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2014-08-22
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Bilateral Tax Treaties: Is Sufficient Relief Provided in Triangular Tax Situations?

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Aresearch report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation).

Johannesburg, 2014

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ABSTRACT

With the international platform for cross border investment and economic development growing year on year at a steady pace, it has become apparent that bilateral income tax treaties do not always operate effectively in multilateral tax situations. Global transactions involving more than two states are certainly not uncommon and it could be said that the most fundamental issue in international taxation is double taxation resulting from the taxing rights of different tax jurisdictions that 'overlap' with regard to, generally speaking, one taxpayer or one declared income stream. Multilateral tax situations, commonly known as triangular cases, occur where tax incidence on a particular stream of income is triggered in three countries. These situations typically arise where a person who is a tax resident in two respective countries for tax purposes (a dual resident), or a person who is a tax resident in one country and has a permanent establishment in another, is earning revenue of which the source is in a third country. Taxing rights and jurisdictions of the three countries involved could potentially be in conflict with each other and therefore such situations may bring about lawful international triangular taxation or double taxation which will inevitably discourage enterprises from continuing investment and development internationally.

Broad multilateral treaties in the income tax arena are not common[1], and most treaties are still of a bilateral nature, i.e. generally addressing tax scenarios where only two specific countries are involved. The Organisation for Economic Cooperation and Development's ('the OECD')*Model Tax Convention* states this:

> There are no reasons to believe that the conclusion of a multilateral tax convention involving all Member countries could now be considered practicable. The Committee therefore considers that bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level.[2]

Key Words: Bilateral Tax Treaties; Multilateral Taxation; Triangular Cases; International Double Taxation; Permanent Establishments; OECD *Model Tax Convention*; Double Tax Agreements; Cross Border Investment; Tax Avoidance.

[1]BLOOMBERG, BNA, Morrison PD, Esq, 1 October 2013, **http://www.bna.com/beps-part-multilateral-n17179877447/,** (Accessed 1 December 2013

[2]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Introduction, Multilateral convention, I-11, Para 40.

GLOSSARY

BILATERAL TAX TREATY

An agreement between two countries for the avoidance of double taxation pertaining to the way in which the countries cater for the differences in treatment of income or capital in terms of their own domestic legislation. A tax treaty may be titled a convention, treaty or an agreement.[3]

DOUBLE TAXATION

Double taxation arises when comparable taxes are imposed in two or more states on the same taxpayer in respect of the same taxable income or capital[4], e.g. where income is taxable in the source country and in the country of residence of the recipient of such income.

DUAL RESIDENT TRIANGULAR CASES

Refer to scenarios where a person who is a tax resident in two respective countries is earning revenue of which the source is in a third country. Taxation is typically triggered in all three of the countries involved with unrelieved double or triangular taxation as a possible consequence.

MULTILATERAL TAX TREATY

An agreement between more than two countries for the avoidance of double taxation pertaining to the way in which the countries cater for the differences in treatment of income or capital in terms of their own domestic legislation. A tax treaty may be titled a convention, treaty or an agreement.[5]

PACTA SUNT SERVANDA

Every treaty in force is binding upon the parties to it and must be performed by them in good faith.[6]

PARTIAL RESIDENCE BASIS OF TAXATION

Partial residence basis of taxation refers to the tax treatment of a permanent establishment in accordance with Article 7 of the OECD *Model Tax Convention*. Like a resident of the permanent establishment state, the permanent establishment is taxed on its worldwide

[3] OECD website, http://www.oecd.org/ctp/glossaryoftaxterms.htm#T, accessed 24 March 2014.
[4] OECD website, http://www.oecd.org/ctp/glossaryoftaxterms.htm#D, accessed 24 March 2014.
[5] OECD website, http://www.oecd.org/ctp/glossaryoftaxterms.htm#T, accessed 24 March 2014.
[6] Vienna Convention On The Law Of Treaties, 22 May 1969, Article 26

income but, unlike a resident, the permanent establishment has no corresponding entitlement to treaty benefits in terms of treaties concluded between the permanent establishment state and other states.

PERMANENT ESTABLISHMENT TRIANGULAR CASES

Permanent establishment triangular cases refer to scenarios where a person who is a tax resident in one country has a permanent establishment in a second country and earns revenue that is attributable to that permanent establishment of which the source is in a third country. Taxation is typically triggered in all three of the countries involved with unrelieved double or triangular taxation as a possible consequence.

TRIANGULAR TAXATION

Triangular taxation occurs in international triangular tax cases when the same person is taxed three times on the same stream of income by three different states with no relief measures provided by any of the three states.

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

_____

Odette Uys

10 April 2014

1 INTRODUCTION

1.1 Context of the study

Several challenges are triggered by globalisation today, one of which, complex cross-border taxation, brought on by extensive international investment and development, represents probably the most fundamental issue. In particular, the vexed issue of triangular cases has drawn considerable attention over the last two decades but, with respect to different aspects of these situations, still gives rise to many unresolved questions. The term 'triangular cases' refers to situations where tax incidence on one particular stream of income is typically triggered in three countries with unrelieved double or triangular taxation as a possible consequence (the extent of the double or triangular taxation depending on the relief measures provided by the relevant states for taxes paid in the other states).

International taxation issues arise largely due to two main bases of taxation, known respectively as sourced-based taxation and residence-based taxation, as well as the applicability of bilateral tax treaties to multilateral situations. The concepts of source and residence arise from domestic tax law provisions and they are fundamental causes of international juridical double taxation. Domestic tax law provisions distinguish between two types of taxpayers, non-residents and residents, as well as source taxation and worldwide taxation. In South Africa, generally a residency test attempts to ensure certainty and predictability on the one hand and to prevent manipulation on the other.[7] Unfortunately, conflict exists between these two goals, and in order to balance these rival considerations, the South African Revenue Service ('SARS') makes use of two tests as per the definition of a 'resident' in section 1 of the Income Tax Act 58 of 1962 ('the Act') for determining the tax residency of a person other than a natural person (referred to in this report as 'legal persons'): the test of incorporation and the test of place of effective management. The second test is generally considered to be more challenging to manipulate, but has presented complex issues of general interpretation and practical application, both in South Africa and elsewhere.[8]

Double taxation can take different forms and occur in many different situations, both domestically and internationally. Juridical double taxation is described as cases where the same income is being taxed twice in the hands of the same taxpayer, whereas economic

[7] Van der Merwe BA, 'The Phrase "place of effective management": Effectively Explained?',*18 South African Mercantile Law Journal*, 121 at p. 124-125 (2006)
[8]South African Revenue Service, *Discussion Paper on Interpretation Note 6, Place of Effective Management*, September 2011

double taxation refers to cases where the same income is being taxed twice in the hands of two different taxpayers. Generally, most bilateral tax treaties currently in force seek to eliminate/reduce international juridical double taxation between two countries, but also international economic double taxation in some instances.

Concluding double tax agreements is a formalized way for different countries to agree on a method of reducing or eliminating the risk of double taxation. Double taxation may occur for any of the following reasons: residence-residence conflict, source-resident conflict, source-source conflict and, as briefly mentioned above, triangular cases. In some cases, a country may have a source-residence conflict with one country and a source-source conflict with another country, which could trigger an incremental layer of unrecoverable taxes, unless some form of relief is provided. As mentioned before, most treaties are bilateral in nature and would not necessarily address triangular cases and thus one stream of income is potentially taxable in three different jurisdictions with double or triangular taxation as a result. The issue that needs to be addressed is how triangular taxation can be avoided by way of tax credit/exemption mechanisms in tax treaties. More specifically, how can credit/exemption mechanisms contained in a single bilateral tax treaty be applied to triangular cases involving multiple countries, seeing that a bilateral treaty does not normally cover the taxing rights of a third/additional state.

From a South African perspective, National Treasury proposed a new 'Gateway to Africa' initiative in 2010 as part of the Taxation Laws Amendment Act No. 7 of 2010.[9] This initiative is intended to make South Africa a more attractive base for investment into other African countries by both domestic and foreign investors.[10] As mentioned, place of effective management is one of the two tests used by SARS to determine whether or not a person other than a natural person is a tax resident in South Africa. In addition, the place of effective management test is also used as the 'tie breaker' rule to determine residency in many of the treaties that South Africa has in place with other countries, particularly those agreements which are based on the OECD (2012)*Model Tax Conventionon Income and on Capital, (updated 2010)*('the OECD *Model Tax Convention')*.[11]

As per Article 1 of the OECD *Model Tax Convention* with regard to the persons covered by the convention, a prerequisite of bilateral tax treaties is that the taxpayer is a resident of at

[9]South African Revenue Service, *Discussion Paper on Interpretation Note 6, Place of Effective Management*, September 2011 p. 2.
[10]South African Revenue Service, *Discussion Paper on Interpretation Note 6, Place of Effective Management*, September 2011 p. 2.
[11]South African Revenue Service, *Discussion Paper on Interpretation Note 6, Place of Effective Management*, September 2011, p. 2.

least one of the contracting states. If this relationship does not exist between the taxpayer and one of the countries in a triangular case, the treaty benefits cannot be utilised and thus the inevitable juridical double taxation that may occur, could remain unrelieved. It is therefore clear that internationally there is a need for specific, updated guidelines on triangular tax scenarios where only one bilateral tax treaty is available. These guidelines should also serve as an accelerator for renewed multilateral treaty negotiations with a focus on addressing triangular cases.

This research report will aim to investigate the applicability of a single bilateral tax treaty that is based on the OECD *Model Tax Convention*, to a triangular tax scenario. The report will not evaluate an existing bilateral tax treaty between two specific countries, but will apply the research methodology to the OECD *Model Tax Convention* seeing that many international bilateral tax treaties (between member states and non-member states) are largely based on the provisions of the convention.[12] This issue arises because most treaties are bilateral in nature, and yet many international business transactions are multilateral in nature. Existing proposals for solving triangular cases, as proposed by the OECD and tax authors, will therefore be evaluated in terms of their compatibility with bilateral treaties. To a lesser extent, the current interpretation of the phrase 'POEM' by SARS will also be briefly discussed as the author believes that the possibility of this contributing to occurrences of possible double or triangular taxation situations where South Africa is involved should be considered. Throughout the report, discussions and examples will be limited to typical dividend and interest income streams (an in depth discussion of each cross border income type will be outside the scope of this report).

1.2 Problem Statement

1.2.1 Main problem

The research report will be an investigation into the ability of a bilateral tax treaty, which is based on the OECD *Model Tax Convention*, to provide sufficient relief in triangular cases. An examination of the causes and consequences of triangular cases will be done in order to establish what tax treaty applicability problems they may entail. The report is not aimed at finding a new solution to triangular cases, but at evaluating the current existing solutions to these cases with reference to their compatibility with bilateral treaties. The author will attempt to point out the reasons why double taxation

[12]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Committee on Fiscal Affairs, Introduction, para. 14.

could still occur in triangular tax scenarios with only bilateral tax treaty provisions at the disposal of the relevant parties.

1.2.2 The Sub-problems

A number of sub-problems will assist in attempting to answer the main research problem.

The first sub-problem is: How does Triangular Taxation arise? What are the various causes of triangular taxation? Two different scenarios, dual resident triangular cases and permanent establishment triangular cases, will be examined. As part of this investigation, the report will also evaluate SARS's current approach to its interpretation of the term 'Place of Effective Management' as contained in Interpretation Note 6 to the Act.

The second sub-problem is: Do bilateral tax treaties, as negotiated between two countries and that are based on the OECD *Model Tax Convention*, provide sufficient relief for multilateral tax cases, i.e. triangular cases involving a third country? An examination will be done of existing proposals for solving triangular cases as proposed by the OECD and tax authors. The compatibility of these solutions with bilateral tax treaties, as applicable in a multilateral tax situation, will be considered.

1.3 Research methodology

The research methodology will be an extensive investigation of the causes and impact of triangular taxation incidents, as well as the applicability of bilateral tax treaties (that are based on the OECD *Model Tax Convention*) to these situations. Background information that will portray the origin and consequences of such cases will be collected from various electronic media portals, research studies and available literature. The latest news articles and developments in the affected legislation and guidelines, as well as reference to recent international double/triangular taxation cases as concluded by various courts internationally, will be included in the research analysis in order to draw a conclusion.

1.4 Chapter outline

The remaining chapters will be arranged as follows:

Chapter 2 will investigate the origin and nature of bilateral tax treaties. Considering triangular cases and specifically the taxing jurisdiction of the third country involved (source country), the principles of the Vienna Convention on the Law of Treaties, as well as specific provisions in the OECD *Model Tax Convention*, will be evaluated in order to better understand the applicability of bilateral tax treaties.

Chapter 3 will examine dual resident triangular cases where a person who is a tax resident in two respective countries, is earning revenue of which the source is in a third country. For treaty purposes, residence is determined in accordance with Article 4 of the OECD *Model Tax Convention* (or its equivalent) by reference to residence under domestic laws and thus, a person who is resident in two states under their respective domestic laws will generally also be a dual resident for treaty purposes. Article 4 contains tie-breaker rules which are intended to assign the residence of a dual resident person to one of the residence states for the purposes of the treaty between those two states. In some situations the applicable tie-breaker rule may not effectively assign residence to a particular state and the person involved may continue to be a dual-resident for the purposes of the treaty. For natural persons this risk could be remedied by mutual agreement between the tax authorities involved. In the case of persons other than natural persons, the place of effective management tie-breaker test is to be utilised to answer the question of dual residence of the taxpayer, but this solution is reliant on compatible interpretation of the phrase place of effective management by both tax authorities involved.

Chapter 3 will also briefly examine SARS's current approach to the term place of effective management,which, despite its widespread use, has never had a universally accepted meaning. Various criticisms of SARS' interpretation will be evaluated as well as the impact of this on using the term place of effective management as the tie-breaker rule in many international tax treaties, as is the case in the OECD *Model Tax Convention*.[13]

Chapter 4will examine permanent establishment triangular cases where a person who is a tax resident in one country, has a permanent establishment in a second country and earns revenue of which the source is in a third country. In a permanent establishment triangular case, tax may be imposed under the respective domestic legislation of all three countries involved. In the residence country, tax is likely to be imposed on the basis of the residence of the person earning the income, while the source country would generally impose tax on a source basis(particularly where passive income such as dividends and interest is involved).

[13]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Committee on Fiscal Affairs, Article 4, para. 3.

In the permanent establishment state, it is the business activities carried on there by the person earning the income and the link between the income and those business activities, which is likely to trigger tax. The residence country may provide double taxation relief unilaterally under its domestic law, but even then the relief may not be sufficient and unrelieved double taxation could still arise.

In chapters 3 and 4 the author will attempt to point out specific issues with or characteristics of triangular cases that could affect the applicability of bilateral tax treaties.

Chapter 5 will consider the compatibility of current solutions to triangular cases, as proposed by the OECD and respective tax authorswith the bilateral nature of tax treaties as examined in chapter 2.

Chapter 6 will summarise the findings of the research and propose areas requiring further research.

2 BILATERAL NATURE OF TAX TREATIES

2.1 Background

Vogel stated that it should never be forgotten that each individual treaty is autonomous, that it concerns important and conflicting interests of the **two** contracting states, and that a coordination of these interests will usually be reached only after difficult and protracted negotiations.[14]The bilateral nature of tax treaties as concluded between two parties is oftenconsidered to be not only the main cause of the issues arising in triangular cases,[15] but that triangular cases are actually a direct result of the bilateral nature of these conventions.[16] Generally theprovisions contained in a double tax agreement only consider bilateral situations and are not intended to interact with nor take into account the effect of provisions of other agreements.

