

TORRIONE Henri (co-auteur), *Treaty Conflicts in Categorising Income as Business Profits caused by Differences in Approach between Common Law and Civil Law*, in : British Tax Review vol. 3 2003, p. 224-246.

**Treaty Conflicts in Categorising Income as
Business Profits caused by Differences in
Approach between Common Law
and Civil Law**

By

John F. Avery Jones *et al.*

Reprinted from

BRITISH TAX REVIEW

Issue 3 2003

Sweet & Maxwell Limited
100 AVENUE ROAD
SWISS COTTAGE
LONDON
NW3 3PF
(Law publishers)

THOMSON



SWEET & MAXWELL

Treaty Conflicts in Categorising Income as Business Profits caused by Differences in Approach between Common Law and Civil Law

JOHN F. AVERY JONES (UNITED KINGDOM), LUC DE BROE (BELGIUM), MAARTEN J. ELLIS AND KEES VAN RAAD (NETHERLANDS), JEAN-PIERRE LE GALL (FRANCE), HENRI TORRIONE (SWITZERLAND), TOSHIO MIYATAKE (JAPAN), SIDNEY I. ROBERTS AND SANFORD H. GOLDBERG (UNITED STATES), JÜRGEN KILLIUS (GERMANY), GUGLIELMO MAISTO AND FEDERICO GIULIANI (ITALY), RICHARD J. VANN (AUSTRALIA), DAVID A. WARD (CANADA) AND BERTIL WIMAN (SWEDEN)

Summary

Civil law countries treat all the income of a commercial company as business income, thus basing the categorisation as business income on the type of person; common law countries do not, and make the determination based on the type of income. These differences can affect the way the income of a non-resident company is considered. In addition in civil law all the income of a permanent establishment is business profits; in common law income attributable to a permanent establishment is not necessarily business profits. The article considers how these differences result in tax treaties being interpreted differently in the two legal systems.

THE OECD Model Tax Convention and its Commentaries have since the 2000 update contained provisions dealing with “conflicts of qualification”, that is, different categorisation of income by the two states.¹ These differences are particularly likely to arise in relation to whether income is categorised as business profits, certainly the most important type of income. We shall examine how such conflicts arise because of the difference in approach between common law and civil law countries to the categorisation 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, so that the approach in the case of income earned by a commercial company² 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

This article has also appeared in the Bulletin for International Fiscal Documentation, Vol. 57, No. 6, June 2003, p.237.

¹ Art.23A(4), preventing the situation that the source state charges only a withholding tax and the residence state exempts the income, explained in Art.23 Comm para.56.1–56.3; and the more general provisions in the Commentary dealing with conflicts of qualification in Art.23 Comm paras 32.1–32.7. Art.23 Comm para.56.3 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 since this is covered by the latter as explained by the Commentary.

² For individuals a type-of-income approach is necessarily used.

between capital gains and business profits when taxing companies³; civil law countries do not, since capital gains are part of business profits.⁴

³ In most common law countries capital gains of companies are taxed differently from other types income with separate computational rules, and capital gains often qualify for reliefs not applicable to other income, for example—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 per cent of gains, in the UK by exempting gains accrued before 1982 and by indexing gains of companies for inflation, and in the US taxation of gains at a lower rate until January 1, 1993. All common law countries prevent offsetting capital losses against income. The probable reason for the different treatment of capital gains is that the distinction between income and capital had been developed in England in trust law on the question of the entitlement of a life tenant of a landed estate. Income tax in the UK naturally adopted this existing distinction and this has influenced income tax in Australia and Canada. The distinction in the UK was clearly established early in the development of its taxation laws, see *A.G. v London County Council*, 4 TC 265 at 293 and *Ryall v Hoare*, 8 TC 521 at 525 without express reference to trust law but trust law considerations were important in deciding that bonus shares were not income of the shareholder in *IRC v Blott* 8 TC 101. In the US the trust law distinction between income and capital was much less important and in 1921 in a case which interestingly concerned a life interest trust, *The Merchants' Loan & Trust Co as Trustee of the Estate of Arthur Ryerson deceased v Smietanka* 1 USTC 1124, the US Supreme Court decided that income for income tax purposes included capital gains, applying the same meaning of “income” as had applied in the earlier Corporation Excise Act of 1909 which did not impose an income tax but which contained references to income. Trust law distinctions between income and capital were ignored since they depended on the terms of the trust instrument; and British income tax decisions were on 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 capital gains of a corporation in *Eldorado Coal and Mining Co v Mager* 1 USTC 1127. A consultation document in the UK has proposed taxing gains of companies as ordinary income (Reform of Corporation Tax, August 2002).

⁴ Historically, civil law countries did not always tax capital gains of a company as income. There was no taxation of capital gains as income in Belgium until the 1930s, in France until 1940 (and there was a separate regime for long term capital gains on shares in subsidiaries until 1965), and until the 1960s Sweden did not tax capital gains on long-term holdings of real estate (10 years) and shares (5 years). There was a separate tax regime for all capital gains in Sweden until 1991 which covered capital gains on 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 personnels*). The early League of Nations reports on double taxation deal with these two types of taxes then existing, see in particular the 1925 Report (*Legislative History of US Tax Conventions Vol.4 p.4059*, the distinction between them being discussed at pp.4075–4080). 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” *ibid.* p.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 moving to an income tax achieved the result of taxing income comprehensively (except for exempting some foreign income on the basis that the income tax should not apply to something taxed by the schedular tax in the other state) by concentrating on the person receiving 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 G. Maisto, “Proposal for an EC Exemption of Capital Gains Realised by Parent Companies of Member States” (2002) 42 *European Taxation* 28 for a table showing the current exemptions given by EU countries. Subsequently the UK enacted the then proposed relief in FA 2002, s.44 and Sched.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 business purpose (either non-listed shares or 10 per cent 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

So far as non-resident companies are concerned, civil law countries do not ask whether the taxpayer is similar to a domestic commercial company but ask, whether a business is carried on, and if it is, consider whether there is a permanent establishment (a fixed place of *business*), which is an approach based on the type of income, although the answer may be influenced by the approach to resident commercial companies⁵; common law countries do the same. Civil law countries will accordingly treat all the income earned through a permanent establishment as business profits; common law countries do not necessarily do this. The Commentaries to the OECD Model indicate that internal law is to be used to determine what are business profits⁶ and therefore these internal law differences apply to the interpretation of the Model. We shall first summarise the different positions in 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

All profits of commercial companies are business profits for tax purposes

In civil law countries the civil or commercial code generally provides that certain transactions are classified as commercial transactions,⁷ and in addition that all transactions of commercial companies⁸ (but not necessarily partnerships⁹) are commercial

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. The UK consultation document on the Reform of Corporation Tax (see n.3) proposes closer alignment of tax and accounting profit.

