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Treaty Conflicts in Categorizing Income as Business Profits: Differences in Approach Between Common Law and Civil Law Countries

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Introduction

Since its 2000 update, the OECD model tax convention[1] and the accompanying commentary have contained provisions that deal with "conflicts of qualification"—that is, different categorization of income by the two states.[2] These differences are particularly likely to arise in relation to whether income is categorized as business profits, the most important type of income. In this chapter,

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1 Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003) (herein referred to as "the OECD model convention").

2 Article 23A(4) of the OECD model convention, preventing the situation in which the source state charges only a withholding tax and the residence state exempts the income, explained in paragraphs 56.1-56.3 of the commentary on article 23; and the more general provisions in the commentary (paragraphs 32.1-32.7) dealing with conflicts of qualification in article 23. Paragraph 56.3 of the commentary on article 23 plays down the significance of the former by saying that it is not needed where the exemption is caused by a difference in qualification of the income by domestic law, because this is covered by the latter (as explained by the commentary).

we will examine how such conflicts arise because of the differences in approach between common law and civil law countries to the categorization of income as business profits.

The essence of the difference is that civil law countries treat all the income of a commercial company as business profits; the result is that the approach in the case of income earned by a commercial company[3] is based on the type of person, while common law countries make the determination according to the type of income. The most obvious example of this difference in approach is that common law countries make a distinction between capital gains and business profits when taxing companies;[4] civil law countries do not, because capital gains are part of business profits.[5]

3 For individuals, a type-of-income approach is necessarily used.

4 In most common law countries, capital gains of companies are taxed differently from other types of income with separate computational rules, and capital gains often qualify for relief not applicable to other income: in Australia, exemption of gains before September 20, 1985 and indexation of the gain for periods up to September 30, 1999; in Canada, by exempting gains accrued before 1972 and by taxing only 50 percent of gains; in the United Kingdom, by exempting gains accrued before 1982 and by indexing gains of companies for inflation; and in the United States, by taxing gains at a lower rate until January 1, 1993. All common law countries prevent the offsetting of capital losses against income. The probable reason for the different treatment of capital gains is that the distinction between income and capital was developed in England in trust law on the question of the entitlement of a life tenant of a landed estate. Income tax in the United Kingdom naturally adopted this existing distinction, and this has influenced income tax in Australia and Canada. The distinction in the United Kingdom was clearly established early in the development of its taxation laws: see *Attorney-General v. London County Council* (1900), 4 TC 265, at 293 (HL), and *Ryall v. Hoare* (1923), 8 TC 521, at 525 (KB). Those cases were decided without express reference to trust law, but trust law considerations were important in *Commissioners of Inland Revenue v. John Blott* (1921), 8 TC 101 (HL), where it was held that bonus shares were not income of the shareholder. In the United States, the trust law distinction between income and capital was much less important. In 1921, in *The Merchants' Loan & Trust Co. as Trustee of the Estate of Arthur Ryerson deceased v. Smietanka*, 1 USTC 1124 (1921), which concerned a life interest trust, the US Supreme Court decided that "income" for income tax purposes included capital gains. The court applied the meaning of "income" found in the earlier Corporation Excise Tax Act of 1909, 36 Stat. 11 (1909), which did not impose an income tax but which contained references to "income." Trust law distinctions between income and capital were ignored because they depended on the terms of the trust instrument; and British income tax decisions involved a statute so different that they were "quite without value" in the construction of the US income tax statute. The same interpretation was applied to the capital gains of a corporation in *Eldorado Coal and Mining Co. v. Mager*, 1 USTC 1127 (SC 1921). A consultation document in the United Kingdom has proposed that gains of companies be taxed as ordinary income: see United Kingdom, HM Treasury, Inland Revenue, *Reform of Corporation Tax* (London: Inland Revenue, August 2002) (available at http://www.hm-treasury.gov.uk/media//42191/ACF1F1C.pdf).

5 Historically, civil law countries did not always tax capital gains of a company as income. Belgium began to tax capital gains as income only in the 1930s and France in 1940 (and in France there was a separate regime for long-term capital gains on shares in subsidiaries until 1965). Sweden did not tax capital gains on long-term holdings of real estate (10 years) and shares (5 years) until the 1960s; until 1991, a separate tax regime covered capital gains on

As far as non-resident companies are concerned, civil law countries do not ask whether the taxpayer is similar to a domestic commercial company. Rather, they ask whether a business is carried on and, if it is, whether there is a permanent establishment (PE) (a fixed place of business). This approach is based on the type of income, although the answer may be influenced by the approach to resident commercial companies;[6] common law countries do the

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shares, real estate, condominiums, and other assets. From 1991, capital gains of companies are included in ordinary business income. Taxation of capital gains as income in civil law countries came as the result of moving from impersonal or schedular taxes (impôts réels), taxing sources of income, to personal or general income taxes, taxing persons (impôts personels). The early League of Nations reports on double taxation deal with these two types of taxes. See, in particular, the 1925 report, League of Nations, *Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations*, League of Nations document no. F.212 (Geneva: League of Nations, February 7, 1925) (reproduced in Joint Committee on Internal Revenue Taxation, *Legislative History of United States Tax Conventions*, vol. 4 (Washington, DC: US Government Printing Office, 1962), 4057-4105; the distinction between the taxes is discussed at 4075-80). Germany had an income tax rather than a schedular tax from the 1890s. The 1923 report by the "four wise men" related mostly to schedular taxes but had a section on "the income tax proper in its developed form, as found in Great Britain, the United States and the German empire": League of Nations, Economic and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations document no. E.F.S.73.F.19. (Geneva: League of Nations, 1923) (reproduced in *Legislative History of United States Tax Conventions*, supra, 4005-55, at 4049). Although the UK income tax is in form a schedular tax, it is an income tax within this approach because the schedules comprehensively cover all types of income irrespective of the recipient. Civil law countries that moved to an income tax achieved the result of taxing income comprehensively (except for exempting some foreign income on the basis that the income tax in the residence state should not apply to income taxed by the schedular tax in the source state) by concentrating on the person that received the income. However, it is now common for civil law countries, which include capital gains as ordinary income of companies, to have exemptions for sales of shares in both resident and non-resident subsidiaries: see Guglielmo Maisto, "Proposal for an EC Exemption of Capital Gains Realised by Parent Companies of Member States" (2002) vol. 42 *European Taxation* 28-39, at 33, for a table showing the current exemptions given by EU countries. Subsequently, the United Kingdom enacted relief in the Finance Act 2002 (UK), 2002, c. 23, section 44 and schedule 8. In Sweden, it is expected that legislation will be enacted in the spring of 2003 providing for non-taxation of gains on shares held for a business purpose (either non-listed shares or a 10 percent holding requirement if the shares are listed on a stock exchange). This participation exemption will apply to both Swedish and non-Swedish holdings. Another difference between the two systems is that there is less connection between profit in commercial accounts and profit for tax purposes in common law countries where, although the starting point is the commercial profit shown in the profit and loss account (not the balance sheet), the adjustments are so numerous that tax profit is a separate concept. *Reform of Corporation Tax,* supra note 4, proposes closer alignment of tax and accounting profit.

6 This is so even if a country treats all the income of a non-resident company as business profits, so that in the absence of a PE the treaty articles relevant to the type of income apply whether or not it is business income. In such cases, there has to be a business before there can be a PE. In some countries, such as France and, since 2001, the Netherlands, it is possible for a distinction to be made between carrying on business and earning business profits.

same. Civil law countries treat all the income earned through a PE as business profits; common law countries do not necessarily do this. The commentaries to the OECD model convention indicate that internal law is to be used to determine what constitutes business profits,[7] and therefore these internal law differences apply to the interpretation of the model convention. In this chapter, we will summarize the positions of the civil law and common law countries on the meaning of business profits, and then examine the extent to which this difference in approach leads to different interpretation of tax treaties.

Civil Law Countries

In civil law countries, all profits of commercial companies are business profits for tax purposes. The civil or commercial code of a civil law country generally provides that certain transactions are classified as commercial transactions[8] and that all transactions of commercial companies[9] (but not necessarily partnerships)[10]

7 Commentary on article 3 of the OECD model convention, at paragraphs 4 (enterprise) and 10.2 (business); the latter was added in 2000.

8 Belgium, Commercial Code, articles 2-3; France, Commercial Code, articles L.110-1 and L.110-2, where the transactions involve commercial dealings (activités de commerce); Germany, Commercial Code, article 1(2): from July 1, 1998, all business is commercial business unless the operations do not require business installations of a businesslike kind and scope (before July 1, 1998, there was a list of commercial transactions); Italy, Civil Code, article 2195: list of entrepreneurs (defined in article 2082) required to be registered in the Registry of Enterprises; Japan, Commercial Code, Law no. 48, March 9, 1899, as amended, articles 501, 502, and 503; Switzerland, Swiss Code of Obligations, article 834, and Ordinance of the Register of Commerce, articles 52, 53, and 54. The Dutch codes, infra note 12, are an exception because they do not distinguish between commercial transactions and other transactions, although certain transactions effected in the course of an enterprise may have different consequences from “private” transactions. Sweden is also an exception because it has no comprehensive civil code and no classification of transactions as commercial.

9 For the purposes of this chapter, we include the following types of company in the expression “commercial companies”: Belgium—SA/NV, SPARL/BVBA, and CVA/SCA; France—SA, SAS, SCA, and Sarl; Germany—AG and GmbH; Italy—SpA, *SAPA*, SRL, and *società di mutua assicurazione*; Japan—*kabushiki kaisha* and *yugen kaisha*; the Netherlands—NV and BV; Sweden—AB; Switzerland—AG/SA and GmbH/SARL.

