
Chapter 6

“Business” and “Business Profits”

by Alexander Rust¹

6.1. Introduction

The OECD Model Convention (OECD Model) does not contain an exhaustive definition of the terms “business” and “business profits”.² While the OECD Commentary³ suggests interpreting these terms in the light of the domestic law of the state that applies the Convention parts of the jurisprudence⁴ and doctrine⁵ suggest the need for an interpretation of such terms which takes the context of the Convention into account. This chapter analyses the differing consequences of an interpretation in accordance with domestic law as well as the effects of a contextual interpretation. It will shed some light on the relationship between Art. 7 of the OECD Model and the other distributive rules and give guidance as to how to interpret the terms “business” and “business profits”.

1. Associate Professor, University of Luxembourg. The author would like to thank Mrs Suzanne Larsen for her valuable help.

2. Art. 3(1)(h) of the OECD Model only states that the term “business” includes the performance of professional services and of other activities of an independent character.

3. Para. 10.2 of the OECD Commentary to Art. 3 explains that the term “business” should under Art. 3(2) “generally have the meaning which it has under the domestic law of the State that applies the Convention.” The explanation of the term “enterprise” in the Commentary confirms this view. Para. 4 of the OECD Commentary to Art. 3 says that “[t]he question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States.” In Para. 71 of the OECD Commentary to Art. 7 the reference to domestic law is again confirmed: “Although it has not been found necessary in the Convention to define the term ‘profits’, it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD member countries.” Following this view: the French *Conseil d’État*, 26 November 1975, case No. 93187 *Droit Fiscal* (1976) Comment No. 733; Lehner, M., *Möglichkeiten zur Verbesserung des Verständigungsverfahren auf der Grundlage des EWG-Vertrages*, Munich: Beck, 1982, pp. 23 and 42.

4. See High Court of Australia, *Thiel v. Federal Commissioner of Taxation*, (1990) 21 ATR 531; *Bundesfinanzhof*, 29 April 2010, *ISr* (2010) p. 525 et seq.; 19 May 2010, *ISr* (2010), p. 530 et seq.

5. Hemmelrath, in Vogel and Lehner, *Kommentar zu den Doppelbesteuerungsabkommen*, Munich: Beck, 2008, 5th edn., Art. 7 Para. 29 et seq.; Lang, M., *Hybride Finanzierungen im Internationalen Steuerrecht*, Vienna: Linde, 1991, p. 75 et seq.

6.2. Consequences of an interpretation in the light of domestic law

Despite the fact that domestic tax systems differ significantly, an interpretation of the term “business profits” in light of the domestic tax laws of the contracting states rarely leads to the application of different distributive rules. And then, even if contracting states apply different distributive rules, Art. 23 of the OECD Model prevents any double taxation that would result therefrom. However, this interpretation might facilitate tax treaty abuse by those contracting states eager to increase their tax revenues to the detriment of the other country.

Domestic tax laws differ in many respects between countries. In some countries, indirect taxes play a significant role in raising tax revenue, while in others, individual and corporate income taxes are the main revenue raisers.⁶ Countries have also designed their income tax laws in different ways. For example, the notion of “income” itself may encompass income from whatever source derived; it might be limited to different income categories, thereby excluding from income tax increases in value that do not fall within the ambit of one of the enumerated categories.⁷ In particular, the delimitation between business income and asset management, between business income and income from agriculture or income from independent personal services⁸ varies from country to country. Some countries categorize capital gains differently than business income even if the particular asset sold formed part of the business assets; other countries regard all profits earned through the sale of business assets as part of business profits. Some countries use fictions, i.e. under certain circumstances non-business income is deemed to be business income: For instance, the domestic law might provide: that all income earned by a corporation is to be regarded as business income;⁹ that all income earned by a partnership is requalified into busi-

6. See the statistics of the OECD at www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html; Gruber, J., *Public Finance and Public Policy*, New York: Worth Publishers, 2005, p. 486 et seq.

7. E.g. for the US, Sec. 61(1) of the IRC: “[g]ross income means all income from whatever sources derived,...”, and in Germany, Sec. 2(1) of the Income Tax Act, which contains an exhaustive list of income categories; see also Lang, M., in Tipke and Lang (eds.), *Steuerrecht*, Cologne: Otto Schmidt, 2010, 20th edn., p. 270.

8. With the abolition of Art. 14 of the OECD Model, the distinction between business income and income from personal services is no longer relevant as now both types of income fall within the ambit of Art. 7 of the OECD Model.