This chapter will briefly investigate the origin and nature of bilateral tax treaties. The main roots of triangular cases lie in the principles of international treaty law and the limited scope of their application. Double tax treaties are international agreements[17] and therefore their creation and consequences are determined according to the rules contained in the Vienna Convention on the Law of Treaties of May 1969[18]. The Vienna Convention on the Law of Treaties contains the rules of interpretation of double taxation treaties and is regarded as declaratory of customary international law.[19] These rules are even referred to by courts of nations which have not yet ratified the treaty.[20]

2.2 The development of tax treaties

Before examining the development of tax treaties, the Vienna Convention on the Law of Treaties and how it relates to tax treaties will be briefly examined.The Vienna Convention on the Law of Treatieshas been in force since 27 January 1980 and more than 100 parties have signed the convention.The convention was adopted on 22 May 1969 and opened for signature on 23 May 1969 by the United NationsConference on the Law of Treaties. The

[14]Vogel K, 'Double Tax Treaties and Their Interpretation', *Berkeley Journal of International Law*, Volume 4, Issue 1, 1986, p 43.
[15]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992), para 1.
[16]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax* 473.
[17]Vienna Convention On The Law Of Treaties, 22 May 1969, Article 2(1)(a)
[18]Vienna Convention On The Law Of Treaties, 22 May 1969, Articles 1 and 2(1)(a)
[19]Baker P, *Double Taxation Conventions and International Tax Law* (2nd Edition 1994), p. 22
[20]Vogel K, *Klaus Vogel on Double Taxation Conventions* (3rd Edition 1997), Introduction, 68 at 35

Conference was convened pursuant to General Assembly resolutions 2166 (XXI) of 5 December 1966 and 2287 (XXII) of 6 December 1967. The Conference held two sessions, both at the Neue Hofburg in Vienna, the first session from 26 March to 24 May 1968 and the second session from 9 April to 22 May 1969.[21]The International Court of Justice has in several cases referred to the Vienna Convention on the Law of Treaties without examining whether the litigants were parties to it.[22] In the *Gabčíkovo-Nagymaros Project* case the Court observed:[23]

> [The Court] needs only to be mindful of the fact that it has several times had occasion to hold that some of the rules laid down in that Convention might be considered as a codification of existing customary law.[24]

The Court's opinion, together with the relatively high number of parties to the Convention, suggests that the Vienna Convention on the Law of Treaties states the current general international law of treaties and it is confirmed by the 1969 Convention's substantive provisions that were by consensus copied into the 1986 Vienna Convention on the Law of Treaties between States and International Organizations or between International Organizations.[25]

A series of model income tax treaties was first developed with the support of the various committees of the League of Nations following the First World War.[26] The efforts of the Organization of European Economic Cooperation and its successor organization, the OECD,to developa system for the avoidance of double taxation picked up where the preparatory research of the League of Nations left off.[27] The Committee on Fiscal Affairs submitted a series of model treaty articles in four interim reports between 1956 and 1961 and a summary report in 1963 to which the complete model treaty, the OECD *Model Tax Convention* and an official Commentary were appended.[28] The OECD Council recommended that member states continue their efforts to enter bilateral double tax agreements, that they adopt as the basis for their negotiations the model submitted by the

[21]Vienna Convention On The Law Of Treaties, 22 May 1969
[22]United Nations Audiovisual Library of International Law, Historic Archives, Vienna Convention on the Law of Treaties, Professor Zemanek K.
[23]United Nations Audiovisual Library of International Law, Historic Archives, Vienna Convention on the Law of Treaties, Professor Zemanek K.
[24] I.C.J. Reports 1997, p. 38, para. 46
[25]United Nations Audiovisual Library of International Law, Historic Archives, Vienna Convention on the Law of Treaties, Professor Zemanek K.
[26] Vogel K, 'Double Tax Treaties and Their Interpretation', *Berkeley Journal of International Law*, Volume 4, Issue 1, 1986, p 11.
[27]Vogel K, 'Double Tax Treaties and Their Interpretation', *Berkeley Journal of International Law*, Volume 4, Issue 1, 1986, p 11.
[28]Vogel K, 'Double Tax Treaties and Their Interpretation', *Berkeley Journal of International Law*, Volume 4, Issue 1, 1986, p 11.

Fiscal Committee as interpreted by the Commentaries in the Report, and that they make allowances for the limitations and reservations contained in the Commentary.[29] Today the OECD *Model Tax Convention* reflects the basic structure of bilateral tax treaties and this notion is confirmed by the Supreme Court of Canada in *The Queen v. Crown Forest Industries* Ltd. whodescribed the OECD *Model Tax Convention* as an instrument recognized worldwide as:

> A basic document of reference in the negotiation, application and interpretation of multilateral and bilateral tax conventions.[30]

2.3 The bilateral nature of tax treaties

The author performed an examination of the Vienna Convention on the Law of Treaties, the OECD *Model Tax Convention* as well as literature on double tax agreements written by authors such as Klaus Vogel in order to establish which provisions contained in treaties effectively determine the nature of the treaty, specifically the bilateral nature thereof. Based on this examination, it is submitted that the specific characteristics as discussed below appear in essence to define the 'bilateralism' of tax treaties.

2.3.1 EligibleContracting Parties

One such characteristic is the bilateralism of treaties, according to which treaty benefits may not be extended to residents of third states. The bilateral effect of international treaties is intended to result in treaties having an effect only between the contracting states and not for third states that did not participate in the treaty-making process.[31]Article 1 of the Vienna Convention on the Law of Treatiesreads, 'The present Convention applies to treaties between States'. It is submitted that a key definition in Article 2 of the Vienna Convention on the Law of Treaties, that of a 'third state', seems to shed light on how many 'States' are referred to in Article 1. Notwithstanding the definition of the term 'third state', because it is called ***third*** state and actually being defined is decisive.It is further submitted that the definition of 'third State', as can be found in Article 2 of the Vienna Convention on the Law of Treaties, that means 'a State

[29]Vogel K, 'Double Tax Treaties and Their Interpretation', *Berkeley Journal of International Law*, Volume 4, Issue 1, 1986, p 11.
[30] *Her Majesty The Queen* v. *Crown Forest Industries Ltd.* [1995] 2 SCR 802 (SCC) 23940, page 31, para 55.
[31]Martin Jimenez AJ, Garcia Prats FA and José M, Carrero C, 'Triangular Cases, Tax Treaties and EC Law: The Saint-Gobain Decision of the ECJ' (2001) 55 *Bulletin for International Taxation* 241, 245.

not a party to the treaty' implies that anything more than two states would not be a party to the specific treaty.

Article 26 of the Vienna Convention on the Law of Treaties requires all treaties to be performed by the parties to it in good faith and it is therefore submitted that tax treaties are also governed by this principle of 'pacta sunt servanda': 'Every treaty in force is binding upon the parties to it and must be performed by them in good faith'.[32] This principle of 'good faith' is repeated in Article 31(1) which reads:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

It is important and relevant to note that, in accordance with these Articles, the extent of the binding effect of a treaty will be limited to the parties to it, which is limited to two parties as mentioned in the opening paragraph of chapter 2.3.1. It is submitted that this principle entitles states to require that obligations in terms of a tax treaty be respected and that it will be adhered to by both treaty partners in good faith.[33]

In addition to the implications of Articles 1, 2 and 26 of the Vienna Convention on the Law of Treaties as discussed thus far in chapter 2.3.1, Articles 34 to 38 specifically address the application of the provisions of the Vienna Convention on the Law of Treaties to third states. Article 34 states that 'A treaty does not create either obligations or rights for a third State without its consent.' In respect of obligations arising for a third state from a provision of a treaty, the third state needs to 'expressly accept that obligation in writing'.[34] In respect of rights arising from a treaty provision, the third state needs to 'assent' thereto, although the assent will be presumed unless the contrary is indicated.[35] It is therefore submitted that the bilateral nature of tax treaties is clear from these provisions and that the Vienna convention was intended to generally impact only the two contracting parties.

Furthermore, Article 1 of the OECD *Model Tax Convention* refers to one or **both** of the contracting states, implying a maximum of two parties, and reads as follows:

> This Convention shall apply to persons who are residents of one or both of the Contracting States.

[32] Vienna Convention On The Law Of Treaties, 22 May 1969, Article 26
[33] Vienna Convention On The Law Of Treaties, 22 May 1969, Article 26
[34] Vienna Convention On The Law Of Treaties, 22 May 1969, Article 35
[35] Vienna Convention On The Law Of Treaties, 22 May 1969, Article 36(1)

It is also clear that the prerequisite for treaty entitlement is residency in at least one of the contracting states and will therefore be applicableonly to the residents of those two countries that concluded the agreement.However, it has also been said that it is difficult to find definitive evidence of existing principles in the international law according to which the tax conventions should be strictly limited to persons who are residents of the contracting states.[36]In the *Commerzbank*[37] case, treaty benefits were extended to a resident of a country which was not party to the applicable treaty related to the case.[38] Although the tax authorities alleged the tax treaties to be limited in the scope of their application, the tax treaty at issue did not contain a provision similar to Article 1 of the OECD *Model Tax Convention* and the court did not see the principle of relative effect of the tax treaties to be in place.[39]The OECD is of the opinion that tax treaties cannot be extended to third country residents.[40]Baker points out that even without Article 1 tax treaties are meant to apply only to the residents of the contracting states.[41]

The application of Article 1 can also be viewed from a more historical development point of viewthat would lead one to believe that the actual inclusion of the article inthe 1963 OECD *Model Tax Convention* was in fact a confirmation of the bilateral nature of tax treaties.[42]The Commentary explained that for practical reasons it is preferable to apply the convention to the persons who are residents of the contracting states. It is unclear as to what exactly these practical reasons are as it has never been fully explained, but apparently it was to avoid the uncertainty with regard to who may claim treaty benefits.[43] Hattingh is of the opinion that Article 1 was included in tax treaties to narrow down the range of persons who are entitled to treaty benefits by

[36]Baker P, *Double Tax Conventions and International Tax Law* (2nd Ed., 1994, London, Sweet & Maxwell) 1-05
[37]*IRC v Commerzbank AG: IRC v Banco Do Brasil* [1990] STC 285.
[38]Baker P, *Double Tax Conventions and International Tax Law* (2nd Ed., 1994, London, Sweet & Maxwell) 1-02.
[39]Baker P, *Double Tax Conventions and International Tax Law* (2nd Ed., 1994, London, Sweet & Maxwell) 1-02.
[40]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Introduction, Multilateral convention, C(24)-1, para 2.
[41]Baker P, *Double Tax Conventions and International Tax Law* (2nd Ed., 1994, London, Sweet & Maxwell) 1-06.
[42]Hattingh JP, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding it' (2003) 57 *Bulletin for International Taxation* 215, 217.
[43]Hattingh JP, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding it' (2003) 57 *Bulletin for International Taxation* 218.

determining those who have an ‘economic allegiance’ to either oneof the contracting states.[44]

Based on the above discussion and apparent implication of the various Articles of the Vienna Convention on the Law of Treaties, as well as Article 1 of the OECD *Model Tax Convention*, it is clear that the rights and obligations contained in international tax treaties are only applicable to the residents and tax authorities of the specific states that have explicitly agreed and accepted to be a party to the treaty and be bound by its provisions.

2.3.2 Reciprocity Obligation

Another expression of the bilateral nature of tax treaties can be seen in the principle of reciprocity. As per the OECD’s Centre for Tax Policy and Administration, the principle of reciprocity is defined as:

> The principle of give-and-take operates in a variety of tax contexts (particularly in the case of tax treaties) where an exchange of tax privileges between countries is desired. Reciprocity is a basis for relieving a taxpayer under domestic law, e.g. relief is granted for foreign tax if the other country gives corresponding or equivalent relief.

It appears that the principle reflects the agreement between contracting parties of a treaty that the treaty obligations and benefits assumed between the treaty partners will be distributed betweenthem to the same extent, in equal measures. Differently stated, it refers to an 'interchange between the parties, i.e. giving and receiving of rights, benefits, concessions or advantages'.[45] The principle is bilateral in scope in the sense that the rights and obligations are conferred to one treaty partner with the understanding that that party will in turn grant the same benefits to the other contracting party. The so-called 'formal reciprocity' means that a contracting state may withdraw its commitments if the other contracting state does not fulfil its own commitments.[46]

[44]Hattingh JP, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding it' (2003) 57 *Bulletin for International Taxation* 221.
[45]Dörr O, Schmalenbach K (eds), *Vienna Convention on the Law of Treaties: a commentary* (Springer Berlin Heidelberg Dordrecht London New York 2012) Art 26 marginal 34.
[46]Vogel K, *Klaus Vogel on Double Taxation Conventions. A Commentary to the OECD-, UN- and US Model Conventions for Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice* (3rd Ed., Kluwer Law International, 1997), Art 24 marginal 39.

Concluding international bilateral tax treaties entails thorough negotiations between the contracting states in order to reach a balanced result of the rights and obligations deriving from the treaty.[47]Being a contracting party to a treaty usually involves both parties waiving a certain part of their rights in favour of the other treaty partner and the reciprocal obligations should guarantee that both treaty partners receive equally beneficial treatment from the other partner.[48]

From the above it is evident that this reciprocal principle, important for the effective and fair application of tax treaties, does not take cognisance of any other party except the two contracting states thathave explicitly agreed to adhere to the reciprocity obligation.

2.3.3 The Non-Discrimination Provision

One important function of tax treaties is to prevent discriminatory tax practices.[49] The principle of non-discrimination governing bilateral tax treaty relations prevents the imposition of a larger or smaller tax burden on income attributable to a non-resident.[50]

Article 24(1) of the OECD *Model Tax Convention* provides:

> Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.

The second sentence leads one to believe that the application of Article 24(1) is extended beyond the usual bilateral scope of tax treaties and applicable not only to the two contracting states. The OECD Commentary confirms thatthe application of this paragraph is not restricted by Article 1 and covers all nationals of both

[47]SA Technical ACCA, Relevant to ACCA Qualification Paper P6 (MYS), Double tax agreements, 2012, pg. 3**.**
[48]Vogel K, 'Double Tax Treaties and Their Interpretation', *Berkeley Journal of International Law*, Volume 4, Issue 1, 1986, p 23.
[49] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 24, para 1.
[50] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 24, para 5.

contracting states regardless of their residence.[51]Vogel adds though that in spite of this provision including application to persons other than residents of the contracting states, i.e. taxation of a national of one of the contracting states in the other contracting state, it is still related to the tax relationships between the twocontracting states.[52] Thusthe overall bilateral nature of the tax treaty is still followed.

Article 24(3) reads as follows:

> 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. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

Vogelpoints out thatthe difference between Article 24(1) and 24(3) is that the former prohibits less favourable treatment of**nationals** of the other contracting state regardless of their residence, while the latter prohibits it to all**tax residents** of the contracting state in question.[53]From Vogel's explanation, it can be said that Article 24(3) was not **meant** to be a diversion from the general bilateral scope of tax treaties when originally drafted, but rather to prevent discrimination as explained by the OECD Commentary on Article 24(3).Thesecond sentence of Article 24(1) was included in the provision to clarify disagreement between the OECD Member states on exactly who will be protected by the non-discrimination clauses in Article 24.[54]

The OECD Commentary onArticle 24(3) states that:

> Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.[55]
> It appears necessary first to make it clear that the wording of the first sentence of paragraph 3 must be interpreted in the sense that it does not constitute discrimination to tax non-resident

[51] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 24 para 6.
[52]Vogel K, *Klaus Vogel on Double Taxation Conventions. A Commentary to the OECD-, UN- and US Model Conventions for Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice* (3rd Ed., Kluwer Law International, 1997), Art 24 marginal 34.
[53]Vogel K, *Klaus Vogel on Double Taxation Conventions. A Commentary to the OECD-, UN- and US Model Conventions for Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice* (3rd Ed., Kluwer Law International, 1997), Art 24 marginal 2.
[54]Vogel K, *Klaus Vogel on Double Taxation Conventions. A Commentary to the OECD-, UN- and US Model Conventions for Avoidance of Double Taxation on Income and Capital with Particular Reference to German Treaty Practice* (3rd Ed., Kluwer Law International, 1997), Art 24 marginal 31.
[55]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 24 para 33.

> persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter.[56]

Furthermore, the OECD recognises that there are differences in the nature of a permanent establishment as opposed to that of a separate legal entity and that this could affect the application of equal tax treatment, as explained in the Commentary on Article 24(3) that says the following:

> The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office.[57]

From the above discussion, it appears reasonable to conclude that the non-discrimination article of the OECD *Model Tax Convention* deviates from the general bilateral application scope of tax treaties by possibly also affecting the rights of residents ofthird states, and not just those of the two contracting states. However, Hattingh states that the bilateral nature of tax treaties still prevails regardless of the provisions that are drafted otherwise.[58]

2.3.4 Other Treaty Provisions

The bilateral nature of tax treaties also appears to be evident from the general wording and operation of other articles of the OECD *Model Tax Convention* not yet mentioned above.

One such provision is Article 4 that provides for tie-breaker rules to assign residency to one state where a person appears to simultaneously be a dual-resident in respect of both of the contracting states.[59] This provision deals specifically with dual residency between the two contracting states and would therefore not be able to solve a residency conflict where a third country is involved.

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[56] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 24 para 34.
[57] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 24 para 39.
[58] Hattingh JP, 'The Role and Function of Article 1 of the OECD Model' (2003) 57 *Bulletin for International Taxation* 546, 553.
[59] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 4 para 5.

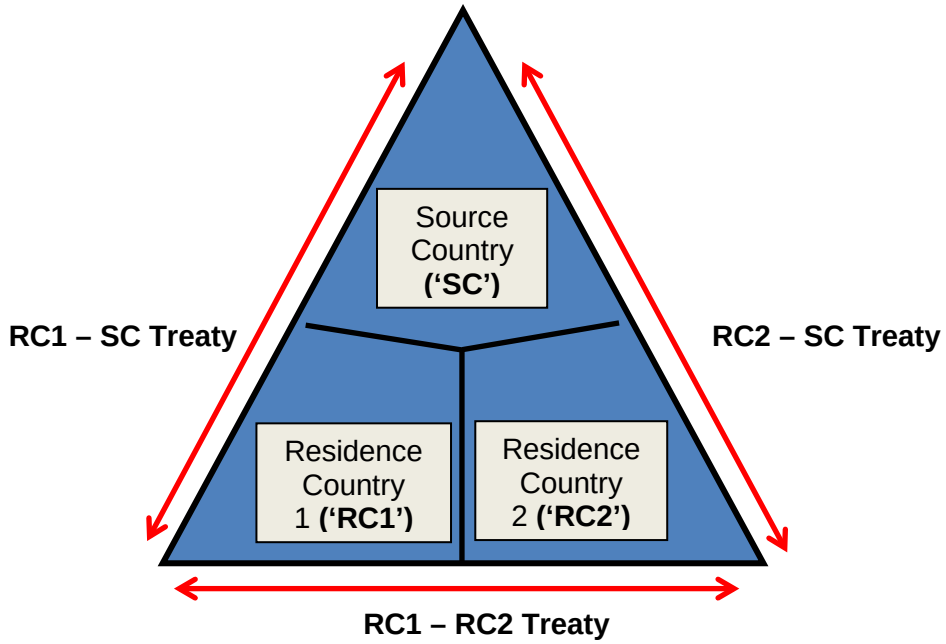
The distributive rules contained in tax treaties, such as Article 7 of the OECD *Model Tax Convention*, operate in the same way by using terminology that constantly refer to 'one' or 'both' or 'the other' Contracting State.[60]

[60]Baker P, *Double Tax Conventions and International Tax Law* (2nd Ed., 1994, London, Sweet & Maxwell) B-01.

3 DUAL RESIDENT TRIANGULAR CASES

3.1 Background

In a double tax agreement context, tax residence of a person is generally determined with reference to the domestic legislation of the countries involved.[61] Dual resident triangular cases have been widely discussed in the available literature[62] and refer to scenarios where a person who is a tax resident in two respective countries, is earning revenue of which the source is in a third country. The situation can be graphically portrayed as follows:



Due to the difference in criteria applied by respective countries in order to determine a person's tax residency, one person could simultaneously be a dual resident in accordance with the domestic legislation of two countries, RC1 and RC2 as above. If a person is such a so called dual resident, the person will most likely also be a dual resident for bilateral tax treaty purposes, unless effective tie-breaker rules apply. Tie-breaker rules could be effectively applied only if the relevant tax treaty provides for it, and if it is possible to factually determine an enterprise's place of effective management or if the relevant tax authorities that are involved are able to reach a mutually beneficial agreement (mutual agreement

[61] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 4, para 1.

[62] For example, Avery Jones J and Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999); OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992); Van Raad, K., 'Dual Residence and the 1977 OECD Model Treaty Article 4(1), Second Sentence', *European Taxation* 1, (1990); and Sasseville, J., *A Tax Treaty Perspective: Special Issues*, *Tax Treaties and Domestic Law,* edited by Maisto, G., (Amsterdam: IBFD, 2006).

procedures are the OECD's alternative proposed tie-breaker clause in Article4(3)). If residency cannot be effectively assigned to either RC1 or RC2, the person will continue to be a dual resident for tax treaty purposes. This is becausetreaties refer to the contracting states' domestic legislation[63] as a starting point for determining residency. For the discussion that follows, a dual resident is a person that is considered to be a resident in terms of the relevant domestic legislation of both countries RC1 and RC2.

Dual resident conflicts are resolved in accordance with tie-breaker rules contained in Article 4(2) and 4(3) of the OECD *Model Tax Convention*, whereby the OECD intends to assign the residency of a dual resident person to one of the respective countries involved. Only for discussion purposes in Chapter 3, it is assumed that residency is assigned to RC2 in accordance with the RC1-RC2 treaty as graphically illustrated above. It is important to note that this assignment of residency is however applicable only to those specific two contracting states, i.e. RC1 and RC2. The assignment of residency should be dealt with separately for each treaty involved in a multilateral situation, i.e. in addition to the RC1-RC2 relationship, residency should also be determined in accordance with the RC1-SC and the RC2-SC treaties respectively.

In a triangular scenario,a situation could thus occur where three bilateral tax treaties are applicable at the same time with reference to one taxpayer, between one source country and two residence countries[64]. The question that arises is therefore whether the dual resident can claim the benefits of the tax treaties concluded by both of its resident states with the third state from which it derives income, i.e. the RC1-SC treaty and the RC2-SC treaty.

3.2 Typical Dual Resident Triangular Cases

Because bilateral tax treaties are concerned with the taxing rights of the two contracting countries only, together with domestic legislation being the starting point of determining the residency of a taxpayer for treaty purposes, two significant opposing risks arise for the taxpayer and the relevant revenue authorities respectively, that of double taxation for the taxpayer, and that of tax avoidance for the relevant revenue authorities.

[63]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 4 para 1.
[64]Avery Jones J and Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 *Bulletin or International Taxation* 16, 19.

The Commentary to Article 4(1) of the OECD *Model Tax Convention* specifically addresses dual resident triangular cases by excluding from the definition of a resident of a contracting state a person such as described in the second sentence of paragraph 8.2, which reads:

> It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States.

It follows that according to the Commentary, the taxpayer is no longer fully liable to tax in RC1 because it is a resident of RC2 under article 4(3) of the RC1-RC2 tax treaty. It is submitted that the taxpayer can therefore not be regarded as a resident of contracting state RC1 for purposes of article 4(1) of another tax treaty to which RC1 is a party. An example of such a treaty would be the RC1-SC treaty in the scenario in chapter 3.1. When applying the RC1-SC tax treaty, the residency implications in accordance with the RC1-RC2 treaty would thus need to be considered.

In the Netherlands, the Dutch Supreme Court came to a similar conclusion in a case involving a Dutch incorporated company which was effectively managed in the Netherlands Antilles and which paid a dividend to its Belgian resident shareholder (February 28, 2001, No. 35 557, BNB 2001/295).[65] The issue at hand was whether the Netherlands was entitled to levy Dutch dividend withholding tax on the dividend distribution by the Dutch company. The Supreme Court considered whether the company qualified as a resident of the Netherlands for purposes of the 1970 Belgium- Netherlands tax treaty. The Supreme Court ruled that the company did not qualify as such because it was not fully liable to tax in the Netherlands as a result of it being a tax resident only of the Netherlands Antilles under the tiebreaker clause of the tax arrangement between the Kingdom of the Netherlands ('BRK') ('*Belastingregeling voor het Koninkrijk'*, this is a law containing an arrangement similar to double tax treaties among the Netherlandsand its overseas territories) and that the Netherlands could therefore not levy its dividend withholding tax. The Court reasoned that because the company qualified as a resident only of the Netherlands Antilles under the BRK, the company was in fact only subject to tax in the Netherlands on its Dutch-sourced income and not on its worldwide income.[66]

In some situations, specifically with regard to companies, the applicable tie-breaker rule of place of effective management may not effectively assign residence to a particular country

[65]Van Den Berg JP, Van Der Gulik B, 'The Mutual Agreement Tiebreaker —OECD and Dutch Perspectives', *Tax Notes International*, Volume 54, Number 5, 4 May 2009, pg. 420.
[66]Van Den Berg JP, Van Der Gulik B, 'The Mutual Agreement Tiebreaker —OECD and Dutch Perspectives', *Tax Notes International*, Volume 54, Number 5, 4 May 2009, pg. 420.

and consequently a person could continue to be a dual resident for treaty purposes with unrelieved double taxation as a result. It is currently not clear how such a treaty that does not effectively assign residence between two states (for example the RC1-RC2 treaty) should be further applied to resolve the issue of dual residency that could potentially result in unrelieved double taxation. This matter is discussed further specifically from a South African point of view in chapter 3.5.

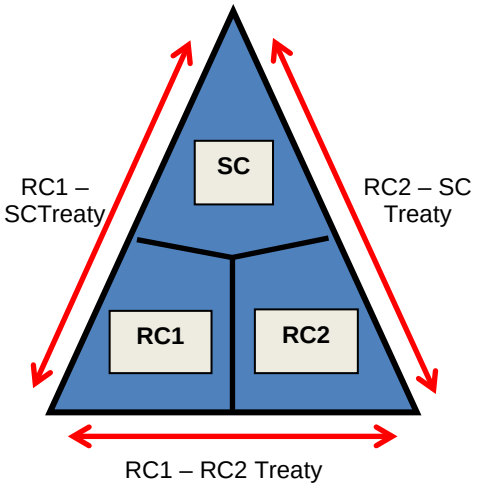
Avery Jones and Bobbett pointout that, in a triangular situation, a dual resident person may be entitled to treaty benefits in accordance with both the tax treaties concluded by the residence states with the source state.[67]For example, should residency not be assigned to either RC1 or RC2 due to the place of effective management test not being effective, or a mutual agreement not being reached, paragraph 8.2 of the Commentary to Article 4(1) cannot apply to the dual residenttaxpayer and the taxpayer will remain fully liable to tax in both countries.[68] In principle, the dual resident would therefore not be excluded from the benefits of the other two tax treaties, RC1-SC and RC2-SC, and effectively be simultaneously entitled to the benefits of two tax treaties. It is generally understood that in the case of simultaneous application of tax treaties, the more restrictive tax treaty in relation to the respective revenue authorities should be applied.[69]It follows then that the taxpayer might have an interest in leaving the dual residency unresolved.

An example will be analysed to further explain and clarify the situation described above of unresolved dual residency in a triangular case:

[67]Avery Jones J and Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 *Bulletin for International Taxation* 16, 19.
[68]Van Den Berg JP, Van Der Gulik B, 'The Mutual Agreement Tiebreaker —OECD and Dutch Perspectives', *Tax Notes International*, Volume 54, Number 5, 4 May 2009, pg. 421.
[69] Van Raad C, 'The 1992 OECD Model Treaty: Triangular Cases', *European Taxation*, Sept. 1993, p. 301.

Example 1:

Diagram:



Facts:

a) Taxpayer X (legal entity) is a tax resident of both RC1 and RC2 in accordance with Article 4(1) of the OECD Model Tax Convention;

b)The dual residency of X has not been resolved by RC1 and RC2;

c)X received a dividend of CUR 1000 from a resident company in SC;

d)The RC1-SC treaty contains a 0% dividends withholding tax rate;

e)The RC2-SC treaty contains a 10% dividends withholding tax rate; and

f)Both RC1 and RC2 apply a full participation exemption to the dividends received by X.

Analysis:

Because paragraph 8.2 of the Commentary to Article 4(1) will not apply to X in this situation (the dual residency was not resolved), X is effectively entitled to claim treaty benefits from two bilateral treaties that are applicable at the same time. SC will be able to follow its treaty obligations by applying only the treaty conditions that are more favorable to the recipient of the income.[70] The benefit to X of the unresolved dual residency in a triangular case would thus be that the company has a choice of which treaty benefits to apply, a 0% dividends withholding tax rate in terms of the RC1-SC treaty or a 10% dividends withholding tax rate in terms of the RC2-SC treaty.Because both RC1 and RC2 apply a participation exemption, X will not pay tax in terms of domestic legislation in either of the two countries. If X then selects to apply the RC1-SC treaty, the company will not pay any tax on the CUR 1 000 dividend received from SC (CUR 1 000 * 0% withholding tax rate).Paragraph 24.1 of the Commentary to Article 4 of the OECD *Model Tax Convention* as well as Article 25(1) of the OECD *Model Tax Convention* indicates that the mutual agreement residency tiebreaker will normally be initiated by the dual resident entity itself. This would make sense seeing that it would be the dual resident entity itself and not the contractingstates thatwould be aware of the potential double taxation because of both contracting states wishing toimpose tax on a particular income stream.[71]

[70]See inter-alia: Avery Jones J, Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 *Bulletin for International Taxation* 16; and Damen S, 'Netherlands Supreme Court Rules on the Residence of Dual Resident Companies under Tax Treaties with Third Countries' (2001) 55 *Bulletin for International Taxation* 290; and Gusmeroli M, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? - Part 1' (2005) 45 *European Taxation* 2.

[71]Van Den Berg JP, Van Der Gulik B, 'The Mutual Agreement Tiebreaker —OECD and Dutch Perspectives', *Tax Notes International*, Volume 54, Number 5, 4 May 2009, pg. 422.

Example 1 (cont.)

If the residency of X was determined to be in RC2 in terms of a tie-breaker clause in the RC1-RC2 treaty, the 10% withholding tax rate as per the RC2-SC treaty would apply and X would not be able to apply the treaty benefits of the RC1-SC treaty.

The potential negative implication to a taxpayerin a dual resident triangular case would be evident in a situation where RC1 and RC2 do **not** apply a participation exemption to the dividend received by X in which case the resident would be double taxed.It poses the question of whether it is correct for two bilateral treaties to potentially be applied simultaneouslyto a dual resident taxpayer, and if not, which one should be excluded?

Paragraph 8.2 of the Commentary to Article 4(1) of the OECD *Model Tax Convention*reads:

> It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States.

