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Applicability of bilateral tax treaties in triangular cases

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1. Introduction

1.1 Tax treaties are usually entered into between two states and often it is seen that bilateral tax treaties do not always function efficiently in situations where more than two states are involved. These situations are referred to as 'triangular cases' and they arise where a person who is resident in one state and has a permanent establishment (PE) in another state or where a person who is resident in two states for tax purposes (a dual resident), has transactions with a resident of a third state.

1.2 Since, each nation has its own tax rules and the rules of one nation are rarely perfectly matched with those of another, it is possible that income will be taxed more than once or that it will go untaxed by any jurisdiction. Hence, proper solution needs to be figured out, so that each jurisdiction's right to tax over a particular income is established.

1.3 Broadly, triangular cases can arise in following situations –

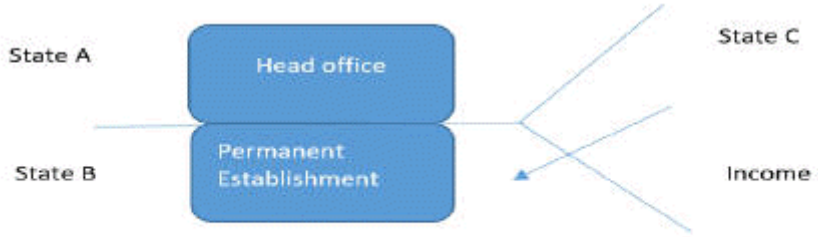
- A person resident in one state (State A) carries on business in another state (State B) through its permanent establishment (PE) and the PE earns income from third state (State C *i.e.* source state) (This situation is often referred to **PE triangular case**)
- A person resident in one state (State A) pays to the resident of another state (State C) and the income originates in third state (State B). (This situation is often referred to **Reverse PE triangular case**)
- A person who is resident of two states (State A and State B) for tax purposes receives income from sources in a third state (State C) (This situation is often referred to **Dual resident triangular case**)
- A person who is resident of two states (State A and State B) pays an amount which forms the income of a resident of third state (State C) (This situation is often referred to as **Reverse dual resident triangular case**)

2. Issues in triangular cases

2.1 PE triangular case

2.1.1 In this scenario, the income is taxed in the third state (State C) which is the source state of the income earned by the PE. Thereafter, the same income is taxed in the State where PE is located (State B). Finally, the income which is taxed twice, is taxed third time in the State of residence of the person *i.e.* State A.

2.1.2 A PE triangular case is illustrated in the following diagram –



PE triangular case

2.1.3 The question is whether tax treaties fully or partly covers the transaction at issue and whether domestic tax law of State B applies to PE's similarly as it does in the case of a residence. The double taxation relief to be provided by PE state and residence state are examined below –

Relief by State B for taxes paid in State C -

- Even though there may be treaty between State B and State C, the same may not be applicable as the scope for claiming the double tax relief under State B and State C tax treaty is limited to residents of the tax treaty states. *Hence, PE being neither the resident of State B nor of State C may not be able to claim tax treaty benefit between tax treaty of State B and State C.*
- Further, unilateral relief in State B shall be applicable only to the residents of State B. *PE not being resident of State B will not be eligible for unilateral relief.*

Possible resolutions

- In both the aforementioned situations, a resident of State A would qualify for the benefit of unilateral or double taxation relief rules of State C in respect of the income of the PE from State C, only if State B has a tax treaty with State A and such tax treaty has a PE non-discrimination clause consistent with Article 24(3) of the OECD model convention.
- Further, if under State B and State C tax treaty, the double taxation relief available to non-residents is more favourable than the unilateral relief under the domestic law of State B, a resident of State A would qualify for some more favourable relief.

Comments – Presence on non-discrimination clause in the tax treaty between state of residence and PE state is essential for claiming aforementioned relief

Relief provided by State A for taxes paid in State B and State C-

- State A in a PE triangular case may have an obligation to provide relief for tax imposed in the State C under the terms of the State A and State C tax treaty and may also have an obligation to provide relief for tax imposed in the State B under the terms of the State A and State B tax treaty.
- **Situation 1 - Credit method of relief**

If State A uses the credit method of relief under both its tax treaty with the State C and its tax treaty with the State B, then it will generally be capable of providing sufficient relief only in cases where the combined effective tax rate in the source state and the PE state is less than its own effective tax rate.

Comments - If both such reliefs were to be granted by State A in respect of the State C income and if it is assumed that PE state also provides double taxation relief in respect of State C tax, State C source income would virtually be tax-free because of the triple taxation of State C income under the domestic laws of the three states which is offset by triple relief one by PE state and twice by State A. While this may prevent unrelieved double taxation, it arguably does not result in an equitable sharing of tax revenues

between the three states involved because the residence state is reducing the tax it collects on other income. It would be more equitable for the PE state to grant relief for tax imposed in the source state and consequently, for less relief to be granted in the residence state.

