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**Bilateralism of tax treaties versus triangular cases:  
is there a conflict?**

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## List of Abbreviations

OECD	Organisation for Economic Co-Operation and Development
OECD MTC	OECD Model Tax Convention
VCLT	Vienna Convention of the Law of Treaties
The Commentaries	The Commentaries to the OECD Model Tax Convention
State PE	state where the permanent establishment is situated
State S	state of source, i.e. the state where the income is derived
State R	state where the taxpayer is resident

# Chapter 1. Introduction

## 1.1. Background

The most fundamental issue in international taxation is double taxation resulting from the overlapping of different tax jurisdictions. States that wish to mitigate the problem of international double taxation and to facilitate cross-border activities conclude international bilateral or multilateral treaties which purpose is to divide the taxing rights between the states as well as to set the rules which state has the primary right to tax and which one is responsible for elimination of double taxation.

Although there are a couple of multilateral tax conventions concluded between the states, the vast majority of tax treaties are still bilateral, i.e. agreements between two states.<sup>1</sup> As it is stated in the commentaries to the OECD Model Tax Convention, bilateral tax treaties are considered to be more appropriate way to tackle international double taxation since multilateral agreements between several countries are relatively difficult to reach.<sup>2</sup>

This statement seems to be true if to imagine what precedes the conclusion of a double tax treaty. Each treaty is a result of profound negotiations between the contracting states where every provision of the treaty is subject to detailed examination from the perspectives of the domestic tax laws of both states in order to take into account all the peculiarities of the different tax systems. The outcome of the negotiations can be viewed as a trade-off between the treaty partners where one state waives a certain part of its taxing rights in favour of the other and the latter does the same according to the reciprocity principle of bilateral agreements.<sup>3</sup> Thus, the agreement is normally made by taking into account situations where only these two countries are involved.

## 1.2. Issue

Despite the fact that tax treaties are bilateral, the variety of transactions in the modern world is often not limited to two countries that may claim their taxing rights. Therefore, the situation where three or even more states are concerned is not unusual in international tax practice. Although no official definition can be detected, a common understanding of a typical triangular situation seems to be clear – it occurs when a resident of one state has a permanent establishment in another state and receives income from a third state while the important fact is that the third state income is attributed to the permanent establishment. The main problem with the tax treaty applicability in this case is that even if all the states involved have concluded the tax treaties with each other, no tax treaty is applicable in that situation between the state of source and the state where the permanent establishment is situated.<sup>4</sup> Since the prerequisite of the bilateral tax treaty application is a person who is a resident of at least one of the contracting states, the absence of such person in a relationship between these two source countries leads to the result that the treaty benefits cannot be claimed and thus the juridical double taxation may remain unrelieved. Alternatively, triangular situation can also result in low or non-taxation if the state of the permanent establishment does not properly tax the income from a third state and the state of residence exempts the profits of the

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<sup>1</sup> Philip Baker, *Double Tax Conventions and International Tax Law* (2<sup>nd</sup> Ed., 1994, London, Sweet & Maxwell) B-16.

<sup>2</sup> Model Tax Convention on Income and on Capital (8<sup>th</sup> Ed, 2010, OECD, Paris), Introduction, para 37, 40.

<sup>3</sup> Baker (n 1) para B-01.

<sup>4</sup> Klaus Vogel, *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* (3<sup>rd</sup> Ed., Kluwer Law International, 1997) Article 1, marginal no 16a.

permanent establishment.<sup>5</sup>

If to take a closer look to the described situation, it appears that the triangular situation is actually caused by the tax treaties themselves. A connecting factor for taxation of income in a foreign state, such as the permanent establishment, is a “fiscal fiction” designed by the tax treaties and it does not exist for any other purpose than for international taxation. In the absence of such concept, the situation would involve only two countries – the country of residence and the country of source. However, since the concept of the permanent establishment and the attribution of income to it is internationally accepted and widely used, it cannot be denied and the situation has to be solved somehow.

The typical triangular situation is discussed from the different angles in the tax literature and the solution, which is also suggested by the OECD, is to grant the permanent establishment the tax treaty benefits by virtue of the article 24(3) of the OECD MTC. This provision requires equal treatment of a resident company of a contracting state and a permanent establishment of a company in the other contracting state. It is generally agreed that the application of this provision offers a reasonable way out of the problem entailed by the typical triangular case since it makes it possible to allow the tax benefits to the permanent establishment which it otherwise would not be entitled to.

Although the problems of triangular cases have been acknowledged already when the first OECD MTC was drafted in 1963,<sup>6</sup> the solution to the typical triangular case gives still rise to many questions concerning different aspects of these situations as well as probably cases yet undiscovered.

### **1.3. Purpose**

The general aim of the thesis is to find the answer to the question whether a single bilateral tax treaty is able to solve a triangular case. The question arises because of the bilateral nature of tax treaties. Bilateral tax treaties do not normally cover the taxing rights of the third states, but if the two states, partners to the bilateral tax treaty, have to solve this kind of situations, it might be useful to know whether the means of their bilateral tax treaty are sufficient to solve it or what other instruments they could use. In order to answer the general question, it is necessary to find out what creates a triangular situation and what kind of tax treaty applicability issues they entail. On the basis of this, the thesis attempts to establish whether the contracting states are able to mitigate the negative results of the triangular situations simply by their bilateral agreement or whether they have to look for the solution further outside from their bilateral relations. In the process of answering the question, the proposals by different authors are presented and evaluated from the point of view of the research question.

It needs to be mentioned that the thesis is not aimed on finding a new solution to triangular situations, but to focus on the existing proposals and to assess them from the perspective of how compatible they are with the bilateral nature of tax treaties.

### **1.4. Method and materials**

The method of research is the analysis of the OECD MTC provisions in order to evaluate how they operate as effective law. Although, the answering to the research question focuses not solely on the

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<sup>5</sup> OECD, 'Triangular Cases' *Model Tax Convention: Four Related Studies* (Paris, OECD, 1992) para 53-57.

<sup>6</sup> Hans Pijl, 'The Epic of Gilgamesh, or the Noise of the Profession' (2011) 65 *Bulletin for International Taxation* 606.

law provisions in effect but also on the interpretation that has given to them by the drafters of the OECD tax treaty provisions, by different scholars and in judicial decisions. Hence the method also comprises the assessment and the comparison of the Commentaries of the OECD MTC and the doctrinal viewpoints on interpretation of the current law, i.e. *de lege lata*, as well as *de lege ferenda* in the cases where the proposals to change the OECD MTC have made.

The starting point of the legal interpretation is the provisions of the OECD Model Tax Convention. The author acknowledges that the text of the OECD MTC is not a source of law as such, but since many states adopt the OECD MTC provisions into their bilateral tax treaties, these provisions are apparently applicable as the effective law.<sup>7</sup> The other important source of law that is used to evaluate the research question is the Vienna Convention on the Law of Treaties which encompasses the basic principles of international treaty law. The analysis of the application of the OECD MTC provisions in triangular cases is aimed to find the consistency in connection with the underlying principles of the international treaty law.

Besides the model text of the tax treaties and the VCLT, the commentaries to both sources are used to understand the interpretation of the 'legislator'. The latest updated version of the OECD MTC Commentaries was published in July 2010 and this version is used since the aim of the study is to establish the most up-to-date interpretation of the bilateral tax treaty provisions. The commentaries to the VCLT published in 2012 are used for the same reason.

In addition, the OECD Report on Triangular cases<sup>8</sup> is taken into account, because it serves as the official standpoint of the OECD Model Tax treaty drafters. Further, the books and doctrinal articles that are selected for examination are these that are available in the Lund University libraries and its online databases such as IBFD and Kluwer Law International. The timespan of the publishing dates stretches back to the 1992 when the OECD Report was issued in order to follow the development of the argumentation. The materials are limited to those published in English.

The case-law is selected from the IBFD tax treaties case law database by using the keyword "triangular". However, not all the search results were relevant in terms of this study, thus only these cases that dealt with the bilateral tax treaty applicability were chosen to be presented. The cases are reported on the basis of the summaries or articles written about it since the original court decisions were not published in the language understandable to the author. It is acknowledged that there is a risk that the summaries do not transmit the exact text of the court rulings and that they should be interpreted with that precaution.

## 1.5. Delimitation

The thesis does not cover the European Union law. Although the case called *Saint-Gobain*<sup>9</sup> was a landmark case decided by the European Court of Justice precisely dealing with the problem of the triangular situation in the context of the European Union law, this paper does not include the European Union law perspective and remains within the limits of the tax treaty law.

The author is aware that the legal status of the OECD MTC and its commentaries is extensively disputed and their impact on the interpretation of the bilateral tax treaties in effect is sometimes questioned.<sup>10</sup> This paper shall not plunge into the discussions whether the contracting states support

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<sup>7</sup> For example, Estonian tax treaties follow in major part the OECD Model. Estonian tax treaties are available here: <http://www.fin.ee/index.php?id=11738> (accessed in 9 May 2012).

<sup>8</sup> OECD *Triangular Cases* (n 5).

<sup>9</sup> Case C-307/97 *Saint-Gobain* [1999] ECR I-6161.

<sup>10</sup> See eg: Monica Erasmus-Koen and Sjoerd Douma 'Legal Status of the OECD Commentaries – In Search of the

the ambulatory or static interpretation of the commentaries and whether they consider the OECD MTC as binding at all. This paper relies on the assumption that the contracting states follow the provisions of the OECD MTC and the guidelines given by way of the Commentaries, unless in certain cases it is explicitly stated otherwise.

The thesis does not have the objective to describe all possible triangular situations, but tries to highlight the most commonly occurred cases and to generalise and distinguish them according to the features with respect to the bilateral tax treaty applicability. The typical triangular case that is discussed in the mentioned OECD Report involving the problem of attribution of a third country income to the permanent establishment is the case that is mainly dealt in the thesis. The other types of triangular cases such as the situations of dual residence or source and those caused by the allocative rules of the Article 15 OECD MTC are dealt to a lesser extent since the literature about these cases is more limited.

## **1.6. Outline**

Chapter 2 describes the origins of the bilateral nature of the tax treaties. The principles of the Vienna Convention on the Law of Treaties are described and explained how they affect the applicability of the tax treaties, especially with a focus on the third country rights and obligations.

Chapter 3 demonstrates the creation of the triangular situations by describing the most discussed triangular cases and highlighting the issues that triangular cases involve. Based on the description of actual triangular cases, this part tries to identify common features of the triangular cases in order to be able to highlight the issue of tax treaty applicability.

