The David R. Tillinghast Lecture ...*; García Prats, *supra* n. 2; B. Langoth, *Treaty Entitlement of Permanent Establishments*, in *Triangular Tax Cases* (F.P. Sutter & U. Zehetner eds., Linde Verlag 2004); Martín Jiménez, García Prats & Calderón Carrero, *supra* n. 2; Yong, *supra* n. 2; Zhai, *supra* n. 2. This will be discussed in detail in chapter 5.

13. OECD Triangular Cases Report, *supra* n. 2, at para. 21; S. van Weeghel, *The Improper Use of Tax Treaties* pp. 124-126 (Kluwer Law International 1998).

to impose tax on a source basis in accordance with their respective treaties with the residence state. The second factor underlying the issues arising in PE triangular cases is the hybrid nature of the PE concept. While generally considered to be a threshold for source-based taxation, the PE concept has a number of features which make it more akin to a residence concept.¹⁴ In addition, PEs are commonly in the same way as a resident enterprise.¹⁵ One consequence of this is that the PE state is entitled to impose tax on the worldwide income attributable to a PE, including income which has a close link to a third state, e.g., as a result of being paid by a resident of that state. Finally, the bilateral nature of tax treaties means that their provisions generally only contemplate bilateral situations, and are not intended to interact with the provisions of other tax treaties. This means, for example, that the application of the R-S treaty does not take into account the result of applying the R-PE treaty, i.e., the distribution of taxing rights to the PE state and limitation of the taxing rights of the residence state. These underlying causes of the issues arising in PE triangular cases will be discussed in chapter 6.

1.2.1.5. Potential solutions

The underlying causes of the issues arising in PE triangular cases, outlined briefly above, suggest three general approaches which may potentially resolve such issues. Firstly, the PE concept could be treated more like a source concept, and the overlap in the implicit sourcing rules under tax treaties could be resolved. This would involve either treating the PE state as the only state of source in relation to the income and preventing State S from imposing tax, or treating State S as the only source state and preventing the PE state from imposing tax. This would be a relatively simple approach; however, as will be discussed in chapter 6, it would give rise to significant tax avoidance concerns. Alternatively, the hybrid nature of the PE concept could be resolved by treating the PE concept more like a residence concept. This would involve, broadly, requiring the source state to apply the conditions of the PE-S treaty, and requiring the PE state to provide relief for tax imposed in the source state. This could be done either by making the PE equivalent to a treaty-eligible person in some way, or by allowing the entity to which the PE belongs to claim the benefit of the PE-S treaty in relation to the income arising in State S and attributable to the PE. In either case, treaty benefits would essentially be extended to PEs and, for ease of expression, this thesis will generally refer to the extension

14. This will be discussed in detail in chapter 5.

15. *Id.*

of treaty benefits to PEs (and to PEs being entitled to claim treaty benefits) without making a distinction between these two approaches.¹⁶ For reasons which will be discussed throughout this thesis (but particularly in chapters 5, 6 and 7), the extension of treaty benefits to PEs is, in my view, the best approach for dealing with PE triangular cases. Finally, PE triangular cases could be resolved by replacing the relevant bilateral tax treaties with a multilateral treaty. However, the drafters of any multilateral treaty would still have to consider how that treaty should deal with PE triangular cases and for various reasons, which will be discussed in chapter 6, the resolution of the issues arising in PE triangular cases is not considered sufficient reason to warrant replacing the existing network of bilateral treaties with (one or more) multilateral treaties.

1.2.1.6. Extension of treaty benefits to PEs

Chapters 7, 8 and 9 will further explore the possible extension of treaty benefits to PEs. In chapter 7, the focus will be on the general approach for requiring the PE state and the source state to apply the conditions of the PE-S treaty. It will address whether treaty benefits should be available to PEs directly under provisions included in the PE-S treaty, or whether it would be preferable for provisions included in the R-S treaty and the R-PE treaty to indirectly require the application of the terms of the PE-S treaty. It will also consider the appropriate limitations on the relief to be provided in the PE state and the appropriate method of relief. Finally, chapter 7 will deal with the non-application of the conditions of the R-S treaty with respect to income that is attributable to a PE in a third state, both in tax avoidance situations and in situations where the source state applies the conditions of the PE-S treaty.

Chapter 8 will consider the basic structure of the provisions extending treaty benefits to PEs, and the appropriate prerequisites, if any, for the availability of treaty benefits to PEs. It will also outline various specific provisions which could be included in tax treaties to prevent improper access to treaty benefits through PEs. Finally, chapter 9 will consider various other issues which may arise if treaty benefits are extended to PEs, including the resolution of multilateral disputes through the mutual agreement procedure, the application of threshold requirements in tax treaties, and the extension of treaty benefits to PEs of insurance companies.