Important to note though is that the application of the second sentence of the definition of a resident of a contracting stateappears to have 'inherent difficulties and limitations' and that it has to be interpreted in light of its 'object and purpose'.[72]This object and purpose is to exclude from the definition persons who will not be liable to 'comprehensive taxation (full liability to tax)' in a particular state.[73] For example, if residency of a taxpayer is assigned to RC2 in terms of the RC1–RC2 tax treaty, the taxpayer will not be a resident of a contracting state as defined because RC1 will not be entitled to impose full taxation on the person (as RC2 will be able to do), but only impose tax on income which has a source in RC1.

3.3 Source of the Income

It is clear from the above discussion in chapter 3.2 that a key concept in determining the correct application of the second sentence of Article 4(1) in the context of dual-residents is the *source* of the income concerned. The OECD Commentary argues[74] that, as a result of the tax treaty between the two resident countries, RC1 and RC2 for purposes of this discussion, the contracting state to which residency is not assigned is entitled to impose tax

[72]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 4, para 8.3.
[73] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 4, para 8.3.
[74] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 4, para 8.2 and 8.3.

only on income from sources in that particular state. A consideration that could then complicate this interpretation is when there is a disagreement with respect to the source of that income, whether or not it is in fact in RC1 or another country. An example of such income will be passive income such asinterest that is attributable to a permanent establishment in RC1 but that arises in another state, the SC (permanent establishment triangular cases are discussed in chapter 4).[75] It could be argued that the source of the income is both the permanent establishment state, RC1, because of the activities of the permanent establishment giving rise to the income,as well as the state where it actually arose and was paid from.

If it is argued that theinterest that is attributable to a permanent establishment in RC1 is sourced in the SC, the dual-resident will be taxable in RC1 (in accordance with Article 7 of the OECD's *Model Tax Convention*) on income which is **not** sourced in that state and therefore treaty benefits cannot be denied.[76] This is because the income will be taxed in the permanent establishment state, RC1, as well as the SC in terms of source-based taxation. Double taxation relief must therefore be extended by RC1 in order to prevent double taxation. Alternatively, if it is argued that the income is sourced in the state where the permanent establishment is located as a result of its activities there, RC1, the taxation of such income will result in treaty benefits under the second sentence of Article 4(1) being denied.[77] This is because RC1 will not be a **resident of a contracting state** as defined because it will not be entitled to impose full taxation on a person, but only impose tax on income which has a source in RC1. The differing standpoints with regardto the source of this type of income clearly demonstrate that there are two possible interpretations of the second sentence of Article 4(1), the first of which is that treaty benefits would be allowed as long as income that is sourced in a state other than RC1 has accrued to the taxpayer, even if that income can also be considered to be sourced in RC1, the non-residence country.[78] This is because RC1, which is the resident country for purposes of the RC1-SC treaty, will be

[75]Van Raad, K., 'Dual Residence and the 1977 OECD Model Treaty Article 4(1), Second Sentence,' 30 *European Taxation* 1, (1990), pp. 27-29; Sasseville, J., *A Tax Treaty Perspective: Special Issues*, *Tax Treaties and Domestic Law,* edited by Maisto, G., (Amsterdam: IBFD, 2006), pp. 37-61, (Chapter 3), Section 3.3.

[76]Van Raad, K., 'Dual Residence and the 1977 OECD Model Treaty Article 4(1), Second Sentence,' 30 *European Taxation* 1, (1990); Van Raad, K., '2008 OECD Model Tax Convention: Operation and Effect of Article 4(1) in Dual Residence issues under the Updated Commentary,' 63 *Bulletin for International Taxation* 5/6, (2009), pp. 187-90.

[77]Sasseville J, *A Tax Treaty Perspective: Special Issues*, *Tax Treaties and Domestic Law,* edited by Maisto, G., (Amsterdam: IBFD, 2006), pp. 37-61, (Chapter 3)

[78]Van Raad, K., 'Dual Residence and the 1977 OECD Model Treaty Article 4(1), Second Sentence,' 30 *European Taxation* 1, (1990); Van Raad, K., '2008 OECD Model Tax Convention: Operation and Effect of Article 4(1) in Dual Residence issues under the Updated Commentary,' 63 *Bulletin for International Taxation* 5/6, (2009), pp. 187-90.

obligated to extend double taxation relief for tax paid in SC. The second interpretation allows treaty benefits to be claimed only if it is possible to identify income that is taxable in RC1 that does not have its source there.[79] Clearly these two interpretations would result in a significantly different **scope**of the second sentence of Article 4(1) but are arguably both correct. It would then seem inappropriate to deny treaty benefits to an entity that would usually be entitled to them (even if the SC considers that such benefits should not be available) based on, what is submitted to be,one of two equally defendable interpretations of the wording of Article 4(1).

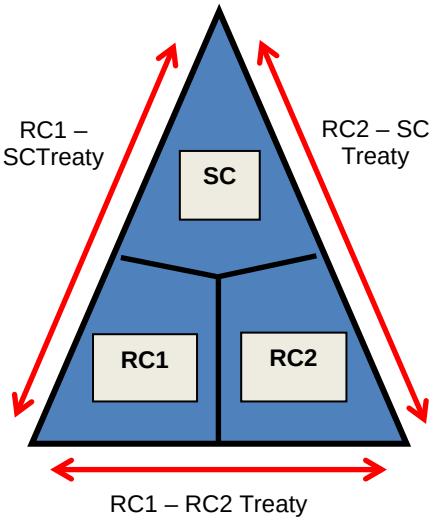
Furthermore, if the relevant residence state, RC1, is entitled to impose tax on income that is attributable to a permanent establishment in that state that arises in a third state (SC), the risk to the taxpayer is that RC2 (which is considered to be the place of residence in accordance with the RC1 – RC2 treaty) may not be able to provide sufficient relief in order to prevent double taxation. Adequate relief can only be ensured if the permanent establishmentstate provides relief for tax imposed in the SC. If the RC1-SC treaty applies, it will require RC1 to grant relief[80] for tax imposed in the SC and unrelieved double taxation will be prevented. However, if the dual resident is not considered to be a tax resident in RC1 for the purposes of that treaty, then RC1 would generally have no direct obligation to provide relief for tax imposed in the SC and unrelieved double taxation may very welloccur.

To further explain the preceding paragraph, a numerical example will be analysed:

[79]Sasseville J, *A Tax Treaty Perspective: Special Issues*, *Tax Treaties and Domestic Law,* edited by Maisto, G., (Amsterdam: IBFD, 2006), pp. 37-61, (Chapter 3)
[80]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Articles 23 A or 23 B.

Example 2:

Diagram:



Facts:

a) Taxpayer Y (legal entity) is a tax resident ofboth RC1 and RC2 in accordance with Article4(1) of the OECD *Model Tax Convention*;

b)Y's tax residency is assigned to RC2 in termsof Article 4(3) of the OECD*Model TaxConvention*;

c) Y has a permanent establishment in RC1;

d)Y received interest to the amount of CUR 1 000 from a resident company in SCthat is attributable to the permanent establishment in RC1;

d) The RC1-SC treaty contains a 10% interesttax rate; and

e) The RC2-SC treaty contains a 15% interest tax rate.

Analysis:

Country	**RC1 (30% corp tax rate)**	**SC**	**RC2 (30% corp tax rate)**
Note: Y is not a tax resident in RC1 for purposes of the RC1-RC2 treaty and therefore RC1 is not considered to be the residence country for purposes of any other treaty.			
Tax imposed:	CUR 1 000 * 30%	CUR 1 000 * 15%	0
Reason:	Article 7 of the OECD *Model Tax Convention*	Sourced based taxation	Article 7 and 23 of the OECD *Model Tax Convention*
Relief provided:	CUR 0	CUR 0	CUR 1 000 is exempt
Reason:	RC1 is not a resident of a contracting state for the RC1-SC treaty, no obligation to provide relief.	Not the residence country of either treaties involved, Article 11 provides for taxing of interest in the SC	Tax is not imposed in RC2 because of the implications of Article 7 and 23 of the OECD *Model Tax Convention*.
Tax incurred:	CUR 300	CUR 150	CUR 0
Total tax incurred:	**CUR 450**	**Effective double taxation**	
Alternative relief provided:	**(150)**		
Reason:	RC1-SC treaty being applied		
Total tax incurred:	**CUR 300**	**Effective double taxation prevented**	

3.4 SARS's Current Approach to Place of Effective Management

3.4.1 Background

Article 4(3) of the OECD *Model Tax Convention* states:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

As mentioned in chapter 2, the tax residency of a person as per a double tax agreement is generally determined with reference to the domestic legislation of the countries involved. In a situation where a person is considered to be a tax resident in both of the two contracting states, one could refer to tie-breaker rules contained in Article 4 of the OECD *Model Tax Convention* in order to assign the residency to a particular state. The tie-breaker rule in Article 4(3) with regardto legal persons is the test of 'place of effective management' which is describedas:[81]

> The place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.

Application of the place of effective management test would generally effectively assign tax residency to one of the contracting states, unless the meaning of the term place of effective management is interpreted differently bythe two states involved. This difference in interpretation of the place of effective management tie-breaker rule could be problematic because a taxpayer could therefore effectivelybe a dual resident for bilateral tax treaty purposes and be subject to double taxation. One solution could be for such cases to be settled by competent authorities by virtue of mutual agreement, but this could still result in double taxation if an agreement cannot be reached. In addition to the place of effective management test being used as a tie-breaker in double tax agreements, it is also one of two tests in the South African tax legislation for determining a legal person's tax residency in South Africa. The approach of SARS to the interpretation of the place of effective management is however not the same as the approach adopted by the OECD for purposes of double tax agreements.[82]The

[81]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 4, para 24.
[82]Pearson B, Gounden N, 2011, Tax News No. 3 of 2011, Place of Effective Management – Foreign entities to take heed of a recent court case, Deloitte

differences between the approaches of SARS and the OECD will be examined to illustrate an example of possible differing approaches.

3.4.2 SARS's current interpretation of place of effective management

The term place of effective management is not defined in South African tax law and therefore guidance has been provided in *Interpretation Note 6: Resident: Place of Effective Management (Persons other than Natural Persons)* that was issued by SARS in March 2002. South African tax courts[83] have also only recently started interpreting the phrase. The general approach taken by *Interpretation Note 6*[84] is that a company's place of effective management is:

> 'the place where the company is managed on a **regular or day-to-day basis** by directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meet' (emphasis added).

The focus in *Interpretation Note 6,* and by direct implication that of SARS, is therefore on the actual location where policy and strategic decisions *are executed and implemented* by a company's senior management, rather than the place where the ultimate authority over the company is exercised by its board of directors or similar body, i.e. where the decisions are made.[85]

Interpretation Note 6 has been a cause for concern for taxpayers establishing offshore companies and trusts, as the views expressed by SARS appear to be much wider than the international view on this issue. This could deter investment into Africa using South Africa as a gateway and possibly have an effect on the economic growth of Africa as a whole. Furthermore, a foreign entity that is a tax resident in South Africa will be subject to tax in South Africa on its world-wide income. If no relief is provided to this foreign entity by way of a double tax agreement with its country of incorporation due to a different interpretation of the place of effective management, the entity could face serious cash flow implications as a result of effectively being subject to double taxation.

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[83] For example, *The Oceanic Trust Co. Ltd N.O v the Commissioner for the South African Revenue Service,* 13 June 2011, 74 SATC 127.

[84] South African Revenue Service, *Interpretation Note 6: Resident: Place of Effective Management (Persons other than Natural Persons)*, March 2002, para 3.2.

[85] South African Revenue Service, *Discussion Paper on Interpretation Note 6, Place of Effective Management*, September 2011

Internationally there is broad consensus that the term 'place of effective management has at least two main interpretations, namely the place where the board of directors **meets** or the place where the senior management **operates**.'[86]These interpretations are respectively labelled the 'Anglo-American', as followed by the OECD, and the 'Continental' approach[87], as followed by SARS in its current interpretation of the place of effective management.

Regardless of the OECD's interpretation of place of effective managementpossibly still presenting certain practical issues in today's modernized global business environment, '*Interpretation Note 6* appears to have caused uncertainty in at least three ways: first, by adopting an approach that appears to conflict with the weight of international authority insofar as the general approach of *Interpretation Note 6* focuses on the place where strategic decisions are 'executed and implemented'[88], rather than on the place where the decision-making, in substance, takes place; second, by appearing at times to blur the lines between what have been called the 'second' and 'third' levels of management; and third, by including certain factors in the 'guideline'[89] to determining place of effective management that appear to conflict with the general approach taken by *Interpretation Note 6*.'[90]

3.4.3 Case Law

In June 2011 a Mauritian company, The Oceanic Trust Co Ltd, submitted an application to the Western Cape High Court in its capacity as trustee of a Mauritian Trust.[91] The company appealed to the court for an order declaring that the trust is not a South African taxpayer as it is not a South African tax resident and did not derive South African sourced income. Interestingly, in its ruling the court did not even consider *Interpretation Note 6* as issued by SARS, but thought key features of a UK case, *Commissioner for Her Majesty's Revenue and Customs v Smallwood and*

[86] Russo M, *European Tax* 459 (2008).
[87]South African Revenue Service, *Discussion Paper on Interpretation Note 6, Place of Effective Management*, September 2011, page 5.
[88] South African Revenue Service, *Interpretation Note 6: Resident: Place of Effective Management (Persons other than Natural Persons)*, March 2002, para 3.2.
[89] South African Revenue Service, *Interpretation Note 6: Resident: Place of Effective Management (Persons other than Natural Persons)*, March 2002, para 3.4.
[90]South African Revenue Service, *Discussion Paper on Interpretation Note 6, Place of Effective Management*, September 2011.
[91]*The Oceanic Trust Co. Ltd N.O v the Commissioner for the South African Revenue Service,* 13 June 2011, 74 SATC 127

Another [2010] EWCA Civ 778,[92] more relevant in determining the place of effective management of the Mauritian Trust. The applicant's request for the declaratory order was dismissed[93] based on the actual facts surrounding the trust's management being unclear. The importance of this decision by the Court was however its acknowledgement[94] that the place of effective management of a person other than a natural person is the place where key management and commercial decisions that are necessary for the conduct of a person's business are in substance made.[95]

The applicant placed reliance[96] on the UK case, *Commissioner for Her Majesty's Revenue and Customs v Smallwood and* Another [2010] EWCA Civ 778,and specifically the following key features[97] relating to the interpretation of place of effective management:

- The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made;
- The place of effective management will ordinarily be the place where the most senior group of persons (e.g. a board of directors) makes its decision, where the actions to be taken by the entity as a whole are determined;
- No definite rule can be given and all relevant facts and circumstances must be considered to determine the place of effective management of an entity; and
- Although there may be more than one place of management, there may only be one place of effective management at any one time.

This interpretation corresponds to that of the OECD Commentary and casts further doubt on SARS's interpretation which focuses more on day to day management.

[92]*The Oceanic Trust Co. Ltd N.O v the Commissioner for the South African Revenue Service,* 13 June 2011, 74 SATC 127, pg. 131.
[93]*The Oceanic Trust Co. Ltd N.O v the Commissioner for the South African Revenue Service,* 13 June 2011, 74 SATC 127, pg. 131.
[94]*The Oceanic Trust Co. Ltd N.O v the Commissioner for the South African Revenue Service,* 13 June 2011, 74 SATC 127, pg. 131.
[95]La Grange A, Tax Manager, Edward Nathan Sonnenbergs, 'case law guidance on effective management', September 2011.]
[96]*The Oceanic Trust Co. Ltd N.O v the Commissioner for the South African Revenue Service,* 13 June 2011, 74 SATC 127, pg. 130.
[97]*The Oceanic Trust Co. Ltd N.O v the Commissioner for the South African Revenue Service,* 13 June 2011, 74 SATC 127, pg. 131.