10 For example, in Germany (unless all the general partners are corporations and only if corporations or persons who are not partners are authorized to manage the activities of the limited partnership) and the Netherlands, a partnership must actually carry on business in order to be a commercial partnership (oHG and VOF, respectively). In France, a commercial partnership is sometimes taxed on part of its income as a civil profit and part as a commercial profit. A problem of terminology arises in this distinction between companies and partnerships, because civil law countries use the same term—*société*, *società*, *Gesellschaft*, *bolag*, and *vennootschap*—to include both partnerships and companies. This is also partly true in common law countries, where the word “company” can denote a partnership (as in “Smith & Company”) or a corporation (as in the often-used expression “company law”), although in current usage in English “company” normally means “corporation.”

are commercial transactions[11] governed by commercial law, which deals with such matters as the keeping of accounts. The position was formerly the same in the Netherlands, but now commercial companies there are not necessarily treated as carrying on an enterprise.[12] Sweden is different; there is no classification of

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11 Belgium, Code on Companies, article 3; France, by case law (Com., February 14, 1956, JCP.1956.II.9375; November 19, 1956: Gaz. Pal. 1957.1.203; January 3, 1956, JCP 1956.II.9232, note Derrida, March 10, 1998: Bull. Civ. IV no. 101, *D. Affaires* 1998.722, Bull Joly 1998.665, note Daigre, *Rev. sociétés* 1998.307, note Barbièri); Germany, Commercial Code, article 6—provisions relating to business activities of individuals apply to commercial companies, with the result that all activities of a commercial company are regarded as business activities regardless of whether the company engages in a business or commercial activity; Italy, by case law (Supreme Court, November 4, 1994, no. 9084 concerning bankruptcy; Supreme Court, July 23, 1998, no. 7209; and Supreme Court, August 10, 1979 concerning keeping of accounts); Japan, by Commercial Code, article 52(2): "An association which has for its object the acquisition of profit and is formed in accordance with the provisions of this chapter shall be deemed to be a company even if it does not engage in commercial acts as a business." Companies include *kabushiki kaisha* (equivalent to a German AG) and *yugen kaisha* (equivalent to a German GmbH), which are merchants for the purposes of the Commercial Code (Commercial Code, article 4(2); Yugen Kaisha Law, article 2). Therefore, all acts effected by them for the purposes of their business are commercial acts, and any acts effected by them are presumed to be commercial acts. Switzerland has no such classification. Although Sweden has no formal classification of transactions as commercial (see supra note 8 and infra note 13), in practice the transactions of a commercial company are regarded as commercial in cases where the distinction is relevant because the company has a profit-making purpose (Companies Act, c. 12, section 1).

12 Although the Netherlands has a Commercial Code, this statute is mainly a relic because the parts dealing with commerce have been removed. It now deals with partnerships and with shipping and financial instruments. For a historical survey, see the advocate general's opinion in *Kamer van Koophandel en Fabrieken voor Nijmegen e.o. v. Annemiek Hirschmann Beleggingsmaatschappij BV et al.*, Hoge Raad, December 22, 1989, NJ 1990/433. In 1918, a Trade Register Act required all merchants (*kooplieden*) to register their businesses or enterprises (*zaken of ondernemingen*). Because there was some uncertainty whether NVs would always be covered by this provision, the Act declared that an NV would always be regarded as a merchant. In 1934, the Code of Commerce abandoned the concept of "merchant," but business within the meaning of the Trade Register Act (*zaak in de zin van de Handelsregisterwet*) continued to require registration. The deeming provision by which NVs carried on business was not included in the 1954 Trade Register Act but was regarded as implied (*Mariahoeve*, Hoge Raad, January 13, 1966, NJ 1966/189). In 1976, legislation provided that NVs and BVs could be properly incorporated and active without having a real enterprise within the meaning of the Trade Register Act. The 1989 Hoge Raad decision concluded that for the purposes of the Trade Register Act the 1976 change was not sufficient to support the view that NVs were not always deemed to carry on business. Thus, until 1976 the position was the same as it was for other civil law countries, but it is not entirely clear whether the Hoge Raad's 1989 decision applies only to article 1 of the Trade Register Act or whether the general principle still applies that commercial companies are always deemed to carry on a business. The confusion arises because in its judgment, the Hoge Raad referred explicitly to a statement in the legislative history of the 1976 change that NVs and BVs exist that do not have a business. The tax law position is, however, the same as in non-tax law in other civil law countries: see infra note 16, subject to the qualification mentioned in that note.

transactions as commercial.[13] In many civil law countries[14] some entities are governed by commercial law, and their income is automatically business profits for general law purposes. Other entities are governed by civil law, which means that their income is not necessarily business profits. Even in civil law countries that have a single civil code[15] (as opposed to separate civil and commercial codes), the same distinction between types of entities can be found.

A natural consequence of treating a company as commercial is the tax rule that such a resident company carries on an enterprise. This means that all the income of the company is classified for tax purposes as business profits.[16] In

13 In this respect, Sweden is the same as common law countries (see infra note 24); it has no comprehensive civil code but it does have certain acts that are applicable to commercial transactions.

14 Belgium (that is, the distinction between commercial companies and civil companies that carry on a non-commercial activity under the form of a commercial company to benefit from a legal personality distinct from that of its members, an advantage offered by the commercial company form); France; Germany (lawyers can now incorporate as an AG or GmbH; however, that means that for income and trade tax purposes they will generate business profits); and Japan. See supra note 12 for the position of the Dutch Commercial Code.

15 Italy, Switzerland, and Sweden (although there is no comprehensive civil code, non-business vehicles, such as unregistered partnerships, are possible).

16 Belgium, Income Tax Code, article 183. The Supreme Court (February 20, 1962, Pas., 1962, I, 706; March 17, 1964, Pas., 1964, I, 771; and June 7, 1966, Pas., 1966, I, 1281) has held that all assets owned by a company are deemed to be used for the exercise of the business activity and that all income and realized capital gains from those assets is taxable profit (unless specifically exempt in the tax law). The Belgian tax authorities recognize that so-called civil companies carrying on a non-commercial activity under a commercial form (see supra note 14) could, depending upon the circumstances, not be engaged in a profit-making activity (Official Commentary, ITC 179/18). This is particularly relevant to civil companies with a commercial form that engage in real estate activities. If they are successful in convincing courts that they do not engage in a profit-making activity, they are not taxed on rental income at the ordinary corporate tax rate but at a lower rate, and they are normally exempt from tax on capital gains. It seems that in practice courts are very reluctant to accept that such civil companies do not engage in a profit-making activity, even if the activity does not go beyond passive management. However, an opposite view has been expressed in two decisions (compare Court of Appeals Gent, January 29, 2002; T.F.R., 2002/66, 813 and Tax Court Brugge, March 5, 2002, Fiskale Koerier, 2002/369 to Supreme Court, cases quoted in Official Commentary ITC 179/17). These recent decisions have been criticized (D. Deschrijver, *Patrimoniumvennootschappen: geen rechtspersonenbelasting*, T.F.R., 2002, 818). France, Code Général des Impôts, articles 34 and 205: corporation tax is imposed on profits from all activities carried on in France calculated in accordance with the rules for industrial and commercial profits with minor differences. There are exceptional cases where income of a company can be non-commercial profits, such as the exemption in section 44 quarter that is conditional on the carrying on of a commercial activity: see Conseil d'État, October 15, 1997, *SA Ondif*, no. 146931, RJF 12/97, no. 1111. Germany, Corporate Income Tax (KStG), section 8(2): all income of a commercial company that has to maintain books in accordance with the Commercial Code is classified as business income. Italy, Income Tax Code, article 51, referring to Civil Code, article 2195 (see supra note 8) and effectively treating all income of a company as being within that article. In Japan, although this is not stated specifically in the

civil law countries, the nature of the recipient is more important than the nature of the income.[17] In instances where civil law countries need to make a distinction

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tax code, it follows from case law that undefined terms in tax law should be interpreted in accordance with the definition given to the term under general private law; and see the Commercial Code, article 52: "The term company as used in this Code shall mean an association formed for the purpose of engaging in commercial acts as a business," and the Corporation Tax Law, Law no. 28, March 31, 1947, article 22: "The income amount of a domestic corporation for each business year shall be the amount of gross income for the business year minus the amount of deductible expenses for the business year." The Netherlands, Corporation Income Tax Act 1969, article 2(5): Dutch-incorporated commercial companies and certain other resident entities (that may or may not be commercial entities) are deemed to carry on a business with all their assets, which has the same effect (note that such a deeming provision applies for tax purposes in spite of the different approach in civil law: see supra note 12). However, in several examples of "passive" companies, the context shows that the deeming provision cannot apply. For example, article 14 formerly permitted a rollover for assets-for-shares exchanges, provided that the companies concerned "carry on an enterprise," which was interpreted (BNB 1976/13 on the same condition in article 40) to mean "carry on a real enterprise"; article 20(5) limits the loss carryforward relief when a company has ceased to carry on an enterprise prior to a change of shareholders, which was interpreted (BNB 1982/229) to mean "carry on a real enterprise"; in article 28, the favoured treatment of investment funds is conditional on the company's not carrying on an enterprise; and article 13 denies the participation exemption for foreign shareholdings that do not carry on an enterprise. Sweden, Income Tax Act, c. 1, section 3: in spite of the different approach in civil law, the section applies even if the assets are not held for business purposes (for example, capital gains on non-business assets: Income Tax Act, c. 13, section 2). All the income is treated as one class of income: Income Tax Act, c. 14, section 10. Switzerland, Civil Code, article 60-89bis applies to all legal entities, including non-commercial entities governed by the Civil Code such as foundations and associations whether or not the entity has a business activity (LIFD, article 52). In an interesting example of the difference in the approaches of civil law countries and common law countries, in the Netherlands J.J. de Klerck, writing in the authoritative *Fiscale Encyclopedie de Vakstudie* (1962), states: "The article [article 2(5), described above] seems superfluous. We can hardly imagine that it would be possible to assume that any asset of an entity mentioned in the article would not be a business asset." For the very different position in common law, see the text accompanying note 31, particularly the UK case, *The Commissioners of Inland Revenue v. The Korean Syndicate, Ltd.*, cited infra note 36 in relation to a former tax: there is no difference between an individual and a company in determining whether a business is carried on.