Chapter 4 discusses the proposed solutions to the triangular cases, mainly dealing with the typical triangular case involving the permanent establishments. This chapter contains analysis of solutions that might affect the bilateral nature of the tax treaties and attempts to assess the effect whether these solutions are compatible with the bilateral nature of tax treaties.

Chapter 5 contains conclusions that the author has made with respect to the research question.

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Holy Grail of International Tax Law' (2007) 61 Bulletin for International Taxation 339.

## Chapter 2. The bilateral nature of tax treaties

### 2.1. General remarks

Triangular situations, as they have been named in international tax law, are actually the result of the bilateral nature of the tax conventions concluded between the states.<sup>11</sup> A triangular situation is not a defined term in the international tax law, although they continue to occur more often with respect to the bilateral tax relationships between the countries since international business operations become more complex and involve more parties.

This chapter describes briefly the basics of international treaty law concerning the bilateral nature of the treaties in order to demonstrate the origins of the bilateral nature of tax treaties. The main roots of the triangular situations lie in the principles of the international treaty law and the limited scope of their application.

### 2.2. The relative effect of the treaties

Bilateral nature of international treaties reveals in the first place through the principles enshrined in the Vienna Convention of the Law of Treaties which, according to its article 1, applies to treaties between the states.

The principle of the relative effect of the international treaties means that treaties should have effects only between the contracting states and not for the third states that did not participate in the treaty-making process.<sup>12</sup> It is expressed in the articles that set the scope for the binding effect of the treaties and relations with the states that are out of that scope.

Article 26 of VCLT prescribes an ancient 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'. This fundamental principle of international law has its roots in civil law and international customary law, now mirrored in the VCLT article 26.<sup>13</sup> The relevant part of the article here is the extent of the binding force of the treaty which is limited to the treaty partners. The other important underlying principle of the treaty performance – the good faith – expresses the trust and confidence in the international co-operation<sup>14</sup> and affects not only the obligation to be bound by the treaty, but also the interpretation of the treaty rules.<sup>15</sup>

Article 34 VCLT concerns the bilateral nature of the international treaties as to the relations with the third states. The general rule regarding third states stipulates that 'A treaty does not create either obligations or rights for a third state without its consent'. This article is based on the maxim that 'agreements neither harm nor benefit the third parties' and it can be seen as the opposite aspect of the *pacta sunt servanda* principle resting on the principles of the sovereignty and independence of

<sup>11</sup> Francisco Alfredo Garcia Prats, 'Triangular Cases and Residence as a Basis for Alleviating International Double Taxation. Rethinking the Subjective Scope of Double Tax Treaties' (1994) 22 Intertax 473.

<sup>12</sup> 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.

<sup>13</sup> Oliver Dörr, Kirsten Schmalenbach (eds), *Vienna Convention on the Law of Treaties* (Springer-Verlag Berlin Heidelberg 2011) 437.

<sup>14</sup> Dörr and Schmalenbach (n 13) 435.

<sup>15</sup> Article 31(1) VCLT provides that '[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'.



the states.<sup>16</sup>

Subsequent articles of the VCLT provide for more specific provisions concerning the third states. Article 35 deals with the obligations for the third states and Article 36 for the rights. The keystone of those provisions is that in order to confer rights or obligations to the third parties, the consent of that party is necessary. If with respect to the obligations the consent needs to be duly signed and accepted by the third state, as regards to the rights, the consent is presumed so far as contrary is not indicated.

These provisions demonstrate clearly the relative effect of the treaties, i.e. that the rights and obligations derived from the international treaties are only conferred on the states that are explicitly declared and accepted to be bound by the treaty containing them.

### **2.3. Principle of reciprocity**

The principle of reciprocity expresses itself in the reciprocal or mutual obligations consisting in an 'interchange between the parties, i.e. giving and receiving of rights, benefits, concessions or advantages'.<sup>17</sup> In bilateral relationships it means that the rights and obligations are conferred to the other treaty partner who in turn grants the former the same benefits. The so-called 'formal reciprocity' means that a contracting state may withdraw its commitments in case the other contracting state does not fulfil its own.<sup>18</sup>

Similar to any other agreement between two independent and sovereign parties, bilateral treaties presume negotiations between the contracting states. Especially the treaties that entail financial rights and obligations for the states are subject to a thorough negotiation process the aim of which is to reach a balanced result of the rights and obligations deriving from the treaty. Since by concluding the treaty states usually waive a certain part of their rights in favour of the other treaty partner, the reciprocal obligations should guarantee that both treaty partners receive the equally beneficial treatment from the other partner.

### **2.4. The effect of the Article 1 of the OECD MTC**

Bilateralism of tax treaties lies mostly in the Article 1 of the OECD MTC which determines the personal scope of the treaty protection as follows: 'This Convention shall apply to persons who are residents of one or both of the Contracting States'.

The criterion for the treaty entitlement is the residence of one or both of the contracting states what evidently brings out the relative effect of the tax treaties – the entitlement of the treaty benefits is given only to the residents of those two countries that concluded the convention.

However, it has been also stated that it is hard to find a definitive evidence of existing principle in the international law according to which the tax conventions should be strictly limited to persons who are residents of the contracting states.<sup>19</sup> It can be argued that without the explicit requirement of the limited scope in article 1, tax treaties could be a special kind of treaties that may create the rights also for the third country residents. This conclusion is stemmed from the frequently described

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<sup>16</sup> Dörr and Schmalenbach (n 13) Art 34 marginal 1.

<sup>17</sup> Dörr and Schmalenbach (n 13) Art 26 marginal 34.

<sup>18</sup> Vogel (n 4) Art 24 marginal 39.

<sup>19</sup> Baker (n 1) 1-05.

case called *Commerzbank*<sup>20</sup> which resulted in the extension of treaty benefits to a resident to a country which was not party to the treaty at issue.<sup>21</sup> Although the tax authorities alleged the tax treaties to be limited in scope of their application, the tax treaty at issue did not contain the provision similar to Article 1 OECD MTC and the court did not see the principle of relative effect of the tax treaties to be at place.<sup>22</sup>

The point of view of the OECD is different and assumes that tax treaties cannot be extended to the third country residents.<sup>23</sup> Baker points out that even without the Article 1 tax treaties are meant to apply only to the residents of the contracting states.<sup>24</sup>

Hattingh analyses the application of the Article 1 from the perspective of its historical development and infers that the inclusion of the article to the 1963 OECD MTC was the confirmation of the bilateral nature of the tax treaties.<sup>25</sup> He refers to the text of the commentaries in the Report of the Fiscal Committee from 1960 which explained that for practical reasons it is preferable to apply the convention to the persons who are residents of the contracting states. The text of the article has remained unchanged and the commentary is, in principle, the same in the current version<sup>26</sup>, although the practical reasons are still not illustrated. Apparently, the reason was to avoid the uncertainty as regards to who may claim the treaty benefits.<sup>27</sup>

Nevertheless, Hattingh takes the position that the role of Article 1 in the tax treaties was not to establish a principle, but to narrow down the range of persons who are entitled to the treaty benefits by determining those who have an “economic allegiance” to either of the contracting states. It was also meant to safeguard the principles of the other provisions of the convention.<sup>28</sup>

## 2.5. Bilateral nature of the tax treaty provisions

The bilateral nature of the tax treaties also appears in the wording and operation of the other tax treaty provisions.

For example, the Article 4 provides for tie-breaker rules in cases where a person appears to be a resident of both of the contracting states simultaneously. The rules are meant to resolve the double residence problem between two countries by giving the preference to one of the two contracting states.<sup>29</sup> This provision would not be able to solve a situation where a third country might be involved.

The distributive rules of the tax treaties operate in the same way by using the terminology which constantly refer to 'one' or 'both' or 'the other' Contracting State.<sup>30</sup> There is normally one state where the income is sourced and the other which resident receives it. Although, as Vogel points out, “the state of source” and the “state of residence” does not have to be opposites<sup>31</sup>, it is usually presumed

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<sup>20</sup> *IRC v Commerzbank AG: IRC v Banco Do Brasil* [1990] English High Court.

<sup>21</sup> Baker (n 1) 1-02.

<sup>22</sup> Baker (n 1) 1-02.

<sup>23</sup> OECD MTC (n 2) Art 24 para 2.

<sup>24</sup> Baker (n 1) 1-06.

<sup>25</sup> Johann P. Hattingh, 'Article 1 of the OECD Model: Historical Background and the Issues Surrounding it' (2003) 57 Bulletin for International Taxation 215, 217.

<sup>26</sup> OECD MTC (n 2) Art 1 para 1.

<sup>27</sup> Hattingh, 'Historical Background' (n 25) 218.

<sup>28</sup> Hattingh, 'Historical Background' (n 21) 221.

<sup>29</sup> OECD MTC (n 2) Art 4 para 5.

<sup>30</sup> Baker (n 1) B-01.

<sup>31</sup> Klaus Vogel, "State of Residence" may as well be "State of Source" - There is no Contradiction' (2005) 59 Bulletin

in the treaty provisions that there are two overlapping tax jurisdictions and the income taxation could be affected by these two.

It is also worth to mention here, that in spite of the general bilateral character of tax treaty provisions, there are some allocative rules that contain connecting factors derogating from the character. For example, the Article 8 OECD MTC gives the taxing right to the state where the effective management of the enterprise operating in the international traffic is situated. Although that kind of a distributive rule expects the connecting factor to coincide with one of the contracting states where the enterprise is a resident, it is not always the case, and thus the rule is not completely compatible with the personal scope of the tax treaties established by Article 1 OECD MTC. Nevertheless, it has been observed that the bilateral nature in the tax treaties still prevail regardless of the provisions that are drafted otherwise.<sup>32</sup>

## **2.6. Extension of the treaty application – the non-discrimination article**

The non-discrimination article of the OECD MTC contains more concrete exception from the applicability of the tax treaties to the residents of the contracting states. The article 24(1) 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 makes it clear that the application of Article 24(1) is extended over the limits of the general bilateral scope of application of tax treaties. The OECD Commentaries confirm that the application of the paragraph is not restricted by Article 1 and covers all the nationals of both of the contracting states regardless of their residence.<sup>33</sup>

Although, as regards to the Article 24(1), Vogel adds that despite the fact that this provision can cover also the residents of the third states, it still applies to the tax relationships between the two contracting states - taxation of a national of one of the contracting state in the other contracting state.<sup>34</sup> Thus, in a sense, the bilateral nature of the tax treaty is nevertheless followed.

Article 24(3), however, does not explicitly include an exception to the general bilateral scope of tax treaties. It 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.

Vogel explains that the difference between Article 24(1) and 24(3) is that the former prohibits less

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for International Taxation 420, 422.

<sup>32</sup> Johann P. Hattingh, 'The Role and Function of Article 1 of the OECD Model' (2003) 57 Bulletin for International Taxation 546, 553.