16. These two approaches will be discussed in section 8.2.1.

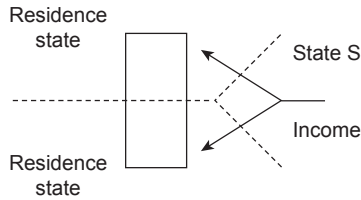
Extending treaty benefits to PEs would result in PEs being treated more like separate enterprises for treaty purposes. If this occurs, the question arises as to how far this separate entity treatment should be taken. That is, whether the PE should be treated as a separate treaty-eligible entity for the purposes of the R-PE treaty and, in addition, whether notional payments between different parts of the enterprise should be recognised for treaty purposes, thus allowing states to impose source-based taxation on such notional payments. This will also be discussed, albeit briefly, in chapter 9.

1.2.2. Dual resident triangular cases¹⁷

Dual resident triangular cases occur where a person who is resident in two states for tax purposes (a dual resident) receives income from sources in a third state (the “source state” or “State S”). This is illustrated in the following diagram:

17. For literature on dual resident triangular cases, refer to: J.F. Avery Jones, *The Interaction between Tax Treaty Provisions and Domestic Law*, in *Tax Treaties and Domestic Law* sec. 6.4.1. (G. Maisto ed., IBFD 2006), Online Books IBFD; Avery Jones & Bobbett, *supra* n. 2; R. Betten, *Denial of Certificate of Residence to a Dual Resident Company*, 29 Eur. Taxn. 11, pp. 371-373 (1989), Journals IBFD; J.W.J. de Kort, *HR 28 February 2001, nr 35.557: The Supreme Court of the Netherlands Reaches a Questionable Decision in a Triangular Dividend Withholding Case*, 29 Intertax 12, pp. 402-406 (2001); S. Damen, *Netherlands Supreme Court Rules on the Residence of Dual Resident Companies under Tax Treaties with Third Countries*, 55 Bull. Intl. Fiscal Docn. 7, pp. 290-292 (2001), Journals IBFD; Kosters, *supra* n. 2; Gusmeroli, *supra* n. 2; J.B. Libin, *Treaty Status of Dual-Resident Countries*, 33 Tax Management International Journal 11, pp. 659-660 (2004); J. Sasseville, *A Tax Treaty Perspective: Special Issues*, in *Tax Treaties and Domestic Law* ch. 3 (G. Maisto ed., IBFD 2006), Online Books IBFD; P.M. Smit, *Treaty Residence of a Company in a Triangular Situation: Decision of the Supreme Court of 28 February 2001*, 42 Eur. Taxn. 4, pp. 155-158 (2002), Journals IBFD; J-P. van den Berg & B. van der Gulik, *The Mutual Agreement Tiebreaker – OECD and Dutch Perspectives*, 54 Tax Notes International 5, pp. 417-428 (2009); C.J.A.M. van Gennep, *Dual-Resident Companies: The Second Sentence of Article 4(1) of the OECD Model Convention of 1977*, 31 Eur. Taxn. 5, pp. 141-146 (1991), Journals IBFD; K. van Raad, *Dual Residence and the 1977 OECD Model Treaty Article 4(1), Second Sentence*, 30 Eur. Taxn. 1, pp. 27-29 (1990), Journals IBFD; K. van Raad, *Dual Residence*, 28 Eur. Taxn. 8, pp. 241-246 (1988), Journals IBFD; Van Raad, *The 1992 OECD Model ...*, *supra* n. 2; K. van Raad, *2008 OECD Model: Operation and Effect of Article 4(1) in Dual Residence Issues under the Updated Commentary*, 63 Bull. Intl. Taxn. 5/6, pp. 187-190 (2009), Journals IBFD; Vann, *supra* n. 2, at ch. 7.

Figure 1.2.: A dual resident triangular case



Residence for treaty purposes is determined in accordance with article 4 (or its equivalent) and generally depends on residence under domestic laws. As a result, a person may be a dual resident for treaty purposes if they are considered to be a resident in two different states under their respective domestic laws. Dual residence can occur, for example, where an individual lives for part of the year in each of the two states or, in the case of a company, where the company is incorporated in one state and is managed in another, or has its management split between two states. To deal with such situations, article 4 contains tie-breaker rules which are intended to assign the residence of a dual resident to one of its residence states for the purposes of the treaty between those two states (article 4(2) and article 4(3)). However, in some situations the applicable tie-breaker rule may not operate effectively and the person's residence may not be assigned to one state for the purposes of that treaty. The situations where dual residence can arise, and the tie-breaker rules for allocating residence under tax treaties, will be discussed in chapter 10.