17 A distinction based on the type of income is, however, found in value-added tax (VAT), which in the European Union is imposed on economic activities, defined in article 4(2) of the Sixth VAT Directive (European Communities, Sixth Council Directive 77/388/EEC of 17 May 1977 on the Harmonization of the Laws of the Member States Relating to Turnover Taxes—Common System of Value-Added Tax: Uniform Basis of Assessment, [1977] OJ L 145/1) to comprise "all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions." The provision continues: "The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis shall also be considered an economic activity." Dealing in investments is an economic activity; but merely investing is not, as in the case of a private individual or the charity in *Wellcome Trust*, [1996] ECR I-1013. A passive holding company does not carry on an economic activity: for example, *Polysar Investments Netherlands BV v. Inspecteur der Invoerrechten en Accijnzen*, C-60/90, [1991] ECR I-3111, nor does a limited partnership

between the active and passive income of a foreign subsidiary—for example, in controlled foreign corporation (CFC) legislation—different definitions need to be adopted to achieve this result.[18] For a non-resident company with a PE in the country concerned, all the income attributable to the PE will be business profits.[19] In other cases, there is no investigation of whether the taxpayer is equivalent to a domestic commercial company; taxation is based on the type of income.[20] Indeed, if the income of a commercial company were categorized as business

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holding shares and bonds: *Harnas & Helm CV v. Staatssecretaris van Financiën*, C-80/95, [1997] ECR I-745 (decisions available at http://europa.eu.int/common/recdoc/indexaz/en/c2.htm; click on "C-60/90" and "C-80/95," respectively). Because VAT is a tax on supplies, classifying all companies as carrying on economic activities would not be logical. The distinction between active and passive income may derive from the approach that dividends are outside the scope of VAT because they are not consideration for a supply, but the same approach is also applied to interest. A holding company that merely reinvests dividends as loans to its subsidiaries does not carry on an economic activity because it is in the same position as a private investor; on the other hand, if the holding company makes capital available to its subsidiaries, it may be exploiting the capital "for the purpose of obtaining income therefrom on a continuing basis" and therefore may be treated as carrying on an economic activity, provided that the activity is carried out with a commercial purpose characterized by a concern to maximize returns and is not confined to managing an investment portfolio in the same way as a private investor: *Floridienne SA and Berginvest SA v. Belgian State*, C-142/99, [2000] ECR I-9567 (available at http://europa.eu.int/common/recdoc/indexaz/en/c2.htm; click on "C-142/99"). The reason for the distinction may be that, economically speaking, transactions with subsidiaries are not really transactions with third parties, whereas in banking, interest is paid to and by third parties.

18 Swedish CFC law currently makes no distinction between active and passive income, but there is a proposal to make such a distinction.

19 All income attributable to a PE is automatically characterized as business profits in Belgium (there is no code article expressly stating this, but it is implicitly confirmed in article 228, section 2, 3˚ Income Tax Code and generally accepted: see Luc Hinnekens, *Criteria voor Onderworpenheid, Vennootschap & Belastingen*, III, 2, 1265 en 1270), France (non-resident companies with a PE in France are assimilated to French companies), Germany (HGB article 13(f)), Italy (Income Tax Code, article 113(1)), Sweden (Income Tax Act, c. 6, section 11), and Switzerland (LIFD, article 11). The rule applies more widely in Sweden because all income of a foreign legal person, as defined in the Income Tax Act, c. 6, section 8 without regard to whether the foreign classification is as a legal person, is business income, although the income is taxable only if there is a PE or it is income from real property in Sweden: Income Tax Act, c. 6, section 11 (there is also a withholding tax on dividends in the absence of a PE, but this does not apply if the shareholder is not resident in a low-tax jurisdiction or is resident in a country on the white list, which includes most treaty countries, or if the EC parent-subsidiary directive applies). For royalties and other periodic payments for the use of tangible or intangible assets paid by a business with a PE in Sweden, the non-resident recipient is deemed to have a PE in Sweden. This causes a charge to Swedish tax, but on a net basis; if there is no actual PE, a treaty may limit the tax on the deemed PE to the treaty rate of tax applied to the gross income.

20 The existence of a withholding tax on dividends paid to non-resident companies without a PE in France shows that such a company is not liable to corporation tax (see Doctrine administrative 4 J-1336, no. 3, November 1, 1995). For an example in Germany of a UK company without a PE in Germany earning non-taxable business income by providing knowhow to a

profits when there was no PE, the country might not be able to tax domestic-source investment income if business income was not taxable in the absence of a PE.[21] It follows that income from passive investment in domestic immovable property normally does not constitute business profits for a non-resident company.[22] Nonetheless, the law has been changed in Belgium, Germany, and the Netherlands to make such income business profits in order to enable those countries to tax capital gains on the immovable property.[23]

Germany company, see the BFH decision of March 4, 1970, BStBl. 1970 II 428. The statement in the text is not true for Japan. Foreign corporations are liable to tax in Japan on a defined list of domestic-source income, which is wider than the treaty "permanent establishment" definition by virtue of its including business assets or real property, personal service income, and leasing of ships or aircraft.

21 This result would not follow if the income were taxed under another act, such as a withholding tax act, and sometimes in the case of real property: see infra note 23.

22 Japan is an exception to the statement in the text: income from real estate in Japan owned passively by a foreign corporation is business income for the purposes of Japanese tax law (see supra note 20). In Italy, in the absence of a PE, income is determined by the rules for classes of income other than business profits (Income Tax Code, article 113(2)). In France, in the absence of a PE, income from immovable property can be business income if it is so treated by a tax treaty, which is the case under some older treaties: see infra notes 69 and 76. This leads to the odd consequence that France cannot tax because a building cannot be a PE. The rules for income from immovable property accordingly apply to passively held immovable property not used in a business activity. In the Netherlands before 2001, non-residents could be taxed on business profits derived from a PE (Income Tax Act 1964, article 49(1)(a), referred to in the Corporation Income Tax Act) and income from Dutch real property (article 49(1)(c)(2)), which left taxpayers in doubt whether income from real property that was business profits could be taxed in the absence of a PE. A decision of the Hoge Raad of October 25, 1972, BNB 1972/261, held that such income could be taxed under the latter provision even when the real property was held as a business asset. This taxing provision did not apply to capital gains: hence the change in the law described in note 23 infra. Switzerland is also an exception to the statement in the text because income and capital gains on real estate are taxable in the absence of a PE (LIFD, article 51(1)(c)).

23 Tax law in Belgium (article 228, section 2, 3˚ a) Income Tax Code) in 1989, Germany in 1994 (Income Tax Act (EStG), article 49(1) no. 2(f)), and the Netherlands in 2001 (CITA, article 17a) to enable gains on domestic real estate to be taxed if the income is not attributable to a PE. Belgium and Germany provide that income from immovable property (that is not business income in the civil or commercial code) can be taxed as business income, whether or not the real estate business is active or passive. Upon enactment of the Belgian law of 1989, the question was raised whether this would mean that any non-resident corporation that derived income from Belgian real property would henceforth be taxed on business profit, even if its investment was passive (J. Defoort, *De inkomstenbelasting van de Belgische vastgoedverrichtingen van niet-verblijfhouders*, N.F.M., 1991.2, 46; Luc Hinnekens, *Fiscale kwalificatievragen in verband met buitenlandse commerciële en burgerlijke vennootschappen en rechtspersonen met onroerend goed in België*, in Lib. Amicorum J.P. Lagae, Ced. Samsom, 1998, 384). Although Belgian courts almost invariably ruled that a non-resident corporation that makes investments in real property derives business profits (see, for example, Supreme Court, January 19, 1995, Pas., 1995, I, 55), a Luxembourg société civile immobilière (that is, without legal personality) that rented a storage facility was held not to carry on a commercial activity or to be engaged in a profit-making activity because of the civil nature of the

Common Law Countries

At common law, there is no distinction between "commercial" law and "civil" law.[24] Therefore, the common law offers no choice of types of entities to be used according to the nature of the transaction.[25] Although there is no concept of an "enterprise"[26] in either general law or income tax law, there is usually a concept

corporation that excluded the carrying on of commercial activities; the fact that the property was inherited by the partners of the société civile (and not purchased) and rented for 25 years to the same tenant; and the passive nature of its investment activity in general (absence of infrastructure, of skilled personnel, of knowhow and of advertising, etc.) (Court of Appeals Gent, January 8, 1998, T.F.R., 1999, 55, note J. Werbrouck). In the Netherlands, gains on domestic real property not held as a business asset previously were not taxable, whether in the hands of a resident or a non-resident, and gains on real property held as a business asset were taxed only if they were attributed to a PE. From 1967, the PE requirement was abolished for real property held as a business asset. The 2001 change deems income and gains on domestic real property owned by a non-resident taxpayer (other than an individual) to be business profits, thus enabling both income and gains to be taxed without a PE. It is interesting to note that in common law countries (other than the United Kingdom) capital gains on real property owned by a non-resident can be taxed.

24 Originally, the common law on business transactions was developed as a separate system of "law merchant." Now the only difference is that some statutory provisions may be applicable only to business transactions—for example, the Sale of Goods Act 1979 (UK), 1979, c. 54. The main distinction recognized in common law countries is between civil and criminal law; for the same reason, common lawyers also have difficulty understanding that in civil law countries tax law is not part of civil law, which they interpret as meaning anything that is not criminal law, and consequently they have difficulty understanding why ordinary tax liabilities are not included in "civil rights and obligations" in article 6(1) of the European Convention on Human Rights, signed at Rome on November 4, 1950, as amended by the protocols signed on March 20, 1952, May 6, 1963, September 16, 1963, and January 20, 1966: see *Ferrazzini v. Italy* (App no. 44759/98), [2001] Eur. Ct. HR 1314.

25 Common law countries usually have one type of company with some different rules applying to public and private companies; general partnerships and limited partnerships; and, except for Australia, limited liability partnerships. Other vehicles exist, such as cooperatives in Australia, companies limited by guarantee in Australia and in the United Kingdom, and companies without share capital in Canada.