<sup>33</sup> OECD MTC (n 2) Art 24 para 6.

<sup>34</sup> Vogel, *Double Tax Conventions* (n 4) Art 24 marginal 34.

favourable treatment to nationals of the other contracting state regardless of their residence, while the latter prohibits it to all residents.<sup>35</sup> The exceptional second sentence was added to the Article 24(1) because of the disagreement between the OECD member states in order to clarify the issue.<sup>36</sup>

Baker assumes that the scope of the Article 24(3) is wider in practice than that of the Article 24(1) since it requires the national treatment to permanent establishments, but does not take into account the objective differences of permanent establishments as compared to the residents of the contracting state.<sup>37</sup>

The Commentaries to the OECD MTC clarify that Article 24(3) is meant to prevent discrimination based on the situs of an enterprise. The treatment that is required for the permanent establishment of the resident of a contracting state must be similar to the treatment of the resident of that contracting state, but it does not mean that it could not be different, as long as it is not burdensome for the permanent establishment.<sup>38</sup> The Commentaries acknowledge that there are objective differences between a resident as a separate single entity and the permanent establishment and this could sometimes lead to difficulties with respect to guaranteeing the equal treatment.<sup>39</sup>

On the other hand, the OECD Commentaries make clear that the most-favoured-nation treatment<sup>40</sup> is not required by the non-discrimination article:

Where a State has concluded a bilateral or multilateral agreement which affords tax benefits to nationals or residents of the other Contracting State(s) party to that agreement, nationals or residents of a third State that is not a Contracting State of the treaty may not claim these benefits by reason of a similar non-discrimination provision in the double taxation convention between the third State and the first-mentioned State. As tax conventions are based on the principle of reciprocity, a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State party to that agreement by reason of a specific economic relationship between those Contracting States may not be extended to a resident or national of a third State under the non-discrimination provision of the tax convention between the first State and the third State.<sup>41</sup>

It follows that the non-discrimination article of the OECD MTC derogates from the general limited personal scope of application of the tax treaties and may also affect the rights of the residents of third states.

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<sup>35</sup> Vogel, *Double Tax Conventions* (n 4) Art 24 marginal 2.

<sup>36</sup> Vogel, *Double Tax Conventions* (n 4) Art 24 marginal 31.

<sup>37</sup> Baker (n 1) 24-12.

<sup>38</sup> OECD MTC (n 2) Art 24 para 33, 34.

<sup>39</sup> OECD MTC (n 2) Art 24 para 39.

<sup>40</sup> Most-favoured-nation treatment in tax treaties has typically 'the effect of requiring one of the contracting states to grant similar tax benefits to residents of the other contracting state to the extent it grants such benefits (eg by way of a bilateral tax treaty) to residents of other countries and those benefits are more favourable than those in the tax treaty between the two contracting states', IBFD Tax Glossary, available online:

<[http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/collections/itg/html/itg\\_most\\_favoured\\_nation\\_status.html&q=%22most-favoured-nation%20treatment%22&WT.z\\_nav=search&hash=itg\\_most\\_favoured\\_nation\\_status](http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/collections/itg/html/itg_most_favoured_nation_status.html&q=%22most-favoured-nation%20treatment%22&WT.z_nav=search&hash=itg_most_favoured_nation_status)>  
accessed 10 May 2012.

<sup>41</sup> OECD MTC (n 2) Art 24 para 2.

## Chapter 3. The types and the common features of triangular cases

As it has been established in Chapter 2, the principles of international treaties are rarely able to encompass rights or obligations for a state which is not a party to the treaty. This chapter describes triangular situations that are brought up in the literature and highlights the issues of each such case. As a result, common features of the triangular situations are identified in order to distinguish the relevant issue for this study – the application of bilateral tax treaties.

### 3.1. Typical triangular case

The OECD Report on triangular cases describes the so-called 'typical triangular case' which is a specific situation involving certain types of income. According to the OECD it is where:

- income from dividends, interest or royalties is derived from a source in State S;
- such income is received by a permanent establishment in State P;
- the permanent establishment depends on an enterprise resident in State R.<sup>42</sup>

This case demonstrates how the triangularity is created because of the problems in the application of the tax treaties. If the income is derived from the State S by the resident of the State R, normally the bilateral tax treaty between these states applies. As regards to the profits of the permanent establishment, the tax treaty between State R and State P applies. However, the crucial point is the fact that the income is effectively connected with the permanent establishment and not with the head-office in the state of residence. On one hand, from the legal point of view, the taxpayer is the resident of State R, on the other hand, for the purposes of taxation the income is attributable to the permanent establishment which is only treated as a separate entity.<sup>43</sup> Thus, the main issue of discussion is the applicability of the tax treaty between the State S and State P. The typical triangular situation can be visualised as follows:

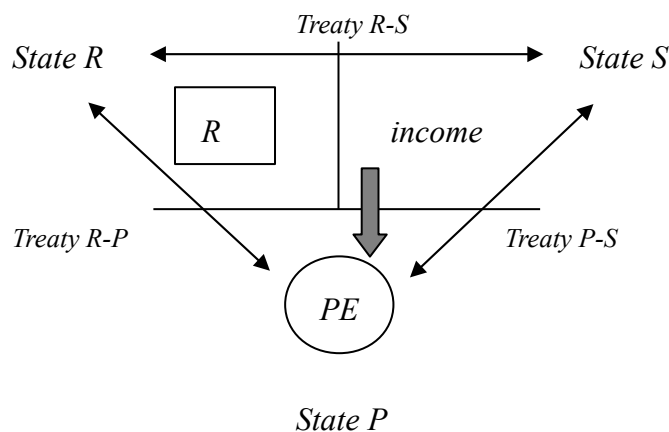


Figure 1

First of all, the triangular situation in this case appears to be a consequence of the personalisation of the permanent establishment.<sup>44</sup> According to Article 7(1) OECD MTC, a contracting state is entitled to tax the profits of a non-resident enterprise if that enterprise carries on business in that state

<sup>42</sup> OECD 'Triangular Cases' (1992). 'State S' is the state of source, ie where the income is derived from, 'State R' is the state of residence of the taxpayer, 'State P' is the state where the permanent establishment of the taxpayer is situated.

<sup>43</sup> OECD MTC (n 2) Art 7 para 3.

<sup>44</sup> Garcia Prats (n 11) 473.

through a permanent establishment and the profits are attributable to the permanent establishment. The tax treatment of the permanent establishment is in many aspects equalised with the taxation of a company resident in that state, thus it can be asserted that the permanent establishment is similarly taxed on the worldwide basis<sup>45</sup> in the state of its location as a resident of that state. Taxation of worldwide income includes taxation of income from third states where the same income may be taxed on the source basis and thus this situation entails juridical double taxation between the State P and State S. The question that arises is if there is an applicable tax treaty that is able to relieve such double taxation?

Secondly, by way of Article 1 OECD MTC, tax treaties are applicable only to the persons who are residents of the contracting states. The permanent establishment is neither a person nor a resident of the contracting state, but only a concept that is necessary in order to determine the extent of the source state's right to tax the income of a non-resident company.<sup>46</sup> Thus, the permanent establishment serves just as a connecting factor for the purposes of the source state taxation and the only tax treaty that applies to it is the treaty between State R and State S. The problem is that this tax treaty does not cover the tax relationships with the third state where the permanent establishment derives its income.

Thirdly, the treaty that normally is applicable to the third country income is the tax treaty between the State R and State S as the taxpayer is a resident in one of these states. Thus, two concurrent tax treaties apply from the perspective of the State R. The question is, are they able to relieve multiple taxation in this situation or can they create double relief? This, in turn, depends on how the income from the permanent establishment is treated in State R – is the credit or exemption method applicable to that income.<sup>47</sup> However, the common comprehension is that the situation results in simultaneous application of the bilateral tax treaties between States R and P and States R and S.

### 3.2. Dual residence case

Another widely discussed case is called in the literature as the dual residence case<sup>48</sup>. It is the case involving two countries of residence with respect to one country of source.

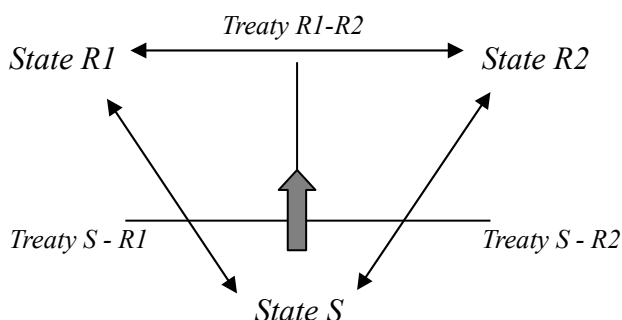


Figure 2

The situation occurs because of the different criteria that states apply to determine the residence of

<sup>45</sup> Singyuan Yong, 'Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place' (2010) 54 Bulletin for International Taxation 152, 155.

<sup>46</sup> OECD MTC (n 2) Art 5 para 1.

<sup>47</sup> OECD *Triangular Cases* (n 5) para 6.

<sup>48</sup> John Avery Jones and Catherine Bobbett, 'Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London' (1999) 53 Bulletin 16, 19.

the taxpayers and it may lead to a situation where two tax treaties, with both states of residence, concurrently apply in respect of one and the same person and income from the third state.<sup>49</sup>

This is a situation which is mentioned in the OECD Report but not dealt with therein<sup>50</sup>. As a rule, dual residence issue is solved by way of Article 4(2) or 4(3) of the OECD MTC, although, the tie-breaker rule applies only between those two contracting states. Due to the bilateral nature of the tax treaties the result of the application of the tie-breaker rule does not by default affect the determination of residence status with respect of the third state where the income is derived from,<sup>51</sup> although it has also been contested otherwise.<sup>52</sup> The issue here is which tax treaty should be applicable and whether the result of the application of the tie-breaker rule might have any effect for the treaty applicability with third states?

The analogous problems occur in the case referred in the OECD Commentaries involving three states where the partnerships are concerned. It is created where a partner is a resident of one state, the partnership is established in the other state and the partner shares in partnership income is derived in a third state.<sup>53</sup> Similar to the dual residence case, the issue is the application of the two concurrent tax treaties with respect to the single state of source. Vogel mentions this case also as a triangular case.<sup>54</sup>

However, the problems of uniform characterisation of partnerships in different states is far more complex issue<sup>55</sup> than the tie-breaking in dual residence cases which is why this study does not deal with the cases involving partnerships. The OECD Commentaries suggest that the contracting states should find a bilateral solution<sup>56</sup>, but the solution, if it is more focused on resolving the qualification problem between two states, may nevertheless be limited in application and might not influence the third country income.