In another UK case, *Commissioner for Her Majesty's Revenue and Customs v Laerstate BV*[2009] UKFIT 209 (TC), the First-Tier Tribunal observed that:[98]

> Where a company is managed by its directors in board meetings it will normally be where the board meetings are held. But if the management is carried out outside board meetings one needs to ask who was managing the company by making high level decisions and where, even where this is contrary to the company's constitution.

In this case it was established[99] that the company was actually controlled and managed by its sole shareholder and not its sole director at the time. The Tribunal emphasized that 'it is clear that the mere physical acts of signing resolutions or documents do not suffice for actual management.' The Tribunal concluded[100] that the shareholder's activities were concerned with 'policy, strategies and management matters' and that his activities constituted the 'real top management' of the company which confirmed its POEM to be in the UK where the shareholder performed these activities.

3.4.4 The OECD v SARS

It could be argued that the OECD place of effective management test is old fashioned and has not kept up with the pace of changes in telecommunications, international travel, modern business practices and general technology and the OECD has been under pressure to expand and develop this test.[101] In some of South Africa's tax treaties the tie breaker is actually not the place of effective management but mutual agreement by competent authorities of the two countries. Article 25 offor example South Africa's treaties with China, Botswana, Nigeria and Turkey governs the mutual agreement procedures between South Africa and these countries. In the most recent treaties this test of mutual agreement has now been adopted as the tie-breaker rule due to difficulties in determining the place of effective management and due to the number of disputes SARS has had to deal with on the place of effective management test. Examples of these are the treaties between South Africa and China (2001), Belarus (2004) and Turkey (2006) respectively. The mutual agreement procedure is

[98] *Commissioner for Her Majesty's Revenue and Customs v Laerstate BV* [2009] UKFIT 209 (TC), para 25, page 33.
[99] *Commissioner for Her Majesty's Revenue and Customs v Laerstate BV* [2009] UKFIT 209 (TC), para 25, page 39.
[100] *Commissioner for Her Majesty's Revenue and Customs v Laerstate BV* [2009] UKFIT 209 (TC), para 25, page 39.
[101] See for example, Organization for Economic Co-Operation and Development, Technical Advisory Group, *Discussion Draft: Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention*, 27 May 2003.

the OECD's alternative proposed approach[102] and a legal person's place of effective management would be one of the factors taken into account in determining residence of the taxpayer.

In the UK it has been stated that:[103]

> [W]e might ask whether concepts developed before the age of international telephone and even before the wireless telegraph . . . are still appropriate in today's world. . . The contrast with the current availability of international communications by telephone, e-mail, videophone, video conferencing and the ubiquity of air travel is sharp.

From a South African point of view, BA van der Merwe has expanded on these same issues:[104]

> The adequacy of effective management as a tie-breaker rule based upon [the location of superior management decision making] has been questioned. This interpretation of the phrase was coined when companies were generally organised in a hierarchical structure and management could be located at a specific point within a certain period of time. However, modern companies are increasingly run and managed divisionally rather than through the legal entities in which the divisions are formed. This has resulted in an organisational network spread across different countries. Also, due to modern technology, management has become much more mobile and traditional places of effective management may rotate. Technology has furthermore made it possible to manage without the need for a group of persons to be physically located or to meet in one place, for instance at the company's headquarters. Because of these changed management structures and technology, effective management based on where the directors meet becomes a matter of choice and manipulation. Even when based on a wider interpretation of key management and decision making, it is evident that technology makes it difficult to pin effective management down to one constant location, and double or multiple residences or even non-residence may be the result.

After a comprehensive process of investigating and analysing its Commentary on place of effective management, the OECD revised its Commentary in 2008 based on comments received on its discussion paper 'Place of Effective Management Concept: Suggestions for Changes to the OECD *Model Tax Convention*'(2003 Discussion Paper). In particular, the revised Commentary[105] omits any reference to an entity's board of directors or similar body. The OECD noted that even the more expansive explanation put forward by its Technical Advisory Group 'would not be in line with the views of the majority of its member countries as to the meaning of the concept of place of effective management.'[106] In particular,

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[102]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 4, para 24.1

[103] Miller A & Oates L, *Principles of International Taxation*, para 4.16 (Tottel Publishing Ltd: 2006).

[104] Van der Merwe BA, 'The Phrase "place of effective management": Effectively Explained?', *18 South African Mercantile Law Journal*, 121 at p. 124-125 (2006).

[105] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing

[106] OECD, Centre for Tax Policy and Administration, 'Draft Contents of the 2008 Update to the Model Tax Convention', at p. 7 (2008).

> many countries . . . considered that the advisory group's proposed interpretation gave undue priority to the place where the board of directors of a company would meet over the place where the senior executives of that company would make key management decisions.

3.5 Closing Thoughts

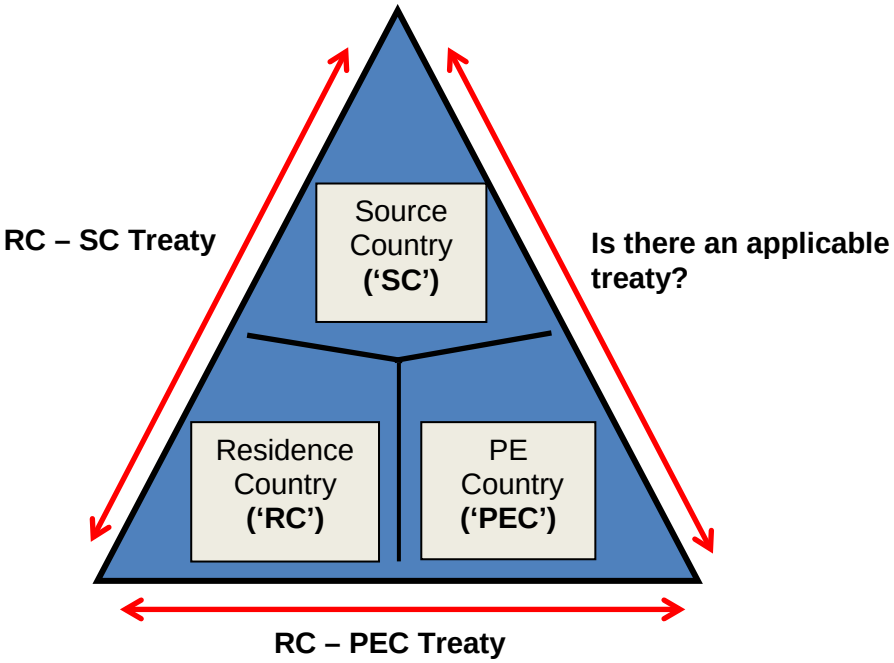
One approach to resolving dual-resident triangular caseswould be to include a specific provision in tax treaties to prevent dual resident persons from claiming treaty benefits under treaties concluded by RC1 (being the non-resident state in respect of the RC1-RC2 treaty) and SC,as discussed in the numerical analysis in chapter 3.2 above. The provision could deny treaty benefits with specific reference to the allocation of residence under treaties concluded with third states. The problem with this solution is that double tax agreements usually take a considerable amount of time with extensive negotiations to be concluded. Once implemented, such double tax agreements are often not renegotiated for quite a long time, and thus such a solution is not effective in the short term because of the length of time it will take for any existing treaty to be renegotiated to take into account such a provision.

The author is therefore of the opinion that the difference in interpretation of the phrase place of effective management by SARS and the OECD Commentary could lead to international double taxation and that SARS should continue to further reconsider its interpretation so that it is even more aligned with international practices.

4 PERMANENT ESTABLISHMENT TRIANGULAR CASES

4.1 Background

Permanent establishment triangular cases arise where a person who is a tax resident in one country has a permanent establishment in a second country and earns revenue that is attributable to that permanent establishment of which the source is in a third country.A permanent establishment triangular case can be graphically portrayed as follows:



All three the countries that are involved in a permanent establishment triangular case, RC, PEC and SC for purposes of discussion in chapter 4could potentially impose tax in accordance with the domestic legislation in each country or in terms of a double tax agreement. Please refer to Table 4.1 below for an analysis of this scenario.In the respective countries, tax will most likely be imposed in accordance with local tax legislationfor the following reasons:

Residence country:	Tax residency of the person earning the income, taxed on world-wide income[107];
Permanent establishment country:	Business presence and activities of the taxpayer forming a link to the income earned, taxed on income attributable to the permanent establishment; and

[107]See for example, South African Income Tax Act 58 of 1962 (as amended), section 1, definition of 'gross income', sub-paragraph (i).

Source country:	Source basis of the income, taxed on income with a local source[108].

The OECD Report on triangular cases also describes the situation illustrated above as the so-called 'typical triangular case', specifically involving passive income (interest, royalties and dividends).[109]

It could be said that the complexity of applying the relevant treaties that are involved in a triangular case is what actually creates the triangular tax effect. Normally, the bilateral tax treaty between RC and SC would apply if income is earned by a tax resident of RC with a source in SC.The conditions of the RC-SC treaty will apply to the SC and it will generally be entitled to impose tax in accordance with the provisions of the treaty (specifically with regard to passive income).With regard to the profits of thepermanent establishment, the tax treaty between RC and PEC would apply, effectively assigning taxing rights to the PEC in accordance with Article 7 of the OECD *Model Tax Convention* (attribution of business profits)on the profit attributable to the permanent establishment.

The important pointis however that the income earned by the taxpayer in the RC, has a source in a different country, SC, but is actually connected to the activities of the permanent establishment in yet another country, PEC, and not the business in the RC. For bilateral tax treaty purposes, the permanent establishment is to be treated as if it is a 'distinct and separate enterprise'[110] insofar as the attribution of business profits is concerned.The PEC, not being a party to a treaty with the SC, will not have any obligation to provide relief to the permanent establishment in respect of the tax imposed by the SC,but may have an obligation to do so under the permanent establishment non-discrimination article[111] of its treaty with the residence state (the RC-PEC treaty). This obligation may arise in the event that the permanent establishment incurs an overall heavier tax burden than the tax residents of the PEC country would incur in a similar scenario.The RCwill be entitled to impose tax on the income (that is attributable to the PE and has a source in the SC) but will have an

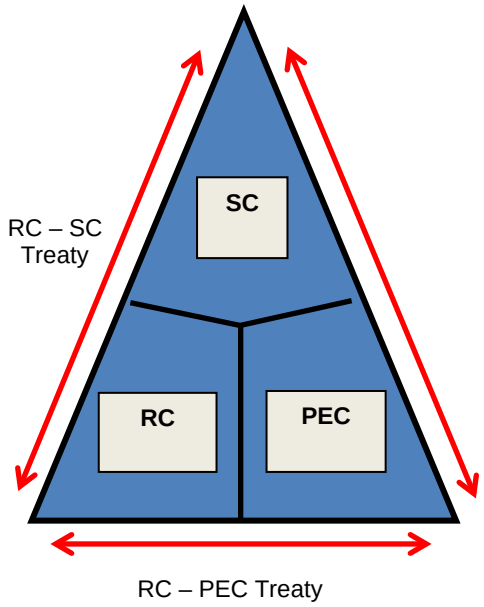
[108]See for example, South African Income Tax Act 58 of 1962 (as amended), section 1, definition of 'gross income', sub-paragraph (ii).
[109]OECD, 'Triangular Cases,' in *Model Tax Convention: Four Related Studies* (Paris: OECD, 1992)
[110] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 7 para 2.
[111] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 24.

obligation to provide relief under both the RC-SC treaty[112] and the RC-PEC treaty,[113] which may not be sufficient to eliminate the triangular tax effect.

A numerical analysis is done below in order to further illustrate the triangular effect in a permanent establishment triangular case:

Example 3:

Diagram:



Facts:

a) TaxpayerZ, an investment bank, is a tax resident of RCand has a permanent establishment in PEC by virtue of having a branch there;

b) The bank branch in PEC extended a loan to a resident of a third country, SC;

c) The resident of SC paid interest of CUR1 000 on the loan amount to the branch in PEC;

d) The RC-SC treaty contains a 10% interest tax rate applicable in SC; and

e)The SC-PEC treaty does not apply because the permanent establishment is not a resident of the PEC.

Note:

RC: The beneficial owner of the interest is a tax resident in RC;
PEC: The loan was given to the recipient by the permanent establishment in the PEC; and
SC: The interest was paid from SC (assumed to be the source country for purposes of this example).

Analysis:

Country	PEC (30% corp tax rate)	SC (10% interest tax rate)	RC (30% corp tax rate)
Applicable treaty:	RC-PEC treaty	RC-SC treaty	RC-PEC treaty
Gross income amount:	CUR 1 000	CUR 1 000	CUR 1 000
Reason:	Article 7 of the OECD *Model Tax*	Article 11(2) of the OECD *Model Tax*	Definition of gross income in RC (the

[112] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 23.
[113] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 23.

	Convention (the interest is attributable to a loan that was given by the permanent establishment in the PEC). Article 11 is not applicable as the interest does not arise in PEC.	*Convention*(the interestarose in and was paid from the SC).	beneficial owner is a resident in RC).
Relief provided:	CUR 0	CUR 0	CUR 1 000 is exempt
Reason:	In terms of Article 7of the OECD *Model Tax Convention* the PEC is entitled to impose tax but has no obligation to provide relief.	In terms of Article 11of the OECD *Model Tax Convention* the SC is entitled to impose tax at 10% with no obligation to provide relief.	Tax is not imposed in RC because of the implications of Articles 7 or 11 and 23of the OECD *Model Tax Convention*.
Tax incurred:	CUR 300	CUR 100	CUR 0
Total tax incurred:	**CUR 400**	**Effective double taxation**	

It could be argued that the main problems surrounding permanent establishment triangular cases can be comprehensively attributed to the personalisation of the permanent establishment concept[114]. Three main sub-problems will be discussed below:

4.2 Permanent establishmentspartially treated as residents

In interpreting the provisions of the OECD *Model Tax Convention*, the scope of the treaty and the following definitions are of importance (emphasis added):

Scope:[115] This Convention shall apply to **persons** who are **residents** of one or both of the Contracting States.

[114]Martin Jimenez JA, Garcia Prats FA and José M, Carrero C, 'Triangular Cases, Tax Treaties and EC Law: The Saint-Gobain Decision of the ECJ' (2001) 55 *Bulletin for International Taxation* 473.
[115] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 1

Person:[116] the term 'person' includes an individual, a company and any other body of persons;

Resident:[117] For the purposes of this Convention, the term 'resident of a Contracting State' means any **person** who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

Also important to note is Article 7 of the OECD *Model Tax Convention* regarding 'BusinessProfits'[118] that states the following:

> The 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 of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

As mentioned previously in chapter 4.1, Article 7(2) of the OECD *Model Tax Convention*further states that apermanent establishment should be treated as if it is a completely separate entity from the original enterprise in the resident state, insofar as the attribution of business profits is concerned. This leads one to conclude that any and all profits attributable to the permanent establishment, even if sourced in another state, should be taxed by the permanent establishment country. This is because there is noprovision in the OECD *Model Tax Convention* that stipulates an exception to Article 7 with regard to profits that are sourced from a third state. The provision simply allocates the taxing right of business profits that are **attributable** to a permanent establishment, to the country in which the permanent establishment is situated. The tax treatment of a permanent establishmentis thus in many aspects very similar to that of a company that is a tax resident in a particular state, that would consequently be taxed on a worldwide basis[119]as a resident of that state. If the income that is attributable to the permanent establishment is sourced in a third country,

[116] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 3, para 1(a)
[117] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 4, para 1
[118] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 7, para 1
[119]Yong S, 'Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place' (2010) 54 *Bulletin for International Taxation* 152, 155.

SC, and that country imposes tax on that income, then juridical double taxation occurs between the PEC and the SC.The question to ask is thus, is there a bilateral tax treaty between the SC and the PEC that could be appropriately applied in order to prevent the double taxation?