26 As was said in an English case, " 'Enterprise' . . . [has] no exact counterpart in the taxing code of the United Kingdom": *Ostime (HM Inspector of Taxes) v. Australian Mutual Provident Society* (1959), 38 TC 492, at 517 (HL), per Lord Radcliffe. The same point was made in Australia in *Thiel v. FC of T*, 90 ATC 4717, at 4719, 4721, 4726, and 4728 (Full HC) (discussed under the heading entitled "Common Law Countries' Interpretation of 'Enterprise' in Tax Treaties." However, carrying on an enterprise is the central concept of GST (equivalent to VAT) in Australia. Australia also uses the expression "enterprise" in connection with interest withholding tax, where "enterprise" is defined in the Income Tax Assessment Act 1936, section 128A (herein referred to as "ITAA 1936 (Aust.)") as "a business or other industrial or commercial undertaking." The term's use there is probably explained by the close relationship between withholding tax and tax treaties. The term "enterprise" is used in the United States in the reorganization provisions (Internal Revenue Code of 1986, as amended, section 368) to mean a business entity rather than a passive investment company. In relation to Canada, see note 27 infra. The word "enterprise" may be used in tax law in common law countries, as in "enterprise zone."

of "business" in tax law, which may be similar to "enterprise,"[27] with a distinction made between business and property income.[28] The exception is the United Kingdom tax law, where the nearest category to business is "trade," which is narrower than "business."[29] More importantly, in common law there is no rule that all the income of a resident company must be classified as business income; rather, the type of income is determined and taxed accordingly. The United States is in principle an exception to this rule because, as in civil law countries,

27 In Canada, the French version of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended uses "entreprise" (as does the French version of the OECD model convention) where the English text of the Act uses "business," and so they are given the same meaning. In *Spire Freezers Ltd. et al. v. The Queen*, 2001 DTC 5158, at 5162, the Supreme Court of Canada held that the passive receipt of rent may constitute a business for the purpose of the common law definition of a partnership. For the purposes of the Act, however, the concept of a business is narrower in Canada: see *Wertman v. MNR*, 64 DTC 5158 (Ex. Ct.). For an example of the difference in interpretation between business and enterprise, see the Dutch case in which a US limited partnership owning land as a passive investment that would have been regarded by the United States as carrying on a business could not be equated with a Dutch CV (limited partnership) because it did not carry on an enterprise: Tax Court of Amsterdam, October 5, 1989, nr.643/86, V-N 1988, 1860. The expression "enterprise" is used in different senses in the OECD model convention.

28 In Australia, " 'business' includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee" (ITAA 1936 (Aust.), section 6(1)). Australia makes a distinction between income from property and income from personal exertion, although this distinction is no longer relevant to companies. Canada makes a distinction between income from property and income from business (for which the French version of the Income Tax Act uses "entreprise," which is the same word used in the French version of the OECD model convention). For a decision in which interest on a tax refund was classified as active business income that had the effect of increasing the deduction for manufacturing and processing profits, see *The Queen v. Irving Oil Limited*, 2002 DTC 6716; [2002] 1 CTC 191 (FCA): the court said that if the tax overpayment had not been made, the money would have been used in the business to earn business income. Similarly, interest on a tax refund paid to a non-resident insurance company was interest from property used in, or held in the course of, carrying on insurance business in Canada and was accordingly taxable as part of its profits because the right to the interest had been acquired in the course of carrying on the insurance business: *Munich Reinsurance Company (Canada Branch) v. The Queen*, 2002 DTC 6701; [2002] 1 CTC 199 (FCA). The United States makes a distinction between investment income and income from a trade or business.

29 The United Kingdom does not use "business" as a taxing category; under its schedular system there are many other categories of income. Exceptions where "business" is relevant include provisions for taxing partnerships (the definition of which requires the carrying on of a business: see infra note 37); carrying on business but not trade in the Income and Corporation Taxes Act 1988 (UK), 1988, c. 1, section 111(10) (herein referred to as "ICTA 1988 (UK)"); for relieving expenditure on the "trade or business" of exploiting films in the Finance (No. 2) Act 1992 (UK), 1992, c. 48, section 41; and a group company that has not carried on any trade or business is disregarded in allocating the small companies rate of corporation tax among members of a group (see *Jowett v. O'Neill and Brennan*, infra note 36): ICTA 1988 (UK), section 13(4). There are other references to "business" in income tax—for example, the definition of "investment company," infra note 31. The United Kingdom also makes a distinction between earned income and investment income, but this has no relevance to companies.

all the income of a US company is business income. Nevertheless, the United States makes a distinction between active and passive income for holding companies.[30] Thus, in general, in common law countries a company may carry on a trade or business, and, as far as investment income is concerned, it may carry on a business of holding investments, or it may receive investment income without carrying on any business.[31] In Canada, the fact that one is dealing with a company (rather than, say, an individual or trustees) creates a rebuttable presumption that the company's income is business income.[32] In Australia and the

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30 The reorganization provisions dealing with demergers also require a company to carry on an active business (Code section 355).

31 In Australia, although most collective investment is carried out through unit trusts, a category of "listed investment company" has been introduced recently in the Income Tax Assessment Act 1997, section 115-290. The provision is designed to give similar treatment to collective investment made through companies and unit trusts. To qualify as a listed investment company, the company must be resident and listed (or a 100 percent subsidiary of a listed company) and must have 90 percent of its assets in essentially passive investments. In Canada, a distinction is made between an "active business carried on by a corporation" and a "specified investment business," meaning "a business . . . the principal purpose of which is to derive income (including interest, dividends, rents, and royalties) from property but does not include a business carried on by the corporation in the year where (a) the corporation employs in the business throughout the year more than 5 full-time employees," and a "personal services business," meaning "a business of providing services where (a) an individual who performs services on behalf of the corporation . . . is a specified shareholder of the corporation (section 125(7) of the Income Tax Act). In the United Kingdom, a distinction is made between a trading company ("a company whose business consists wholly or mainly of the carrying on of a trade or trades"), an investment company ("any company whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom": ICTA 1988 (UK), section 130), and a company that merely holds investments, with significant differences between the first two categories (these are listed in *Reform of Corporation Tax*, supra note 4) and smaller differences between the last two. A close investment-holding company is not entitled to the small companies rate of corporation tax. In the United States, domestic personal holding company income is defined by a list of various items of passive income. There are also investment companies and real estate investment trusts that until recently could not have active business income.

32 *Canadian Marconi v. The Queen*, 86 DTC 6526 (SCC). The company that had sold one business and had actively invested the proceeds for three years while actively looking for another business to purchase was held to be carrying on business particularly in light of the active management of the investments (compare the UK case of *Jowett v. O'Neill and Brennan Construction*, infra note 36, in which there was no active management of the investments and the court reached the opposite result). See also Vern Krishna, *The Fundamentals of Canadian Income Tax*, 5th ed. (Scarborough, ON: Carswell, 1995), 277 and 772. The SCC relied on earlier (1925 and 1960) Supreme Court tax cases, Federal Court cases, a Revenue Canada interpretation bulletin, and three English cases; but one case was a partnership law case, another concerned excess profits duty (a World War I tax, where trade or business was relevant), and another was a Privy Council appeal from Malaysia. The test developed in Canada is whether the property (the income from which is in question) is employed or risked in the business—that is, committed to the carrying on of the business. The test is perhaps similar to the tests in articles 10(4), 11(4), and 12(3) of the OECD model convention in that the property that gives rise to the dividends, interest, or royalties must be

United Kingdom, there is no such presumption.[33] In the United Kingdom, the schedular system of taxing income concentrates on the type of income virtually to the exclusion of the recipient of the income.[34] As a result of the UK approach, the fact that the taxpayer is a company has little influence on the question whether a trade is being carried on,[35] and no influence on whether a business is carried on in those rare cases where business is relevant.[36] A partnership is

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effectively connected to the fixed place of business (that is, the PE) to be considered to be business profits.

33 Neither Australia nor Canada regards a company as automatically carrying on a business; and even if it is carrying on a business, it can have passive income that is seen as separate from that business and hence not income of the business. In Canada, see *The Queen v. Rockmore Investments Ltd.*, 76 DTC 6156 (FCA). In Australia, it was once thought that trustees were less likely to be carrying on a business (see *Charles v. Federal Commission of Taxation* (1954), 90 CLR 598 (HC)). But in more recent times, because of the prevalence of unit trusts (which are taxed under the general trust regime) as pooled investment vehicles, the Federal Court has rejected this view of trusts: see, for example, *FC of T v. Radnor Pty Ltd.*, 91 ATC 4689 (Full FC), per Hill J; *Fanmac Ltd. v. FC of T*, 91 ATC 4703 (FC), per Beaumont J; and *London Australia Investment Co. Ltd. v. Federal Commissioner of Taxation* (1977), 138 CLR 106 (HC). In Australia, as in Canada, it is easier to draw an inference that a company (rather than an individual) carries on business: *Brookton Co-operative Society Limited v. Federal Commissioner of Taxation* (1981), 147 CLR 441, at 469 (HC). In Canada, most mutual funds are structured as mutual fund trusts, although there are some mutual fund corporations. In most cases, the income and profits of these trusts and corporations are not considered to be business income or profits. In *Unisys Corporation v. Federal Commissioner of Taxation*, [2002] NSWSC 1115, the New South Wales Supreme Court drew attention to the existence of conflicting lines of cases on whether the income from investment-type activities constitutes business profits in internal law: one confined the taxability of investment profits to banks and insurance companies, and the other dealt with the source of profits from making contracts, highlighting the jurisdiction in which the contract is made as a significant element in determining whether a company is carrying on business in a particular jurisdiction.

34 In the United Kingdom before 1965, no distinction was made between types of taxpayers in taxing income (except for a supplementary profits tax on corporate income). Since 1965, companies pay a different tax—corporation tax—but income is still computed for corporation tax purposes in accordance with the schedular income tax, subject to a few variations for companies (ICTA 1988 (UK), section 9) and in accordance with the capital gains tax; the total profits are then charged to corporation tax. *Reform of Corporation Tax* (supra note 4) examines the case for the abolition of the schedular system for companies.