- **Situation 2 –Exemption method of relief**

State B shall be entitled to give exemption for the taxes paid in State C. Subsequently, State A grants an exemption from its taxes paid in State B.

Comments - If State A exempts the income attributable to the State B in a PE triangular case, then it is generally considered to be incapable of fully relieving double taxation unless relief is also granted in the State B.

2.1.4 Case study on PE triangular case

X Co., a company resident of State A has PE in State B. The PE derives some income from State C. The global income of X Co. is as under –

- Income of US$ 100 from sources in State A (tax rate @50%)
- Income of US$ 60 from the sources in PE state *i.e.* State B (tax rate@40%)
- Income of US$ 40 from the sources in State C (tax rate @30%)

In the above example, income of X Co. from State B will be doubly taxed and income of X Co. from State C will be triply taxed.

- Taxes in State A – 50% on US$ 200 = US$ 100
- Taxes in State B – 40% on US$ 100 = US$ 40
- Taxes in State C – 30% on US$ 40 = US$ 12

Taxes after relief –

Relief by PE state i.e. State B –

Under exemption method	Taxes will be US$ 24 (*i.e.* US$60*40%)
Under deduction method	Taxes will be US$28 (*i.e.* US$40-US$12)

Relief by residence state i.e. State A –

Under exemption method	Taxes will be US$ 50 (*i.e.* US$100*50%)
Under deduction method	Taxes will be US$60 (*i.e.* US$100-US$40)

2.1.5 In the ruling of Authority of Advance ruling in the case of Shell Technology India (P.) Ltd., In re [2011] 16 taxmann.com 345/[2014] Taxman 314/345 ITR 206 (AAR) –

Indian company entered into agreement with Philippines branch of Netherlands company under which the Indian company was to pay a monthly fee to Philippines branch for the services rendered by the branch in India. Indian company approached AAR for ruling on the question whether the payment was Fees for technical services.AAR was to decide which tax treaty to apply for withholding tax purposes –

- India-Philippines tax treaty
- India-Netherlands tax treaty

If India-Netherlands tax treaty were considered applicable, the amount paid by the Indian company to the Philippines branch would not be taxable in India because of the make available clause in the tax-treaty. However, if India-Philippines tax treaty were to apply, the amount would be considered taxable in the hands of branch. Authority ruled that India- Netherlands tax treaty would apply and the income would be exempt because of the make- available clause in the tax treaty.

2.2 Reverse PE triangular case

2.2.1 In a reverse PE triangular case, both the head office state (State A) and the PE state (State B) of the payer may seek to impose source-based taxation on the payment made to the resident of third state (State C).

2.2.2 A reverse PE triangular case is illustrated in the following diagram –

2.2.3 Let's presume that head office state (State A) pays interest to the resident of State C on a loan that can be attributed to the PE in State B (*i.e.* income originates from PE in State B).

Issue - If the tax treaty between State A and State C provides for source state taxation on interest at the rate of 10% while the tax treaty between State B and C only allows taxation up to 5% of the gross amount of the interest, how interest will be taxed in State A, State B and State C.

Tax treaties between States A and State C and between States B and State C provides State C has the unrestricted right to tax interest sourced in State A or State B. Also, State C is obliged to grant a foreign tax credit for the tax paid in the source state.

The question that arises is therefore, which state should be considered as the source state (*i.e.* State A or State B) regarding the interest payment as both States A and State B are entitled to levy tax on the interest payment.

Further, if the 'interest' article in the State B and State C tax treaty contains a sourcing rule similar to Article 11(5) of the OECD model convention, under the second sentence, State B should be regarded as the source state. Relevant text of the OECD model convention are reproduced below –

> *'.....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'*

This means that in State B the interest payment may be subjected to a withholding tax of 5% of the gross amount of the interest.

If the 'interest' article of the State A and State C tax treaty is similar to Article 11 of the OECD model convention, the first sentence of the sourcing rule of Article 11(5) would deem State A to be the source state of the interest. Relevant text of OECD model convention are as under –

> '*Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State'*

The second sentence of this provision does not alter this since the PE is not in State A or State C and State B is not a signatory to the tax treaty. The State A and State C tax treaty, therefore allows State A to levy tax at a rate of 10% of the gross amount of the interest.

Resolutions - To resolve reverse PE triangular cases, either the State B or the State A should be prevented from imposing source-based taxation. Of these two states, it seems more appropriate to prevent taxation in the State A, since the interest must have a significant economic connection to the activities of the PE.