9. See e.g. Art. 183 of the Belgian Income Tax Code; Arts. 34 and 205 of the French *Code Général des Impôts*; Sec. 8(2) of the German Corporate Tax Act; Art. 162(3) of the Luxembourg Income Tax Act; for further references, see Avery Jones, J. F., et al., “Treaty conflicts in categorizing income as business profits caused by differences in approach between common law and civil law”, *Bulletin for International Fiscal Documentation* (2003) p. 237 (239) note 13.

ness income if at least part of the income is business income;¹⁰ that lease payments made by a corporation to its shareholder or by a partnership to its partner are to be requalified into business income;¹¹ that rental income is to be requalified into business income if a complete business is leased for a limited time to another person.¹² Such examples show that different countries answer the question as to what constitutes “business income” under their respective domestic tax law differently.

If income is categorized in one contracting state as business income and in the other contracting state as non-business income, and both states interpret the distributive rules according to Art. 3(2) in light of their domestic law, they will consequently apply different distributive rules. In many cases, this conflict is already resolved by the OECD Model itself. Art. 7 declares itself inapplicable if the income falls within the ambit of a more specific rule. More particularly, Art. 7(4) provides that business profits which include items of income which are dealt with separately in other Articles of the OECD Model, are covered by such other articles. Typically, the deeming provision in the domestic law merely alters the starting point. Ultimately, both countries will apply the more specific distributive rule. This can be illustrated by the following examples:

Example 1

Country A regards all income earned by a corporation as business income while country B categorizes income earned by a corporation according to the particular nature of the income. A corporation resident in country A is engaged in asset management and derives dividends from country B.

Solution: Country A will start by applying Art. 7. As Art. 7(4) refers to Art. 10, the dividend article, country A will finally apply Art. 10. Country B, on the other hand, starts directly with the application of Art. 10 without making the detour over Art. 7. However, both countries will ultimately apply the same distributive rule.

10. E.g. Sec. 15(3) No. 1 of the German Income Tax Act, so called “*Abfärbe- oder Infektionstheorie*”, see Wacker, R., in Schmidt, *Kommentar zum Einkommensteuergesetz* Munich: Beck, 2010, 29th edn., § 15 Marg. note 185 et seq.

11. Sec. 15(1) No. 2 of the German Income Tax Act, Art. 14 No. 2 of the Luxembourg Income Tax Act; theory of “*Betriebsaufspaltung*” (company split-up) see for Germany: Wacker, R., in Schmidt, *Kommentar zum Einkommensteuergesetz*, id., § 15 Marg. note 800 et seq.; for Luxembourg: Steichen, *Manuel de droit fiscal*, Luxembourg: Saint Paul, 2006 edn., p. 1047.

12. In German tax law theory of “*Betriebsverpachtung*” (lease of a branch of activity) see Wacker, R., in Schmidt, *Kommentar zum Einkommensteuergesetz*, id., § 16 Marg. note 690 et seq. The same for Luxembourg tax law: “*Théorie de la location-gérance*” see Steichen, A., *Manuel de droit fiscal*, Luxembourg: Saint Paul, 2006, p. 1047.

Similarly, both contracting states will come to a common result and apply the same distributive rule if (a) the company engages in a business activity, (b) the shares are part of the assets which support the business activity, and (c) such shares are attributable to a permanent establishment (PE) in the other contracting state.

*Example 2*¹³

Country A regards all income earned by a corporation as business income while country B – again – categorizes income earned by a corporation according to the particular nature of the income. Country B does not regard dividend income as part of the business income even though it is connected to the business activity. A company resident in country A (“company X”) is engaged in a genuine business activity and it is the majority shareholder of another corporation resident in country B (“company Y”). Company X has a PE in country B and its shares in company Y are attributable to the PE.

Solution: As in the first example, country A will again start with the application of Art. 7 as all income earned by a corporation is deemed to be business income under its domestic law. Country A is then sent to Art. 10 via Art. 7(4). Art. 10(4), however, immediately send country A back to Art. 7 as the holding in respect of which the dividends are paid is effectively connected with the PE. For the source state, country B, which does not apply the same fiction, the starting point remains Art. 10. It characterizes the income as dividend income. However, Art. 10(4) also sends the country B to Art. 7 as the dividends are connected with the business carried on through the PE, even though the dividends are not regarded as business profits in the domestic law of country B. Thus, once again, both country A and country B are ultimately applying Art. 7.

However, both contracting states will apply different distributive rules if the company does not exercise a genuine business activity and only one contracting state treats all income derived by a company as business income in its domestic law.