35 In the United Kingdom, see *Lewis Emanuel & Son, Ltd. v. White* (1965), 42 TC 369 (Ch. D.), in which a company carrying on an unrelated trade was treated as carrying on the trade of dealing in securities in circumstances in which it had carried out a large number of transactions (over 100 securities bought or sold in one year) even though it probably did not have the power to carry on such a trade and did not show the transactions as trading transactions in its accounts. The court accepted (at 378) that the position of an individual was different: "[O]ne expects a trading company's activities, apart from capital investment, to be by way of trade." There is also some authority relating to obsolete taxes to the effect that a company is likely to be carrying on a trade or business where that was the relevant criterion: see, for example, *The Commissioners of Inland Revenue v. The Korean Syndicate, Ltd.* (1921), 12 TC 181 (CA).

36 The observation of Pollock MR in *Inland Revenue Commissioners v. Westleigh Estates Co.*, [1924] 1 KB 390, at 409 (CA) ("if [a company's] objects are business objects and are in fact

different: as in common law countries, the definition of "partnership" requires the carrying on of a business.[37] This may influence the tax treatment by assuming that where there is a partnership there is a business that is carried on—although, strictly speaking, the determination of whether there is a business should precede the determination of whether there is a partnership.

The common law approach—namely, that a company may or may not be carrying on a business—applies equally to non-resident companies for the purposes of determining whether the existence of a PE in the common law country is relevant. In some cases,[38] the PE concept is not used in internal law, so a rule

carried out . . . the company carries on business") appears to be contrary, but it was pointed out in *American Leaf Blending v. Director-General*, [1978] STC 561, at 565, that "[t]his . . . was said in the context of a company which was carrying out one of the principal objects stated in its memorandum. Their Lordships would not endorse the view that every isolated act of a kind that is authorised by its memorandum if done by a company necessarily constitutes the carrying on of a business." *Jowett v. O'Neill and Brennan Construction*, [1998] STC 482 (Ch. D.) is an example of a company that discontinued its trade in May 1994 and placed funds on deposit at a bank until it started a new trade in January 1997. It was held not to carry on business during this period for the purpose of a provision that ignored the existence of the company that did not carry on a trade or business for splitting the small companies rate of corporation tax among the group (compare the similar Canadian case, *Canadian Marconi v. The Queen*, supra note 32, in which the court reached the opposite result). See the Special Commissioner's decision in *Land Management Ltd v. Fox*, [2002] STC 152 (SCD) for an example of a passive investment company being held to carry on an investment business. In relation to a former tax (excess profits duty), it was said that in determining whether a business was being carried on there was no difference between an individual and a company that performed the same activities, except that the objects of a company are a matter to be considered: *Korean Syndicate*, supra note 35, at 202, per Lord Sterndale MR.

37 "Partnership is the relationship which subsists between persons carrying on business in common with a view of profit" (Partnership Act, 1890 (UK), 53 & 54 Vict., c. 39, section 1), and equivalent provisions in New South Wales (Partnership Act 1892, 55 Vict., no. 12, as amended, part 2, section 1) and Ontario (Partnerships Act, RSO 1990, c. P.5, section 2). "The expression 'business' includes every trade, occupation, or profession" (Partnership Act, 1890 (UK), section 45), and equivalent provisions in New South Wales (section 1B), and Ontario, which adds "(enterprise)" at the end (section 1(1)). In the American state of Delaware, "partnership" is defined as "the association of two or more persons (i) to carry on as co-owners a business for profit . . . and (ii) to carry on any purpose or activity not for profit" (Delaware Code, title 6, subtitle II, Revised Uniform Partnership Act, c. 15, section 15-202(a)). This possibility of having not-for-profit partnerships does not exist in other common law countries. In the Supreme Court of Canada decision in *Spire Freezers Ltd. et al. v. The Queen*, supra note 27, at 5162, it was held that the passive receipt of rent may constitute a business for the purpose of the common law definition of a partnership. For the purposes of the Act, however, the concept of a business is narrower than the concept of partnership in Canada: *Wertman v. MNR*, supra note 27. In Australia, in *Unisys Corporation*, supra note 33, while the New South Wales limited partnership must have been carrying on business because otherwise it would not have been a partnership, it was held not to be carrying on business through a PE in the United States, where all its business was conducted.

38 "Permanent establishment" has been used in internal law in Australia since 1959: see ITAA 1936 (Aust.), section 6(1) for the definition, and Australian Taxation Office, *Taxation Ruling*

about the type of income attributable to a PE cannot exist. Like civil law countries, common law countries will ask first whether the income is business profits; if it is, they will go on to ask whether there is a PE. If the income is not business profits, the existence of a PE is irrelevant; if there is a PE, it does not mean that all the income attributable to it is business profits. As in the case of a resident company, in Canada there is at most a rebuttable presumption that the income of a non-resident company is business profits; in Australia there is no presumption at all. In the United States, the presumption that all the income of a domestic company is business income does not apply to foreign companies.[39] The United Kingdom differs the most from the civil law countries because a non-resident company must be trading in the United Kingdom before the income of a branch can be charged to corporation tax.[40] If the non-resident company is not trading in the United Kingdom, the only tax imposed is income tax on a source basis.[41]

TR 2002/5, March 13, 2002 (available at http://law.ato.gov.au/pdf/tr02-005.pdf) for a ruling on its interpretation, which uses the OECD model convention commentary as an aid to interpretation. It is used in Canada, but mainly for the purpose of allocating income between the provinces. Other limited purposes include those related to leasing transactions with a non-resident lessor, the application of the thin capitalization rules to loans from non-resident insurance corporations, and the reserve available until 2003 for individual taxpayers carrying on business prior to 1995 on a non-calendar year fiscal period. It is not used in internal law in the United States. In the United Kingdom, draft legislation revised on March 14, 2003 (Taxation of UK Branches of Foreign Companies, available at http://www.inlandrevenue.gov.uk/drafts/tax_foreign_co-leg.htm), proposes to substitute “permanent establishment” for “branch or agency” in internal law.

39 In the United States, a distinction is made between income effectively connected with a trade or business carried on in the United States and other income. Code section 864(c) determines whether income is so connected, which results in almost all US income being effectively connected. For periodic income, the factors to be taken into account include whether the income is derived from assets used in or held for use in the conduct of the trade or business, and whether the activities of the trade or business were a material factor in the realization of the income. Regard is had to whether the asset or income was accounted for through the trade or business. All non-periodic income is treated as effectively connected with the conduct of the trade or business, so that the force-of-attraction principle applies.

40 Once the company is carrying on a trade in the United Kingdom, the branch is taxable not only on the trading profit but also on any income from property or rights used by or held by or for the branch or agency (ICTA 1988 (UK), section 11), and on capital gains on UK assets so used or held for the purposes of the branch or agency (Taxation of Chargeable Gains Act 1992 (UK), 1992, c. 12, section 10). The proposed legislation, which uses the expression “permanent establishment” in internal law (see supra note 38) defined in a similar way to the OECD model convention and depending on a business being carried on, will not change the position that the corporation tax charged on a non-resident company applies only where it carries on a trade.

41 Article 11(6) of the OECD model convention can apply to determine the source of interest paid by a non-resident but connected with a PE that was not carrying on a trade.

Common Law Countries' Interpretation of "Enterprise" in Tax Treaties

Against the background of the different meanings of business profits in common law and civil law countries, coupled with the fact that the expression "enterprise" is not used by common law countries in internal law,[42] common law countries have had to face the difficulty of interpreting "enterprise" in tax treaties when deciding whether they can impose tax on income attributable to a PE.[43] The Australian case of *Thiel* is a good example.[44] The case concerned a Swiss-resident individual who bought and sold shares[45] within 12 months, resulting in Australian taxation on gains made within that period. The individual argued that he was not taxable in Australia by reason of the Switzerland-Australia treaty.[46] Specifically, he argued that the income was a profit within the meaning of article 7 and (which was agreed) that there was no PE in Australia. Three main questions were raised by the case:

1) whether his activity amounted to an adventure in the nature of trade, which was the internal tax law category, and, if it did,
2) whether the taxpayer carried on an enterprise, which was the treaty expression; and
3) whether the treaty protection of article 7 extended to such one-time situations or was confined to continuing businesses.

42 See supra note 26. The absence of the concept of "enterprise" in internal law makes it impossible to apply the statement in paragraph 4 of the commentary on article 3 of the OECD model convention: "The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States." Paragraph 10.2 of the commentary on article 3 (added in 2000), however, states that "business" generally has the meaning it has under the domestic law of the state applying the treaty. The OECD model convention now equates "enterprise" with "business," which is a term used in tax law in common law countries (other than the United Kingdom) (see supra notes 28 and 29), because article 3(1)(c) of the OECD model convention provides that "the term 'enterprise' applies to the carrying on of any business." This should remove the problem of countries' not using the term "enterprise" in their internal law.

43 This will be less of a problem for countries that use "business" as a criterion for taxing after new treaties follow the OECD model convention's 2000 change that equates "enterprise" with "business."

44 *Thiel*, supra note 26. See also *Unisys Corporation*, supra note 33, in which a company that made a 0.5 percent margin on licensing intellectual property was held to be carrying on business for the purpose of an Australian internal law provision based on the definition of "permanent establishment" in the OECD model convention.

45 Strictly speaking, he bought units in a unit trust that was acquired by a company in exchange for shares during the time he held them.

46 Agreement Between Switzerland and Australia for the Avoidance of Double Taxation with Respect to Taxes on Income, signed at Canberra on February 28, 1980.

