The Relationship between the Taxation of Business Profits and Income from Immovable Property under Tax Treaties

This article examines the relationship between the provisions in the OECD Model on income from immovable property and on business profits, establishes the overlaps, demonstrates how these overlaps were solved by the predecessors of the OECD and domestic courts – thereby leading to qualification conflicts – and discusses how this situation is currently resolved.

1. Introduction

1.1. The treaty framework

Although many companies have digitalized large parts of their businesses, they still have immovable property that either supports their activities, or serves as an independent source of income (for example, in respect of leasing of immovable assets). In cross-border cases, the question always arises as to the allocation of the taxing right with regard to the income generated from the immovable property of a company. A brief example illustrates this situation.

A company has its registered office and place of management in Italy. It owns immovable property in France. It rents out the property or uses it for its own business purposes (an example would be the office building of a professional partnership). It is questionable whether Italy, as the state of residence of the company (the “state of residence”), or France, as the state of the source of income (the “source state”), should be allocated the taxing right, and how any double taxation of the income generated from the immovable property should be avoided.

The allocation of taxing rights between the state of residence and the source state is regulated by the states by way of tax treaties, which are based on the (current) OECD Model (2017). The OECD Model fulfills this allocative function through rules (“distributive rules”), which determine which is the taxable event, and the legal consequences attached to it. The latter consist, on the one hand, in the allocation of the taxing right to the state of residence or source state (“legal consequence 1”) and, on the other, in the avoidance of double taxation of the income concerned (“legal consequence 2”).

If a distributive rule provides that the income that only be taxed in one of the contracting states (as is the case, for example, in article 8 of the OECD Model: “Profits […] can only be taxed in the Contracting State”), it also states that, at the same time, the other state must exempt the income attributable to the corresponding distributive rule. If, on the other hand, the distributive rule does not exclusively grant the taxing right to a contracting state, it only grants that contracting state the prior right to tax without excluding the other contracting state’s right of taxation. The distributive rule, therefore, does not state how double taxation is to be avoided. In these cases, article 23 should be consulted, which contains two methods for avoiding double taxation. These two methods are: (i) the exemption method in article 23A(1), according to which the state of residence exempts the income taxable in the source state from taxation; and (ii) the credit method in article 23B(1) (a), under which the state of residence credits the tax paid on the income in the source state against the tax to be levied on the income of this person.

With regard to the allocation of the right of taxation (i.e. legal consequence 1), the following two distributive rules of the OECD Model come into question in the above example: (i) article 6 (Income from immovable property); and (ii) article 7 (Business profits). On the one hand, under article 6:

- [Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State (the “situs state”).]

- "OECD Model Tax Convention on Income and on Capital (21 Nov. 2017)." Treaties & Models IBFD.

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1. OECD Model Tax Convention on Income and on Capital (21 Nov. 2017), Treaties & Models IBFD.


3. It must be said that there is a controversy as to the function of the distributive rules. There are three opinions in the literature. These opinions are: (i) distributive rules allocate taxing rights; (ii) distributive rules restrict existing taxing rights of the contracting states; and (iii) by way of distributive rules, the contracting states avail of exercising existing taxing rights. See F. Wassermeyer, Artikel 1, in Doppelbesteuerungsabkommen (Double Taxation Agreements) para. 8 et seq. (F. Wassermeyer ed., C.H. Beck Jan. 2008), with further references.

4. In general, all articles of the OECD Model are cited hereinafter without the addition of the words “OECD Model”.

5. Lehner, supra n. 2, at para. 82.
On the other hand, under article 7(1), sentence 1:  

profits of an enterprise of a Contracting State shall be taxable only in that State [the state of residence] unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.

In the latter case, i.e. if there is a permanent establishment (PE), the primary taxing right is to be allocated to the state in which the PE carries on the business activity of the enterprise (the "PE state") under article 7(1), sentence 2.

Applied to the preceding example, articles 6 and 7 allocate the taxing right differently if there is no PE in the situs state ("non-PE cases"). In cases where there is no PE, the taxing right lies with the situs state (in the example in question, France) when applying article 6. In contrast, when applying article 7, the taxing right lies exclusively with the state of residence due to the lack of a PE according to article 7(1), sentence 1 (in the example in question, Italy!). It becomes apparent that the allocation of the taxing right according to article 6, on the one hand, and article 7, on the other, can differ in the non-PE cases.

Furthermore, the method for the avoidance of double taxation (i.e. legal consequence 2) in the non-PE cases may also differ depending on whether article 6 or 7 is applied. According to article 7(1), sentence 1, the profits of an enterprise of a contracting state can only be taxed in the state of residence. If, on the other hand, the enterprise carries on its business through a PE located in the other contracting state, the profits of the enterprise may be taxed in the PE state (article 7(1), sentence 2). Similarly, according to article 6, income from immovable property may ("only" is missing) be taxed in the situs state. With regard to the latter two cases, reference must be made to the provision corresponding to article 23 on the methods for avoiding double taxation to determine which of these methods (i.e. the exemption or credit method) applies in the case of articles 6 and 7 (in respect of article 7, only for PE income).