As per the various existing bilateral tax treaties that could potentially be available to the respective parties in a permanent establishment triangular case, the SC must apply the provisions of the RC-SC treaty when imposing tax on income with a source in that country, and not the PEC-SC treaty.[120]Certain authors consider this to be the application of the incorrect treaty by the SC becausethe RC-PEC treaty willmost likely assign the taxing right of the income to the PEC.[121]This view is based on the notion that, although the concept of a permanent establishment is presumably just a mechanism to determine whether source-based taxation can be imposed in a particular country, it has the characteristics of a partial-residence basis of taxation, as discussed in the following four paragraphs.

As per the above extracts of the OECD *Model Tax Convention* in the introductory paragraph to chapter 4.2 (scope, person and resident), the treaty provisions are applicable only to persons who are a tax resident of at least one of the contracting states. It is clear that the permanent establishment is not a person and therefore also not a resident of a contracting state. It can be argued that the concept of a permanent establishment[122] is necessary only in a treaty context in order to determine the extent of the right of the source state (where the permanent establishment is situated) to tax the income of a non-resident company, and thus essentially operates as a sourcing rule for treaty purposes. The result is therefore that a permanent establishment cannot take advantage of a double tax agreement between the source state and another state, i.e. is not entitled to treaty benefits because it is not a separate legal entity, a 'person' as defined, and can therefore not be a resident of a contracting state.

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[120] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Articles 1, 3(1) and 4(1)

[121]See, inter alia: Avery Jones, J.F., 'The David R. Tillinghast Lecture: Are Tax Treaties Necessary?' 53 *Tax Law Review* 1, (1999), pp. 1-38; Arnold, B.J. and Sasseville, J., Source Rules for Taxing Business Profits Under Tax Treaties, *The Taxation of Business Profits Under Tax Treaties* (Toronto, Canadian Tax Foundation, 2003) at p 118; Yong, S. 'Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place'*Bulletin for International Taxation* 3, (2010), pp. 152-64; Adolfo J. Martin Jimenez, Francisco Alfredo Garcia Prats and José M. Calderon Carrero, 'Triangular Cases, Tax Treaties and EC Law: The Saint-Gobain Decision of the ECJ' (2001) 55 *Bulletin for International Taxation* 241, 245; Avery Jones J and Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 Bulletin 16, 19; Madeira, E.A. and Neves, T.C., 'Exploring the Boundaries of the Application of Article 10(5) of the OECD Model,' 38 *Intertax* 8/9, (2007), pp. 473-483.

[122]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 5 para 1.

From a legal perspective, there is a key difference between a permanent establishment and a subsidiary company. In a tax treaty context, a permanent establishment can be described as simply being a foreign branch of a company that is a tax resident in another country, and in contrast to that, a subsidiary company is a separate legal entity and would usually be a corporate taxpayer by virtue of its incorporation in a particular country. This raises the question of whether this difference permits different treatment with respect to treaty eligibility. In general, there is a trend towards treating permanent establishments and subsidiaries in the same way on the basis that the economic substance of the two different forms of business is effectively the same.[123] From a practical and substance-over-form perspective, the tax characterization of a situation is not always equal to the legal characterization and therefore the distinction between a permanent establishment and a subsidiary legal entity may be somewhat unclear and complicated. What is considered a permanent establishment under the domestic law of one state may be considered a separate taxable entity under the laws of another state and vice versa. For the purposes of determining the source of interest income, the payment of interest by a permanent establishment is generally treated as being equivalent to the payment of interest by a resident person.[124] Furthermore, the OECD *Model Tax Convention* also provides for the taxation of a permanent establishment to be similar to that of a resident taxpayer in the permanent establishment non-discrimination article (Article 24(3)), which requires the permanent establishment state to impose tax on the permanent establishment to the same extent as it would on a resident enterprise of that country.

The above discussion highlights the hybrid nature of the permanent establishment concept. On the one hand, the permanent establishment concept seems to operate more as a sourcing rule in a treaty context seeing that the profits attributable to a permanent establishmentare taxed in the source country of its profits, but on the other hand it could be argued to be more of a residency rule seeing that that the permanent establishment is required by Article 7 to be taxed by the permanent establishment country in a similar way as it would tax a tax resident of that country.

This hybrid nature of permanent establishments as discussed in the preceding paragraph,complicates matters in permanent establishment triangular cases where the income which is attributable to apermanent establishment and which the permanent establishment state is entitled to tax under the RC-PEC treaty includes income which is

[123]Schön, W., 'International Tax Coordination for a Second-Best World (Part I),' 1 *World Tax Journal* 1, (2009), 106.
[124]Vann, R., Reflections on Business Profits and the Arm's-Length Principle, *The Taxation of Business Profits Under Tax Treaties,* (Toronto, Canadian Tax Foundation) 2003, p 144.

sourced in a third state. The problem is the partial-resident treatment of permanent establishments whereby, just like a resident, the permanent establishment is taxed[125] on its world-wide income but, unlike a resident, the permanent establishment has no corresponding entitlement to treaty benefits. It has no corresponding entitlement to treaty benefits because it cannot be a person covered by a tax treaty as explained above in the sixth paragraph of chapter 4.2 and is therefore unable to rely on relief provided by the provisions of the treaty.The consequence of this is that the PEC has no direct obligation to grant relief to the permanent establishment for tax imposed in the SC (apart from the application of the non-discrimination principles) and the SC has no obligation to apply the conditions of the SC-PEC treaty because the permanent establishment is not a resident of a contracting state to said treaty and is therefore not entitled to treaty benefits. Thus, difficulty can arise with regard to the application of bilateral treaties in permanent establishment triangular cases because, for treaty purposes, permanent establishments are treated partially like residents of the permanent establishment state, i.e. only to the extent of profit attribution, and not to the extent of being entitled to corresponding treaty benefits.

4.3 Simultaneous application of two bilateral tax treaties

As mentioned before in chapter 4.1, the residence country in a permanent establishment triangular case will be a contracting state to two bilateral tax treaties being applied simultaneously, the RC-SC treaty as well as the RC-PEC treaty. Consequently, the RC may have an obligation to provide relief for tax imposed in both the SC and the PEC on the same taxable income. This situation gives rise to two main concerns.[126]

Considering that source-based taxation may be imposed in both the SC and the PEC, and residence-based taxation will be imposed in the RC, the issue is not whether the RC will be able to provide relief, but whether it will be able to provide sufficient relief to prevent unrelieved triangular taxation.

It can be said that unrelieved double taxation should only occur in triangular cases if the overall tax burden imposed on one person is more than the highest of the applicable tax

[125]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 7.
[126]See, inter alia: OECD, 'Triangular Cases,' in *Model Tax Convention: Four Related Studies* (Paris: OECD, 1992); Van Raad, K. 'The 1992 OECD Model Treaty: Triangular Cases,' 33 *European Taxation* 9, (1993), pp. 298-301; Potgens, F.P.G., 'The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case' 48 *European Taxation* 4, (2008), pp. 210-5; Zhai, G., 'Triangular Cases Involving Income Attributable to PEs'. 53 *Tax Notes International* 12 (2009), pp. 1105-1123.

rates in each of the three countries that seek to impose tax on the income.[127]It follows then that the residence state should be able to extend sufficient double taxation relief (by way of the credit method)[128]in permanent establishment triangular caseswhere the combined effective tax rate in the two source states is lower than the applicable tax rate in the residence state.[129]

The second concern is the RC's potential obligation to provide dual relief as is required in terms of both the applicable treaties. For example, if the RC-PEC treaty requires the RC to exempt the income arising in a permanent establishment triangular case and the RC-SC treaty requires the RC to grant relief using the credit method, the RC will only be able to meet its treaty obligations by allowing both relief measures.The OECD *Model Tax Convention*limits the amount of credit relief in the residence state to the amount of tax imposed by this state which is attributable to the income.[130] If the exemption under one treaty is taken into account for purposes of applying the other bilateral treaty, no credit relief should be available because there would be no tax attributable to the income in the residence state.[131]As a result of the exemption, the prerequisite requirement for granting a credit (i.e. that tax was imposed on the income in the RC) is factually not met. The RC should therefore not be in a position where dual relief is required in terms of both the RC-SC treaty and the RC-PEC treaty.

4.4 Source of the Income

Another contributing factor to problems arising in permanent establishment triangular cases is an overlap of the 'source' principle as contained in the relevant bilateral tax treaties involved.[132] For purposes of the RC-SC treaty, the income generally arises and is effectively

[127]Langoth B, *Treaty Entitlement of Permanent Establishments*, *Triangular Tax Cases*, edited by Sutter, F.P., and Zehetner, U. (Wein, Linde Verlag, 2004), p 24; García Prats, F.A. 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' 11 *Intertax* (1994), pp. 473-91, note 30.
[128]Langoth B, *Treaty Entitlement of Permanent Establishments*, *Triangular Tax Cases*, edited by Sutter, F.P., and Zehetner, U. (Wein, Linde Verlag, 2004), p 24; García Prats, F.A. 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' 11 *Intertax* (1994), pp. 473-91, note 30.
[129]Langoth B, *Treaty Entitlement of Permanent Establishments*, *Triangular Tax Cases*, edited by Sutter, FP, and Zehetner, U. (Wein, Linde Verlag, 2004), p 24; García Prats, F.A. 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' 11 *Intertax* (1994), pp. 473-91, note 30
[130]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 23A(2) and Article 23B(1).
[131] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 23A and Article 23B.
[132]Vogel, K., '"State of Residence" may as well be "State of Source" – There is no Contradiction', 59 *Bulletin for International Fiscal Documentation*10, (2005), pp. 420-423.

sourced in the SC and, depending on the type of income, theSC may be entitled to impose tax on that income. For purposes of the RC-PEC treaty, the income which is attributable to the permanent establishment is effectively considered to be sourced in the PECfor application of that treaty. This overlap in the source rules can create conflict in permanent establishment triangular cases because both the SC and the PEC may have a legitimate claim to impose source-based taxation on the income earned. The question to ask is therefore should one of the source states, either SC or PEC, be prevented from imposing tax on the relevant income stream?

Whilst the apparent answer appears to be yes, one country should be prevented from imposing tax in order to prevent unrelieved double taxation to the taxpayer in the SC and the PEC, the problem is which country? The income concerned has a lawful economic connection to both the SC and the PEC and thus, both countries arguably have a valid taxing claim in relation to the income. If one country's taxing rights are to be denied entirely, the fiscus of one of the two states will effectively incur a financial loss, and it is doubtful that states would be willing to settlefor such an agreement. If the PEC is prevented from taxing the income attributable to a non-resident's permanent establishment that was derived from sources in a third state, it would undermine the residence-supporting role of the permanent establishment concept in tax treaties[133] and give rise to significant tax avoidance concerns (effectively being an incentive to'replace' residence entities with permanent establishment entities). Alternatively, if the source state were to be prevented from imposing tax on income derived in permanent establishment triangular cases, it is submitted that all source-based taxation could be avoided by simply operating through a permanent establishment in a third country, and thus yet again result in significant tax avoidance opportunities. An acceptable solution would thus be that neither country should be required to completely surrender its taxing rights, but that effective measures should be put in place to ensure the prevention of double-taxation as well as tax avoidance.

[133]Vann, R., *Reflections on Business Profits and the Arm's-Length Principle*, *The Taxation of Business Profits Under Tax Treaties,* (Toronto, Canadian Tax Foundation) 2003, p 147.

5 COMPATIBILITY OF TREATIES WITH CURRENT SOLUTIONS

Existing proposals by the OECD and, where applicable, tax authors, for solving triangular cases will be evaluated in terms of their compatibility with bilateral treaties. It has been observed that the bilateral nature of tax treaties is the reason why triangular cases are created.[134]Dual resident triangular cases as well as permanent establishment triangular cases, together with particular issues of bilateral tax treaty applicability to these cases, were discussed in Chapters 3 and 4 respectively. The solutions that have been suggested to solve triangular cases with the aim to find out whether these solutions are compatible with the bilateral nature of tax treaties and whether a single bilateral treaty is able to provide for an efficient solution, are discussed in this chapter. This chapter is not meant to present a new solution, but to assess the proposed solutions from the perspective of the bilateral nature of the tax treaties.

5.1 Dual ResidentTriangular Cases

5.1.1 Simultaneous application of two bilateral tax treaties

The OECD attempted to solve dual resident triangular cases by way of supplementary provisions in bilateral tax treaties. One such solution meant to solve double taxation in a triangular situation is the inclusion of a tie-breaker rule in a bilateral tax treaty that would determine which tax treaty is applicable.[135]Based on a Dutch case (28 February 2001, BNB 2001/295) where the tax authorities wanted to prevent the favourable arrangements of Dutch resident companies transferring their residence to other states while still taking advantage of the Dutch treaty network,[136] the second sentence of Article 4(1) could apparently be seen as such a rule because a resident of a contracting state, who is the person who usually has a full tax liability in that state, cannot be considered to have the status of resident if he is taxed only on a source basis (i.e. limited tax liability). This would then also restrict the person from being seen as a resident of a contracting state for the purposes of any **other** tax treaty. This understanding of the second sentence of Article 4(1) has been widely

[134]Sasseville J, 'The Role of Tax Treaties in the 21th Century' (2002) 56 *Bulletin for International Taxation* 246, 247.
[135]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992), para 30.
[136]Damen S, 'Netherlands Supreme Court Rules on the Residence of Dual Resident Companies under Tax Treaties with Third Countries' (2001) 55 *Bulletin for International Taxation* at 290-292.

criticised[137]because the first sentence of Article 4(1) of the OECD *Model Tax Convention* specifically states that the term 'resident of a contracting state' is defined for the 'purposes of **this**Convention' and therefore it cannot be applicable for the purposes of any other bilateral tax treaty.

Another question to consider[138] when determining whether the second sentence of Article 4(1) excludes dual-residents from treaty eligibility, is whether the RC1-RC2 treaty implications regarding tax imposed in RC1 should at all be taken into account, or whether consideration should be limited to the tax imposed under the domestic legislation of that state, RC1. The appropriate interpretation seems to be that the second sentence of Article 4(1) refers only to domestic law.[139] Consequently the dual resident would still be a resident of the 'non-resident' state for the purposes of bilateral tax treaties concluded between that state and other third states.

Avery Jones points out that the dual residence problem is best solved by domestic law provisions that could provide that if a resident of a state loses its residence status under one tax treaty, then it is also lost for domestic law purposes as well as for the purposes of other bilateral tax treaties with that state.[140]

Garcia Prats views the dual resident triangular case in the same light as the typical permanent establishment triangular case. The difference between the two situations is that a permanent establishment can never be a resident of the state where it is located, whereas the person that is a dual resident is still considered to be a resident under domestic laws of both of the two contracting states. He therefore agrees that domestic law should have the provision that changes the residence status under the domestic law in order to prevent the tax treaty access for the non-resident.[141]

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[137]Avery Jones J and Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 *Bulletin for International Taxation* 16, 19; Madeira, E.A. and Neves, T.C., 'Exploring the Boundaries of the Application of Article 10(5) of the OECD Model', 38 *Intertax* 8/9, (2007), 19.
[138]Van Gennep, C.J.A.M., 'Dual-Resident Companies: The Second Sentence of Article 4(1) of the OECD Model Convention of 1977,' 31 *European Taxation* 5, (1991), pp. 141-146.
[139]Van Gennep, C.J.A.M., 'Dual-Resident Companies: The Second Sentence of Article 4(1) of the OECD Model Convention of 1977,' 31 *European Taxation* 5, (1991), pp. 141-146.
[140]Avery Jones J and Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 *Bulletin for International Taxation* 16, 19; Madeira, E.A. and Neves, T.C., 'Exploring the Boundaries of the Application of Article 10(5) of the OECD Model', 38 *Intertax* 8/9, (2007), 20.
[141]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax*, 484.