On the facts, the court held that there was an adventure in the nature of trade. It was accepted that the court could rely on the OECD commentary in resolving the second and third issues. Reference was made to the commentary on article 3, which states: "The question whether an activity is performed within [the framework of][47] an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States." On the basis of this cryptic sentence, the court held that a one-time transaction could give rise to an enterprise that was carried on and could also fall within article 7, even though the concept was then unknown in domestic tax law.[48] This view seems odd given the terms of the quotation relied upon, unless the "adventure in the nature of trade" doctrine is seen as pointing to that conclusion (and thus implicitly lining up the treaty concept and the quite different concept of domestic law). It should be pointed out that the treaty in question had a standard article 7 but only a limited capital gains article (with no equivalent article 13(4) of the OECD model convention) and that there was no "Other Income" article. Therefore, unless article 7 applied to protect the taxpayer, he would be exposed to taxation outside the treaty by domestic law, which is the normal position in Australian treaties. It was further argued that even if there were an enterprise, article 7 could not apply because it required a continuous business. The court disagreed with this argument on the basis that the first part of the first sentence of article 7 can encompass a one-time business

47 The words in brackets were omitted in 1995 but were there at the time *Thiel* was decided. The notes to the commentary on article 3 of the OECD model convention in the looseleaf version (Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (Paris: OECD) (herein referred to as "the looseleaf OECD model convention") state that in 1995 a number of stylistic changes were made to the commentary that are not specifically noted. This is one of them; there is no record of why it was done.

48 A somewhat similar issue arose in the Australian case of *Commissioner of Taxation v. Lamesa Holdings BV* (1997), 77 FCR 597. Because there was no PE, the question was simply whether the alienation-of-property article (article 13) of the Australia-Netherlands treaty applied, particularly the lookthrough provision for landholding companies that would take the case out of article 7 by reason of paragraph 7, or whether article 7 applied (Agreement Between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on March 17, 1976). The court held that the lookthrough provision did not apply, and therefore the profits were within article 7. Note that it was agreed that the case involved an adventure in the nature of trade, as in *Thiel*. See also *ES & A Bank v. FC of T*, 69 ATC 4069 (HC), in which the court considered the reason for the specific exclusion of dividends, interest, rents, royalties, management charges, or remuneration for personal services from the definition of "industrial or commercial enterprise or undertaking" in the former 1946 United Kingdom-Australia treaty (Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at London on October 29, 1946, article II(1)(i)), to be that there was nothing industrial or commercial about such income. It is suggested that, rather, the purpose of the provision is the same as that of article 7(7) of the OECD model convention.

transaction but the second part required a continuing business.[49] On the face of article 7, this seems an odd result; but it can be justified by reference to the definition of "permanent establishment," which itself requires some continuity of business in a country. The court in effect dealt with the mismatch of domestic law and the treaty by assimilating the domestic law and treaty concepts even though they were quite different in nature.

A similar example arose in Canada in *MNR v. Tara Exploration & Development Co. Ltd.*,[50] in which an Irish-resident company bought shares in three Canadian companies and sold the shares in one of them at a profit within two years. This was held to be an adventure in the nature of trade and therefore was within the definition of a business in the Canadian Income Tax Act. The Supreme Court held this to be within the business profits article of the Canada-Ireland treaty,[51] in which "Irish enterprise" was defined as "an industrial or commercial enterprise or undertaking carried on by a resident of Ireland." The United States adopts the same approach. The technical explanation to the US model convention (1996) states: "Despite the absence of a clear, generally accepted meaning for the term 'enterprise,' the term is understood to refer to any activity or set of activities that constitute a trade or business,"[52] which is the domestic law concept. The United Kingdom does the same, but because the internal tax law category of "trade" is narrower than the category of "business," there is little doubt that anything that is a trade will be a business or enterprise.

Approaches to the Application of Tax Treaties

As mentioned, the commentary to the OECD model convention refers to internal law to decide whether something is an enterprise or a business. It follows that whether income is categorized as business profits is also determined by internal law, even though the concept of "permanent establishment" is defined by the treaty and even though one might expect that the categorization of income relevant to that concept would not be left open to differing interpretations by each of the two states. But in view of the clear statements in the commentary, it does not seem possible to look for a common meaning of "business profits."[53]

49 It should be noted that the first part of article 7(1) refers to "an enterprise of a Contracting State," which is defined by article 3(1)(d) to mean an enterprise carried on by a resident of that state. Therefore, the first part of article 7(1) also requires a continuing business.

50 (1972), 28 DLR (3d) 135 (SCC).

51 An Agreement Between the Government of Canada and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Ottawa on November 23, 1966, article II(1)(g).

52 United States, Treasury Department, United States Model Income Tax Convention of September 20, 1996, Technical Explanation, "Article 3—General Definitions."

53 One might argue that the context requires that a common meaning rather than the meaning under domestic law by virtue of article 3(2) of the OECD model convention be used, but the commentary clearly shows that the use of internal law is intended.

We next consider areas in which different treaty interpretations can arise because of the different approaches to defining business profits.

When a Permanent Establishment Is Considered To Exist by the Residence State Only

A conflict can arise if the residence state considers that there is a PE in the other state but the other state does not. Suppose that a resident of the other state has a presence in the country concerned, such as an office, that would be a PE if that concept were relevant. Both common law and civil law countries start by asking whether a business is carried on. If the answer is yes, then in a civil law country there may be a PE. If so, all the income attributed to it is business profits, which means that one can concentrate on the question whether there is a PE. In a common law country, not all the income of a PE is business profits, and it is therefore necessary to separate the question whether there are business profits from the question whether there is a PE.[54] We shall examine the result, starting with a civil law state in which the PE is located.

In such a state, if one starts with article 7 of the OECD model convention on the basis that all the income of the PE is business profits, one discovers that income is not necessarily covered by article 7. Article 7(7) provides as follows:

> Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

When one goes to article 10, 11, 12, or 21, in certain circumstances one is returned to article 7:

> The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends [or interest, or royalties], being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident [or the interest arises, or the royalties arise] through a permanent establishment situated therein and the holding in respect of which the dividends are paid [or the debt-claim in respect of which the interest is paid, or the right or property

54 In civil law countries other than the Netherlands (see supra note 12), the approach that all income of a resident company and of a PE is business profits has the advantage that it prevents any discrimination against PEs. If income attributable to a PE were not taxed as business income, as is the case for a resident company carrying on the same activities, there could be discrimination, which is prohibited by article 24(3) of the OECD model convention if the taxation on the PE is less favourably levied—for example, by being charged at a higher rate or being based on the gross income. Similarly, in common law countries, if the question whether the income of both a resident company and a PE is business profits is determined in the same way, there should be no discrimination, although the United States treats a PE of a non-US company differently from a PE of a US company.

> in respect of which the royalties are paid] is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.[55]

The commentary as amended in the 2003 version now warns against abuse in exemption states by emphasizing that a business must be carried on for a PE to exist. This does not explain the meaning of "business," which is crucial:

> It has been suggested that the paragraph could give rise to abuses through the transfer of shares [or loans, or rights or property] to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend [or interest, or royalty] income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognized that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a shareholding [or debt-claim, or right or property] be "effectively connected" to such a location requires that the shareholding be genuinely connected to that business.[56]

Having been sent to article 10, 11, 12, or 21, one is then returned to article 7 if the property that gave rise to the income is effectively connected with a PE, with the result that the PE state has the right to tax the income attributable to the PE, including such dividends, interest, royalties, and other income. The scope of business profits for treaty purposes therefore comprises (1) anything regarded as business profits by internal law that is attributable to the PE, excluding income covered by other treaty articles (except article 21(2), "Other Income"); (2) dividends,

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55 Articles 10(4), 11(4), and 12(3) of the OECD model convention combined. Article 21(2) is of similar effect.

56 The following paragraphs of the commentary on the OECD model convention combined: paragraph 32 of the commentary on article 10; paragraph 25 of the commentary on article 11; and paragraph 21 of the commentary on article 12. This statement may also have in mind non-treaty cases in which domestic law incorporated the same definition of "permanent establishment." "Triangular Cases," in Organisation for Economic Co-operation and Development, *Model Tax Convention: Four Related Studies*, Issues in International Taxation no. 4 (Paris: OECD, 1992), 27-41, reproduced in vol. 2 of the looseleaf OECD model convention, is related to this. Assets may be transferred to a PE in a country with little or no tax on the PE; the source state (a third state) applies the treaty with the residence state and reduces its taxation; and the residence state exempts the income because it is from property effectively connected to a PE, so that only a withholding tax is charged by the source state. Some US treaties deal specifically with this problem—for example, the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, signed at Paris on August 31, 1994, article 30(5), denying treaty benefits in the United States (as source state) if the tax paid in the PE state is less than 60 percent of the tax that would have been imposed in France in the absence of a PE in a state other than France and the United States.

interest, and royalties paid on property effectively connected with the PE; and (3) income that falls within the "Other Income" article (mainly third-country-source income) from rights or property effectively connected with the PE.[57] If the residence state is an exemption country[58] in respect of business income, it will exempt that income from tax, with the result that it is taxed only in the PE state.

Common law source states, on the other hand, will identify the type of income without much regard to the fact that it is received by a company. This results in the following possibilities with respect to dividends, interest, and royalties that arise in the common law state and are paid to a non-resident company with a PE in the same common law state:

1) Where the non-resident carries on a financial trade or business (for example, a bank), the same analysis used in civil law jurisdictions will apply: the dividends, interest, and royalties are part of the business profits, and the shares, debt obligations, or other property or rights are usually effectively connected with the PE.
2) If the common law country considers that no trade or business is being carried on but that merely passive income is being received, there cannot be a PE and article 7 does not apply,[59] with the result that the dividends, interest, or royalties articles are the only relevant treaty articles. The effect is that the state in which the income arises will impose a withholding tax only on certain types of income, and no tax on capital gains;[60] if the income arises in a third state, the state that would otherwise be the PE state will not tax.
3) In some instances, a company carries on a non-financial trade or business, such as manufacturing, through a PE, and the dividends, interest, or royalties are received from property effectively connected with the PE (which presumably means connected with the business carried on at the PE),[61] even though the dividends, interest, or royalties are not regarded as business

57 Paragraph 35 of the commentary on article 7 of the OECD model convention. Head office income seems to be within article 21 rather than within article 7; otherwise, it would not have been necessary to exclude PE income by article 21(2). See infra note 62 for another possible explanation of article 21(2). It would be helpful if the commentary could clarify the relationship between articles 7 and 21(2).

58 Not Italy and Sweden.

59 In the United Kingdom, there has to be a trade before there can be taxation of a branch or agency (the internal law equivalent to PE; it is now proposed to change this to refer in internal law to "permanent establishment," a concept relating to business while still retaining the rule that there must be a trade. See the draft legislation referred to in note 38, supra).