### 3.3. Dual source case

The variation of the typical case described above can be referred to as the 'dual source case'. It has also been called as the 'reverse'<sup>57</sup> triangular case, because it appears reversely to the typical case referred in Chapter 3.1. in the sense that there are two states of source with respect of one country of residence of the income recipient.

The reason of this situation is the Article 11(5) OECD MTC which provides for two different connecting factors that can entail source taxation in two different states.<sup>58</sup> Article 11(5) OECD MTC reads as follows:

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

<sup>49</sup> Avery Jones and Bobbett (n 48) 19.

<sup>50</sup> OECD Report (n 39) para 1

<sup>51</sup> Avery Jones and Bobbett (n 46) 16.

<sup>52</sup> See Baker (n 1) 4-13.

<sup>53</sup> OECD MTC (n 2) Art 1 para 6.5.

<sup>54</sup> Vogel, *Double Tax Conventions* (n 4) Art 1 marginal 30.

<sup>55</sup> See John Avery Jones, 'Characterisation of Others States' Partnerships for Income Tax' (2002) 56 *Bulletin for International Taxation* 288

<sup>56</sup> OECD MTC (n 2) Art 1 para 6.5.

<sup>57</sup> Michele Gusmeroli 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? - Part 1' (2005) 45 *European Taxation* 2, 5.

<sup>58</sup> Gusmeroli (n 57) 6.

borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.<sup>59</sup>

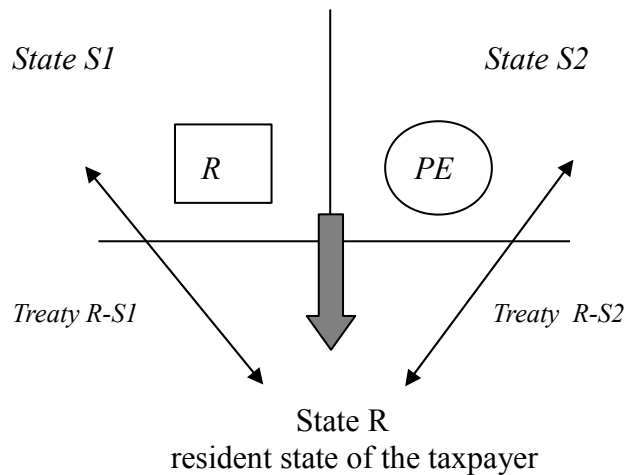


Figure 3

Thus, the possibility of two countries claiming the right to tax the same income is evident, where the payer of the interest is a resident in one state and the interest is effectively connected to the permanent establishment in the other state. The issue here is also the applicability of the tax treaty between the two states of source.<sup>60</sup> Since the two tax treaties with the state of residence of the recipient apply concurrently, it raises the question, which tax treaty is the “right” tax treaty to apply?

### 3.4. “Bilateral” triangular case

It has been observed that for the creation of a triangular situation it is not always necessary that three countries are involved.<sup>61</sup> The OECD Commentaries describe a triangular case with only two states where the state of source and the state of residence are the same whereas the income is effectively connected with the permanent establishment the recipient has in another state.<sup>62</sup>

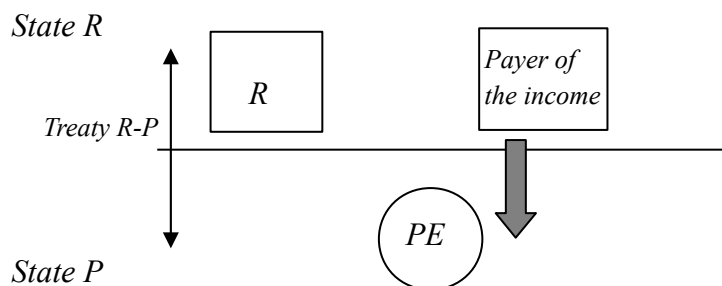


Figure 4

It might not be even perceived, *prima facie*, that taxation of the income could be triggered by

<sup>59</sup> The similar situation can occur with respect to royalties if the contracting states do not follow the OECD MTC and give limited taxing right to the state of source.

<sup>60</sup> Gusmeroli (n 57) 6.

<sup>61</sup> Gusmeroli (n 57) 7.

<sup>62</sup> OECD MTC (n 4) Art 21 para 5, Art 24 para 72.



another state since the payment takes place between the residents of the same country. Although, since the income is attributable to the permanent establishment of the payee<sup>63</sup>, it should be the state of the permanent establishment which is entitled to primary right to tax of that income.<sup>64</sup>

Regardless of the fact that the two states involved in this case have only one bilateral tax treaty concluded between them, there are issues similar to the typical triangular cases that might arise. It is the question of the tax treaty applicability between states R and P which raises because of the personalisation of the permanent establishment and the problem here is the same as in the typical case described in chapter 3.1 – should the tax treaty between the state of source and the state of the permanent establishment be applicable?

On one hand, where the state R is acting as a state of source the bilateral tax treaty does not apply. Even despite the fact, that the income is actually cross-border income for the permanent establishment, neither of the states are obliged to apply the tax treaty. State R, acting as a source state, does not assume that the income is paid to the resident of the other contracting state and thus applies only its domestic tax laws. Usually states do not apply any withholding taxes in domestic situations, thus State R expects the tax to be levied in the hands of the receiver of the income. State P attributes the income to the permanent establishment and uses its primary taxing right also as a source state, thus not generally obliged to give any relief. On the other hand, the tax treaty between the states is applicable with respect of the income of the permanent establishment where the state P has the primary right to tax and the State R should relieve double taxation. The paradox is, that if the State R uses exemption method as regards to the income from foreign permanent establishments, the state R is not able to tax that income at all since it did not tax it as a source state and exempts the income when it is attributed to the permanent establishment.<sup>65</sup>

Hence, although in this case there are only two states involved, there is still the question of the tax treaty applicability with respect to the income attributable to the permanent establishment that it derives from another state. This case shows that the other state does not have to be a third state, but it still entails the problem of the bilateral tax treaty application between these states. The problem here is caused rather by three different connecting factors such as the residence of the taxpayer, the location of the permanent establishment and the state where the income arises, while two of them are situated in the same state. By the same token, the bilateral triangular situation occurs where the state of source is in the same state with the permanent establishment. Furthermore, the quadrangular triangular situation may occur when the income flows between two permanent establishments of two different taxpayers resident in two different states.<sup>66</sup> Thus, the number of the states involved is of no importance for identification of a triangular case, but rather more than two connecting factors are capable of creating the situation where a tax treaty application is questionable.

### **3.5. Employment income cases**

Triangular cases may as well occur because of the design of the distributive rules in the tax treaties. The following cases are also described as triangular cases.

One type of these situations concern employment income taxed under Article 15(2)(c) where the connecting factor for the taxing right in the state of source is the existence of a permanent establishment. However, the issue here is not the profit attribution to the permanent establishment

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<sup>63</sup> For example, if the interest is paid with respect to the loan that has been given on account of the funds that belong to the permanent establishment.

<sup>64</sup> OECD MTC (n 4) Art 21, para 5.

<sup>65</sup> Gusmeroli (n 57) 7.

<sup>66</sup> See Gusmeroli (n 57) 9-12.

regulated by the Article 7 OECD MTC, but rather the existence of the permanent establishment dealt in the Article 5 OECD MTC. Thus, the situation is indirectly connected to the personalisation of the permanent establishment since it serves as a connecting factor for taxation of the employment income, but it does not concern the taxation of or the relief given to the permanent establishment. The situation appears when the state of residence of the employee, the state of residence of the employer and the state where the employment is exercised are all different states. It is not entirely clear whether the tax treaty with the state of the employer or the employee should be applied in order to determine the existence of the permanent establishment in the state of employment.

Although, it must be mentioned that if the tax treaties at issue follow exactly the wording of the OECD MTC then the result should be the same under both treaties. If they are different, for example the threshold as regards to the length of the building project, the permanent establishment might constitute under one and not under the other treaty.<sup>67</sup>

Another similar situation may be effectuated by application of Article 15(3) OECD MTC which deals with employment income in respect of an employment aboard a ship or aircraft operated in international traffic. This provision gives the taxing right to the contracting state in which the place of effective management of the enterprise operating in international traffic is situated. However, if the place of the effective management is not in the contracting state where the employment is exercised, it might give rise to a triangular situation. The state in which territory the employment is exercised (exceeding the 183 days threshold), may invoke its taxing right under the Article 15(2)(a) and disregard the exception which should apply to the employment in international traffic since the place of effective management of the enterprise is in neither of the contracting states. The question that might arise is which tax treaty should apply, i.e. whether the taxation under one bilateral tax treaty could be prevented by the other tax treaty?

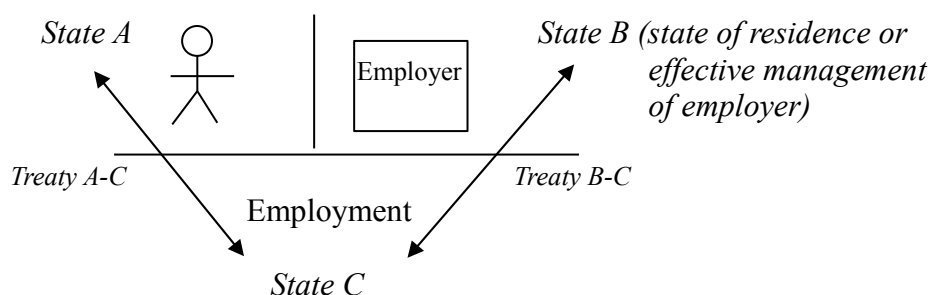


Figure 5

### 3.6. Summary of the common features of triangular cases

The situations described in this chapter are the selection of cases that have been discussed in the literature and mentioned as triangular cases. Usually triangular cases are mentioned as situations involving more than two states, thus defining it through the number of countries concerned. But as it was seen above, the situation may likewise appear only between two countries. Thus, to summarise the essence of the triangular situation, a definition suggested by Garcia Prats seems to be the most adequate - 'the situation in which a multilateral tax claim leads to triple taxation – at least - on the same subject and income'.<sup>68</sup>

However, the OECD Commentaries refer to the possible abuse cases where instead of triple taxation

<sup>67</sup> Bernard Peeters, 'Article 15 of the OECD Model Convention on "Income from Employment" and its Undefined terms' (2004) 44 *European Taxation* 72, 82.

<sup>68</sup> Garcia Prats (n 11) 475.

triangular situations can result in double non-taxation, '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'.<sup>69</sup> Since this result occurs rather because of the abusive practices what is also possible in other cases than triangular cases, it rather would not be considered as a consequence of the triangular situations. Although, as it shows, the non-taxation or very low taxation is also possible.

