

ICAI's INTERNATIONAL TAX COMMITTEE OF GOA BRANCH

Course on International Taxation Presentation on Triangular Cases under DTAA

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Overview of Presentation

- Application of DTAA and Tax credit
- Principle of Tax credit vs Application of treaty
- Types of Triangular Cases
- Case Study

Meaning of Triangular Cases

- Tax treaties are generally concluded between two States for the purpose of eliminating or reducing the incidence of double taxation for the residents of either of the States
- More often not only two states but sometimes three or four states could be part of the same transaction
 - Tax treaty entered into between two states generally do not cover the incidence of double taxation involving more than two states
- IBFD's International Tax Glossary describes the expression 'triangular cases' as

“Term used most commonly in the context of relieving double taxation where more than two (typically three) states are involved. For example, a resident of one state (State R) has a permanent establishment in another state (State P), which in turn derives income in the form of dividends, interest or royalties from a third state (State S), thus raising the issue (if double taxation treaties have been concluded between the states) which tax treaty should be applied to relieve double taxation in State S i.e. should the R-P or the R-S treaty be applied

Meaning of Triangular Cases (con't)

- In normal parlance, 'triangular cases' refers to a situation involving applicability of tax treaties where tax incidence on a particular stream of income is typically triggered in three countries
 - The income could be passive like capital gains, dividend, interest, etc. or active like income of the PE from the Source State
- The OECD Model Convention (MC) does not provide any general and consistent solution to the problems raised by typical triangular transactions
- As per OECD, triangular situations occurs generally and frequently in the banking and insurance sectors
 - Banks often have foreign branches that may receive interest from third countries on loans granted to residents of those countries
 - Offshore branches of insurance companies located in a contracting state other than its head office are required to have risk-cover capital and income from such capital (often in the form of shares/bonds) comes from another contracting state

Types of Triangular Cases

- OECD contemplates two types of triangular situations:

Type I - Cases where an enterprise of a contracting state (Resident State) has a permanent establishment (PE) in another contracting state (PE State) and such PE earns income from a third contracting state (Source State)

Type II - Cases where an enterprise qualifies as a resident of more than two contracting states (Resident States) and such enterprise earns income from a third contracting state (Source State)

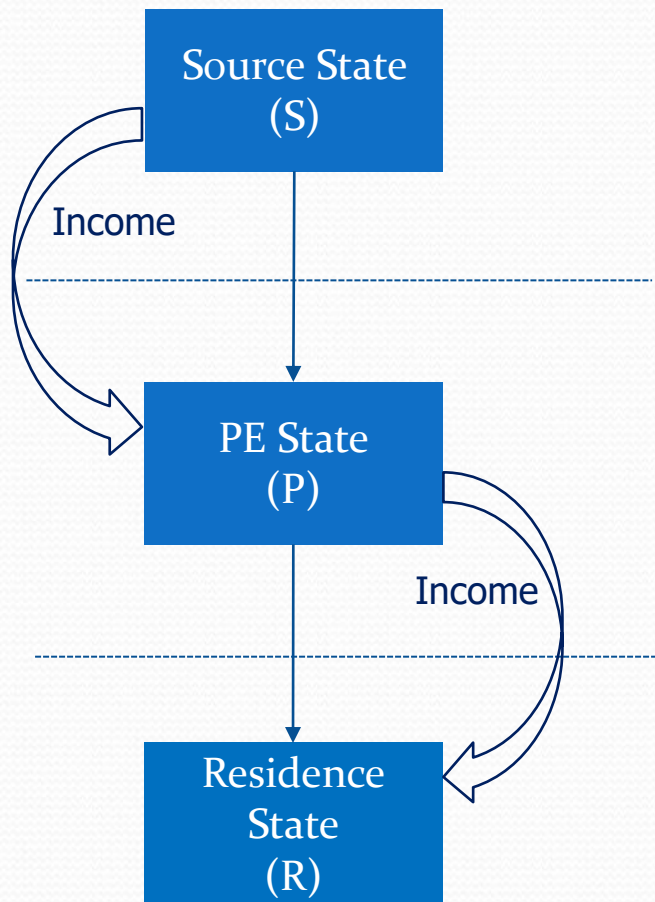
Application of Treaty to PE & Tax Credit

- Article 23 provides for methods for elimination of double taxation either by the exemption method (Article 23A) or by the credit method (Article 23B)
 - To claim exemption under Article 23, one needs to be a resident of either of the contracting states
- Article 1 of the MC states that the Convention shall apply only to persons who are residents of one or both of the Contracting States
- Article 3 (1)(a) of the MC defines 'person' and would include an individual, a company and any other body of persons