60 Article 13(4) of the OECD model convention applies to capital gains that are gains on business assets in the absence of a PE.

61 It would be helpful if the commentary stated that this interpretation was intended, because article 7 includes income that a state does not regard as business profits.

> profits in internal law. This is always the case in the United Kingdom's schedular system, and it may be the case in Australia and Canada. In such a case, the effect of the statement in the treaty that "the provisions of article 7 shall apply" is to send one to article 7 with the result that, although the internal law tax charge is on dividends, interest, or royalties and not business profits, article 7 does not prevent the permanent establishment state from taxing.[62]

There is a possible fourth case, in which a business is carried on through a PE and the property that gave rise to the investment income is managed from that place but has no connection with the business. For example, the person managing the property is located at the PE but has no responsibilities relating to the business carried on there and the property is not used or intended to be used in the business carried on at the PE. The property is effectively connected with the fixed place but not with the business carried on there, and therefore the income does not come within the scope of article 7. In this case, the income from the property is not business income, so the result is the same as it is in the second case.

In the second case, this difference in approach on the part of the common law states can result in the common law source country taking the position that because the PE is irrelevant, there is therefore no right to tax the non-resident on the dividends, interest, and royalties arising in the state concerned as business profits; there is only a right to charge a withholding tax (and the interest and royalties will be deductible by the payer), and no right to tax capital gains on the assets that produce such income. The civil law residence state, by contrast, takes the position that all the income of the company that is attributable to the PE is business income. Accordingly, if it is an exemption country in respect of business income, it exempts the income from tax.

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62 Paragraph 35 of the commentary on article 7 of the OECD model convention confirms that the income may, "subject to the provisions of the Convention," be taxed either in accordance with the other articles or as business profits in conformity with the state's tax law. The quoted words mean that where article 7 applies, taxation must be on a net basis. The purpose of article 21(2) may relate to third-state income, such as dividends, interest, and royalties, where the right or property that gives rise to the income is effectively connected with a PE, but the income is not regarded as business profits by the PE state. The result is then the same for third-state income that is not regarded as business profits as it is under articles 10(4), 11(4), and 12(3) for domestic income in the same circumstances. For both domestic and foreign income, the result is the same as it would have been if the income were business profits and one had been sent by article 7(7) to article 10(4), 11(4), 12(3), or 21(2) and returned to article 7. Australia is in this position with respect to dividends. Prior to the introduction of imputation in 1987, Australia did not apply dividend-withholding tax under domestic law if the dividends were connected to a PE (as defined in domestic law). When imputation was introduced, this limitation on dividend withholding tax was removed, but the tax applied only to unfranked dividends. It is generally considered that this was incorrect, though it affects only non-residents who have unfranked dividends and deductions.

The commentary[63] introduced provisions in the 2000 update to deal with this problem by giving priority to the source state's categorization of the income. It is suggested that the question is solely one of "qualification" of the income, even though the existence or non-existence of a PE (or the connection of the income to the PE) is also involved, which might be a matter of treaty interpretation.[64] The question whether there is a PE does not result from any disagreement about whether the definition of "permanent establishment" is met on the facts; rather, it follows from whether the income is treated as business profits in internal law. In addition to the commentary, new article 23A(4) states:

> The provisions of paragraph 1 [exemption] shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

This provision specifically prevents exemption in the second situation and requires credit to be given even if the residence state does not accept the source state's categorization.

Even if the residence state accepts the right of the source state to categorize the income as something other than business profits, if the residence state is a civil law exemption state exemption can still result, provided that exemption is accorded by internal law rather than by treaty, which it is in France and Switzerland.[65]

No Permanent Establishment

As we have seen, articles 10, 11, 12, and 21 return one to article 7 if the income-generating property or rights are effectively connected with a PE. If there is no PE, those articles apply to dividends, interest, royalties, and other income that is business income. This results, in the case of dividends and interest (and royalties under some treaties), in a withholding tax on the gross income that may be too

63 Paragraphs 32.1-32.7 of the commentary on article 23 of the OECD model convention.

64 Paragraph 32.5 of the commentary on article 23 of the OECD model convention. A dispute about whether there is a PE can arise in a related context if, for example, a Netherlands corporation is a silent partner in a Japanese corporation's business in Japan. Japan does not recognize the existence of a PE of the Netherlands corporation; the Netherlands regards its corporation as having a PE in Japan and exempts the income.

65 The Netherlands does not apply an internal law exemption if there is a treaty. In the Convention Between the Kingdom of the Netherlands and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, signed at The Hague on November 12, 1951, as amended by the protocol signed on June 22, 1966 (the only treaty providing for credit), exemption is granted by extrastatutory concession except for "passive" (financing) PEs, for which a 50 percent exemption applies.

high to be fully credited against the residence country's tax on net profits. This might occur where a bank received interest on the only loan made to a resident of a particular state. The result may be considered undesirable and may lead to the creation of PEs to avoid it. Although this would not be a case of differing treaty interpretation, differing internal law on the categorization of business profits may give a different treaty result. Internal law in the source state may regard the income as business profits,[66] which it cannot tax by internal law in the absence of a PE, so that article 7(7) has no effect because there is no withholding tax charge in internal law.

Similar Problems Under Older Treaties

Different concepts of business profits can also arise under old treaties that do not contain article 7(7). For example, in a 2002 Luxembourg case[67] that involved the France-Luxembourg treaty,[68] a Luxembourg commercial company received rent from real property in France. In an earlier decision of the Conseil d'État in France[69] under the former France-Italy treaty[70] concerning an Italian

66 France treats interest on arrears of a commercial debt as profits of an enterprise and not interest. In a case relating to interest on unpaid debts paid by a French SA to its Swiss parent, the Conseil d'État held that under the Convention Between the French Republic and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, signed at Paris on September 9, 1966, as amended by the protocols signed on December 3, 1969 and July 22, 1997, the income was not taxable in France in the absence of a PE of the Swiss company in France: Conseil d'État, *Golay Buchel*, July 27, 2001, no. 215124, Rec. Lebon.

67 Tribunal administratif, December 3, 2001, case no. 12,831; upheld on appeal by Cour Administrative no. 14442C, April 23, 2002 (herein referred to as "the 2002 Luxembourg case"). See the note by Begga Sigurdardóttir, "Taxation of Income from French Real Estate in Luxembourg" (2002) vol. 42, no. 4 *European Taxation* 165-67.

68 Convention Between France and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance with Respect to Taxes on Income and on Capital, signed at Paris on April 1, 1958, as amended by the protocol signed on September 8, 1970 (herein referred to as "the France-Luxembourg treaty").

69 Conseil d'État, *SpA Rafaella*, May 22, 1992, no. 63,266, RJF 7/92, no. 960. See the note by Henry Lazarski, "New Developments in the Taxation of Property Held by Foreign Companies: The *Rafaella* Case" (1993) vol. 33, no. 8 *European Taxation* 276-79.

70 Convention Between France and Italy for the Avoidance of Double Taxation and To Settle Certain Other Questions with Respect to Direct Taxes on Income and Fortune, signed at Paris on October 29, 1958, as amended by the additional agreement signed on December 6, 1965 (herein referred to as "the France-Italy treaty" (1958)); since replaced by a 1989 treaty: Convention Between the Government of the French Republic and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital and for the Prevention of Fiscal Evasion and Fraud (with a Protocol and Exchange of Letters), signed at Venice on October 5, 1989. Lazarski, supra note 69, lists 11 French treaties then in force, including the treaty with Luxembourg, under which the results would be the same. All of these except those with Gabon and Italy are still in force. The French Conseil d'État subsequently came to the same decision on the France-Luxembourg treaty: see infra note 76.

commercial company that owned real property in France and allowed the use of it free of charge, the court decided that the deemed income caused by the act of improper management in not charging rent was commercial or industrial profits—the internal law categorization[71]—and not income from immovable property.[72] Therefore, the income was not taxable in France in the absence of a PE (the mere ownership of immovable property was not a PE).[73] The treaty provided that income derived from all the operations of an enterprise was taxable only in the state in which a PE was situated,[74] thus concentrating on the enterprise and not on the type of income. That decision is in accordance with the commentary to the League of Nations London draft, which has similarities to the treaty concerned and on which it was presumably based.[75] The same decision was

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71 The *Schneider* case (Conseil d'État, June 28, 2002, *Ministre de l'économie, des finances et de l'industrie c/ société Schneider Electric*, no. 232276) on CFCs is another example of the internal law categorization being used for treaties.

72 "Income from immovable property, including profits from agricultural and forestry enterprises and gains derived from the alienation of such property, shall be taxable only in the State in which the property is situated" (article 4(1) of the France-Italy treaty (1958)). If it had been a case of charging rent rather than allowing the use of the property at no cost, Italy would take the same view as France that it was business profits that were taxable only in Italy in the absence of a PE in France.

73 But see the opposite conclusion reached by the Dutch Hoge Raad (supra note 22): the fact that income was categorized as business profits in internal law did not prevent it from being taxed as income from real property if there was no PE.

74 "Where an enterprise operated in one of the Contracting States has a permanent establishment within the meaning of Article 3 of this Convention in the other State, income derived from all the operations effected by that establishment and gains arising from the total or partial alienation of assets invested in the said establishment shall be taxable only in the latter State": article 5(1) of the France-Italy treaty (1958). The reference to *all* the operations made the case stronger for applying the business profits article than it was under the League of Nations London draft model convention, for the relevance of which see infra note 75: League of Nations, London Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property, annex A to League of Nations, Fiscal Committee, *Report to the Council on the Work of the Tenth Session of the Committee*, League of Nations document no. C.37.M.37.1946.II.A. (Geneva: League of Nations, April 25, 1946); text of commentary and convention reproduced in *Legislative History of United States Tax Conventions*, supra note 5, at 4328-53 (commentary) and 4379-4405 (convention) (herein referred to as "the London draft model convention"). The London draft model convention stated, in article IV(1): "Income derived from any industrial, commercial or agricultural enterprise and from any other gainful occupation shall be taxable in the State where the taxpayer has a permanent establishment," which is recognizably similar.