Whether double taxation arises in dual resident triangular cases depends on the category of income involved. In many cases the state to which residence is not assigned (the losing residence state) will be prevented from imposing tax on income arising in third states under the conditions of the treaty between the two residence states. However, where the income is attributable to a PE in the losing residence state, then the losing residence state may be entitled to impose tax in accordance with the terms of that treaty. In this case, the situation is effectively a PE triangular case, with the exception that the treaty between the losing residence state (the PE state) and the source state may potentially apply.

An important issue in dual resident triangular cases is the ability of the dual resident to claim benefits under treaties concluded by the losing residence state with third states. If a dual resident is entitled to claim treaty benefits under the treaties concluded by both of its residence states with the source state, then the source state will only be able to satisfy its treaty obligations

by applying the treaty conditions that are more favourable to the taxpayer.¹⁸ This can give rise to significant tax avoidance concerns because the source state may continue to be bound by the conditions of its treaty with the losing residence state in situations where that state is prevented from imposing tax under the treaty between the two residence states.

The allocation of residence under the treaty between the two residence states is generally effective only for the purposes of the treaty between those two states. Residence must be determined independently for the purposes of each treaty under article 4 of that treaty, i.e., by reference to residence under domestic law. However, the OECD Commentary takes the position that a dual resident will not be a resident of the losing residence state for the purposes of treaties with third states on the basis of the second sentence of article 4(1).¹⁹ The second sentence of article 4(1) provides that a person is not a resident of a particular state if they are “liable to tax in that State in respect only of sources in that State or capital situated therein.” The view expressed in the OECD Commentary is that the dual resident is taxable in the losing residence state only on income from sources in that state as a result of the restrictions imposed under the treaty between the two residence states. This approach is controversial, however, and will be discussed in detail in chapter 11, along with potential alternative approaches to denying treaty benefits to dual residents.

1.2.3. Reverse PE triangular cases²⁰

Reverse PE triangular cases occur where a person resident in one state (“State R”) receives income from a person resident in a second state (the

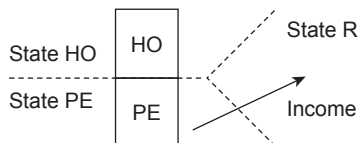
18. See, inter alia: Van Raad, *The 1992 OECD Model ...*, *supra* n. 2; Avery Jones & Bobbett, *supra* n. 2; Gusmeroli, *supra* n. 2.

19. Para. 8.2 *OECD Commentary on Article 4*.

20. For literature on reverse PE triangular cases, refer to: J.F. Avery Jones et al., *Tax Treaty Problems Relating to Source*, 38 *Eur. Taxn.* 3, pp. 78-93 (1998), *Journals IBFD* (also published under the same title in *British Tax Review* 3, pp. 225-250 (1998); Avery Jones & Bobbett, *supra* n. 2; Gusmeroli, *supra* n. 2; P.J. Hattingh, *The Role and Function of Article 1 of the OECD Model*, 57 *Bull. Intl. Fiscal Docn.* 11, pp. 546-553 (2003), *Journals IBFD*; C. Jakobson, *Payment of Interest by a Permanent Establishment to a Third State Recipient*, in *Triangular Tax Cases* pp. 77-97 (F.P. Sutter & U. Zehetner eds., Linde Verlag 2004); M. Lombardi, *Triangular Situations: A Case of Double Source Taxation of Interest and Royalties*, 51 *Bull. Intl. Fiscal Docn.* 4, pp. 177-182 (1997), *Journals IBFD*; R. Pereira Ribeiro, *Dual Source Situations and the Multiple Taxation of Dividends and Interest*, IV *Diritto e Pratica Tributaria Internazionale* 1, pp. 151-190 (2004); K. Vogel, M. Engelschalk & M. Görl, *Klaus Vogel on Double Taxation Conventions: A Commentary*

“head office state” or “State HO”), and that income originates in a PE of the payor located in a third state (the “PE state” or “State PE”). This situation is illustrated in the following diagram:

Figure 1.3.: A reverse PE triangular case



In a reverse PE triangular case, both the residence state and the PE state of the payor may seek to impose source-based taxation on the payment. In general, assuming that both these states have concluded treaties with the residence state of the recipient of the income, only one of them will be entitled to impose tax as a result of the limitations imposed under those treaties. In the case of interest, however, both the PE state and the residence state of the payor are likely to be entitled to impose tax under article 11 of their respective treaties with the residence state of the recipient of the income. Dual source-based taxation may similarly arise in relation to royalties in situations where the applicable treaties depart from the OECD Model in allowing source-based taxation of such income. To the extent that both the payor’s residence state and the PE state are entitled to impose tax, the residence state of the person receiving the income would generally be required to provide relief under its treaties with each of those states. However, if tax is imposed on a source basis in two separate states, then the recipient’s residence state may be unable to provide sufficient relief to prevent double taxation.