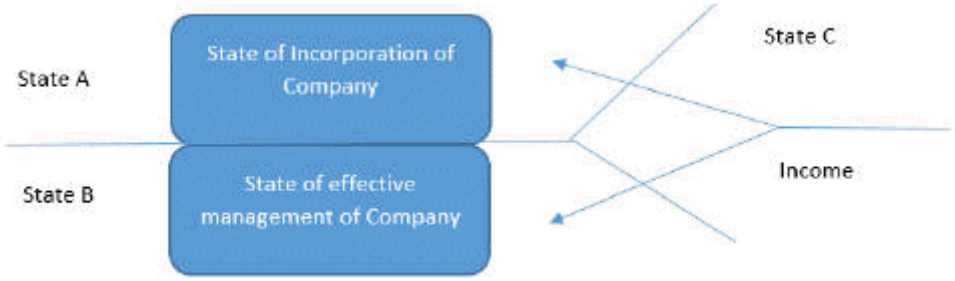
Other way of preventing State A from imposing tax in reverse PE triangular cases is by altering the wording of Article 11(5) in tax treaty between State A and State C to the effect that interest which are connected with a PE would be considered to arise in the PE state (State B) even if the PE state is not one of the contracting states to the tax treaty. As a result, the interest would not be considered to arise in the State A for the purposes of applying the State A and State C tax treaty, and thus the distributive rule of Article11 would not apply.

Comments - Commentary to Article 11 of the OECD Model Tax Convention does contain a possible solution for dual source income. However, the suggested provision to solve the issue has not been included in many tax treaties.

2.3 Dual resident triangular cases

2.3.1 Dual resident triangular cases usually arises where a person who is resident in two states (State A and State B) for tax purposes receives income from sources in a third state (State C).

2.3.2 A dual resident triangular case is illustrated in the following diagram –



2.3.3 This above situation possibly arises because of the fact that domestic tax systems of different state uses different criteria (say incorporation under the laws of that state or effective management test or management and control test) for determining the residential status. In illustration above, if the dual resident company receives interest income from State C, then two tax treaty shall be applicable (State A and State C tax treaty and State B and State C tax treaty). If the withholding tax rates in two treaties are different, it then become important to analyse which tax treaty should apply.

Possible view in such situations are –

- **Situation 1 -** Tax treaty that contains lower tax rate should be applied. This premise is based on the presumption that the taxpayer (the dual resident company) may elect which tax treaty should be applied or that international law requires the application of the most favourable tax treaty.
- **Situation 2-** This is based on the text of the second sentence of Article 4(1) of the OECD Model Tax Convention which reads as under –

  '.....This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'

This above sentence stipulates that a person for the purposes of the tax treaty is not treated as a resident of a contracting state if that person is liable to tax in that state only in respect of income from sources within that state although the person is a resident of that state according to the domestic legislation of that state.

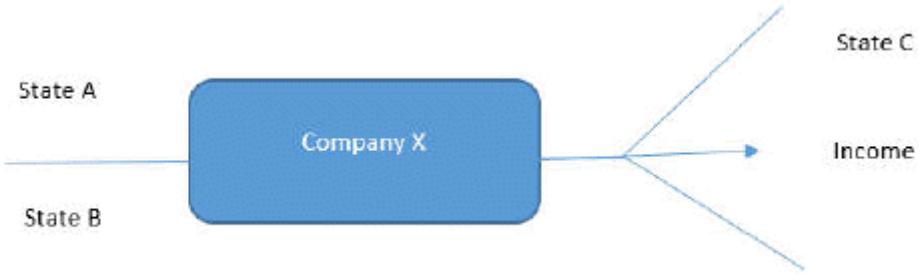
Now, if there is a tax treaty applicable between States A and State B and tax treaty contains the tiebreaker rule of Article 4(3) of the tax treaty, the dual resident company will for the purposes of tax treaty be considered a resident of the state in which the place of effective management is situated (State B in our case). Hence, company shall be taxable on worldwide income in State B. In the other state (*i.e.* State A) due to the impact of the State A and State B tax treaty, the company is only liable to tax in respect of income from sources within that state. Therefore, due to the second sentence of Article 4(1) of the tax treaty, the company does not qualify as a resident of State A under the State A and State C tax treaty.

Resolutions - For Situation 2 to be applicable, relevant tax treaty should contain second sentence in its Article 4(1) of the tax treaty similar to that of OECD Model convention. Pertinent to mention that since the 2008 update, the Commentary to the OECD model convention also indicates that Situation 2 should be followed.