Application of Treaty to PE

- Article 4(1) of the MC defines the term 'resident' of a contracting state as any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof but 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
- Article 4(3) of the MC provides for situation wherein a person other than an individual is a resident of both the contracting states?
 - The person shall be deemed to be a resident only of the State in which its place of effective management is situated

Types of Triangular Cases - Type I



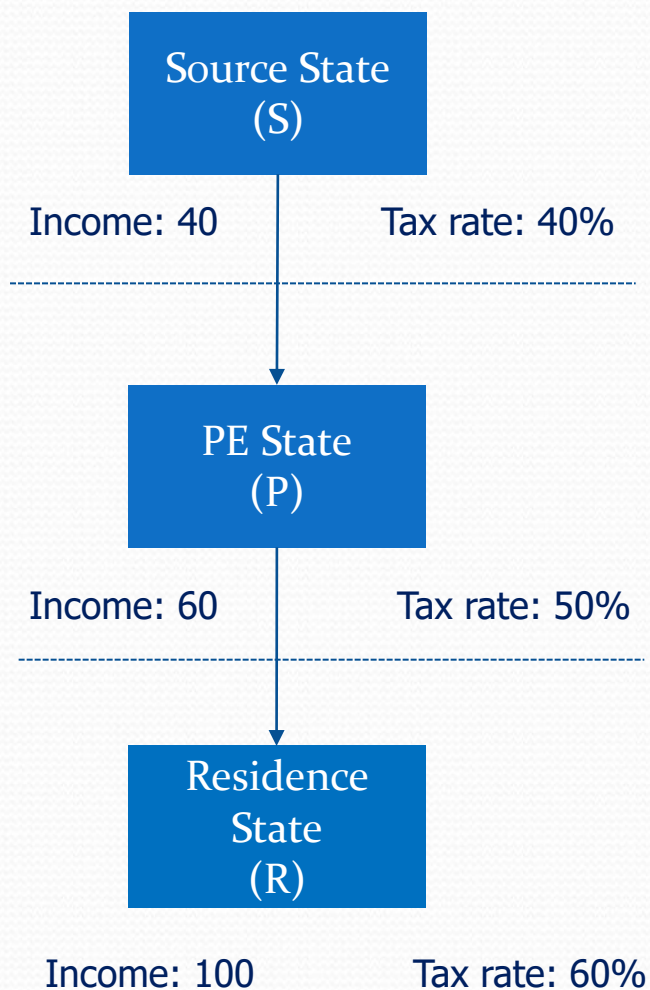
Facts

- An enterprise of a contracting state (Residence State) carries on its business through a PE in another contracting state (PE State) and earns income from a third state (Source State)

Issues

- Whether PE State to give credit for taxes paid in Source State?
- If yes, which tax treaty to apply i.e. Source State-PE State or Source State-Residence State?

Type I – No Treaty exist between States S, P & R



- Source State would claim the right to tax income arising in that State - Source based taxation
(Tax payable: 40% of 40 = 16)
- PE State would claim the right to tax income attributable to a PE of a non-resident operating in that State
(Tax payable: 50% of (40+60) = 50)
- Residence State would claim the right to tax all its residents on their global income - Residence based taxation
(Tax payable: 60% of (40+60+100) = 120)

Type I (con't) – Treaty exist between States S, P & R

Method	State Residence	State P where PE located	State of Source
• Income where no treaty amongst the countries	• Taxed	• Taxed	• Taxed
• Income where treaty between R & S similar to Article 23B	• Credit for tax paid in S	• Taxed	• Taxed
• Income where treaty between R & S similar to Article 23A	• Exempt – No credit	• Taxed	• Taxed
• Income where treaty between R & PE similar to Article 23A	• No credit	• Exempt	• Taxed

R – P State Treaty (Non-discrimination)

Article 24(3) of the OECD Model provides:

- *“The taxation of a PE which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that State carrying on the same activities.”*
- Tax on PE must not be less favorably levied in State P than the tax levied on enterprises resident in State P
- If resident of P claims credit for the taxes paid in State S , it should be consequently possible for PEs of enterprises of the other Contracting States
- However, State P would have to apply the S-P treaty unilaterally to the PEs
- Hence a question remains that the PE enjoys the same treatment as residents in State P, but it is not treaty entitled and the treaty S - P in the Source State is not applicable.