Even if tax treaties contain tie-breaker rules that are designed to solve the conflict of rules between the two contracting states, it is submitted that they do not affect any other treaties in accordance with the 'pacta sunt servanda' principle in Article 26 of the Vienna Convention on the Law of Treaties. In terms of the 'pacta sunt servanda' principle only the two contracting states to a treaty can rely on the provisions of the treaty to be adhered to in good faith, no other party has access to this assurance. In order for the problem of two bilateral tax treaties being applied simultaneously to be solved, there has to be another explicit provision that could exclude the applicability of one of the treaties. Generally international treaties do not have any order of priority with regard to application[142] and one bilateral treaty cannot exclude the application of another. Thus, a specific tie-breaker rule[143] or a separate supplementary provision is necessary to be included either in domestic legislation or as part of the provisions of bilateral tax treaties to prevent the simultaneous application of two bilateral treaties.

It is interesting to note that the inverse of the dual resident triangular case as discussed in this report, a **dual source** triangular case (which falls outside of the general scope of this report and was therefore not examined), has also been addressed by the OECD by the inclusion of Article 11(5) in the OECD *Model Tax Convention* that reads as follows:[144]

> 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.

5.2 Permanent Establishment Triangular Cases

5.2.1 Proposed solutions by tax authors

Tax authors have proposed solutions to permanent establishment triangular cases specifically with regard to the bilateral nature of tax treaties.

[142]Pötgens FPG, 'The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case' (2008) 48 *European Taxation* 215.
[143]Gusmeroli M, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? - Part 1' (2005) 45 *European Taxation* 2, 6.
[144]Gusmeroli M, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? - Part 1' (2005) 45 *European Taxation* 2, 23.

One of these suggestions was made by Avery Jones and Bobbett. They proposed that the SC-PEC bilateral tax treaty include a specific provision which states that this treaty should apply with regard to income derived from the SC that is attributable to a permanent establishment. They explained that the alternative, i.e. the RC-SC treaty not applying, would be more complicated seeing that different bilateral tax treaties do not have the power to affect the applicability of each other.[145] It could be argued though that this solution of including a specific provision in the SC-PEC treaty, assuming that one exists, is contrary to the relative effect of tax treaties since it attempts to create an obligation, although reciprocal, for contracting states to grant the benefits of their bilateral treaty to a resident of a third state that was not party to the treaty-making process. Nevertheless, explicit consent is not required for granting rights to third countries (refer 2.3.1) and it depends solely on the generosity of the bilateral treaty partners, however unlikely the possibility might seem.

This path was further explored by Zhai who attempted to take into account this exact issue of the relative effect of tax treaties.[146] He proposed that a supplementary provision be included in one of the treaties of which the RC is a contracting state, the RC-SC treaty. This supplementary provision should place an obligation on the SC to apply the other bilateral treaty which it has concluded with the PEC.[147] It would appear that this solution is the most appropriate to solve permanent establishment triangular situations while still keeping the overall bilateral nature of tax treaties. As Zhai mentioned, by changing the extent to which the obligations to contracting states in a bilateral tax treaty can be applied, the**bilateral obligations** are honoured without granting the permanent establishments any treaty benefits.[148] Therefore, both tax treaties that RC and SC have concluded with the PEC should provide that the income attributable to a permanent establishment is treated as if it was derived by a resident of the PEC. It would seem that this solution is closely related to how a permanent establishment is currently being treated in terms of the RC-PEC treaty (with regard to the attribution of business profits), except that the possibility of double taxation within a

[145]Avery Jones J and Bobbett C, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 *Bulletin for International Taxation*16, 19; Madeira, E.A. and Neves, T.C., 'Exploring the Boundaries of the Application of Article 10(5) of the OECD Model,' 38 *Intertax* 8/9, (2007), 18.
[146]Zhai G, 'Triangular Cases Involving Income Attributable to PEs' (2009) 53 *Tax Notes International* 1113.
[147]Zhai G, 'Triangular Cases Involving Income Attributable to PEs' (2009) 53 *Tax Notes International* 1113.
[148]Zhai G, 'Triangular Cases Involving Income Attributable to PEs' (2009) 53 *Tax Notes International* 1122.

permanent establishment triangular case is mitigated by the inclusion of similar permanent establishment provisions in the SC-PEC treaty as is currently in the RC-PEC treaty. There are however two important prerequisites for this solution to effectively prevent triangular cases and those are firstly that both RC and SC have tax treaties with the PEC, and secondly that the treaties contain the non-discrimination provision that will prevent unrelieved double taxation as a result of discrimination against the permanent establishment based on nationality.[149]

If such supplementary provisions, as suggested by Zhai,were not present in treaties, it would be difficult to treat the permanent establishment as a resident with respect to the income attributable to it by both treaty partners. This was illustrated by the *Hana Semiconductor* case[150] in which a resident taxpayer of Thailand had received a loan from a branch of a foreign bank and paid interest to this branch. The branch was located in Singapore and represented a permanent establishment in Singapore of the foreign bank.The relevant parties in this permanent establishment triangular case are as follows:

Thailand:	SC (country where the interest was paid from);
Singapore:	PEC (country where the permanent establishment is situated); and
Foreign country:	RC (country of the bank's head office).

The Thai Supreme Court, in the SC, refused to grant tax treaty benefits to the permanent establishment, the bank branch that was situated in Singapore, because the branch was not a resident liable to tax in Singapore for purposes of the tax treaty between Thailand and Singapore, the SC-PEC treaty. The court in this case demonstrated the general extent of the application and impact of bilateral tax treaties (that is to residents of the two contracting states only) in a permanent establishment triangular tax case, specifically with regard to the difficulty of extending bilateral tax treaty benefits to permanent establishments that are situated in third states.

[149]Zhai G, 'Triangular Cases Involving Income Attributable to PEs' (2009) 53 *Tax Notes International* 1122.

[150]IFBD *Hana Semiconductor (Bangkok) Co Ltd vs Thai Revenue Department* Case no 1056/2549(2006) [23 February 2006] Supreme Court of Thailand: on-line summary provided at <http://online2.ibfd.org/kbase/#topic=doc&url=/collections/ttcls/html/cl_be_2006-02-23_1-summary.html&WT.z_nav=Navigation&colid=4938>, accessed 20 December 2013.

Despite the non-discrimination Article 24(3), the SC has no reason to treat the permanent establishment similarly to the residents of the other contracting state, PEC. This is because the permanent establishment is not situated in the SC and therefore Article 24(3) does not apply to the permanent establishment and the SC.

It is therefore clear that Zhai's proposal to include an additional provision in both of the bilateral tax treatiesto which the SC is a contracting state (in the RC-SC treaty to compel the SC to apply its treaty with the PEC, and in the SC-PEC treaty to provide for income attributable to a permanent establishment as if it was derived by aresident of the PEC), contributes towards more equal treatment of the permanent establishment with regard to treaty benefits entitlement. At the same time, the inclusion of such provisions does not grant the permanent establishment full access to resident status and thus tax treaties, and neither does it conflict with the bilateral nature of tax treaties.

5.2.2 The OECD's Solution to Permanent Establishment Triangular Cases

Member countries of the OECD realised early on that triangular cases are possible in the context of bilateral tax treaties.[151] The conclusion at the time was that it was too difficult to deal with such situations in the OECD *Model Tax Convention* or its Commentary and the member countries were advised to search for a solution in their bilateral tax treaties.[152] Some 30 years later the OECD compiled a report called 'Triangular Cases' which led to amendments being made to the Commentary that were adopted by the OECD Council on 23 July 1992 (first published in 2000). The wording of the OECD *Model Tax Convention* did not change at the time and that Commentary has remained basically unchanged since 1992.

To the extent that the PEC imposes tax on income arising in a permanent establishment triangular case, it should be obliged to grant relief for tax imposed in the SC, both to ensure that double taxation can be prevented and to ensure a fair distribution of taxing revenues between the PEC and the RC.

Paragraph 67 of the OECD Commentary to Article 24 reads as follows:

[151]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992) pp. 26-27.
[152]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992) pp. 26-27.

> In a related context, when foreign income is included in the profits attributable to a permanent establishment, it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

The OECD's current recommendation to solve a typical permanent establishment triangular case is thus based on Article 24(3) which requires that a permanent establishment could not be treated less favourably than aresident of the contracting state where the permanent establishment is situated. It therefore recommends that treaty benefits, i.e. the granting of a tax credit, be extended to permanent establishmentseven though a permanent establishment is not normallyentitled to treaty benefits of the state where it is situated.[153]

The Commentary further states that 'the majority of Member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 3' which is the non-discrimination provision of tax treaties. States that are not able to extend such relief may include a supplementary provision in their bilateral tax treaties providing for the granting of the tax credit.[154] This suggested supplementary provision reads as follows:

> When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends or interest from a third State and the holding or debt-claim in respect of which the dividends or interest are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends or interest, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first mentioned State can claim under that State's convention on income and capital with the third State.[155]

Even though the current solution is viable, it would depend on the contracting states actually negotiating to include it in their treaties.

It is interesting to note that Article 24(3) is more general in nature by requiring only that the permanent establishment should not be treated less favourably than a resident of

[153]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 24, para 68.
[154]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 24, para 70.
[155]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 24, para 70.

that state. It does not prescribe any other conditions such as credit or exemption method being used, domestic law or the tax treaty relief being applied. The Commentary confirms that it is the result alone that counts, that it should not be more burdensome for the permanent establishment compared to the resident enterprise in carrying on similar activities.[156] In contrast to this general approach, the Commentary explicitly recommends the credit method being applied to the taxation of profits of the permanent establishment.[157] In addition to the credit method being prescribed, it also sets the conditions that the relief should be subjected to the provisions of the RC-SC tax treaty and the amount of credit is limited to the amount that the residents of the permanent establishment state would normally receive (refer above for the suggested supplementary provision).

Vogel pointed out[158] that the Supreme Court of the Netherlands[159] gave a ruling in the 'Japanese royalties' case that seems to be in line with the OECD's solution. A tax resident of the Netherlands had a permanent establishment in Switzerland and received royalties from Japan.

The relevant parties in this case were:

Netherlands:	RC (resident country of the taxpayer);
Switzerland:	PEC (permanent establishment country); and
Japan:	SC (country from which the royalties originated).

The royalties paid by Japan, the SC, were split 90% to the Switzerland permanent establishment and 10% to the head-office in the Netherlands. The royalties were subject to withholding tax in terms of the Switzerland-Japan tax treaty[160], and the profits of the Swiss permanent establishment were deemed to be exempt in the Netherlands in terms of the Switzerland-Netherlands tax treaty. In the Netherlands, the taxpayer claimed a tax exemption with regard to all profits attributable to the permanent establishment, including the 90% royalties received from Japan, under the

[156]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 24, para 34.
[159] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Commentary to Article 24 pp. 67-68.
[158]Vogel K, 'Tax Treaty News' (2003) 61 *Bulletin for International Taxation* 235.
[159]IBFD Case no 36.155 [8 February 2002] Supreme Court of the Netherlands: on-line summary provided at <http://online2.ibfd.org/kbase/#topic=doc&url=/collections/ttcls/html/cl_be_2002-02-08_1-summary.html&WT.z_nav=Navigation&colid=4938>, accessed 20 December 2013.
[160]Convention between Japan and Switzerland for the Avoidance of Double Taxation with respect to Taxes on Income, signed at Tokyo on 19 January 1971, Article 12.

Netherlands-Switzerland tax treaty, and a full tax credit under the Netherlands-Japanese tax treaty. The Netherlands tax authorities allowed only 10% of the credit with regard to the royalties seeing that only 10% of the royalties were attributable to the head office and subject to tax in the Netherlands. The Supreme Court supported this decision and stated that the purpose of the tax treaty credit rules was to ensure that the credit would not exceed the taxes that were attributable to the Netherlands.[161]Contrary to the OECD's recommendation, the Switzerland tax authorities did not grant a tax credit relating to the withholding tax paid on the 90% royalties in Japan to the permanent establishment and thus the situation still resulted in juridical double taxation for the taxpayer seeing that the royalties attributable to the permanent establishment were taxed in Japan via withholding tax, and again in Switzerland as part of the permanent establishment's business profits.[162]

In another Supreme Court of the Netherlands' case,[163] a Netherlands tax resident had a permanent establishment in Belgium and derived income from Brazil and Italy. With reference to the 'Japanese royalties' case, the court confirmed its previous viewpoint that atax credit for taxes paid in another jurisdiction (like for example withholding tax on royalties) cannot be granted to the taxpayer since the profits of the permanent establishmentwere not subject to tax by the Netherlands revenue authority. Furthermore, the court also established that the permanent establishment in Belgium was entitled to a tax credit under both tax treaties with the third states from which the income originated, i.e. the treaty between Belgium and Brazil, as well as the treaty between Belgium and Italy. Even though it is clear that it cannot be presumed that permanent establishments are normally entitled to treaty benefits in their state of location[164] (as in the Japanese royalties case), Belgium granted tax credits for withholding taxes paid in other countries on income derived by the taxpayer from those countries and double taxation was thus prevented.[165]

From the latter case mentioned in the preceding paragraph, it is clear that the OECD solution is sometimes accepted internationally for example, by Belgium, and that the

[161]Vogel K, 'Tax Treaty News' (2003) 61 *Bulletin for International Taxation* 235.
[162]Pötgens FPG, 'The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case' (2008) 48 *European Taxation* 210, 211-212.
[163]IBFD Case no 42.385 [11 May 2007] Supreme Court of the Netherlands: on-line summary provided at <http://online2.ibfd.org/kbase/#topic=doc&url=/collections/ttcls/html/cl_be_2007-05-11_1-summary.html&WT.z_nav=Navigation&colid=4938>, accessed 20 December 2013.
[164]Pötgens FPG, 'The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case' (2008) 48 *European Taxation* 210, 211-212.
[165]Pötgens FPG, 'The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case' (2008) 48 *European Taxation* 214.

permanent establishment treaty partner is expected to apply the non-discrimination article and allow access to its tax treaty network with third states. The court's decision appears to be reasonable since it prevented the double taxation that the taxpayer might otherwise have incurred, but, because the court preferred the purposive interpretation instead of the actual wording of the tax treaty, they have also been criticised for not actually following the rules of treaty interpretation as per the Vienna Convention on the Law of Treaties.[166]

5.2.3 Personalisation of the Permanent Establishment Concept

As mentioned in the closing paragraph of chapter 4.1, the main contributing factor to the occurrence of triangular cases is the personalisation of the permanent establishment concept.[167] Although a permanent establishment is not a separate legal entity, it is treated similarly from an international taxation point of view in order to determine the right of a contracting state to tax the profits of the enterprise of the other contracting state.[168]

Permanent establishments are effectively taxed on their worldwide income by virtue of Article 7 of the OECD *Model Tax Convention* whereby the income attributable to the permanent establishment it is submitted includes not only income from the state of its location, but also includes income from third states[169] (it includes **all** income attributable to the permanent establishment). Article 21(2) also confirms that a right to tax is given to the contracting state where the permanent establishment is situated, and it is submitted that that right includes the right to tax income from third states. This interpretation is based on income from third states not specifically being excluded anywhere in the OECD *Model Tax Convention* from this income that is attributable to the permanent establishment and subject to tax in the PEC. It is thus clear that if the domestic legislation of the PEC utilises its right to tax income from third states as part of the income attributable to a permanent establishment situated therein, the OECD approach as stipulated in Article 7 of the OECD *Model Tax Convention* with regard

[166]Pötgens FPG, 'The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case' (2008) 48 *European Taxation* 213.
[167]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax*, 474.
[168]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing,Commentary to Article 5, para 1.
[169]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 7.

tothe taxing of a permanent establishment, serves as a confirmation of the worldwide taxation basis.