Thus, in order to deal with the issues that arise in triangular situations at the more general level and to be able to assess the compatibility of the suggested solutions with the bilateral nature of tax treaties, it would be useful to identify the common features of these cases. Based on the situations described in this chapter it can be concluded that triangular cases usually:

- 1) involve rather more than two different connecting factors, but not necessarily in more than two different states
- 2) normally entail multiple layers of taxation
- 3) raise a question of the treaty applicability i.e. whether a certain tax treaty is applicable or which of the possible concurrent tax treaties prevail.

Situations entailing more than triple taxation have also been referred as quadrangular<sup>70</sup> or polyangular<sup>71</sup>, but since the essence and the features of these kind of situations remain the same, the same term – triangular situations – can be used.

The first characteristic of the triangular case expresses the circumstances where these situations appear. The second describes the result of these situations what is necessary to avoid if the states wish to mitigate the negative effects, such as juridical double taxation, of the cross-border trade. The third feature is the issue that is of special interest for this study since it raises the question of tax treaty applicability and helps to assess if the suggested solutions are compatible with the bilateral nature of tax treaties.

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<sup>69</sup> OECD MTC (n 4) Art 24 para 71.

<sup>70</sup> Gusmeroli (n 57) 7

<sup>71</sup> Vogel, 'State of Residence' (n 31) 422.

## Chapter 4. Solutions to triangular cases concerning the applicability of bilateral tax treaties

It has been observed that the bilateral nature of the tax treaties is the reason why the triangular cases are created.<sup>72</sup> The types, the creation and the issues of the bilateral tax treaty applicability were discovered in Chapter 3. This chapter discusses the solutions that have been suggested to solve the triangular cases with the aim to find out whether these solutions are compatible with the bilateral nature of the tax treaties and whether a single bilateral treaty is able to provide for an efficient solution. 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.

### 4.1. The OECD solution to the typical triangular case

It is not correct to say that the drafters of the first OECD MTC in 1963 could not envisage the appearance of triangular situations.<sup>73</sup> Already then the Member countries of the OECD realised that the triangular situations are possible in the context of the bilateral tax treaties, but the conclusion was then that it was too difficult to deal with them in the OECD MTC or its Commentary and the Member countries were advised to search for a solution in their bilateral tax treaties.<sup>74</sup>

Three decades later, the OECD nevertheless examined the triangular cases again in the special report. As a result of this, the amendments were inserted to the Commentary by the Report entitled “The Revision of the Model Convention”, adopted by the Council of the OECD on 23 July 1992, on the basis of that special report named “Triangular cases”. The Commentaries including the amendments were firstly published in 2000. The text of the OECD MTC was not changed. The Commentaries that concern the amendments have remained basically the same in the recent version of 2010, regardless of some minor changes in numbering and wording.

The OECD recommendation to solve the typical triangular case is based on the extension of double tax relief to the permanent establishments, although it is recognised that the permanent establishment is not normally entitled to the treaty benefits of the state where it is situated.<sup>75</sup> The OECD solution relies on Article 24(3) which requires that the permanent establishment could not be treated less favourably than the resident of the contracting state where the permanent establishment is situated. The Commentaries clarify, that the similar treatment covers also the tax relief by granting credit for foreign tax if the contracting state grants it to its residents.<sup>76</sup>

The Commentaries state that the majority of the OECD Member countries are able to grant tax credit in these cases on the basis of their domestic law or by applying the non-discrimination provision of the tax treaties, but the states that cannot give the relief in such a way, may wish to introduce a special provision in their bilateral tax treaties providing for conditions for granting the credit.<sup>77</sup>

As it appears, on one hand, the text of Article 24(3) OECD MTC is more general by requiring only that the permanent establishment should not be treated less favourably. Article 24(3) does not set

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<sup>72</sup> Jacques Sasseville, 'The Role of Tax Treaties in the 21<sup>st</sup> Century' (2002) 56 *Bulletin for International Taxation* 246, 247.

<sup>73</sup> Pijl (n 6) 606.

<sup>74</sup> OECD *Triangular Cases* (n 5) para 26-27.

<sup>75</sup> OECD MTC (n 2) Art 24 para 68.

<sup>76</sup> OECD MTC (n 2) Art 24 para 67.

<sup>77</sup> OECD MTC (n 2) Art 24 para 70.

any other conditions whether the state should apply credit or exemption method or whether the relief should be given on the basis of the domestic law or the tax treaties. The Commentaries state that it is the result alone that counts.<sup>78</sup> On the other hand, the Commentaries seem to support the credit method by explicitly providing for the credit to be given regarding the taxation of profits of the permanent establishment.<sup>79</sup> Furthermore, the recommendation to include a special provision not only prescribes credit, but also sets the conditions that the relief should be subjected to the provisions of the tax treaty between the State R and State S and the credit is limited up the amount of the credit that the residents of the PE state would normally receive. The special provision that is suggested to add by the Commentaries 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.<sup>80</sup>

Since the credit method is the relief method that the OECD MTC normally suggests to apply in respect to the passive income which tax rate is usually limited<sup>81</sup> it is reasonable to assume that the Commentaries follow the same principle by also suggesting the credit. However, it has been impossible to find a bilateral tax treaty where that provision is included.

The current solution that is provided in the OECD MTC relies on the application of the non-discrimination clause which commentaries state that it should be interpreted in a way that only the result of taxation is important and that the result should not be more burdensome for the permanent establishment compared to the resident enterprise in carrying on similar activities.<sup>82</sup> It is clarified that this solution does not require the resident treatment for the permanent establishment for the purposes of the tax treaty access.<sup>83</sup>

It seems that at least the courts in the Netherlands expect the OECD solution to work since in both cases reported from the Netherlands, the Supreme Court, being the court of the state of residence of the taxpayer, refused to allow the tax credit with respect of income from the third state by assuming that it is the obligation of the state of the permanent establishment.

In the so-called 'Japanese royalties' case<sup>84</sup> it was a resident of the Netherlands, having its permanent establishment in Switzerland and receiving royalties from Japan. The profits from the sale of rights were 90% attributed to the permanent establishment and 10% to the head-office. In accordance with the tax treaty between Japan and the Netherlands, the royalties were subject to withholding tax, under the tax treaty between the Switzerland and the Netherlands, the profits of the permanent

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<sup>78</sup> OECD MTC (n 2) Art 24 para 34.

<sup>79</sup> OECD MTC (n 2) Art 24 para 67-68.

<sup>80</sup> OECD MTC (n 2) Art 24 para 70.

<sup>81</sup> OECD MTC (n 2) Art 23A and 23B para 31.

<sup>82</sup> OECD MTC (n 2) Art 24 para 34.

<sup>83</sup> OECD Public discussion draft 'Application and Interpretation of Article 24 (Non-discrimination)' 3 May 2007 OECD, para 58 <<http://www.oecd.org/dataoecd/59/30/38516170.pdf>> accessed 24 May 2012

<sup>84</sup> Case no 36.155 [8 February 2002] Supreme Court of the Netherlands <[http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/highlight/collections/ttcls/html/cl\\_nl\\_2002-02-08\\_1-summary.html&q="triangular"&WT.z\\_nav=search](http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/highlight/collections/ttcls/html/cl_nl_2002-02-08_1-summary.html&q=)> (IBFD) accessed 24 May 2012

establishment were exempt in the Netherlands. The taxpayer claimed for exemption under Swiss tax treaty and full credit under Japanese tax treaty. Tax authorities allowed only 10% of the credit with respect of the royalties since this was the part of the profits that the Netherlands were entitled to tax as the profits of the head-office. The Supreme Court confirmed this position by stating that all the relevant rules must be taken into account, including the 1951 Netherlands – Switzerland tax treaty. The court held that the purpose of the tax treaty credit rules was to ensure that the credit would not exceed the taxes that the Netherlands receive.<sup>85</sup>

It is noteworthy that the court did not refer to the non-discrimination article 24(3) OECD MTC, but referred to the European Court of Justice decision in *Saint-Gobain*. In addition, the Swiss tax authorities did not implement the OECD recommendation to grant tax credit to the permanent establishments and thus the situation nevertheless resulted in juridical double taxation.<sup>86</sup>

In the subsequent similar case<sup>87</sup>, the triangular situation was created by Dutch resident with a permanent establishment in Belgium and deriving income from Brasil and Italy. By referring to the 'Japanese royalties' case, the Supreme Court of the Netherlands confirmed its previous statement that the credit cannot be granted since the profits of the permanent establishment are not included in the taxable base of the resident company in the Netherlands. Moreover, in this case the court established that the permanent establishment in Belgium was entitled to the tax credit under both tax treaties with the third states. Regardless that the attention has been drawn to the fact that it cannot be presumed that permanent establishments are normally entitled to the treaty benefits in their state of location<sup>88</sup>, in that case Belgium granted tax credits and thus double taxation was eliminated.<sup>89</sup>

Although the national courts in Europe are able to rely on the treaty freedoms of the European Union, besides this, these cases demonstrate that the OECD solution is accepted and therefore the other tax treaty partner is expected to apply the non-discrimination article. Even more, the treaty partner is expected to allow the access to its tax treaty network with third states, including those outside of the European Union. The above-mentioned court decisions have been considered to be reasonable since they prevented the double benefits what the taxpayer might otherwise have obtained, but they have also been criticised for not actually following the rules of treaty interpretation deriving from the VCLT, because the court preferred the purposive interpretation instead of the actual wording of the tax treaty.<sup>90</sup>

## 4.2. Personalisation of the permanent establishment

The main reason that causes the triangular case is the personalisation of the permanent establishment.<sup>91</sup> Although the permanent establishment is not a separate legal entity, it is treated like one for the cross-border taxation purposes in order to determine the right of a contracting state to tax the profits of the enterprise of the other contracting state.<sup>92</sup>

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<sup>85</sup> Klaus Vogel, 'Tax Treaty News' (2003) 61 Bulletin for International Taxation 235.

<sup>86</sup> Frank P.G. Pötgens, 'The Netherlands Supreme Court Again Excludes Credit of Withholding Tax in a Triangular Case' (2008) 48 European Taxation 210, 211-212.

<sup>87</sup> Case no 42.385 [11 May 2007] Supreme Court of the Netherlands  
<[http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/highlight/collections/ttcls/html/cl\\_nl\\_2007-05-11\\_1-summary.html&q="triangular"&WT.z\\_nav=search](http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/highlight/collections/ttcls/html/cl_nl_2007-05-11_1-summary.html&q=)> (IBFD) accessed 25 May 2012

<sup>88</sup> Pötgens (n 86) fn 2.