⁵ This is so even where a country considers that all the income of a non-resident company is business profits so that in the absence of a permanent establishment 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 permanent establishment. In some countries, *e.g.* France, and, since 2001, the Netherlands, it is possible for there to be a distinction between carrying on business and earning business profits.

⁶ Art.3 Comm paras 4 (enterprise), 10.2 (business), the latter added in 2000.

⁷ Belgium Art.2–3 Commercial Code; France Commercial Code Arts L.110–1 and L.110–2, where the transactions involve commercial dealings (*activités de commerce*); Germany Commercial Code Art.1(2), from July 1, 1998 all business is commercial business unless the operations do not require business installations of a business-like kind and scope (before July 1, 1998 there was a list of commercial transactions); Italy Civil Code Art.2195, list of entrepreneurs (defined in Art.2082) required to be registered in the Registry of Enterprises; Japan Commercial Code, Arts 501, 502 and 503; Switzerland Code of Obligations, Art.834 and Ordinance of the Register of Commerce Arts 52, 53 and 54. The Dutch Codes (see n.11) are an exception, as they do not distinguish between commercial 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 as there is no comprehensive civil code and no classification of transactions as commercial.

⁸ For the purposes of this Article we include the following types of company in the expression “commercial companies”: Belgium SA/NV, SPARL/BVBA, CVA/SCA; France SA, SAS, SCA, Sarl; Germany AG, GmbH; Italy SpA, *SAPA*, SRL, *società di mutua assicurazione*; Japan *kabushiki-kaisha*, *yugen-kaisha*; Netherlands NV, BV; Sweden AB; Switzerland AG/SA, GmbH/SARL.

⁹ For example, unlike a commercial company, in Germany (unless all the general partners are corporations and only if corporations or persons who are not partners are authorised 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, VOF respectively), and in France there are circumstances in which a commercial partnership is taxed on part of its income as a civil profit and part as a commercial profit. There is a problem of terminology in making this distinction between companies

transactions,¹⁰ governed by commercial law, which deals with such matters as the keeping of accounts. The position used to be the same in the Netherlands but now commercial companies are not necessarily treated as carrying on an enterprise.¹¹ Sweden is different; there is no classification of transactions as commercial.¹² In many civil law countries¹³ some

and partnerships since civil law countries use the same term, *société*, *società*, *Gesellschaft*, *bolag*, and *vennootschap* to include both partnerships and companies, and the same is 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 a company normally means a corporation.

¹⁰ Belgium Code on Companies, Art.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 n 101, *D. Affaires* 1998. 722, Bull July 1998. 665, note Daigre, *Rev sociétés* 1998.307, note Barbièri); Germany Commercial Code, Art.6 that 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 they engage in a business or commercial activity; Italy by case law (Supreme Court, November 4, 1994, No.9084 concerning bankruptcy, and Supreme Court July 23, 1998, No.7209 and Supreme Court August 10, 1979 concerning keeping of accounts); Japan by Commercial Code, Art.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, Art.4(2); *Yugen Kaisha Law*, Art.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. In Switzerland there is no such classification. Although there is no formal classification as transactions as commercial in Sweden (see nn.7 and 12), in practice 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, Ch.12, s.1).

¹¹ Although the Netherlands has a Commercial Code this is mainly a relic as 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*). Since 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 (Hoge Raad decision *Mariahoeve*, January 13, 1966, NJ 1966, 189). Legislation in 1976 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 for other civil law countries but it is not entirely clear from the Hoge Raad's 1989 decision whether it applies only to Art.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 contained 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 n.15, subject to a qualification mentioned in that note.

¹² In this respect Sweden is the same as common law countries (see n.23) having no comprehensive civil code but certain Acts applicable to commercial transactions.

¹³ Belgium (*i.e.* the distinction between, on the one hand, commercial companies and, on the other hand, civil companies carrying on a non-commercial activity (*i.e.* liberal profession) but under the form of a

entities are governed by commercial law and their income is automatically business profits for general law purposes, and others 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 code¹⁴ (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 which in its turn means that all the income of the company is classified for tax purposes as business profits¹⁵; thus in civil law countries,

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), Japan. See n.11 for the position of the Dutch Commercial Code.

¹⁴ Italy, Switzerland, Sweden (although there is no comprehensive civil code, non-business vehicles, such as unregistered partnerships, are possible).

¹⁵ Belgium Income Tax Code, Art.183. The Supreme Court (February 20, 1962, Pas., 1962, I, p.706, March 17, 1964, Pas., 1964, I, p.771, and June 7, 1966, Pas., 1966, I, P.1281) has added that all assets which are owned by a company are deemed to be used for the exercise of the business activity and that all income and realised capital gains from those assets is taxable profit (unless specifically exempt in the tax law). The Belgian tax authorities recognise that so-called civil companies carrying on a non-commercial activity under a commercial form (see n.13) 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 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, in two recent court decisions an opposite view has been expressed (compare Court of Appeals Gent, January 29, 2002, TFR, 2002/66, p.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 criticised (D. Deschrijver, *Patrimoniumvennootschappen: geen rechtspersonenbelasting*, TFR, 2002, 818). France *Code Général des Impôts*, Arts 34, 205 which imposes corporation tax 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 s.44 *quarter* which is conditional on the carrying on of a commercial activity, see *Conseil d'Etat, SA Ondif*, October 15, 1997, No.146931, RJF 12/97, No.1111. Germany Corporate Income Tax (KStG) s.8(2) that all income of a commercial company which has to maintain books in accordance with the Commercial Code is classified as business income. Italy: Income Tax code Art.51, referring to Civil Code Art.2195 (see n.7) and effectively treating all income of a company as being within that article. Japan, although this is not stated specifically in the 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 Commercial Code Art.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 Art.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". Netherlands Corporation Income Tax Act 1969, Art.2(5) that Dutch incorporated commercial companies and certain other resident entities (which 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 in spite of the different approach in civil law, see n.11). However there are

where such entities are involved the nature of the recipient is more important than the nature of the income.¹⁶ Where civil law countries need to make a distinction between the active and passive income of a foreign subsidiary, for example in CFC legislation, different definitions need to be adopted to achieve this result.¹⁷ For a non-resident company with a permanent establishment (a fixed place of *business*) in the country concerned all the income

several examples where “passive” companies are concerned where the context shows that the deeming provision cannot apply. For example, Art.14 used to provide for a roll-over 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 Art.40) to mean carry on a real enterprise; Art.20(5) limits the loss carry-forward relief where 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 Art.28 the favoured treatment of investment funds is conditional on not carrying on an enterprise; and Art.13 denies the participation exemption for foreign shareholdings that do not carry on an enterprise. Sweden ITA, Ch.1, s.3, which, in spite of the different approach in civil law, applies even if the assets are not held for business purposes, *e.g.* capital gains on non-business assets Ch.13, s.2; all the income is treated as one class of income Ch.14, s.10. Switzerland Civil Code Art.60–89*bis*: this 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 Art.52). In an interesting example of the difference of approach between civil law and common law countries, in the Netherlands J.J. de Klerck writing in the authoritative *Fiscale Encyclopedie de Vakstudie* (text 1962) states: “The Article [Art 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 around n.30, particularly the UK case cited in n.35 in relation to a former tax that there is no difference between an individual and a company in determining whether a business is carried on.