75 The real property article (article II) in the London draft model convention provided that "[i]ncome from real property shall be taxable in the State in which the property is situated," which is similar to the article in the France-Italy treaty (1958): see supra note 72. The commentary to that article of the London model draft convention stated that "[i]ncome derived from the exploitation of lands, buildings, and sub-soil as part of a business, including mining, forestry and agriculture, does not come within the purview of Article II [income from real property], but of Article IV, concerning business income" (*Legislative History of United States Tax Conventions*, supra note 5, at 4332). The reason must be that income of an

subsequently reached by the Conseil d'État in a 1994 case (cited in the 2002 Luxembourg case) in relation to the France-Luxembourg treaty.[76]

In the 2002 Luxembourg case, Luxembourg had previously exempted the income from the immovable property in France from tax[77] on the basis that it was income from immovable property that was taxable only in France under the France-Luxembourg treaty. Following the 1992 French case on the France-Italy treaty,[78] the Luxembourg tax authority argued that the income should be treated as business profits that were taxable in Luxembourg in the absence of a PE in France. The Luxembourg court declined to follow the French case and, by interpreting the treaty provision according to the context, decided that the income was income from immovable property,[79] since the treaty made no distinction according to the type of owner of the immovable property. This resulted in double exemption.[80] It is suggested that on the wording of the treaty and in the light of the commentary to the League of Nations London draft, the court might equally well have come to the opposite conclusion on the meaning of the business profits article, which provided that "[i]ncome from industrial, mining, commercial or financial enterprises shall be taxable only in the State in which a permanent establishment is situated."[81] This focuses on the enterprise and not on the type of income and might therefore

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enterprise was comprehensively dealt with in the business profits article, leaving no scope for the income from the real property article to apply to an enterprise receiving such income. The France-Italy treaty (1958) was under negotiation at the time of the publication of Organisation for European Economic Co-operation, *The Elimination of Double Taxation: Report of the Fiscal Committee of the O.E.E.C.* (Paris: OEEC, 1958) (herein referred to as "the OEEC first report") and was not influenced by that report (the OEEC immovable property article was contained in the Organisation for European Economic Co-operation, *The Elimination of Double Taxation: 2nd Report by the Fiscal Committee of the OEEC* (Paris: OEEC, 1959) (herein referred to as "the OEEC second report"). The business profits article was contained in the Organisation for European Economic Co-operation, *The Elimination of Double Taxation: Third Report of the Fiscal Committee* (Paris: OECD, 1960) (herein referred to as "the OEEC third report), neither of which was available at the time of this treaty), so that the League of Nations London draft model convention was the (then) latest model for such articles.

76 Conseil d'État, March 18, 1994, *Société d'Investissement Agricole et Forestier*, no. 79971, 8th and 9th subsections, RJF 5/94, no. 530.

77 And the property from net worth tax.

78 See *SpA Rafaella*, supra note 69. The French Conseil d'État had also reached the same decision in relation to the France-Luxembourg treaty in issue in this case: see supra note 76.

79 Article 3 of the France-Luxembourg treaty states: "Income from immovable property and property accessory thereto, including profits from agricultural and forestry undertakings, may be taxed only in the State in which the property is situated. This provision shall also apply to profits derived from the alienation of such property."

80 Had the facts been reversed and a French commercial company owned immovable property in Luxembourg, both states would have taxed the income. The only possibility of relief from this double taxation would be through the mutual agreement procedure.

81 Article 4(1) of the France-Luxembourg treaty.

impliedly have priority over the immovable property article.[82] The double exemption was caused by France's concentrating on the business property article and the Luxembourg court's concentrating on the immovable property article. Both of the treaties were concluded in 1958; they did not contain a definition of immovable property referring to internal law; more importantly, they contained neither what is now article 6(4) of the OECD model convention (which provided that paragraphs 1 and 3 of the immovable property article also applied to income from immovable property of an enterprise), nor article 7(7) (which gives priority to other articles over the business profits article).[83] The same conflict could have arisen in old treaties if a common law country had been substituted for France. Such a result would not be reached in a modern treaty that contained the provisions referred to above, because it would be clear that the income was from immovable property and not from business profits. However, the cases illustrate the effect of the differing interpretations of what constitutes business profits for the purposes of a treaty that can still arise when states take different views of whether a person carries on business in the other state through a PE.

Conclusion: Resolving the Differing Categorizations of Business Profits

The OECD model convention permits the odd combination of a type-of-person approach in the residence state (that, in a civil law residence state, all the income of a commercial company is business profits) with a type-of-income approach in

82 As pointed out by Sigurdardóttir, supra note 67, article 4(1) of the France-Luxembourg treaty is similar to article IV of the protocol to the League of Nations London draft model convention, on which see supra note 74. This treaty is referred to as an existing treaty in the OEEC first report and was therefore not influenced by that report, so that the League of Nations London draft model convention was the (then) latest model. The decision is therefore contrary to the (then) latest commentary.

83 Articles 6(4) and 7(7) of the OECD model convention seem to overlap, and the former seems to be unnecessary. The explanation may be that article 6(4) is derived from article XIII in the OEEC second report, the commentary to which states (in paragraph 4): "[T]he provisions of the Article apply not only to income from agricultural and forestry enterprises but also to income from immovable property of industrial, commercial and other enterprises as well as to income from immovable property used for the performance of professional services." There was no equivalent to the current article 7(7) in the equivalent provision that is contained in the OEEC third report; this was first included in the OECD 1963 draft model convention: Organisation for Economic Development and Co-operation, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963). This point is discussed by Raul-Angelo Papotti and Nicola Saccardo, "Interaction of Articles 6, 7 and 21 of the 2000 OECD Model Convention" (2002), vol. 56, no. 10 *Bulletin for International Fiscal Documentation* 516-21, which (at 517, note 5) comments on Alexander Rust, "Situs Principle v. Permanent Establishment Principle in International Tax Law" (2002) vol. 56, no. 1 *Bulletin for International Fiscal Documentation* 15-18.

the source state (that is, in both civil law and common law source states, the existence of a PE depends on whether there is a business, although the different approach for resident commercial companies may influence the answer). Civil law residence states that apply a type-of-person approach to a commercial company will categorize more income as business profits than common law residence states that apply a type-of-income approach. A civil law residence state is therefore more likely than a common law residence state to treat a business establishment in the source state as a PE and to attribute an item of income to a PE, because it expects all the income to be business profits. Civil law states tend to be exemption states; therefore, they are more likely to exempt income in circumstances where the common law source state may not regard the income as business profits, and therefore not recognize the existence of a permanent establishment, and not tax the income as business profits attributable to a PE. This difference in approach is less important if the residence state follows the categorization by the source state in accordance with the commentary and under new treaties that contain article 23A(4), which prevents exemption from applying.

There should be less difference in source states, because both civil law and common law source states determine whether there is a PE by applying a type-of-income approach. However, the difference in approach to resident commercial companies may mean that a civil law source state may be more inclined to recognize a PE and attribute income to it. If the residence state is a common law state applying the credit method, it will be more likely to follow the commentary and give credit in these circumstances.

If the source state does not recognize the existence of a PE it normally makes no difference whether the income is categorized as business profits. Either one starts with article 7 and is sent to another article (and, if the other article is article 10, 11, or 12, one is not returned to article 7 because there is no PE), or one starts in the other article. This is likely to result in a withholding tax being charged even if both states accept that the income is business profits—for example, the bank that makes loans to residents of a state without having a PE there. Such a withholding tax may be too high in relation to the profit on the income to enable full credit to be obtained. One might expect business profits not to be charged to a withholding tax, but that is not the approach of the OECD model convention.

It might be thought that the problem could be solved by defining "business profits" as well as "permanent establishment" in the treaty so that the two would tend to coincide from the point of view of the residence state. But if the treaty definition of business profits is wider than the internal law definition (which it might be in common law states), there is the problem that the taxation in the source state is by virtue of the narrower internal law, and thus the income still will not always be taxed as business profits. However, an advantage of this approach is that deductions will have to be allowed because the income will be within article 7, which means that tax will have to be charged on a net basis at ordinary rates rather than as a withholding tax. This may not be possible under internal law.[84] The problem of exemption in the residence state in circumstances where the source state does not tax the income as business profits would be made worse. Because the income is within the definition of business profits, the treaty will require the residence state, if it is an exemption state, to exempt the income attributable to the PE whether or not the source state taxes the income (necessarily under internal law) as business profits. Neither the commentary nor article 23A(4) will prevent exemption from applying because there is no disagreement about the meaning of the treaty. The issue is not one of internal law categorization but rather internal law's failure to tax income that the treaty allows it to tax. In relation to article 23A(4), the problem is not that the source state "applies the provisions of this Convention" to exempt the income or charge a withholding tax, but rather that the internal law's charging provision is narrower than the treaty permits.

A better approach might be to ensure that articles 10(4), 11(4), and 12(3) return one to article 7 only if the income is in fact subject to tax[85] as profits attributable to the PE. If the income were not subject to tax as business profits, it would remain in article 10, 11, or 12, with the result that the residence state would not exempt the income but would give credit for the withholding tax. This approach does not solve the problem of excess credit.

The problem of excess credit caused by charging a withholding tax on business profits could be cured by removing article 7(7) so that no tax arises in the source state on business profits. But if a source country defined all the income of a commercial company as business profits, this would mean that no withholding tax would be charged on dividends, interest, and royalties paid to a commercial company.

It may be that the problems identified in this chapter cannot be solved for all cases, in which event they need to be addressed specifically in treaty negotiations. They are surely problems that need solving.

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84 In some states the only tax on dividends, interest, or royalties paid to a non-resident may be a withholding tax, and so a requirement to tax on a net basis may mean that there is no tax. Canada has a provision in regulation 805 of the Act that the withholding tax on dividends, interest, and royalties applies except where the income is attributable to a business carried on through a PE. For this purpose, the domestic definition of "permanent establishment" is considerably broader than the treaty definition.

85 Apart from relief for losses, etc.