<sup>89</sup> Pötgens (n 86) 214.

<sup>90</sup> Pötgens (n 86) 213.

<sup>91</sup> Garcia Prats (n 11) 474.

<sup>92</sup> OECD MTC (n 2) Art 5 para 1.

The income from outside of the state where the permanent establishment is situated may be included in the taxable base of the permanent establishment. It is not restricted by the OECD MTC neither the Commentaries, but it depends how it is regulated by the national law.

The principle of worldwide taxation of permanent establishments is indirectly included in the article 7 of the OECD MTC since the income attributable to the permanent establishment is not restricted by the state of its location. Additionally, article 21(2) of the OECD MTC and its commentary refer to the income of the permanent establishment from the third states which taxing right is given to the contracting state where the permanent establishment is situated. It follows that if the national law of the state where the permanent establishment is situated uses the taxing right of the income that the permanent establishment derives from the third states, the OECD approach does not prevent to tax it on the worldwide basis.

Normally the obligation to grant relief corresponds to the right to tax the worldwide income, otherwise it would result in juridical double taxation. Nevertheless, the provisions for the elimination of double taxation in the OECD MTC deal only with the relief that must be granted to the residents of the contracting states that receive income from the other contracting state and not with the permanent establishments.<sup>93</sup> Thus, it seems to be justified to raise a question about the traditional bilateral functioning of the tax treaties<sup>94</sup> - if one of the contracting states is given the right to tax the worldwide income of the permanent establishment, provided that is it attributable to it, should that state be also the state which is obliged to make sure that the income from the third state does not fall under the two overlapping tax jurisdictions?

The Commentaries seem to leave this decision up to the contracting states. The OECD report has mentioned that many OECD Member states are able to grant the double tax relief under their domestic law, but recognises that there might be such states that need to adopt the special provision to their bilateral tax treaties in order to implement the relief.<sup>95</sup> Thus, it is an indication that the OECD approach adheres to the limited personal scope of the tax treaties prescribed by Article 1 OECD MTC and rather suggests that the contracting states solve these situations in their bilateral tax treaties by adding special provisions or by applying their national law.

There are different solutions proposed to solve this situation: apart from the general rule of equal treatment provided by Art 24(3) OECD MTC, these solutions vary from granting the full tax treaty entitlement to the permanent establishment,<sup>96</sup> treating the permanent establishment as if it were a resident of that state<sup>97</sup> or even to giving the resident status to the permanent establishment<sup>98</sup>. It has also been suggested to avoid too strict and formal interpretation of the bilateral tax treaties with respect to residence and source.<sup>99</sup>

As Hattingh concluded, Article 1 OECD MTC was not meant to be a guiding principle of the tax treaties, but it is rather a provision corollary to the limited scope of the other provisions of the tax treaties.<sup>100</sup> The older tax treaties did not contain such article and seemed to function without it,<sup>101</sup> but as he assumes, the inclusion of this article was the confirmation of the bilateral nature of the tax

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<sup>93</sup> OECD MTC Art 23 A and 23 B, para 10 explicitly states that there is no provision in the OECD MTC that requires the relief to be given by the state of the permanent establishment with respect to the income received from third state, except for the non-discrimination clause of Art 24(3).

<sup>94</sup> Garcia Prats (n 11) 474.

<sup>95</sup> OECD MTC (n 2) Art 24 para 70.

<sup>96</sup> Jimenez et al (n 12) 241.

<sup>97</sup> Zhai (n 68) 1105.

<sup>98</sup> Yong (n 45) 152.

<sup>99</sup> Garcia Prats (n 11) 491.

<sup>100</sup> Hattingh 'The Role and Function' (n 32) 546.

<sup>101</sup> Hattingh 'Historical Background' (n 25) 215.

treaties<sup>102</sup> and thus the genuine part of the treaty concluded between the two states. At the same time, the addition of the article 1 to the OECD MTC was important clarification to whom the tax treaty benefits are applicable, i.e. who is sufficiently connected to the contracting state to claim the benefits of the tax treaties concluded by this state.<sup>103</sup> If in the older treaties the treaty entitlement was granted to the 'citizens' or 'taxpayers' of the contracting states, the newer treaties are applicable to residents.<sup>104</sup>

Provided that the inclusion of the Article 1 sought to determine the applicability of the tax treaties to those who are more closely connected to the contracting state, it seems to be tenable to argue that the permanent establishment has equally close connection to the state where it is situated. Actually the reason, why the taxing right of the non-resident enterprise is given to the state where the permanent establishment is situated, is the sufficiently strong connecting factor with that state - the participation in the economic life of the other contracting state.<sup>105</sup> Moreover, the separate entity approach for determination of the attributable profits and the arm's length requirements in relation to the other parts of the enterprise<sup>106</sup> are all the indicators that the permanent establishment is treated in principle like a resident of the contracting state, although not with respect to the treaty benefits.

The OECD approach, on one hand, attempts to balance the treatment of the permanent establishments by prohibiting the discrimination. On the other hand, the OECD MTC actually do not directly guarantee the equal result since the actual implementation of the equal treatment is left for the contracting states to decide. This also raises the concerns with respect of the equality of the circumstances when a resident as a separate legal person and a permanent establishment as a fiction are to be compared.<sup>107</sup> For that reason, the Commentaries have given certain guidelines regarding the similarly favourable treatment of the permanent establishment<sup>108</sup>, but it is unlikely that the Commentaries are able to cover the whole spectrum of the circumstances that the permanent establishments might appear to be in. The grant of the credit with respect to the third country income received by a permanent establishment is meant to solve the triangular situation and to treat the permanent establishment likewise the resident enterprise, but it nevertheless cannot give the equal result if, for example, the the tax treaty with a third state grants exemption instead of credit. It can be argued, that the exemption is possible only in theory if the treaties follow the OECD MTC, but it is quite possible where the bilateral tax treaties derogate from the Model. Moreover, tax treaties with different states may contain different relief rules which permanent establishments cannot claim.

### **4.3. Tax treaty entitlement for the permanent establishment**

The entitlement of the tax treaty benefits to the permanent establishments gives rise to the discussions whether the permanent establishments should be granted the full access to the tax treaty network of the state where it is situated or just to the extent that is necessary to solve a certain triangular situation.

The main counterargument to the full tax treaty entitlement is the limited scope of application of the tax treaties by way of the Article 1 OECD MTC.<sup>109</sup> Since the article explicitly provides that the tax

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<sup>102</sup> Hattingh 'Historical Background' (n 25) 217.

<sup>103</sup> Hattingh 'Historical Background' (n 25) 218.

<sup>104</sup> OECD MTC (n 2) Art 1 para 1.

<sup>105</sup> OECD MTC (n 2) Art 7 para 11.

<sup>106</sup> OECD MTC (n 2) Art 7 para 16.

<sup>107</sup> OECD MTC (n 2) Art 24 para 39.

<sup>108</sup> OECD MTC (n 2) Art 24 paras 40-71.

<sup>109</sup> Garcia Prats (n 11) 477.



treaties are applicable only to the persons and residents of the contracting states, the permanent establishment is certainly outside the scope of the provision. Thus, the strict and literal interpretation of this article does not leave much room to grant the full treaty entitlement to the permanent establishments without including any special provisions in that respect. It follows that either the permanent establishment should not receive the benefits under the tax treaty, the scope of Article 1 should be either explicitly expanded to the permanent establishments or interpreted in a different way.

Another argument against the treaty entitlement of the permanent establishments is the relative effect of the international treaties.<sup>110</sup> Since under that principle the international treaties that have concluded between the two states cannot normally confer rights or obligations on the third states, it is questionable, whether a bilateral tax treaty is adequate for regulating the relations of either of the contracting states with a third state?

The OECD report 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.<sup>111</sup> The current version of the commentaries to the article 24(3) OECD MTC does not refer to the requirement for the special provision.

It has been contended that granting permanent establishments the rights under the treaty with the third state does not constitute a breach of that bilateral treaty since that treaty entitlement has no effect to the other treaty partner.<sup>112</sup> A convincing line of reasoning by Garcia Prats reaches the conclusion that the contracting states should not limit the scope of application of the non-discrimination article by referring to the limited scope of the other tax treaty - otherwise it would mean that states were able to 'overrule their international obligations by invoking the relative effect of other treaties'.<sup>113</sup>

Granting the full access to the treaty network in the state of situs of the permanent establishment would seemingly be the appropriate way to treat the permanent establishments equally with residents in most of the aspects. However, it raises concerns with regard to the treaty-shopping and the treatment of the permanent establishment results by its state of residence.

As to the treaty-shopping the OECD has paid attention to these concerns in the Report on triangular cases as well as in the Commentaries to the non-discrimination article. The OECD approach recognises that the permanent establishments could be used to take advantage from the favourable tax regime of the country of its location and suggests again the solutions on the bilateral or unilateral basis.<sup>114</sup> Although, authors discussing the OECD solution have expressed different opinions about the treaty-shopping. It has been argued that the treaty-shopping argument is weak since taking the advantage of the treaty network is similarly possible by setting up a subsidiary, i.e. the resident enterprise.<sup>115</sup> It has been opposed, that there are still differences with respect of taxation of the profits of a subsidiary and the permanent establishment, since the latter is not normally subject to withholding tax when it transfers the profits to its head-office.<sup>116</sup> This is also a valid argument for consideration whether the taxation of the permanent establishment and the resident company can be completely equalised or whether the problem could be solved by giving the permanent establishments the status at least similar to the resident of a contracting state.

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<sup>110</sup> Garcia Prats (n 11) 479.

<sup>111</sup> OECD *Triangular Cases* (n 5) para 42.

<sup>112</sup> Zhai (n 68) 1108.

<sup>113</sup> Garcia Prats (n 11) 480.

<sup>114</sup> OECD *Triangular Cases* (n 5) para 53-57.

<sup>115</sup> Garcia Prats (n 11) 481.

<sup>116</sup> Zhai (n 68) 1112.

Granting the resident status to the permanent establishments would certainly eliminate the question of equal treatment and the full access to the tax treaty network including the receipt of their benefits. Although it has its disadvantages as well. If the permanent establishment is granted the full resident status, it means that the concept of the permanent establishment or the concept of residence in the tax treaties needs to be changed. Alternatively, it is possible to take a more flexible approach as Yong suggests that the permanent establishments should be granted the resident status only conditionally, if the state where the permanent establishment is situated actually subjects the permanent establishment under the worldwide taxation with respect of the profits attributable to it. Also, the resident status would not be given for the purposes of all the tax treaties involved in the triangular situation – for the purposes of the bilateral tax treaty with the state of its head-office, the permanent establishment would not receive the resident status since it is not necessary.<sup>117</sup>

However, when the OECD examined the proposal to treat the permanent establishment in its state of situs as the resident of that state, the large majority of the OECD Member states did not support that solution because, in their view, this approach would depart too much from the principles of the OECD MTC.<sup>118</sup>

#### **4.4. Special provisions for extension of tax treaty applicability**

There has been suggestions how the bilateral tax treaties could include a special provision what should affect the applicability of another bilateral tax treaty either by way of obligation to apply or to exclude the application of that other treaty.