¹⁶ A distinction based on the type of income is, however, found in VAT which in the EU taxes economic activities, defined in Art 4(2) of the Sixth VAT Directive 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 just investing is not, as in the case of a private individual or the charity in *Wellcome Trust* [1996] ECR I-3013. A passive holding company does not carry on an economic activity: for example, *Polysar* (Case C-60/90), and nor does a limited partnership holding shares and bonds: *Harnas & Helm CV* (Case C-80/95). Since 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 as 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 as 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 be treated as carrying on an economic activity provided that this is carried out with a commercial purpose characterised by a concern to maximise returns and is not confined to managing an investment portfolio in the same way as a private investor: *Floridiene v Belgium* (Case C-142/99). The reason for the distinction may be that economically transactions with subsidiaries are not really transactions with third parties, whereas with banking, interest is paid to, and by, third parties.

¹⁷ Swedish CFC law currently makes no distinction between active and passive income but there is a proposal to make such a distinction.

attributable to the permanent establishment will be business profits,¹⁸ but 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.¹⁹ Indeed if the income of a commercial company were categorised as business profits where there is no permanent establishment, the country might not be able to tax domestic source investment income if business income is not taxable in the absence of a permanent establishment.²⁰ It follows that normally income from passive investment in domestic immovable property does not constitute business profits for a non-resident company,²¹ although the law has been changed in

¹⁸ All income attributable to a permanent establishment is automatically business profits in Belgium (there is no code article expressly stating this, but it is implicitly confirmed in Art.228, §2, 3 ITC and generally accepted, see L. Hinnekens, *Criteria voor Onderworpenheid, Vennootschap & Belastingen*, III, 2, 1265 en 1270), France (non-resident companies with a permanent establishment in France are assimilated to French companies), Germany (HGB, Art.13(f)), Italy (Income Tax Code, Art.113(1)), Sweden (ITA, Ch.6, s.11), and Switzerland (LIFD, Art.11). The rule applies more widely in Sweden since all income of a foreign legal person, as defined in ITA, Ch.6, s.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 permanent establishment or it is income from real property in Sweden, ITA, Ch.6, s.11 (there is also a withholding tax on dividends in the absence of a permanent establishment, 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 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 permanent establishment in Sweden, the non-resident recipient is deemed to have a permanent establishment in Sweden. This causes a charge to Swedish tax, but on a net basis, whereas if there is no actual permanent establishment a treaty may limit the tax on the deemed permanent establishment to the treaty rate of tax applied to the gross income.

¹⁹ The existence of a withholding tax on dividends paid to non-resident companies without a permanent establishment in France shows that such a company is not liable to corporation tax (see *Doctrine administrative* 4 J-1336, no3, November 1, 1995). For an example in Germany of a UK company without a permanent establishment in Germany earning non-taxable business income by providing know-how to a Germany company, see 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 including business assets or real property, personal service income and leasing ships or aircraft.

²⁰ This result would not apply if the income were taxed under another Act, such as a withholding tax Act, and sometimes in the case of real property, see n.22.

²¹ 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 Japanese tax law (see n.19). In Italy in the absence of a permanent establishment, income is determined by the rules for classes of income other than business profits (Income Tax Code Art.113(2)). In the absence of a permanent establishment, in France 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 nn.67, 74. This has the odd consequence that France cannot tax since a building cannot be a permanent establishment. 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 permanent establishment (Income Tax Act 1964, Art.49(1)(a), referred to in the Corporation Income Tax Act) and income from Dutch real property (Art.49(1)(c)(2)) which left it in doubt whether income from real property that was business profits could be taxed in the absence of a permanent establishment. 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 it was held as a business asset. This taxing provision did not apply to capital gains, hence the change in the law described in the next note. Switzerland is also an exception to the statement in the text since income and capital gains on real estate are taxable in the absence of a permanent establishment: LIFD Art.51(1)(c).

Belgium, Germany and the Netherlands to make it business profits in order to tax capital gains on the immovable property.²²

Common law countries

Common law has no such distinction between “commercial” law and “civil” law²³ and therefore offers no choice of different types of entities to be used according to the nature of the transaction.²⁴ While there is no concept of an enterprise,²⁵ in either general law or

²² If the income is not attributable to a permanent establishment, tax law was changed in Belgium (Art. 228, §2, 3 a ITC) in 1989, Germany in 1994 (Income Tax Act (EStG), Art.49(1), No.2(f)), and the Netherlands in 2001 (CITA, Art.17a) to enable gains on domestic real estate to be taxed. Belgium and Germany provide that income from immovable property (which is not business income in the civil or commercial code) can be taxed as business income, regardless of whether 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 deriving income from Belgian real property would henceforth be taxed on business profit, even if its investment would be of a passive nature (J. Defoort, “De inkomstenbelasting van de Belgische vastgoedverrichtingen van niet-verblijfhouders” (1991) 2 NFM 46; L. 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 the purpose of which is to make investments in real property derives business profits (see e.g. Supreme Court, January 19, 1995, Pas., 1995, I, 55), a Luxembourg *société civile immobilière* (i.e. without legal personality) that rented a storage facility was held not to carry on a commercial activity, nor to be engaged in a profit making activity because of the civil nature of the corporation which 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 know-how and advertising, etc.) (Court of Appeals Gent, January 8, 1998, TFR, 1999, 55, note Werbrouck, J.). In the Netherlands, previously gains on domestic real property not held as a business asset 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 only taxed if they were attributed to a permanent establishment. From 1967 the requirement for a permanent establishment 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 permanent establishment. It is interesting that in common law countries (other than the UK) capital gains on real property owned by a non-resident can be taxed.

²³ 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 UK Sale of Goods Act 1979. The main distinction recognised 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 in understanding why ordinary tax liabilities are not included in “civil rights and obligations” in Art.6 of the Human Rights Convention, see *Ferrazzini v Italy* (App no.44759/98) [2001] 1314 ECtHR.