Usually the obligation to grant relief corresponds with the right to tax income on a worldwide basis. If this was not the case, juridical double taxation would occur. The OECD *Model Tax Convention* relief provisions, however, only deal with the relief that must be extended to the residents of the contracting state that receive income from the other contracting state and not with the relief that must possibly be extended topermanent establishments situated in another state.[170] It therefore seems reasonable to question the traditional bilateral functioning of tax treaties.[171] If one of the contracting states is given the right to tax the worldwide income of the permanent establishment (assuming the income is in fact attributable to the permanent establishment), should that state not also be the state that is obliged to ensure that the income from the third state is not subject to double taxation? Paragraph 70 of the OECD *Model Tax Convention* Commentary to Article 24 seems to take cognisance of the limited personal scope of tax treaties (Article 1) and suggests that the contracting states solve these situations in their bilateral tax treaties by adding supplementary provisions or by applying their domestic legislation.[172]

Hattingh concluded that Article 1 of the OECD *Model Tax Convention* was not meant to be a guiding principle of tax treaties, but rather a consequence of the limited scope of the other provisions contained in tax treaties.[173] Previous versions of tax treaties did not contain such an article and seemed to function without it,[174] but he is of the opinion that the inclusion of this article was a confirmation of the bilateral nature of tax treaties,[175] as well as exactly who the tax treaty benefits are applicable to.[176] If it is considered that Article 1 seeks to extend treaty benefits only to those that are sufficiently connected to a particular contracting state to claim the benefits of tax

[170]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 23 A and 23 B, para 10
[171]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax* 474.
[172]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Art 24 para 70.
[173]Hattingh JP, 'The Role and Function of Article 1 of the OECD Model' (2003) 57 *Bulletin for International Taxation* 546.
[174]Hattingh JP, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding it' (2003) 57 *Bulletin for International Taxation* 215.
[175]Hattingh JP, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding it' (2003) 57 *Bulletin for International Taxation* 217.
[176]Hattingh JP, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding it' (2003) 57 *Bulletin for International Taxation* 218.

treaties concluded by this state, then it would appear reasonable to argue that a permanent establishment has equally a close connection to the state where it is situated. This close connection seems to be illustrated in a number of ways, such as the right to tax the non-resident enterprise being given to the state where the permanent establishment is situated, and the separate entity approach for determination of the attributable profits of a permanent establishment.[177]

It would thus appear that the OECD attempts to prohibit discrimination against permanent establishments, but at the same time does not explicitly guarantee that permanent establishments will be treated equally to residents of contracting states and not be subject to double taxation since the actual implementation of the equal treatment is left to the discretion of the contracting states.Allowing permanent establishments to claim treaty benefits would be a logical extension of the separate enterprise approach and would represent the next step in the on-going process of personalisation of permanent establishments.

5.2.4 Tax treaty entitlement for the permanent establishment

Another point of discussion regarding the extension of tax treaty relief measures to a permanent establishment, is specifically around the question of whether full access to the tax treaty network of the state where it is situated should be granted to the permanent establishment, or if the extent of relief should be capped at what is necessary to solve a triangular tax case.

Thus far the main argument against extending the full tax treaty entitlement to a permanent establishment is the limited scope of application of tax treaties by way of Article 1 of the OECD *Model Tax Convention*.[178]

The current wording of Article 1 of the OECD *Model Tax Convention* explicitly includes only persons and residents of the contracting states in its scope. As discussed before in chapter 4.2, a permanent establishment clearly falls out of this scope (by virtue of it not being a person or a tax resident as defined), and can therefore, strictly speaking, not be entitled to treaty benefits without the inclusion of supplementary provisions in that respect in a tax treaty. Alternatively, in order to include a permanent

[177] OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 7.
[178] Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax* 477.

establishmentin the scope of tax treaties, either the actual wording of Article 1 should be amended to specifically include permanent establishments in the scope of a treaty, or the interpretation of the meaning of Article 1 (in the Commentary to Article 1 of the OECD *Model Tax Convention*) should be amended to include permanent establishments.

Another argument against extending treaty entitlement to permanent establishments is the relative effect of international treaties.[179] One could ask, is it appropriate for a bilateral tax treaty, as negotiated between two states, to regulate either of the contracting states' relations with a third state? The OECD Report on triangular cases stated that the treaty between the state of source and the state where the permanent establishment is situated could only be applied if it expressly provided for treatment of triangular cases.[180]

Garcia Prats concluded that the contracting states should not limit the scope of application of the non-discrimination article in a treaty between them (RC-SC) by referring to the limited scope of the other tax treaty that is relevant within a triangular case (SC-PEC), seeing that states would therefore be able to 'overrule their international obligations by invoking the relative effect of other treaties'.[181]

Granting full treaty access to a permanent establishment in the state where it is situated appears to be the appropriate way in order to treat permanent establishments equally with residents in most aspects.

One of the primary concerns that arise in relation to permanent establishment triangular cases is the potential for improper claims for treaty benefits by virtue of treaty shopping. This is as a result of the source state potentially being required to reduce the amount of tax it imposes on income based on the application of the RC-SC treaty and where the RC is prevented from taxing the income (in accordance with the RC-PEC treaty).[182]The OECD acknowledges that permanent establishments could be used to take advantage of the favourable tax regime of the country of its location and

[179]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax*479.
[180]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992, para 42.
[181]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax* 480.
[182]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992, para 21; Van Weeghel, S., *The Improper Use of Tax Treaties*, pp. 124-126.

suggests again its solution of a bilateral or unilateral approach.[183] Authors such as Garcia Prats have argued that the treaty-shopping concern is weak because resident enterprises, such as subsidiaries, could equally make use and take advantage of the treaty network.[184]

Granting resident status to permanent establishments would certainly address both the issue of equal tax treatment as well as full access to tax treaty benefits. If this were to be done, it would however mean that either the concept of permanent establishment or the concept of residence in tax treaties would need to change. Yong suggests[185] a more flexible approach whereby permanent establishments are granted resident status only conditionally in situations where the state where the permanent establishment is situated actually subjects the permanent establishment to worldwide taxation on profits attributable to it. It would also not be necessary to grant resident status for purposes of all the tax treaties involved in the triangular situation, such as for purposes of the bilateral tax treaty with the state of its head-office.[186]

However, when the OECD examined the proposal to treat the permanent establishment in the state where it is situated as a resident of that state, the large majority of the OECD Member states did not support that solution because it would depart too much from the principles and current practices of the OECD *Model Tax Convention*.[187]

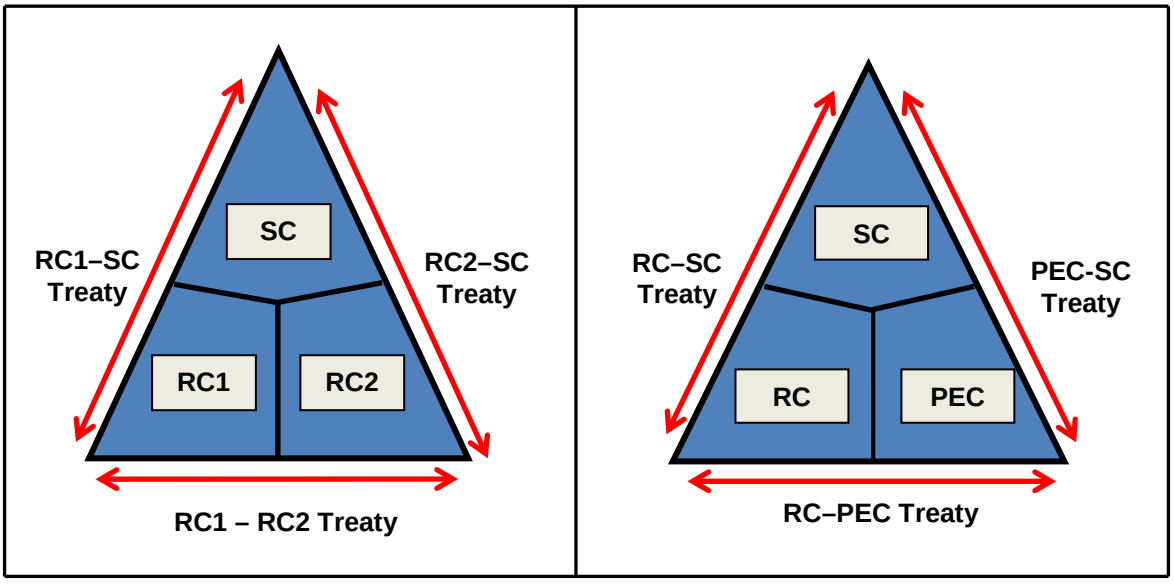
[183]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992, pp. 53-57.
[184]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax* 481.
[185]Yong S, 'Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place' (2010) 54 *Bulletin for International Taxation* 152, 164.
[186]Yong S, 'Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place' (2010) 54 *Bulletin for International Taxation* 152, 164.
[187]OECD 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992, pp. 43, 46.

6 CONCLUSION

The essence of a triangular situation seems to be most adequately described as 'a situation in which a multilateral tax claim leads to triple taxation, at least, on the same subject and income'[188]. The objective of the research report was to investigate the ability of a single bilateral tax treaty (using the OECD *Model Tax Convention*) to solve triangular cases.

For ease of reference, the two types of triangular cases that were discussed in this report are illustrated again below:

Dual resident triangular cases:Permanent establishment triangular cases:



The research report investigated the various underlying causes and contributing factors of specific types of triangular cases and based on this evaluation, has identified four common characteristicsof such cases in Chapter 2 in order to assess the compatibility of current suggested solutions with the bilateral nature of tax treaties.

These common features of triangular cases are: i) they usually involve more than two connecting factors such as three different countries, ii) multiple layers of taxation are involved by virtue of threedifferent tax jurisdictions wanting to impose tax on the same income stream, iii) they usually result in a treaty conflict because more than onebilateral tax treaty could simultaneously be applicable, and iv) the solution would appear to usually involve some degree of ‘generosity’ by one of the applicable states.

[188]Garcia Prats FA, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 *Intertax* 475.

Of specific interest to this research report is the third characteristic of bilateral treaties, which effectively results from the failure of such treaties to take into account the application of other bilateral treaties with regard to matters such as the assignment of taxing rights and allocation of residence.

The OECD also makes reference in the Commentary to Article 24, paragraph 71, to situations where the opposite of unrelieved triangular taxation could occur, i.e. double non-taxation, which reads as follows:

> If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States.[189]

Double non-taxation has not been discussed in this report and the situation is probably not a direct consequence of triangular cases, but it is worth mentioning that it could also occur in triangular cases due to the tax avoidance practices of taxpayers.

An examination was performed in Chapter 5 of the current existing solutions to triangular cases, as proposed by the OECD and tax authors, in order to establish theircompatibility with the bilateral nature of tax treaties. The overall conclusion as discussed in chapters 5.1 and 5.2 isthat one bilateral tax treaty will usually not be sufficient to solve the tax treaty applicability issues and the relevant solution would require at least two different treaties to effectively resolve a triangular case.

In permanent establishment triangular cases, problems arise in triangular cases due to the overlap of the implicit sourcing rules in treaties, as discussed in chapter 4.4. The sourcing of income in a particular state under a bilateral tax treaty has no impact on where the income is considered to be sourced for the purposes of other bilateral treaties, and currently there is no mechanism to resolve this overlap. The apparent solution as discussed in chapter 4.4, would thus be to resolve the overlap of sourcing rules, but regard must be given to the risk of tax avoidance by taxpayers in contracting states.It is submitted that a possible solution to this problem of overlapping source rules, particularly with reference to income attributable to a permanent establishment, is to include as part of the OECD *Model Tax Convention* specific

[189]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 24, para 71.

and more direct guidance as to the true source of different income types that could be utilized during the negotiation of bilateral or multilateral tax conventions. This would probably mean that certain states will have to give up their taxing rights if the source is determined to be in another state, which could prove detrimental to the conclusion of such said conventions. It is further submitted than an alternative could then be to assign a primary and secondary source to particular income streams and assign taxing rights accordingly. For example, if two states cannot agree on one particular source for the income, say interest that is normally taxed at 10%, the specific and direct guidance as mentioned could be utilized to assign for argument's sake a 6% tax rate to the state of the primary source and a 4% tax rate to the source of the secondary source. That way the overall tax rate is still 10%, the taxpayer would not be negatively impacted and both states would receive tax income.

Another complicating factor relating specifically topermanent establishment triangular cases is the hybrid nature and personalisation of the permanent establishment concept as discussed in chapters 4.1 and 4.2. A permanent establishment is generally a source concept that is treated very similarly to a resident of a contracting state, specifically with regard to the application of bilateral tax treaties. What is concerning about this application is that the permanent establishment is only **partially**treated like a resident, i.e. the state in which the permanent establishment is situated is granted the right to tax the permanent establishment on its world-wide income[190], but does not have an equal obligation to extend relief for taxes paid by the taxpayer on income that is attributable to the permanent establishment in another state. This is because the permanent establishment is not a resident of a contracting state as defined in Article 3 of the OECD *Model Tax Convention*, and is therefore not a person covered by the treaty between the SC and the PEC (as per Article 1 of the OECD *Model Tax Convention*), which means the PEC has no direct obligation in respect of taxes paid in the SC.Because the permanent establishment is not a resident of a contracting state, it is therefore also not recognisedfor purposes of determining the applicable treaty provisions in the source state. The proposed solution[191] as discussed in chapter 5.2.4 is to extend treaty benefits to permanent establishments whereby a permanent establishment would be treated**not partially** like a resident entity, but equally and to the same extent with regard to the taxing of profits and availability of benefits. Coupled with this approach of extending treaty benefits to permanent establishments, both the SC and the PEC would be required to apply the provisions of the treaty that is in place between them in relation to the income

[190]OECD (2012) *Model Tax Convention on Income and on Capital, (updated 2010)* OECD Publishing, Article 7.
[191]Yong S, 'Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place' (2010) 54 *Bulletin for International Taxation* 152, 164.

attributable to the permanent establishment, thus the application of two bilateral tax treaties would be required, the RC-SC treaty, as well as the SC-PEC treaty.

With regard to dual resident triangular cases as discussed in chapter 3, the complicating factor specifically related to solving such triangular cases is mostly attributable to the concurrent application of two bilateral tax treaties, the RC1-SC treaty as well as the RC2-SC treaty. The proposed solution to dual resident triangular cases as proposed by the OECD and supported by authors such as Avery Jones and Garcia Prats (discussed in chapter 5.1.1) is to ensure that the allocation of residence in accordance with the treaty between the two residence states, RC1-RC2, is effective for purposes of treaties which the residence states have respectively concluded with third states, i.e. SC. This solution would prevent a dual resident from claiming multiple treaty benefits.

An overall long-term solution to triangular cases could be to negotiate multilateral tax treaties. In general, the approach under multilateral treaties would be similar to the options available for resolving permanent establishment triangular cases by the application of bilateral tax treaties. All three states could be allowed to impose tax with the permanent establishment state and residence state being obliged to grant relief in the form of exemption or tax credit for taxes paid in the SC and PEC respectively or, either the permanent establishment state or the source state could be prevented from imposing tax on the income. The issue of two concurrent bilateral treaties being applicable at the same time, as well as the issue of which treaty the source state should apply, would be eliminated. Multilateral treaties would however be practically challenging to conclude and maintain and the primary obstacle to concluding multilateral treaties is likely to be the difficulty involved in getting multiple states to agree to the terms of the treaty.

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