Avery Jones and Bobbett introduced the solution that the bilateral tax treaty between the state of source and the state where the permanent establishment is situated can include an explicit provision that the treaty between the State P and State S applies with respect of the income derived from the source state that is attributable to the permanent establishment. The authors explained that it would be more difficult to provide that the treaty between the resident state and the source state does not apply, because different bilateral tax treaties do not have the power to affect the applicability of each other.<sup>119</sup> Although, it can be argued that this solution is at variance with the relative effect of the tax treaties since it attempts to lay an obligation – although, reciprocal - to contracting states to grant the benefits of their bilateral treaty to a resident of a third state that was not party in the treaty-making process. On the other hand, granting rights to the third countries does not need a consent and it depends only on the generosity of the bilateral treaty partners.

In that respect, the solution elaborated further by Zhai takes into account the relative effect of the tax treaties and according to this approach, the special provision could be inserted in the treaty where one of the contracting states is the state where the taxpayer is resident. The special provision should obligate the source state to apply another bilateral treaty which it has concluded with the state where the permanent establishment is situated:

If the income derived by a resident of a Contracting State from another Contracting State is attributable to a permanent establishment of the recipient situated in a third State, the other Contracting State is not restricted by this Convention in respect of this income and is obliged to treat the income as if it were derived by a resident of the third state. However, if the income is exempted in the third State, the other Contracting State is only obliged to apply this treaty.<sup>120</sup>

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<sup>117</sup> Yong (n 64) 164.

<sup>118</sup> OECD *Triangular Cases* (n 5) paras 43, 46.

<sup>119</sup> Avery Jones and Bobbett (n 48) 18.

<sup>120</sup> Zhai (n 68) 1113.

It can be agreed that this solution is the most appropriate to solve the typical triangular situation by respecting the bilateral nature of tax treaties. As Zhai contends, by changing the content of obligations in the tax treaties, the bilateral obligations are honoured without granting the permanent establishments any treaty benefits.<sup>121</sup> Thus, both tax treaties that the State R and State S have concluded with the State PE should provide that the income attributable to the permanent establishment is treated as it was derived by the resident of the State PE. However, this solution works properly on assumption that both states have tax treaties with the state where the permanent establishment is situated and that tax treaty contains the non-discrimination provision.<sup>122</sup>

Without these special provisions it would be difficult to treat the permanent establishment as a resident with respect to the income attributable to it by both treaty partners. For example, in the case reported from Thailand<sup>123</sup>, the Supreme Court refused to grant the tax treaty benefits to the permanent establishment situated in the other contracting state. This case represents the point of view of the source state, i.e. the state where the permanent establishment derives its income in the typical triangular case (State S). According to the reported facts of the case, the taxpayer was a resident of Thailand and had taken loan from a foreign bank which branch was located in Singapore. One of the issues of this case was whether Thailand could apply the reduced withholding tax rates to the interest paid to the branch in Singapore. The court took the position that since the branch was not a resident liable to tax in Singapore for the tax treaty purposes, the treaty benefits could not be granted.

The outcome of this case demonstrates the ordinary application of bilateral tax treaties. Regardless of the non-discrimination Article 24(3), the state of source has no reason to treat the permanent establishment similarly to the residents of the other contracting state. Hence, the solution to add the special provision to both of the bilateral tax treaties helps to place the permanent establishment on the same situation as regards to the treaty benefits. At the same time, it does not grant the permanent establishment full access to tax treaties or resident status neither it is in conflict with the bilateral nature of the tax treaties.

#### 4.5. Tie-breaker rules to exclude a concurrently applicable tax treaty

The dual source cases are attempted to be solved also by special provisions in the bilateral tax treaties. For example, a provision initially meant to solve double taxation in the bilateral situation is the article 11(5) OECD MTC.<sup>124</sup> It reads as follows:

Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has *in a Contracting State* a permanent establishment in connection with which the indebtedness on 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.

The systematic interpretation of that provision should have led to the result that the second sentence of that provision had a precedence over the first one and thus it should have been able to solve the

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<sup>121</sup> Zhai (n 68) 1122.

<sup>122</sup> Zhai (n 68) 1122.

<sup>123</sup> *Hana Semiconductor (Bangkok) Co Ltd vs Thai Revenue Department*, Case no 1056/2549 [23 February 2006] Supreme Court

<[http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/highlight/collections/ttcls/html/cl\\_th\\_2006-02-23\\_1-summary.html&q="triangular"&WT.z\\_nav=search](http://online.ibfd.org.ludwig.lub.lu.se/kbase/#topic=doc&url=/highlight/collections/ttcls/html/cl_th_2006-02-23_1-summary.html&q=)> (IBFD) accessed 25 May 2012.

<sup>124</sup> Gusmeroli (n 57) fn 23.

situation of dual source. Unfortunately, these two sentences usually apply simultaneously in two different bilateral tax treaties as regards to the income recipient in the third state and that is why the provision is not able to exclude the applicability of the other tax treaty.<sup>125</sup> One of the treaties determines the source state to be the state where the payer is resident following the first sentence of the provision, regardless that the payment could have been attributed to the permanent establishment that is situated in the third state. The other treaty determines the source state to be the state where the permanent establishment is situated, but this is another bilateral treaty. Hence, only this provision is not able to solve the dual source case.

Although the Commentaries state that Article 11(5) is not meant to deal with triangular situation<sup>126</sup>, the alternative wording of the second sentence is nevertheless suggested:

Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has *in a State* other than that of which he is a resident a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.<sup>127</sup>

The difference between these provisions is that when the current provision in the OECD MTC expects the permanent establishment to be in one of the contracting states, then the alternative provision apparently grants the taxing right to the third state, wherever the permanent establishment of the resident of the contracting state is situated. However, as the Commentaries also state, it is up to the contracting states to decide whether to include the alternative provision in their bilateral tax treaties<sup>128</sup> since the state of the residence of the payer may not wish to give up its taxing rights if the third state where the permanent establishment is situated does not have such provision or does not tax the income at source.<sup>129</sup> Thus, the third state is also a part of this solution, since otherwise, if the third state do not use its right to tax, the solution to include this provision can lead to non-taxation.

Similar solution is discussed with respect of the dual residence cases, whether there is a tie-breaker rule in a bilateral tax treaty that is able to decide which tax treaty is applicable. It has been contended by the Dutch Ministry of Finance that such rule is the second sentence of Article 4(1) OECD MTC which provides that '[t]his term [resident of a Contracting State], 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'. This argument is based on the understanding that since the resident of a contracting state is the person who normally has a full tax liability in that state, he cannot be considered having a resident status if he is taxed only on source basis, i.e. only on the income that is derived from a certain source in that state. Then the person has a limited tax liability in that state and thus cannot be considered as a resident for the purposes of any other tax treaty. The background of this argument has been alleged to be a case in the Netherlands where the tax authorities wanted to prevent the favourable arrangements of Dutch resident companies transferring their residence to another state and still taking advantages of the Dutch treaty network.<sup>130</sup>

The Supreme Court of the Netherlands made a decision in a triangular case which shares the same standpoint, although the line of reasoning of that case was allegedly not clear and that is why the decision has received much critique. Moreover, in that case the bilateral tax treaty between the

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<sup>125</sup> Avery Jones and Bobbett (n 48) 18.

<sup>126</sup> OECD MTC (n 2) Art 11 para 29.

<sup>127</sup> OECD MTC (n 2) Art 11 para 30 (emphasis added).

<sup>128</sup> OECD MTC (n 2) Art 11 para 29.

<sup>129</sup> Avery Jones and Bobbett (n 48) 19.

<sup>130</sup> Stephan Damen 'Netherlands Supreme Court Rules on the Residence of Dual Resident Companies under Tax Treaties with Third Countries' (2001) 55 Bulletin for International Taxation 290.

Netherlands and Belgium did not follow the OECD MTC and did not contain the significant second sentence. Nevertheless, the Supreme Court still motivated its decision by pointing to the full tax liability argument which considered as having an effect to all the treaty network of the Netherlands. As the authors criticising the decision pointed out, it was not really clear, whether it was an internal regulation, an additional provision in the protocol of the Belgium-Netherlands tax treaty or the interpretation of tax treaties that led court to this result.<sup>131</sup>

However, this argument has been criticised by many scholars<sup>132</sup> since the first sentence of Article 4(1) OECD MTC explicitly states that the term 'resident of a contracting state' is defined for the 'purposes of *this* Convention'. Thus it cannot be applicable for the purposes of any other bilateral tax treaty. Avery Jones points out that the dual residence problem is best solved by the national 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 the national law purposes as well as for the purposes of other bilateral tax treaties with that state.<sup>133</sup>

Garcia Prats finds the dual residence case similar to the typical triangular case. If in the typical triangular case the question is whether the tax treaties of the state where the permanent establishment is situated are applicable in respect of the permanent establishment, in the dual residence case the question is whether the tax treaties are applicable in respect of the taxpayer who appears to be a non-resident because of the result on the tie-breaker rule. The difference is, that a permanent establishment can never be a resident of the state where it is located, whereas the person having dual residence is still considered to be a resident under domestic laws of both of the two states. Thus, Garcia Prats agrees that national 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.<sup>134</sup> Zhai claims that the special provision that was created by him to solve the typical triangular case is capable of solving the dual residence case as well, although on condition that the permanent establishment remains in the state where the taxpayer lost its residence status.<sup>135</sup>

Hence, the relative effect of the tax treaties plays a role here as well. In a situation where three connecting factors are concerned, a sole bilateral tax treaty, due to its bilateral nature, is unable to solve the triangular situation but rather creates it. Even if the tax treaties contain the tie-breaker rules that are created to solve the conflict of rules between the two contracting states, they do not affect the other treaties. In order the situation 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 in application<sup>136</sup> and one bilateral treaty cannot exclude the application of the other. Thus, a certain tie-breaker rule<sup>137</sup> or the separate provision is necessary to include, preferably into the treaty that applicability is meant to be excluded or in the domestic law.

#### 4.6. Any solutions to employment income cases?

The less discussed triangular cases about the employment income seem to be in need for an appropriate solution.