²⁴ Common law countries usually have one type of company with some different rules applying to public and private companies; and general partnerships and limited partnerships and, except for Australia, limited liability partnerships. Other vehicles exist, such as co-operatives in Australia and companies limited by guarantee in Australia and the UK, and companies without share capital in Canada.

²⁵ As was said in an English case: “‘Enterprise’ . . . [has] no exact counterpart in the taxing code of the United Kingdom” *Ostime v Australian Mutual Provident Society* 38 TC 492, 517 HL, per Lord Radcliffe. The same point was made in Australia in *Thiel v Comr. of Taxation* 90 ATC 4717 at 4719, 4721, 4726, 4728 discussed in the next heading. 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 it is defined in ITAA, s.128A as “a business or other industrial or commercial undertaking.” Its use there is probably explained by the close relationship

income tax law, there is usually a concept of “business” in tax law, which may be similar to enterprise,²⁶ with a distinction made between business and property income,²⁷ with the exception of UK tax law, where the nearest category in tax law to business is “trade” which is narrower than business.²⁸ 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 US is in principle an exception to this rule, since, as in civil law countries, all the income of a US company is business income, but nevertheless the US makes a distinction between active and passive income for holding companies.²⁹ Thus in general in common law countries a company may carry on a trade or business, and, so far as investment income is concerned it may carry on a business of

between withholding tax and tax treaties. The term “enterprise” is used in the US in the reorganisation provisions (IRC §368) to mean a business entity rather than a passive investment company. See the next note in relation to Canada. The word “enterprise” may be used in tax law in common law countries, as in “enterprise zone”.

²⁶ In Canada the French language version of the Income Tax Act uses *entreprise* (as does the French language version of the OECD Model) where the English text of the Act uses *business* and so they are given the same meaning. In the Supreme Court of Canada decision in *Spire Freezers Ltd. v The Queen* 2001 DTC 5158 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 Income Tax Act, however, the concept of a business is narrower in Canada: *Wertman v MNR* 64 DTC 5158. 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 which would have been regarded by the US 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 p.1860. The expression enterprise is used in different senses in the OECD Model.

²⁷ In Australia “‘business’ includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee” (ITAA 1936, s.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 language version of the OECD Model). For a decision where interest on a tax refund was classified as active business income which had the effect of increasing the deduction for manufacturing and processing profits, see *The Queen v Irving Oil Ltd* 2002 DTC 6716; [2002] 1 CTC 191 since 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 since 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. The US makes a distinction between income from a trade or business, and investment income.

²⁸ The UK 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 n.36) carrying on business but not trade in TA 1988 s.111(10), for relieving expenditure on the “trade or business” of exploiting films in F(No.2)A 1992, s.41, and that 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 n.35 for a case on this): TA 1988, s.13(4). There are other references to “business” in income tax, for example the definition of investment company in n.30. The UK also makes a distinction between earned and investment income but this has no relevance to companies.

²⁹ The reorganisation provisions dealing with demergers also require a company to carry on an active business (IRC §355).

holding investments, or it may just receive investment income without carrying on any business.³⁰

The fact that one is dealing with a company, rather than say an individual or trustees, in Canada creates a rebuttable presumption that the company's income is business income³¹; in Australia and the UK there is no such presumption.³² In the UK the schedular system of

³⁰ In Australia although most collective investment is carried out through unit trusts, a category of "listed investment company" has been introduced recently in ITAA 1997, s.115–290 which is designed to give similar treatment for collective investment through companies as unit trusts. To qualify as a listed investment company, the company has to be resident, listed (or 100 per cent subsidiary of listed company) and have 90 per cent 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 five full-time employees", and a "personal services business", meaning "a business of providing services where an individual who performs services on behalf of the corporation . . . is a specified shareholder of the corporation . . ." (ITA, s.125(7)). In the UK 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" TA 1988, s.130), and a company which just holds investments without this being its business, with significant differences between the first two categories (these are listed in the Reform of Corporation Tax consultation document (see n.3)) 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 US, domestic personal holding company income is defined by listing various items of passive income. There are also investment companies and real estate investment trusts that until recently could not have active business income.

³¹ *Canadian Marconi v The Queen* 86 DTC 6526. The company which 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 in n.35 where there was not active management of the investments and the court reached the opposite result). See also Vern Krishna, *The Fundamentals of Canadian Income Tax*, pp.277, 772. The Canadian court relied on earlier (1925 and 1960) Supreme Court tax cases, Federal Court cases, a Revenue Canada Interpretation Bulletin and three English cases but one was a partnership law case, another concerned excess profits duty, a World War I tax, where trade or business was relevant, and the other 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 Arts 10(4), 11(4) and 12(3) of the Model that the property giving rise to the dividends, interest or royalties must be effectively connected to the fixed place of business (*i.e.* the permanent establishment) to be considered to be business profits.

³² Neither Australia nor Canada regard a company as automatically carrying on a business, and even if it is, it can have passive income which 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 (F.C.A.). In Australia there used to be a view that trustees were less likely to be carrying on a business (see *Charles v FCT* (1954) 90 CLR 598). 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 because of the way they are used in Australia, see *e.g. Comr of Taxation v Radnor*, per Hill J. (1991) 22 ATR 334, *Fanmac v Comr of Taxation*, per Beaumont J. (1991) 22 ATR 413, *London Australia v FCT* (1977) 138 CLR 106. As in Canada it is easier to draw an inference that a company (rather than an individual) carries on business: *Brookton Co-operative Society Ltd v FCT* (1980–81) 147 CLR 441, 469. 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 Corp v FCT* [2002] NSWSC 1115 the New South Wales Supreme Court drew attention to the existence of conflicting lines of cases on whether the

income taxing concentrates on the type of income virtually to the exclusion of the recipient of the income.³³ As a result of this approach in the UK the fact that the taxpayer is a company has little influence on the question whether a trade is being carried on,³⁴ and no influence on whether a business is carried on in those rare cases where business is relevant.³⁵ A partnership is different as in common law countries the definition of partnership requires the carrying on of a business.³⁶ This may influence the tax treatment by assuming that where there is a partnership a business is carried on, although

income from investment type activities constitute business profits in internal law, one confining taxability of investment profits to banks and insurance companies, and the other dealing 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.

³³ In the UK before 1965 no distinction was made between types of taxpayers in taxing income (except for a supplementary tax, profits tax, on corporate income). Since 1965 companies pay a different tax, corporation tax, but income is still computed for corporation tax in accordance with the schedular income tax, subject to a few variations for companies (TA 1988, s.9), and in accordance with the capital gains tax; the total profits are then charged to corporation tax. The consultation document on the Reform of Corporation Tax (see n.3) examines the case for the abolition of the schedular system for companies.