Taxable Event in Source State

- Options with Source State:
 - a. If no Treaty, apply domestic tax law
 - b. If Treaty, which Treaty may apply S – PE or S – R?
- S – R Treaty applies as PE State is not the Resident State

Taxable Event in PE State

- Options with PE State:
 - a. If no Treaty, apply domestic tax law
 - b. If Treaty, which Treaty may apply for source of income in S State: PE - S or PE - R?
- PE - S Treaty does not apply on account of Article 4(1)
- PE - R Treaty will apply but no source in R State; hence non-discrimination under Article 24(3) applies and credit may be given of taxes paid in S State

Taxable Event in PE State (con't)

- Option for Tax Credit:
 - a. Tax paid in S State on unilateral basis
 - b. Tax credit as per PE – S Treaty
 - c. Tax credit as per S – R Treaty
- Tax credit as per S – R Treaty will apply on account of Article 24(3) of PE – R Treaty

Taxable Event in Residence State

- Options with Residence State:
 - a. If no Treaty, apply domestic tax law
 - b. If Treaty, which Treaty may apply R - S or R – PE?

- R State is bound by both Treaties:
 - a. R - S Treaty will apply and R State would give credit for taxes paid in S State; need to ensure that no double relief is provided i.e. taxes paid in S State and PE State (Article 23)
 - b. R – PE Treaty will apply as income of PE is taxable

Types of Triangular Cases – Example

Particulars	Residence State	PE State	Source State	Total
Tax Rate	60%	50%	40%	
Income	100	60	40	200
Taxes on above	60	30	16	106
Total Income (all inclusive)	200	100	40	200
Tax on above	120	50	16	186
Credit of taxes paid in Source State				
Tax payable		50		
Scenario 1 – Exemption Method		NIL		
Scenario 2 – Credit Method ($40 \times 40\%$)		16		

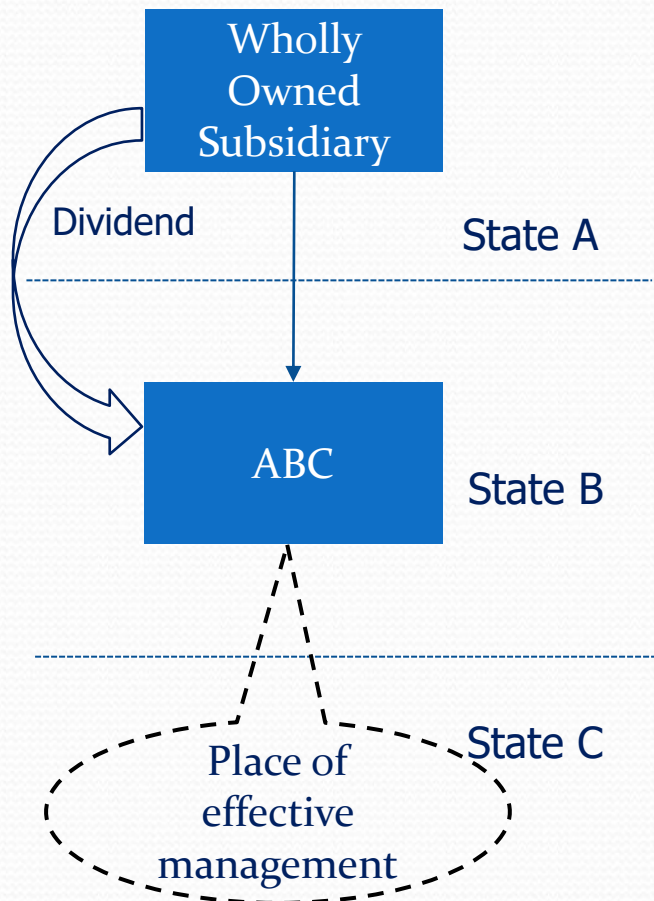
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Tax on above	120	50	16	186
Credit of taxes paid in PE State				
Tax payable	120			
Scenario 1 – Exemption Method	NIL			
Scenario 2 – If PE State had exempted Source State income (60*50%)	30			
Scenario 3 – If PE state had granted credit in respect of Source State income (100*50%) – (40*40%)	34			

Types of Triangular Cases – Example

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Total Income (all inclusive)	200	100	40	200
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Credit of taxes paid in PE State				
Scenario 4 – If Residence State provide credit for taxes paid in PE State (i.e. $60 \times 50\%$ presuming exemption given for Source State income) and Source State ($40 \times 40\%$)	46			
Scenario 5 – If Residence State provide for taxes paid in PE State ($100 \times 50\% = 50 - 16$) presuming credit given for source state income) and Source State ($40 \times 40\%$)	50			