Example 3

As in the previous examples, country A regards all income derived by a company as business income while country B categorizes income earned by a corporation according to the particular nature of the income. This

13. See, for this example, Avery Jones, et al., “Treaty conflicts in categorizing income as business profits caused by differences in approach between common law and civil law”, op. cit., supra note 9, p. 237 (245).

time, however, company X, a resident of country A is not engaged in a genuine business activity; it only manages a portfolio of shares through an office in country B.

Solution: Once again, country A starts with Art. 7, then applies, in turn, Art. 10, which sends country A back to Art. 7 via Art. 10(4). Due to its qualification of asset management as a business activity under its domestic law, country A regards company X's office in country B as a fixed place through which the *business* of asset management is carried on. Thus, for country A, the office in country B is a PE in the sense of Art. 5(1)(2)(c). On the contrary, country B will solely apply Art. 10 because it does not regard the mere management of assets as a business activity. In such circumstances, country B will not treat company X's office as a fixed place through which the *business* of company X is carried on. Without the existence of a PE in the sense of Art. 5 it does not apply Art. 10(4). The qualification of the category of income is decisive for the question whether or not company X's office constitutes a PE. As a result, country A will apply Art. 7 while country B will apply Art. 10(2).

In *Examples 1* and *2* above both contracting states apply the same distributive rule despite the differences in their respective domestic law. In *Example 3* the interpretation of the treaty terms in light of the domestic law leads to the application of different distributive rules. Due to the “new approach” of the OECD,¹⁴ this qualification conflict does not result in double or double non-taxation. In *Example 3* the residence state would normally – assuming it is an exemption state – exempt all income attributable to the PE in the other contracting state. The other contracting state will apply the reduced withholding tax rate prescribed by Art. 10(2). However, as the source state – according to its own interpretation – is not entitled to a full taxing right, the residence state is not obliged to grant exemption provided for in Art. 23A(1). The source state taxes in accordance with Art. 10. As a result, the residence state is only obliged to grant relief pursuant to Art. 23A(2) and credit the withholding tax levied by the source state. In this situation the new approach avoids double non-taxation.¹⁵

14. See for this solution, Déry and Ward, “National Report: Canada”, in *IFA Cahiers de droit fiscal international*, 1993, Vol. 78a, “Interpretation of double taxation conventions”, p. 281 et seq.; the OECD proposed the new approach for the first time in the 1999 report “The application of the OECD Model Tax Convention to partnerships: Issues in international taxation, No. 6”, Para. 94 et seq. This proposal has been included in the 2000 version of the OECD Commentary to Art. 23A and B, Para. 32.1 et seq.

15. Or to be more precise a very low taxation in the source state combined with an exemption in the residence state.

Example 4

In the reverse situation the source state applies the fiction that all income earned by a corporation is to be regarded as business income and the residence state treats all income only with regard to its nature and does not apply this fiction.

Solution: Here, the residence state is of the opinion that Art. 10 should be applied while the source state will end up applying Art. 7.¹⁶ As the source state – due to its interpretation of Art. 7 in light of its domestic law – is entitled to tax all income attributable to the PE within its territory, the residence state is obliged to exempt such income in accordance with Art. 23(A).¹⁷ Here, the new approach avoids double taxation (as opposed to avoiding double non-taxation in *Example 3*).

Thus, the differing interpretations of the terms “business” and “business profits” in light of the domestic law of each of the two contracting states neither lead to double taxation nor double non-taxation. However, it is a valid argument that the new approach may result in an unbalanced division of taxing rights.¹⁸ The source state has the possibility to increase its taxing right unilaterally by changing its domestic law.¹⁹ If the specific tax treaty is drafted in accordance with the OECD Model it is beneficial for the source state to extend the scope of the definition of the terms “business” and “business income” in its domestic law as far as possible by introducing new fictions of business income. This will give a full taxing right to the source state whenever the (passive) activity is exercised through a fixed place in the source state. If the specific tax treaty contains a provision similar to Art. 21(3) of the UN Model²⁰ it is more beneficial for the source state to narrow the scope of the terms “business” and “business profits” in its domestic tax law. This way, the income will be taken out of the scope of Art. 7 and Art. 21(3) allows the

16. The source state will start with Art. 7, will be sent to Art. 10 via Art. 7(4) and finally fall back on Art. 7 via Art. 10(4).

17. Assuming again that the residence state is an exemption state. If the residence state is a credit state it has to grant a credit in accordance with Art. 23B(1).

18. See Vogel, K., in Vogel and Lehner, *Kommentar zu den Doppelbesteuerungsabkommen*, op. cit. supra note 5, Art. 3, Para. 114.