³⁴ In the UK, see *Lewis Emanuel & Sons Ltd v White* 42 TC 369 in which a company carrying on an unrelated trade was treated as carrying on the trade of dealing in securities in circumstances where 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 power to carry on such a trade and did not show the transactions as trading transactions in its accounts. The court accepted that the position of an individual was different: "... one expects a trading company's activities, apart from capital investment, to be by way of trade" (p.378). 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 *IRC v Korean Syndicate* 12 TC 181.

³⁵ The observation of Pollock MR in *IRC v Westleigh Estates Ltd* [1924] 1 KB 390: "if [a company's] objects are business objects and are in fact carried out, the company carries on business" appears to be contrary but it was pointed out in *American Leaf Blending v Director-General of Inland Revenue* [1978] STC 561, a Privy Council appeal from Malaysia, that "This 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 Ltd* [1998] STC 482 is an example of a company which had 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 which ignored the existence of the company which 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 in n. 31 reaching the opposite result). See the Special Commissioner's decision in *Land Management Ltd v Fox* [2002] STC (SCD) 152 for an example of a fairly 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 doing the same activities, except that the objects of a company are a matter to be considered: *IRC v Korean Syndicate Ltd* 12 TC 181, 202, per Sterndale M.R.

³⁶ "Partnership is the relationship between persons carrying on business with a view to profit" (UK Partnership Act 1890, s.1 and equivalent provisions in New South Wales (s.1) and Ontario (s.2). "The expression 'business' includes every trade, occupation or profession" (UK Partnership Act 1890, s.45 and equivalent provisions in New South Wales (s.1B), and Ontario which adds "(enterprise)" at the end (s.1(1)). In the US 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 Revised Uniform Partnership Act, §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

strictly speaking whether there is a business should precede the determination of whether there is a partnership.

The common law approach that a company may or may not be carrying on a business applies equally to non-resident companies for determining whether the existence of a permanent establishment in the common law country is relevant. In some cases³⁷ the permanent establishment concept is not used in internal law so that a rule about the type of income attributable to a permanent establishment cannot exist. As with civil law countries, common law countries will ask first whether the income is business profits, and if it is, go on to ask whether there is a permanent establishment, with the result that if the income is not business profits the existence of a permanent establishment is irrelevant, and if there is a permanent establishment it does not mean that all the income attributable to it is business profits. In the same way as for a resident company, there is at most a rebuttable presumption in Canada that the income of a non-resident company is business profits; in Australia there is no presumption at all. In the US, the presumption that all the income of a domestic company is business income, does not apply to foreign companies.³⁸ The UK differs the most from civil law because a non-resident company must be trading in the UK before the income of a branch can be charged to corporation tax.³⁹ If the non-resident company is not trading in the UK the only tax imposed is income tax on a source basis.⁴⁰

Spire Freezers Ltd v The Queen 2001 DTC 5158 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 Income Tax Act, however, the concept of a business is narrower than for partnership in Canada: *Wertman v MNR* 64 DTC 5158. In Australia in *Unisys Corp v FCT* [2002] NSWSC 1115 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 permanent establishment in the US where all its business was conducted.

³⁷ Permanent establishment has been used in internal law in Australia since 1959, see ITAA 1936, s.6(1) for the definition, and TR 2002/5 for a ruling on its interpretation which uses the OECD Commentaries 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 capital 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 US. In the UK draft legislation revised on March 14, 2003, available on the internet at www.inlandrevenue.govuk/drafts/tax_foreign_co_leg.htm, proposes to substitute "permanent establishment" for "branch or agency" in internal law.

³⁸ In the US a distinction is made between income effectively connected with a trade or business carried on in the US, and other income. IRC, §864(c) determines whether income is so connected, which results in almost all US income being effectively connected. For periodical income, the factors to be taken into account in determining this include whether the income is derived from assets used in, or held for use in, the conduct of the trade or business, or whether the activities of the trade or business were a material factor in the realisation of the income. Regard is paid to whether the asset or income was accounted for through the trade or business. All non-periodical income is treated as effectively connected with the conduct of the trade or business, so that the force of attraction principle applies.

³⁹ Once the company is carrying on a trade in the UK, 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 (TA 1988, s.11), and on capital gains on UK assets so used or held for the purposes of the branch or agency (TCGA 1992, s.10). The proposed legislation using the expression permanent establishment in internal law (see n.37) defined in a similar way to the Model and depending on a business being carried on will not change the position that the corporation tax charge on a non-resident company applies only where it carries on a trade.

⁴⁰ Art.11(6) of the Model can apply to determine the source of interest paid by non-resident but connected with a permanent establishment that was not carrying on a trade.

*Problems of common law countries interpreting "enterprise" in tax treaties*⁴¹

With this different background to the meaning of business profits in which 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 permanent establishment. *Thiel's*⁴³ case in Australia is a good example. The case concerned a Swiss resident individual who bought and sold shares⁴⁴ within 12 months resulting in Australian taxation on gains made within such period. He argued that he was not taxable in Australia by reason of the Swiss treaty. Specifically he argued that the income was a profit within Article 7 and, which was agreed, there was no permanent establishment 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-off situations or was confined to continuing businesses. It was held that there was an adventure in the nature of trade on the facts. It was accepted that the court could rely on the OECD Commentaries in resolving the second and third issues and reference was made to the Commentaries on Article 3⁴⁵ which state:

"The question whether an activity is performed within [the framework of⁴⁶] an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of domestic law."

The court held on the basis of this cryptic sentence that a one-off 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.⁴⁷ This view seems odd given the terms of

⁴¹ This will be less of a problem for countries using "business" as a criterion for taxing after new treaties follow the Model's 2000 change of equating "enterprise" with "business," see n.42.

⁴² See n.25. The absence of the concept of "enterprise" in internal law makes it impossible to apply the OECD Commentary's statement in Art.3 Comm para.4 that "The question whether an activity is performed within an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States." Art.3 Comm para.10.2 (added in 2000), however, states that "business" generally has the meaning which it has under domestic law of the state applying the treaty. The Model now equates enterprise with business, which is a term used in tax law in common law countries (other than the UK) (see nn.27, 28), since Art.3(1)(c) of the Model 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 *Thiel v Comr. of Taxation* 90 ATC 4717. See also *Unisys Corporation v FCT* [2002] NSWSC 1115 in which a company making a 0.5 per cent 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 Model.

⁴⁴ Strictly he bought units in a unit trust which was acquired by a company in exchange for shares during the time he held them.

⁴⁵ Para.4.

⁴⁶ The words in brackets were omitted in 1995 but were there at the time *Thiel* was decided. The notes to the looseleaf version on Art.3 note that in 1995 a number of stylistic changes were made to the Commentary which are not specifically noted. This is one of them so there is no record of why it was done.