Types of Triangular Cases - Type II



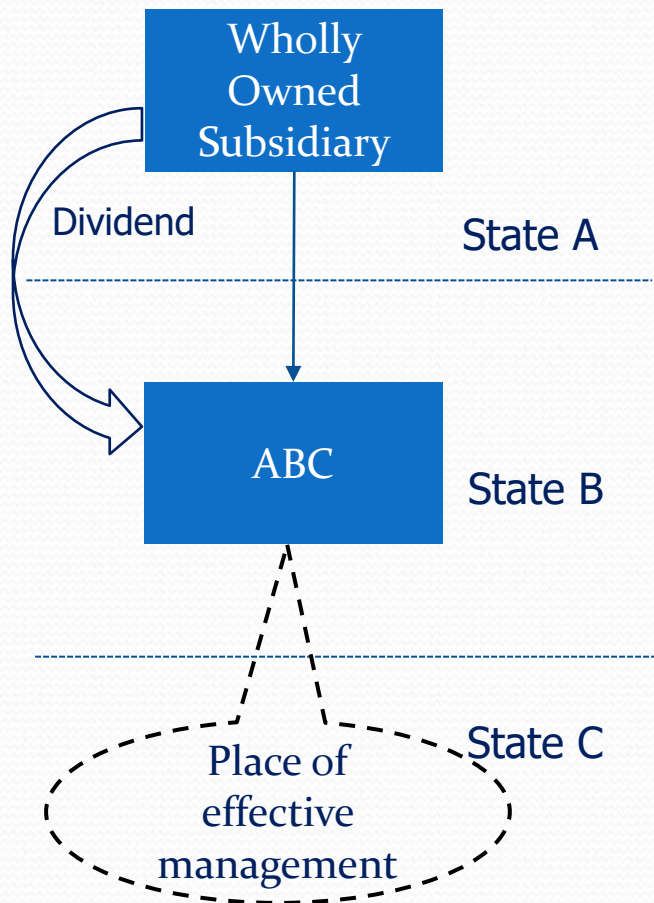
Facts

- ABC is incorporated in State B, however, it is effectively managed from State C
- In State B, a company would be a resident if it is incorporated in that country
- In State C, a company would be a resident if it has a place of effective management in that country
- ABC is receiving dividend from its WOS in State A

Issues

- Whether the dividend received by ABC would be taxable in State B or State C or both?
- If taxable in both states, who shall provide credit for the taxes withheld, if any by State A?

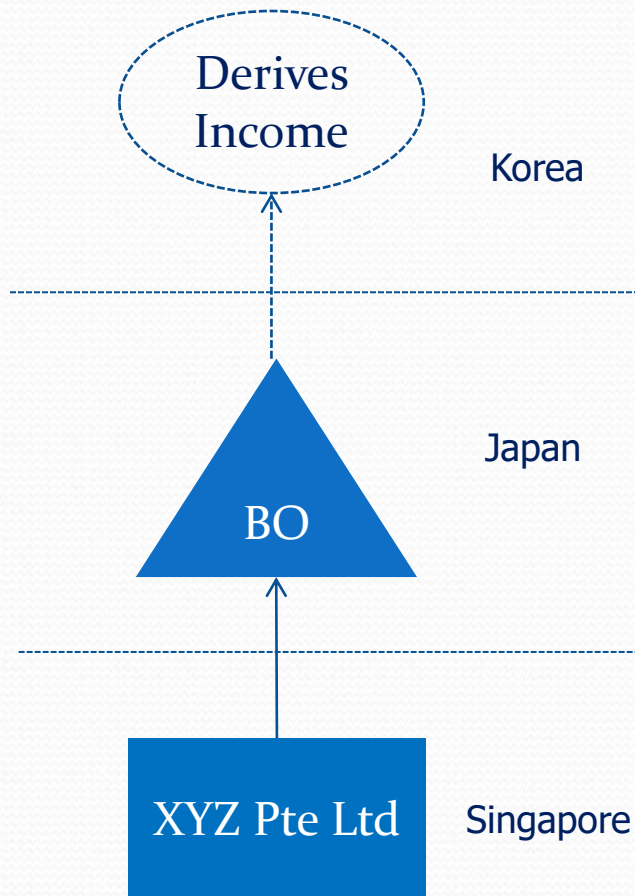
Types of Triangular Cases - Type II



Analysis

- Under State B-State C tax treaty, ABC would qualify as a tax resident of State C
 - State C is entitled to worldwide taxation of ABC
- In view of above, ABC may not be a tax resident in State B since ABC would be liable to be taxed in respect of State B income only (as per State B-State C tax treaty)
- Hence the tax treaty between State A-State B may not apply

Case Study – Type II



- XYZ Pte Ltd is company incorporated in Singapore, however, it has no business operations in Singapore
- XYZ Pte Ltd has branch office in Japan, which derives income from Japan as well as from Korea
- Korean income is subject to tax under its domestic laws

Issues

- XYZ Pte Ltd wants to limit/ eliminate the Korean tax by applying the tax treaty?
- Which tax treaty would be applicable?
 - Singapore/Korea treaty
 - Japan/Korea treaty



Thank You