19. Para. 13 of the OECD Commentary to Art. 3 limits the ability of a source state to extend a taxing right by changing its domestic law. It states that “a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention”.

20. Art. 21(3) of the UN Model 2001 has the following wording: “Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting state may also be taxed in that other State.”

source state to tax the income without respecting a PE threshold.²¹ The possibility of such manipulation speaks against permitting the interpretation of the terms “business” and “business profits” in light of domestic law..

Manipulations can be met with counteractive measures.²² However, permitting terms of the treaty to be interpreted in the light of the contracting states’ domestic law has resulted, on several occasions, in taxation which does not seem to be in conformity with such balanced revenue allocation decisions even if there was no manipulation involved. Beekeeping is an excellent example.²³ Under the domestic law of many countries, beekeepers’ income is considered income earned from agriculture.²⁴ Such income, however, does not fall within the ambit of Art. 6 as it is not considered to be income “from the direct use of immovable property.”²⁵ If the income – due to the interpretation of the term “business profits” in the light of domestic law – is taken out of the ambit of Art. 7 and Art. 6 is not applicable either, the income will be covered by Art. 21. That would mean that even in a situation where bees collect pollen from flowers located in the source state and then create honey in beehives located in that source state and then that honey is collected by the beekeeper, the source state will be excluded from taxing the income from the sale of the honey. The application of Art. 7 instead would come to a more equitable result as the beehives could be regarded as a PE.²⁶

6.3. Consequences of an interpretation taking the context into account

Instead of interpreting the terms “business” and “business profits” in light of the domestic law good arguments support the use of an autonomous interpretation which takes the context into account.²⁷ Such an autonomous

21. On the other hand, the application of the PE provisos in Arts. 10(4) and 11(4) is excluded if the income is taken out of the scope of Art. 7.

22. See e.g. Art. 60 VCLT.

23. The taxation of fishermen and shepherds can serve as additional examples.

24. See e.g. Sec. 13 German Income Tax Act and Art. 61 Luxembourg Income Tax Act. For the beekeeper example see Hemmelrath, in Vogel and Lehner, *Kommentar zu den Doppelbesteuerungsabkommen*, op. cit. supra note 5, Art. 7 Marg. note 31.

25. Reimer, in Vogel and Lehner, *Kommentar zu den Doppelbesteuerungsabkommen*, op. cit. supra note 5, Art. 6 Marg. note 38. There are, however, good arguments to regard beekeeping as falling within the ambit of Art. 6. Getting milk from cows or getting honey from bees does not seem to make much difference. Raising cows for milk production is clearly covered by Art. 6.

26. Art. 21(2) does not allow a renvoi to Art. 7 as the income is not regarded as such as business income.

27. See below at 6.4.4 and 6.4.5.

interpretation has the advantage of being compulsory for both contracting states, which results in both contracting states applying the same distributive rule. This common interpretation²⁸ of treaty terms by both contracting states avoids double taxation. On the other hand, an autonomous interpretation may lead to double non-taxation:²⁹ if the term “business profits” is interpreted in a broader way in the tax treaty than in the domestic law of the source state the source state may not always be able to make use of its taxing right³⁰ but the residence state would nevertheless be obliged to exempt the income. For instance, in its domestic law, the source state might treat the income as a non-taxable one-time activity³¹ or as miscellaneous income subject to a small withholding tax,³² but the tax treaty would still prevent the residence state from taxing the income connected to a PE in the source state.

This would exactly happen in the situation mentioned in *Example 3* above if both countries interpret the treaty term “business profits” in an autonomous way as also including mere asset management. In its domestic law, the source state does not regard the office through which the dividends are received as a PE as it does not requalify the dividends into business income. The autonomous definition of “business profits” contained in the tax treaty does not alter the income qualification in domestic law. The source state will levy a withholding tax on the dividends which might be much less than a tax on the net income attributable to the office.³³ The residence state, if it is an exemption state, is nevertheless still obliged to exempt the income attributable to a PE in the source state although the source state does not tax the income as business income under its domestic law.

28. For the goal of a “common interpretation” see Vogel, K., in *Klaus Vogel on Double Taxation Conventions*, Kluwer, 1997, 3rd edn., Intro Marg. note 74; id., in Vogel and Lehner, *Kommentar zu den Doppelbesteuerungsabkommen*, op. cit. supra note 5, Einl. Para. 114; Schaumburg, H., *Internationales Steuerrecht*, Cologne: Otto Schmidt, 2011, 3rd edn., p. 636; Reimer, R., “Seminar F: Die sog. Entscheidungsharmonie als Maßstab für die Auslegung von Doppelbesteuerungsabkommen”, *ISIR* (2008), p. 551.