⁴⁷ A somewhat similar issue arose in the Australian case of *Lamesa Holdings BV* (1997) 77 FCR 597. As there was no permanent establishment the question was simply whether the alienation of property Article of the Australia-Netherlands treaty applied, particularly the look-through provision for land

the quote 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 had only a limited capital gains Article (with no equivalent in particular of Art.13(4) of the OECD Model) and that there was no "Other Income" Article. Hence, 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 as 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-off business transaction but the second part required a continuing business.⁴⁸ This seems perhaps an odd result just looking at Article 7 but it can be justified by reference to the definition of permanent establishment which itself requires some continuity of business in a country before a permanent establishment can arise. The court in effect dealt with the mismatch of domestic law and the treaty in this case by assimilating the domestic law and treaty concepts even though they are quite different in nature.

A similar example arose in Canada in *MNR v Tara Exploration and Development Co. Ltd*⁴⁹ 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 Income Tax Act. The Supreme Court held this to be within the business profits Article of the Canada-Ireland treaty in which "Irish enterprise" was defined as "an industrial or commercial enterprise or undertaking carried on by a resident of Ireland." The US adopts the same approach. The technical explanation to the US Model (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",⁵⁰ which is the domestic law concept. The UK also does the same but since the internal tax law category of "trade" is narrower than business, there is little doubt that anything that is a trade will be a business or enterprise.

Comparison of the different approaches to the application of tax treaties

As we have already mentioned, the Commentary to the OECD Model refers to internal law

holding companies which would take the case out of Art.7 by reason of para.7, or whether Art.7 applied. The court held that the look-through provision did not apply and therefore the profits were within Art.7. Note that it was agreed that the case involved an adventure in the nature of trade as in *Thiel*. See also *English, Scottish and Australian Bank Ltd v FCT* (1969) 1 ATR 104 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 UK-Australian treaty 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 Art.7(7) of the Model.

⁴⁸ It should be noted that the first part of Art.7(1) refers to "an enterprise of a Contracting State," which is defined by Art.3(1)(d) to mean an enterprise carried on by a resident of that state. Therefore, the first part of Art.7(1) also requires a continuing business.

⁴⁹ (1972) 28 DLR 135.

⁵⁰ Art.3 General Definitions.

to decide whether something is an enterprise or a business. It follows that whether income is categorised as business profits is also determined by internal law, even though the concept of permanent establishment is defined by the treaty and one might expect that the categorisation of income relevant to that concept would not be left to the possibility of a different interpretation 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.⁵¹ We next consider where there can be different treaty interpretations by the different approaches to what are business profits.

Permanent establishment seen by the residence state only

A conflict can arise if the residence state considers that there is a permanent establishment in the other state but the other state does not. Suppose a resident of the other state has a presence in the country concerned, such as an office; that would be a permanent establishment if that concept were relevant. Both common law and civil law countries start by asking whether a business is carried on. If it is, in a civil law country, this means that there may be a permanent establishment and, if so, all the income attributed to it is business profits, so that one can concentrate on the question whether there is a permanent establishment; in a common law country since not all the income of a permanent establishment is business profits it is necessary to separate the issue of whether there are business profits from whether there is a permanent establishment.⁵² We shall examine the result starting with a civil law permanent establishment state.

In a civil law state if one starts with Article 7 of the Model in the permanent establishment state, on the basis that all the income of the permanent establishment is business profits, that income is not necessarily covered by Article 7 because Article 7(7) provides:

“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.”

Thus one goes to the other relevant Articles, and, if these are Articles 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

⁵¹ One might argue that the context requires that Art. 3(2) should not be used but the Commentary clearly shows that the use of internal law is intended.

⁵² In civil law countries other than the Netherlands (see n.11), the approach that all income of a resident company and of a permanent establishment is business profits has the advantage that it prevents any discrimination against permanent establishments. If income attributable to a permanent establishment were not taxed as business income, as is the case for a resident company carrying on the same activities, there could be discrimination prohibited by Art.24(3) of the OECD Model if the taxation on the permanent establishment 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 permanent establishment is business profits is determined in the same way there should be no discrimination, although the US treats a permanent establishment of a non-US company differently from a US company.

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 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.”⁵³

The Commentary as amended in the 2003 version now warns against abuse in exemption states by emphasising that a business must be carried on for there to be a permanent establishment but this does not explain the meaning of business which meaning 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 recognised 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.”⁵⁴

Having been sent to Articles 10, 11, 12 or 21, one is returned to Article 7 if the property giving rise to the income is effectively connected with a permanent establishment, with the result that the permanent establishment state has the right to tax the income attributable to the permanent establishment, 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 which is attributable to the permanent establishment, excluding income covered by other treaty Articles (except the “Other Income” Article⁵⁵), (2) dividends, interest and royalties paid on property effectively connected with the permanent establishment, and (3) income falling within the “Other Income” Article (mainly third country source income) from rights or property effectively connected with the permanent establishment.⁵⁶ Where the residence state is an exemption country⁵⁷ in respect of business income, it will exempt that income from tax with the result that it is taxed only in the permanent establishment state.

⁵³ Arts 10(4), 11(4), 12(3) combined. Art.21(2) is of similar effect.

⁵⁴ The 2003 version of Art.10 Comm para.32, Art.11 Comm para.25, Art.12 Comm para.21 combined. This statement may also have in mind non-treaty cases where domestic law incorporated the same definition of permanent establishment. The OECD Report on Triangular Cases, Issues in International Taxation No.4, 1992, reproduced in Vol.II of the looseleaf Model Tax Convention, is related to this. Assets may be transferred to a permanent establishment in a country with little or no tax on the permanent establishment, 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 permanent establishment, so that only a withholding tax is charged by the source state. Some US treaties deal specifically with this problem, for example US-France (1994) Art.30(5) denying treaty benefits in the US (as source state) if the tax paid in the permanent establishment state is less than 60 per cent of the tax that would have been imposed in France in the absence of a permanent establishment in a state other than France and the US.

⁵⁵ Art.21(2).

⁵⁶ Art.7 Comm para.35. Head office income seems to be within Art.21 rather than 7 because otherwise it would not have been necessary to exclude permanent establishment income by Art.21(2). See n.61 for another possible explanation of Art.21(2). It would be helpful if the Commentary could clarify the relationship between Arts 7 and 21(2).

⁵⁷ Not Italy and Sweden.