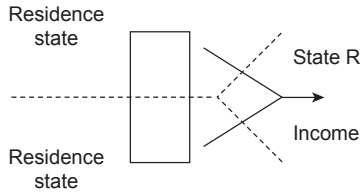
Reverse PE triangular cases will be discussed in chapter 12.

1.2.4. Reverse dual resident triangular cases²¹

Reverse dual resident triangular cases occur where a dual resident pays an amount which forms part of the income of a resident of a third state (State R). This is illustrated in the following diagram:

to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation on Income and Capital: With Particular Reference to German Treaty Practice, 3rd edn, pp. 694-696, m.no. 257-259 and pp. 750-753, m.no. 88-96 (Kluwer Law International 1997).
21. For literature on reverse dual resident triangular cases, refer to: Avery Jones et al., *supra* n. 20; Avery Jones & Bobbett, *supra* n. 2; J. Creus & D. de Jong, *Dividends Paid by Dual Resident Companies*, in *Triangular Tax Cases* pp. 145-171 (F.P. Sutter & U.

Figure 1.4.: A reverse dual resident triangular case



In a reverse dual resident triangular case, both residence states of the dual resident payor may seek to impose source-based taxation on the income under their domestic laws on the basis that it is paid by a local resident person. In relation to most categories of income, either one or both of the source states (the residence states of the payor) will be prevented from imposing tax under their respective treaties with the residence state of the recipient. However, where the applicable treaties allow source-based taxation on the basis of the residence of the payor, e.g., with respect to dividends, interest and (commonly) royalties, both source states may be entitled to impose tax under terms of the applicable treaties.

For the purposes of applying the treaty between the two residence states, the tie-breaker provisions of article 4 of the treaty between the two residence states will generally assign the residence of the dual resident person to one state. If this is the case then it would seem reasonable for the state to which residence is not assigned (the losing residence state) to be prevented from imposing source-based taxation on the basis that the income is no longer paid by a resident of that state. However, this allocation of residence may not be effective for the purposes of the treaties concluded between the residence states of the payor and the third state where the recipient of the income is resident, in which case the dual resident payor would continue to be a resident of both its residence states for the purposes of those treaties. As a result, the source states may both be entitled to impose tax in accordance with article 10, article 11 or article 12 (as applicable) of their respective treaties with the residence state of the person receiving the income. To the extent that both source states do impose tax on the income, the residence state of the person receiving the income would generally be required to provide relief under its treaties with each of those states. However, if tax is

Zehetner eds., Linde Verlag 2004); De Kort, *supra* n. 17; Gusmeroli, *supra* n. 2; Hattingh, *supra* n. 20; E.A. Madeira & T.C. Neves, *Exploring the Boundaries of the Application of Article 10(5) of the OECD Model*, 38 Intertax 8/9, pp. 473-483 (2007); Pereira Ribeiro, *supra* n. 20; P.M. Smit, *Taxation of Dividends Distributed by a Dual Resident Company*, 33 Eur. Taxn. 1, pp. 36-40 (1993), Journals IBFD; Van Raad, *Dual Residence*, *supra* n. 17; Vogel, Engelschalk & Görl, *supra* n. 20, at pp. 694-696, m.no. 257-259.

imposed on a source basis in two separate states, then the recipient's residence state may be unable to provide sufficient relief and thus, unrelieved double taxation may arise.

Reverse dual resident triangular cases will be discussed in chapter 12.

1.2.5. Variations on the basic triangular cases

While this thesis will focus on the four basic situations outlined above, variations on these situations which can arise where more than three states are involved will also be addressed, primarily in the appendices. In general, these situations give rise to the same kind of issues as situations involving just three states, although there is often an additional layer of complexity.

1.3. Scope and assumptions

The cases and situations to be addressed in this thesis will be set out more fully in later chapters; however, in general terms, this thesis will address triangular situations involving PEs and dual residents as set out above. For the sake of simplicity, it is generally assumed that all the states involved agree on the characterisation of the situation. Thus, in PE triangular cases, it will be assumed that the recipient of the income is resident in the "residence state" for both domestic law and treaty purposes, and is not resident in any other state. It will also be assumed that a PE exists in the PE state for the purposes of the treaty between the PE state and the residence state. It will further be assumed that the "source state" considers the income to be locally sourced under its domestic law, and that the amount in question is attributable to the PE. Thus, the rules for the attribution of income to PEs will not be addressed in detail. It will further be assumed that all three states would seek to impose tax under their respective domestic laws in the absence of any treaty restrictions.