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<sup>131</sup> Jan WJ de Kort, 'HR 28 February 2001, nr 35.557: The Supreme Court of the Netherlands Reaches a Questionable Decision in a Triangular Dividend Withholding Tax Case (2001) 29 Intertax 405

<sup>132</sup> Avery Jones and Bobbett (n 48) 19; Peeters (n 67) 81; Damen (n 130) 291.

<sup>133</sup> Avery Jones and Bobbett (n 48) 20.

<sup>134</sup> Garcia Prats (n 11) 484.

<sup>135</sup> Zhai (n 68) 1121.

<sup>136</sup> Pötgens (n 86) 215.

<sup>137</sup> Gusmeroli (n 57) 6.

In the case that may occur with respect to the Article 15(2)(c), the question is whether the existence of the permanent establishment in the state where the employment is exercised should be determined under the bilateral tax treaty between the state of residence of the employer or the state of residence of the employee.

Peeters finds that strict interpretation of the tax treaty leads to the result that the permanent establishment has to be determined according to the treaty between the state of the employee and the state of employment. This is because Article 5 OECD MTC defines the permanent establishment 'for the application of this Convention'. However, he refers to the earlier opinion of the Danish Minister of Finance<sup>138</sup> who contended the alternative solution and considered the permanent establishment to be defined under the treaty between the country of residence of the head-office and the country where the employment is exercised. Peeters recognises that this approach is rational from the economical point of view, since it is connected with the eligibility of cost deduction, however, legally this interpretation does not seem tenable to him.<sup>139</sup>

The similar question about the tax treaty applicability arose in the *Poseidon* case<sup>140</sup>, although the reason why that question occurred was different. Poseidon was a company resident in Switzerland that hired out personnel. The employees were residents of the various countries - Australia, Belgium, Croatia, India, Morocco, Spain and the US and were hired out to other companies domiciled in Switzerland, but the work was exercised on-board ships in the Danish side of the continental shelf. The issue was still whether the permanent establishment should be decided under the tax treaty between Denmark and Switzerland or between Denmark and the states of residence of the employees (eg Australia, Croatia etc.). If the treaty with the Switzerland could apply, the Danish tax authorities could apply their domestic law since that tax treaty did not cover the Danish continental shelf. However, the Danish court applied the same strict interpretation of the bilateral tax treaty as Peeters suggested and reached the conclusion that the treaties with the states of residence of the employees are applicable. As a result, under these tax treaties the employer did not have the permanent establishment and thus, Denmark could not apply its domestic law neither impose its taxing right.<sup>141</sup>

As Pedersen commented on this case, the court accepted the bilateral nature of the tax treaties and that bilateral treaties are not able to solve any conflicts caused by the triangular situations. The court refused to apply the tax treaty between the state of the employer and the state where the employment was exercised because of the personal scope of application of the tax treaties. However, Pedersen refers to the interpretation articles of the VCLT and finds that it could have been possible to argue that the intention of the treaty partners was to interpret the term 'permanent establishment' differently what could have led to a different result, although he recognises that it requires a very strong proof.<sup>142</sup>

The other possible triangular case arises by virtue of the Article 15(3) OECD MTC:

Notwithstanding the preceding provisions of this Article, remuneration derived [by *the resident of the Contracting State*] in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed *in the Contracting State* in which *the place of effective management*

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<sup>138</sup> Peeters (n 67) 82, referring to Andersen, P. 'Taxation of Employment Income under Treaties in Triangular Cases' (1998) 8 European Taxation 269.

<sup>139</sup> Peeters (n 67) 82.

<sup>140</sup> *Poseidon Personnel Services* Case No. B 2581/05 [2 May 2006] Danish High Court (2007) European Taxation 90.

<sup>141</sup> Bente Møll Pedersen, 'Triangular Cases: Art.15 of the OECD Model, Income from Employment and the Definition of Terms' (2007) 47 European Taxation 90, 91.

<sup>142</sup> Pedersen (n 141) 92.

of the enterprise is situated.

In the bilateral context, the provision allocates the taxing right to one of the two contracting states, but only in case where the place of the effective management happens to situate in one of these states. If the place of the effective management is situated in the third state, it creates a triangular situation.

The OECD Commentaries do not address the issue. However, the triangular case concerning Article 15(3) OECD MTC was brought before the court in the Netherlands.<sup>143</sup> In this case, the employee was the resident of Belgium and he worked more than the 183 days in coastal water in Nigeria. The employer was a company resident in the Netherlands and as a ship operator, the company also satisfied the criteria of the Belgium-Netherlands tax treaty article 15(3) that allocated the taxing right of the employment income to the Netherlands. The issue in this case was whether the tax treaty with the state where the employment was exercised (Belgium-Nigeria) could exclude the application of the tax treaty with the state where the effective management of the ship operating in international traffic was situated (Belgium-Netherlands). The Court of Appeal of the Netherlands decided that since the Netherlands was not the party to the treaty between Belgium and Nigeria, the Netherlands is not bound by it. The court also stated that there was no double taxation in this case and if there was, it should have been solved by the mutual agreement procedure under Netherlands-Nigeria tax treaty.<sup>144</sup>

This case is the exact example of the triangular case that is created because of the bilateral distributive rules, especially the article 15(3) that might result in allocation of the taxing right to the third country. Here, the court that decided the case was the court of that third state and thus there was no reason for that state to refrain from exercising its taxing right. Only because the other state (Nigeria), that also had the taxing right under the different bilateral tax treaty, did not use its right to tax, the situation did not result in double taxation.<sup>145</sup> Regardless of the fact that the court held against the taxpayer apparently because he did not suffer double taxation, the important point is that the court had no legal basis to relinquish the application of the tax treaty because of the simultaneous applicability of the other bilateral tax treaty.

These cases demonstrate that in the triangular situations involving employment income the solutions are yet to be proposed. On the basis of the referred case-law, the findings of the courts seem to adhere to the strict interpretation and to the personal scope of the bilateral tax treaties. Hence, without special provisions these cases might lead to the undesired result.

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<sup>143</sup> Case no 08/00404 [30 September 2009] The Court of Appeals (*Gerehtshof*) of the Netherlands.

<sup>144</sup> Hans Mooij, 'Netherlands Supreme Court Decides Against Taxpayer in a Triangular Case Involving the Taxation of Ship Employment Income' (2012) 66 Bulletin for International Taxation 149, 151.

<sup>145</sup> *ibid*

## Chapter 5. Conclusions

The aim of the thesis was to find an answer to the question whether a single bilateral tax treaty is able to solve triangular cases, but the examination of the suggested solutions demonstrated that usually one bilateral tax treaty is not sufficient to solve the tax treaty applicability issues and the appropriate solution needs at least two different treaties to deal with a triangular case.

There are different types of triangular cases which raise different issues, but the common features of the triangular situations are that they involve more than two different connecting factors, they normally entail multiple layers of taxation and they raise a question of the tax treaty applicability, i.e. whether a bilateral tax treaty is applicable (in the typical triangular case the treaty between the state of the permanent establishment and the state of source) or which one of the possible concurrently applicable tax treaties prevail.

The typical triangular case is created because of the personalisation of the permanent establishment. Following the separate entity approach, the permanent establishment is taxed on its worldwide income, but as regards to the benefits, such as the double tax relief for the foreign tax, the treatment of the permanent establishment is not entirely clear and that is what creates the problem in the triangular case.

On one hand, the Article 24(3) OECD MTC requires that the permanent establishment should not be treated less favourably than the resident of the same state, but the OECD MTC does not provide for a particular rule how to do it. The Commentaries recommend to grant a credit, but since the Commentaries cannot serve as the legal basis for claiming such benefit, it is apparently left for the national rules to decide the exact treatment of the permanent establishments as regards to the double tax relief on income from the third country. The bilateral tax treaty with the state of source is not applicable since by way of the Article 1 OECD MTC the bilateral tax treaty applies only to the persons who are residents of the contracting states. For the same reason, the state of source is not able to treat the permanent establishment as the resident of the state where it is situated. It follows that the application of the non-discrimination clause in a bilateral tax treaty between the state of residence and the state of permanent establishment is a solution that two states should use, but if the result of it is similarly favourable to the permanent establishment as for the resident of that state, is not entirely clear. The vagueness as regards to the full tax treaty access can give only a partial solution to this situation.

On the other hand, the proposed solutions to grant the permanent establishment the resident status would eliminate the treaty applicability problem, but it means a fundamental change in tax treaty terminology and principles, e.g. the modification of the concepts of the residence and the permanent establishment. This solution would also be incompatible with the relative effect of the tax treaties and the principle of reciprocity since the treaties that are concluded between the state where the permanent establishment is situated and the third states are meant to apply only to the residents of that state and the extension of the treaty application might require a consent from the third states. Thus, the treaties concluded by the third states should include a special provisions allowing the benefits to the permanent establishments.

The most appropriate solution which respects the bilateral nature of tax treaties appears to be the solution where the both tax treaties concluded by the state of the permanent establishment in triangular situation include the provision that prescribes to treat the permanent establishment as the resident of the contracting state. It follows that the completely similar treatment of the permanent



establishments in the state where they are situated requires more than one bilateral tax treaty to be applicable.

The other triangular cases, such as dual residence, dual source and employment income cases, mostly have to deal with the problem of two concurrently applicable tax treaties while there is no rules which tax treaty should prevail. Since there are no such rules that would automatically exclude the application of one of the treaties, these situation might need a certain kind of a tie-breaker rule.

In dual residence case the provision that can solve the situation can be the tie-breaker rule of Article 4 in the bilateral tax treaty between the two states of residence, although it should have an effect that also applies with respect to other bilateral tax treaties. Therefore, the best solution is to adopt it into internal law. In dual source cases the special provision should be included in the one of the concurrently applicable tax treaties with the state of source. That provision should exclude the applicability of one of the treaties, but since it cannot exclude the other treaty, the only possible solution is that the provision excludes the application of the treaty where it is included and transfers the taxing right to the other state of source. This is compatible with the relative effect of the tax treaties because the granting of the rights to the third states does not need an explicit consent from the third state. However, the solution still works properly only if the the third state is able to exercise its taxing right and the state of residence accepts such taxation. It follows again, that by inclusion of the provisions only in one bilateral tax treaty, the solution is not always entirely consistent.

As regards to the triangular cases concerning employment income, there is no proposed solution that would unambiguously resolve the concurrent application of the tax treaties. Thus, these cases are still open for the proposals or for the disputes in courts. On the basis of the cases referred, it seems that there is no reason for the courts to use other than a strict interpretation of the bilateral tax treaties. Thus, the result might depend on the fact, which court decides the case, i.e. which tax treaty is applicable from that state's point of view. However, the result where that strict interpretation leads to, might be unexpected and inconsistent with the intention of the treaty partners.

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