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 different possibilities so far as concerns dividends, interest and royalties arising in the common law state and paid to a non-resident company with a permanent establishment in the same common law state. First, where the non-resident carries on a financial trade or business, such as a bank, the same analysis as in civil law 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 permanent establishment. Secondly, where the common law country considers that no trade or business is being carried on but merely the passive receipt of income, there cannot be a permanent establishment and Article 7 does not apply,⁵⁸ 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 gains⁵⁹; if the income arises in a third state the state that would otherwise be the permanent establishment state will not tax. Thirdly, there is the case where the company carries on a non-financial trade or business, such as manufacturing, through a permanent establishment, and the dividends, interest or royalties are received from property effectively connected with the permanent establishment, meaning connected with the business carried on at the permanent establishment,⁶⁰ even though the dividends, interest or royalties are not regarded as business profits in internal law, which is always the case in the United Kingdom's schedular system and may be the case in Australia and in 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, not business profits, Article 7 does not prevent the permanent establishment state from taxing.⁶¹

There is a possible fourth case, which is that a business is carried on through a permanent establishment and the property giving rise to the investment income is

⁵⁸ In the UK there has to be a trade before there can be taxation of a branch or agency (the internal law equivalent to permanent establishment; 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 n.37).

⁵⁹ Art.13(4) applies to capital gains that are gains on business assets in the absence of a permanent establishment.

⁶⁰ It would be helpful if the Commentary stated that this interpretation was intended.

⁶¹ Art.7 Comm para.35 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 Art.7 applies taxation must be on a net basis. The purpose of Art 21(2) may relate to third state income, such as dividends, interest and royalties where the right or property giving rise to the income is effectively connected with a permanent establishment but the income is not regarded as business profits by the permanent establishment state. The result is then the same for third state income that is not regarded as business profits as it is under Arts 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 Art.7(7) to Arts 10(4), 11(4), 12(3) or 21(2) and returned to Art.7. Australia is in this position with respect to dividends. Prior to the introduction of imputation in 1987 it used not to apply dividend withholding tax under domestic law if the dividends were connected to a permanent establishment (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.

managed from that place but without there being any connection with the business, for example that the person managing the property is located at the permanent establishment 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 permanent establishment. The property is effectively connected with the fixed place but not with the business and in respect of this particular income, the fixed place is not a permanent establishment to which the income can be attributed. If this case exists, the income from the property is not business income so the result is the same as the second case.

In the second case this difference in approach by common law states can therefore result in the common law source country saying that as the permanent establishment 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 but 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 producing such income; while the civil law residence state says that all the income of the company which is attributable to the permanent establishment is business income and accordingly, if it is an exemption country in respect of business income, it exempts the income from tax.

The Commentary⁶² introduced provisions in the 2000 update to deal with this problem by giving priority to the source state's categorisation of the income. It is suggested that such a dispute is solely one of "qualification" of the income, even though the question whether there is a permanent establishment (or the connection of the income to the permanent establishment) is also involved, which might be taken to be a dispute about the interpretation of the treaty.⁶³ Whether there is a permanent establishment does not result from any disagreement about whether the definition of permanent establishment is met on the facts, but follows from whether the income is 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 applying in the second situation and requires credit to be given even if the residence state does not accept the source state's categorisation.

Even where the residence state accepts the right of the source state to categorise otherwise than as business profits, if the residence state is a civil law exemption state, exemption can still result if exemption is accorded by internal law rather than by treaty (as is the case in France and Switzerland).⁶⁴

⁶² Art.23 Comm para.32.1 to 32.7.

⁶³ Art.23 Comm para.32.5. A dispute about whether there is a permanent establishment 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 recognise the existence of a permanent establishment of the Netherlands corporation; the Netherlands regards its corporation as having a permanent establishment in Japan and exempts the income.

⁶⁴ The Netherlands does not apply an internal law exemption if there is a treaty. In the Netherlands-Switzerland treaty (1951), the only treaty providing for credit, exemption is granted by extra-statutory concession except for "passive" (financing) permanent establishments for which a 50 per cent exemption applies.

No permanent establishment

The corollary of Articles 10, 11, 12 and 21 returning one to Article 7 where the income-generating property or rights are effectively connected with a permanent establishment is that where there is no permanent establishment 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 being charged on the gross income which may be too 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 to be undesirable and may lead to the creation of permanent establishments to avoid it. Although it would not be a case of differing treaty interpretation, differing internal law on the categorisation of business profits may give a different treaty result. Internal law in the source state may regard the income as business profits⁶⁵ which it cannot tax by internal law in the absence of a permanent establishment, so that Article 7(7) has no effect as there is no withholding tax charge in internal law.

Similar problems arising under older treaties

Although the treaty problem of two states having different concepts of business profits is more likely to arise because of the difference between common law and civil law, it can also arise under old treaties not containing Article 7(7) where there is doubt whether the business profits Article, or another Article, applies, as is illustrated by a Luxembourg case⁶⁶ in 2002 on the France-Luxembourg treaty (1958). A Luxembourg commercial company received rent from real property in France. In an earlier decision of the *Conseil d'Etat* in France⁶⁷ under the former France-Italy treaty (1958)⁶⁸ concerning an Italian commercial company owning real property in France and allowing 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 categorisation,⁶⁹ and not income from immovable property.⁷⁰ Therefore the income was

⁶⁵ 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'Etat* held that under the France-Switzerland treaty the income was not taxable in France in the absence of a permanent establishment of the Swiss company in France: *Conseil d'Etat, Golay Buchel*, July 27, 2001, decision No.215124, Rec.Lebon.

⁶⁶ *Tribunal administratif*, December 3, 2001, Case No.12,831, upheld on appeal by *Cour Administrative* No.14442C of April 23, 2002, see the note by B. Sigurdardóttir, "Taxation of Income from French Real Estate in Luxembourg" (2002) 42 *European Taxation* 165.

⁶⁷ *SpA Rafaella*, (*Conseil d'Etat*, May 22, 1992, no63 266, RJF 7/92, no960). See the note by H. Lazarski, "New Developments in the Taxation of Property Held by Foreign Companies: the *Rafaella* Case" (1993) 33 *European Taxation* 276.

⁶⁸ Since replaced by a 1989 treaty. The case note cited in the previous note 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'Etat* subsequently came to the same decision on the France-Luxembourg treaty (1958), see n.74.

⁶⁹ The *Schneider* case, *Conseil d'Etat*, June 28, 2002, on CFCs is another example of the internal law categorisation being used for treaties.