2.4 Reverse dual resident triangular cases

2.4.1 Reverse dual resident triangular cases usually arises where a person who is resident in two states (State A and State B) for tax purposes makes certain payments to the resident of third state (State C).

2.4.2 A reverse dual resident triangular case is illustrated in the following diagram –



2.4.3 In the illustration above, if Company X (dual resident company) is to pay interest to a resident of a third state, which tax treaty should apply. Domestic tax laws of State A deems Company X to be a resident of State A because of its incorporation and the laws of State B consider Company X to be a resident of State B because of the place of effective management in State B.

If the dual resident company (Company X) pays interest to a resident of State C, then, possibly two tax treaties could apply, *i.e.* State A and State C tax treaty and State B and State C tax treaty.

As discussed earlier, that for the purposes of the State A and State B tax treaty, Company X would be considered a resident of State B applying tie-breaker rule of the tax treaty. Although the tie-breaker in principle applies to States A and State B, the effect is that Company X is taxable in State A only in respect of income from sources in State A and therefore should not meet the residence criterion of Article 4(1) of the OECD Model Tax Convention. *(Assuming that the relevant tax treaty has Article 4(1) similar to that of OECD Model convention)*

On the basis of OECD Commentary on dual resident companies and especially the position in the state that lost out in the tiebreaker rule (in this example, State A), the correct view would be that Company X would not be considered a resident of State A for the purposes of the State A and State C tax treaty. However, this does not per se means that State A will have no right to tax the interest paid by Company X.

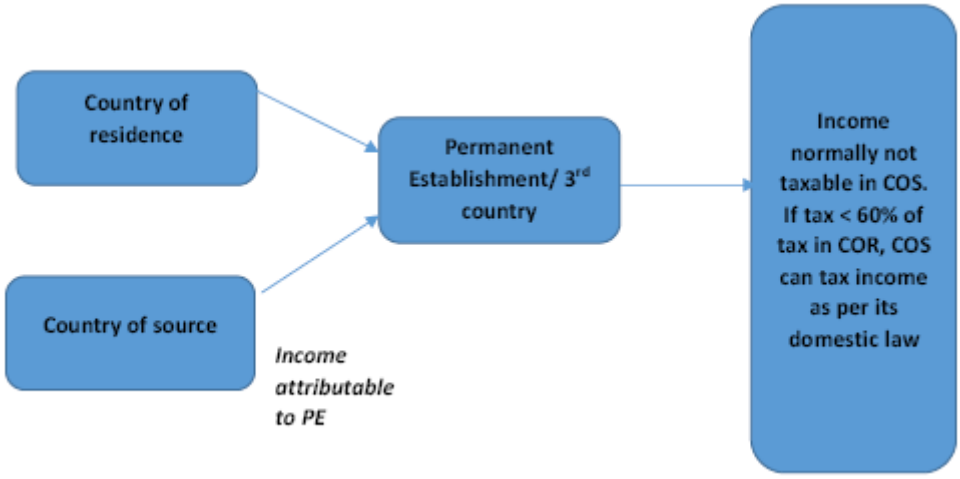
There is a possibility that Company X still has a PE in State A. In that case, sourcing rule of Article 11(5) of the OECD Model Tax Convention will deem the interest to be sourced in State A. Hence, in such situation State A would be entitled to levy tax as per the interest article of the State A and State C tax treaty. But for this to apply it becomes important that the loan on which the interest is paid can be attributed to the PE and that the interest is borne by the PE.

Comments - Possible resolution to this seems to be inclusion of specific provision in the tax treaties or inclusion of provisions in domestic laws which prevent a dual resident from being resident for domestic purposes when the state implementing such provision is the losing residence state *i.e.* State A.

Changes that may be brought pursuant to Multilateral instrument ('MLI') - *Article 10 of the MLI*- Anti-abuse rule for permanent establishments ('PE') situated in third jurisdictions

3. The Article seeks to deny treaty benefits in respect of any item of income on which the tax rate derived by a treaty resident state and attributable to a PE in a third jurisdiction, is exempt from tax in the residence state and the tax in the third jurisdiction (where PE is located) on such income is less than 60% of the tax that would be imposed in the residence state if the PE were located there.

India's position - India has not made any reservations in respect of this article. This rule will not impact India if it is the residence state because global income of residents is taxable as per domestic laws of India.



However, country of source cannot tax income if income in country of source is in connection with or incidental to active conduct of business through PE

Conclusion

4. Triangular cases poses number of interesting issues. Even after so much of work done in this area, over the years, there is still, no satisfactory and generally accepted solution to the issues for resolving triangular case situation. The intention of this article was to present a broad analysis of the issues arising in triangular cases, taking into account recent developments in international tax law, with the objective of identifying a comprehensive solution to such cases.

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