29. See Avery Jones, et al., “Treaty Conflicts in Categorizing income as business profits caused by differences in approach between common law and civil law”, op. cit. supra note 9, p. 237 (248).

30. The source state could of course change its domestic law in order to make use of the taxing right accorded in the treaty.

31. If the source state interpreted the convention in light of its domestic law it would apply Art. 21 of the OECD Model.

32. An interpretation in light of the domestic law of the source state would again lead to the application of Art. 21 of the OECD Model.

33. According to Art. 7(3) of the pre-2010 version of the OECD Model, the source state is nevertheless obliged to grant a deduction for all expenses that are incurred in connection with the dividend income. For treaty purposes, the office in the source state has to be regarded as a PE.

Neither the “new approach” nor Art. 23A(4) will prevent this double non-taxation as there is no disagreement about the interpretation of the treaty terms. The issue is that the source state, pursuant to its domestic tax law does not make full use of its taxing right as attributed by the treaty whenever the autonomous treaty definition is larger than the definition in the domestic tax law.

6.4. Relationship between Art. 7 and other distributive rules

As shown above, with respect to the scope of the terms “business” and “business profits,” neither an interpretation in the light of the domestic law nor an autonomous treaty interpretation offer perfect solutions. Both can lead to undesirable consequences: the former allows a source state to unilaterally increase its taxing right, while the latter might result in double non-taxation.

While the OECD Commentary proposes an interpretation of the term “business profits” in the light of the domestic law, the jurisprudence and doctrine are partly in favour and partly against the application of Art. 3(2).³⁴

34. Courts in favour of the application of Art. 3(2): Dutch *Hooge Raad*, 10 March 1993, BNB 1993/227; French *Conseil d'État*, 26 November 1975, req. No. 93187; *Droit Fiscal* (1976) Comment No. 733. Courts against the application of Art. 3(2): High Court of Australia, *Thiel v. Federal Commissioner of Taxation*, (1990) 21 ATR 531; Austrian *Verwaltungsgerichtshof*, 21 May 1997, 96/14/0084 (see, however, the differing opinion of the Austrian tax administration of 4 December 2000, EAS 1747 and of 14 October 2002, EAS 2127); German *Bundesfinanzhof*, 17 December 1997, *IStR* (1998), p. 243 et seq. (the Germany–US treaty contained an explicit definition of the term “*gewerblicher Gewinn*”); 29 April 2010, *IStR* (2010), p. 525 et seq.; 19 May 2010, *IStR* (2010), p. 530 et seq. (in *Bundesfinanzhof*, 26 April 1966, BStBl. III 1966, however, the Court interpreted the term “*Einkünfte aus Gewerbebetrieb*” in the Germany–Switzerland treaty still in the light of German domestic law; the German tax administration also wants to interpret Art. 7 in the light of German domestic law, see *Bundesfinanzministerium*, 24 December 1999, BStBl. I 1999, 1076). Scholars in favour of applying Art. 3(2): Lehner, M., *Möglichkeiten zur Verbesserung des Verständigungsverfahren auf der Grundlage des EWG-Vertrages*, Munich: Beck, 1982, pp. 23 and 42. Scholars against the application of Art. 3(2): Hemmelrath, A., in Vogel and Lehner, *Kommentar zu den Doppelbesteuerungsabkommen*, op. cit. supra note 5, Art. 7 Para. 29 et seq.; Lang, *Hybride Finanzierungen im Internationalen Steuerrecht*, op. cit. supra note 5, p. 75 et seq.; id., “Der Begriff ‘Unternehmen’ und Art. 24 OECD-Musterabkommen”, *SWI* (2011), p. 9; Schaumburg, *Internationales Steuerrecht*, op. cit. supra note 23, Para. 16.214: “Der Abkommenszusammenhang verbietet die Anwendung von Einkünftequalifikationsregeln des nationalen Rechts. Unternehmensgewinne sind daher Einkünfte aus selbständiger Erwerbstätigkeit, die nicht Nutzung unbeweglichen Vermögens darstellt, soweit diese Einkünfte nicht unter die für Dividenden, Zinsen und Lizenzgebühren oder andere Einkünfte geltenden Verteilungsnormen fallen. Einkünfte von Gewerbebetrieben kraft Rechts, gewerbliche geprägten Personengesellschaft, Betriebsaufspaltung fallen nur dann unter Art. 7, wenn die erwerbstätigkeit einer eigengewerblichen Tätigkeit entspricht.”