⁷⁰ "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" (Art.4(1)). If it had been a case of rent being charged rather than allowing the use

not taxable in France in the absence of a permanent establishment (the mere ownership of immovable property not being a permanent establishment).⁷¹ The treaty provided that income derived from *all* the operations of an enterprise was taxable only in the state in which a permanent establishment was situated,⁷² thus concentrating on the enterprise and not the type of income. This decision is fully 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.⁷³ The same decision was subsequently reached by the *Conseil d'Etat* in another case in 1994 in relation to the France-Luxembourg treaty, which is cited in the 2002 Luxembourg case.⁷⁴

In the 2002 Luxembourg case, Luxembourg had previously exempted the income from the immovable property in France from tax⁷⁵ on the basis that it was income from immovable property that was taxable only in France under the treaty. Following the 1958 French case on the France-Italy treaty,⁷⁶ the Luxembourg tax authority argued that the income should be treated as business profits that were taxable in Luxembourg in the absence of a permanent establishment 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,⁷⁷ since the treaty made no

of the property free of charge, Italy would take the same view as France that it was business profits that were taxable only in Italy in the absence of a permanent establishment in France.

⁷¹ But see the opposite conclusion reached by the Dutch Hoge Raad (see n.21) that the fact that income was categorised as business profits in internal law did not prevent it from being taxed as income from real property if there was no permanent establishment.

⁷² "Where an enterprise operating in one of the Contracting States has a permanent establishment within the meaning of Art.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" (Art.5(1)). 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, for the relevance of which see the next note. The London draft stated: "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 recognisably similar.

⁷³ The real property Article in the League of Nations London draft Model provided "Income 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, see n.70. The commentary to that article of the London draft states that "Income 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." The reason must be that income of an enterprise was comprehensively dealt with in the business profits Article leaving no scope for the income from real property Article to apply to an enterprise receiving such income. The France-Italy treaty is noted as having been under negotiation at the time of the OEEC First Report (1958) and was not influenced by that Report (the OEEC immovable property Article was contained in the OEEC Second Report (1959) and the business profits Article was contained in the OEEC Third Report (1960), neither of which was available at the time of this treaty), so that the League of Nations London draft was the then latest Model for such articles.

⁷⁴ *Société d'Investissement Agricole et Forestier*, (*Conseil d'Etat*, March 18, 1994, n79971, 8th and 9th sub-sections, RJF 5/94, n530).

⁷⁵ And also the property from net worth tax.

⁷⁶ See n.67. The French *Conseil d'Etat* had also reached the same decision in relation to the France-Luxembourg treaty in issue in this case, see n.74.

⁷⁷ "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" (Art.3).

distinction according to the type of owner of the immovable property. This resulted in double exemption.⁷⁸ It is suggested that on the wording of the treaty the court might, in the light of the Commentary to the League of Nations London draft, equally well have come to the opposite conclusion on the meaning of the business profits article which provided: "Income from industrial, mining, commercial or financial enterprises shall be taxable only in the State in which a permanent establishment is situated." This concentrates on the enterprise and not on the type of income and might therefore impliedly have priority over the immovable property Article.⁷⁹ The double exemption was caused by France concentrating on the business property Article and the Luxembourg Court 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, and more importantly contained neither what is now Article 6(4) of the OECD Model, providing that paragraphs 1 and 3 of the immovable property Article also applied to income from immovable property of an enterprise, nor Article 7(7), giving priority to other articles over the business profits Article.⁸⁰ 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 containing the provision referred to above since it would be clear that the income was from immovable property and not business profits. However, the cases well illustrate the effect of differing interpretations of what business profits are for the purposes of a treaty that can still arise where states take a different view of whether the person carries on business in the other state through a permanent establishment.

Reducing the problem of differing categorisations of business profits

The Model therefore permits the existence of 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 the source state (that in both civil law and common law source states whether there is a business determines whether there can be a permanent establishment, although the different approach for resident commercial companies may influence the answer). Civil law residence states applying a type-of-person approach to a commercial company will categorise more income as business profits than a common law residence state applying a

⁷⁸ 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.

⁷⁹ As pointed out by the author of the note cited in n.66 this Article is similar to the League of Nations London draft, on which see n.73. This treaty is referred to as an existing treaty in the OEEC First Report (1958) and was therefore not influenced by that Report, so that the League of Nations London draft was the then latest Model. The decision is therefore contrary to the then latest Commentary.

⁸⁰ Arts 6(4) and 7(7) seem to overlap and the former seems to be unnecessary. The explanation may be that Art.6(4) is derived from the OEEC Second Report (1959), the Commentary to which states: "the 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 Art.7(7) in the equivalent OEEC provision which is contained in the Third Report (1960); this was first included in the OECD 1963 Draft. This point is discussed by P-A Papotti and N Saccardo, "Interaction of Articles 6, 7 and 21 of the 2000 OECD Model Convention" (2002) 56 *Bulletin for International Fiscal Documentation* 10, 516 which comments on A. Rust, "Situs Principle v Permanent Establishment Principle in International Tax Law" (2002) 56 *Bulletin* 1, 15.

type-of-income approach. A civil law residence state is therefore more likely than a common law state to treat a business establishment in the source state as a permanent establishment and to attribute an item of income to a permanent establishment because it is expecting all the income to be business profits. Since civil law states tend to be exemption states 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 recognise the existence of a permanent establishment, and not tax the income as business profits attributable to a permanent establishment. This difference in approach is less important where the residence state follows the categorisation by the source state in accordance with the Commentary and under new treaties which contain Article 23A(4) preventing 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 permanent establishment 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 recognise a permanent establishment, and to attribute income to it. Where 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.

Where the source state does not recognise the existence of a permanent establishment it normally makes no difference whether the income is categorised as business profits. Either one starts with Article 7 and is sent to another article (and, if the other article is Article 10 to 12, not returned to Article 7 as there is no permanent establishment), or one starts in the other article. This is likely to result in a withholding tax being charged even where both states accept that the income is business profits, for example the bank which makes loans to residents of a state without having a permanent establishment 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 Model's approach.

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 as seen by the residence state. But if the treaty definition of business profits were 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 so the income will still 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 a withholding tax. This may not be possible in internal law.⁸¹ The problem that there is 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 permanent establishment whether or not the source state taxes the income (necessarily under internal law) as

⁸¹ 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 s.805 of the *Income Tax Regulations* that the withholding tax on dividends, interest and royalties applies except where the income is attributable to a business carried on through a permanent establishment.

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 categorisation but of internal law failing to tax income which the treaty allows it to tax. In relation to Article 23A(4) it is not that the source state "applies the provisions of this Convention" to exempt the income or charge a withholding tax, but that the internal law charging provision is narrower than the treaty permits.

A better approach might be that Articles 10(4), 11(4) and 12(3) should return one to Article 7 only if the income is in fact subject to tax⁸² as profits attributable to the permanent establishment. If the income were not subject to tax as business profits, it would remain in Articles 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 there would be no tax in the source state on business profits. But where 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 article cannot be solved for all cases, in which event it needs to be addressed specifically in treaty negotiations. It is surely a problem that needs solving.

⁸² Apart from relief for losses, etc.