Similarly, in dual resident triangular cases, it will be assumed that the dual resident is resident in two states and is not resident in any other state. It will also be assumed that the payor of the income is resident in a third state and not in any other state, and that their residence state considers the income to be locally sourced under its domestic law. It will further be assumed that all three states would seek to impose tax under their respective domestic laws in the absence of any treaty restrictions.

In relation to reverse triangular cases, it will be assumed that the person receiving the income is resident in one state (their residence state) and not in any other state, and does not have a PE outside that state. In reverse PE triangular cases, it will be assumed that the person paying the income is resident in one state (generally referred to as the “head office” state) and has a PE in a second state from which the payment originates. In reverse dual resident triangular cases, it will be assumed that the person paying the amount in question is resident in two states under their respective domestic laws. It will further be assumed that all three states would seek to impose tax under their respective domestic laws in the absence of any treaty restrictions.

This study will generally refer to companies. This is primarily for ease of expression and is not to suggest that triangular cases involving individuals cannot arise. It is expected, however, that such cases would be less common and that the analysis of the issues in cases involving companies could also apply to cases involving individuals. Any considerations relevant specifically to individuals will be discussed where appropriate.

This study will not address hybrid entity triangular cases.²² Hybrid entity triangular cases can arise when a particular entity is treated as fiscally transparent in one state but is treated as a corporate taxpaying entity in another. Hybrid entity triangular cases present fundamentally different issues to those which arise in other types of triangular cases. In the cases discussed in this study, issues arise because a single person (either a recipient or payor of income) has a connection to multiple states or, to phrase it another way, because an item of income has a connection to multiple states. This is not the case with respect to hybrid entity triangular cases, where issues arise because different states seek to impose tax on different taxpayers with respect to the same income. The primary issue in hybrid entity triangular cases is the lack of uniform treatment of the entity involved, which is quite separate from the issues being addressed in this study. In addition, the issues associated with applying tax treaties in the context of hybrid entities are not fundamentally different where three states are involved instead of two. The main issue is determining who should be entitled to claim treaty benefits, and the analysis of this issue should not change in any fundamental way depending on whether two or more states are involved (although it is of course more important to determine the appropriate person to claim treaty benefits where the two potential claimants are located in different states).

22. For a discussion of hybrid entities (dealing primarily with bilateral cases but also touching on multilateral cases), refer to: J. Barenfeld, *Taxation of Cross-Border Partnerships*, Doctoral Series, vol. 9 (IBFD 2005), Online Books IBFD.

Transfer pricing considerations will also not be addressed. The transfer pricing issues that arise in situations involving more than two states are, in general, not fundamentally different from those arising where only two states are involved.

The focus of this thesis is on general international and treaty law with respect to taxation. The impact of European (EU) law will not be addressed except to the extent that principles developed in EU law (e.g., with respect to non-discrimination) may be relevant to the interpretation of tax treaties.

Except where otherwise stated, it is assumed that there are bilateral income tax treaties in place between all the relevant states and that those treaties follow the OECD Model (2010). All references to treaty articles are to the relevant article of the OECD Model unless indicated otherwise.

This thesis will only deal with the following categories of income: business profits (article 7), dividends (article 10), interest (article 11), royalties (article 12), income from immovable property (article 6), income from shipping, inland waterways transport and air transport (article 8), capital gains (article 13) and other income (article 21). It does not discuss income from employment (article 15), directors' fees (article 16), artistes and sportsmen (article 17, although article 17 is discussed briefly in relation to business income in chapter 2), pensions (article 18), government service (article 19) or students (article 20), which are outside the scope of this study.

Any departures from these assumptions will be noted where relevant.

1.4. Conclusion

Triangular cases clearly present a number of difficult and interesting issues. Despite the work that has been done on triangular cases over the years, there is still, as yet, no satisfactory and generally accepted solution to the issues they present. To date, there has been no comprehensive and detailed analysis of all the issues that can arise in triangular cases or of the range of potential solutions. The impact which recent developments such as the new AOA to the attribution of profits to PEs may have in PE triangular cases has also not been considered in depth. The intention of this thesis is therefore to present a comprehensive analysis of the issues arising in PE triangular cases, taking into account recent developments in international tax law and with respect to tax treaties, with the ultimate aim of identifying a comprehensive solution to the issues that such cases present.

Notes

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Notes

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