Most of the tax treaties concluded by Germany generally provide for the exemption method as the standard method. The application of the credit method is provided for only in exceptional cases. This applies both to income from immovable property and to PE income. However, there are a number of tax treaties in which the application of the credit method is provided for income from immovable property that is not earned through a PE (i.e. with regard to the non-PE cases). In contrast, the exemption method is applied to business profits, and income from immovable property earned through PE in the situs state ("PE cases"). This deviation is most clearly seen in the Germany-Spain Income and Capital Tax Treaty (2011), article 22(2) of which reads:

(b) ... there shall be allowed as a credit against German tax on the following items of income or on the property situated within the Kingdom of Spain the Spanish tax paid...

(vii) income from immovable property... insofar as such property is not effectively connected with a permanent establishment situated in the Kingdom of Spain.

Conversely, there are also German tax treaties that prescribe the credit method as the standard method. With regard to these tax treaties, there are also deviations in the application of the method for the avoidance of double taxation between articles 6 and 7. In respect of business profits and income from immovable property derived from a PE, for example, the Germany-Switzerland Income and Capital Tax Treaty (1971) provides for the application of the exemption method instead of the application of the credit method, which applies in all other respects (i.e. also to income from immovable property not earned through a PE). As is stated in article 24(1)(1)(a) of the Germany-Switzerland Income and Capital Tax Treaty (1971):

(l) The following items of income from Swiss sources which may be taxed in Switzerland in accordance with the above Articles shall be excluded from the base on which German tax is imposed:
(a) profits of the meaning of Article 7... the same applies to income from immovable property used by such a permanent establishment...

In summary, there is a tendency in German treaty policy to favour the credit method for income from immovable property in the non-PE cases, whereas business profits and income from immovable property are exempted in the PE cases. However, this is not the only differentiation. For instance, according to one view in the literature, as is demonstrated section 3.4., the rules on the allocation of profits between the head office and the PE (the "Authorised OECD Approach", or "AOA") set out in article 7(2) do not apply to income from immovable property, even if this income is earned through a PE.

6. On the increasing tendency of German treaty policy to favour of the application of the credit method, see M. Schiessl & B. Keller, Übergang auf die Anrechnungsmethode – Paradigmenwechsel in der Abkommenpolitik? Internationales Steuerrecht 8 (2011)

7. DE: (Verhandlungsgrundlage für Doppelbesteuerungsabkommen im Bereich der Steuern vom Einkommen und Vermögen) (Basis for Negotiations for Agreements for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital), art. 22(1)(a)(c) and (d), as published by the German Bundesfinanzministerium (Federal Ministry of Finance).

8. See the agreement overview on article 23 under the column "Unbewegliches Vermögen, falls nicht zu Betriebsstätte gehörend" ("Immovable property, if not pertaining to permanent establishment", author’s unofficial translation), in R. Ismer, Articles 23A and B, in Ismer ed., supra n. 2, at para. 16.


11. See also the agreement overview on article 23 under the column "Einkünfte aus unbeweglichem Betriebsvermögen" ("Income from immovable business assets", author’s unofficial translation), in Ismer, supra n. 8, at para. 16.

12. OECD, Attribution of Profits to Permanent Establishments – Report 22 July 2010 (OECD 2010), Primary Sources IBFD.
1.2. Structure of the article
Against the background outlined in section 1.1., it is important both for the allocation of the taxing right and for the application of the correct method for the avoidance of double taxation, first, to determine the scope of article 6 and article 7, respectively. Then, the question arises as to whether there are cases in which articles 6 and 7 coincide in terms of their scope of application, so that both can apply and this relationship between these norms must be regulated.

The relationship between these provisions is regulated by article 6(4), which grants article 6 precedence over article 7:

The provisions of paragraphs 1 and 3 [of article 6] shall also apply to the income from immovable property of an enterprise.

Article 6(4), therefore, provides the following demarcation between articles 6 and 7. If articles 6 and 7 apply at the same time, article 6 is given priority. Consequently, this provision indicates that there may well be cases that initially fall under both articles 6 and 7 (the “overlap”).

However, article 6(4) does not specify when such an overlap exists. For instance, it is questionable whether both the rental and the business use of the property (from the example in section 1.1.) fall under both articles 6 and 7. As a result, in section 2., the constituent elements of these provisions are analysed to: (i) clarify their individual scope of application (see sections 2.2. and 2.3.); and (ii) identify the area of overlap area between them (see section 2.4.).

In section 3., a historical overview of the relationship between articles 6 and 7 and the birth of article 6(4) is provided (see section 3.3.) and the practical significance of the latter provision in relation to the allocation of the right of taxation is illustrated with examples from case law (see section 3.2.). In the remainder of section 3., the author explores the nature of this relationship, and presents the views expressed in the literature in this respect (see section 3.4.) as well as his own views (see section 3.5.). The author’s conclusions are set out in section 4.

2. The Overlap between Articles 6 and 7
2.1. Introductory remarks
A demarcation between two legal norms, like that in article 6(4), is only necessary if, and to the extent that the norms coincide for the same facts (a so-called “conflict of norms”). The existence of a conflict of norms, and, therefore, the need for a demarcation between the conflicting legal norms presupposes two things. First, both legal norms must be applicable simultaneously in terms of their preconditions. Second, the norms must determine different legal consequences. To this end, as demonstrated in section 1.1., articles 6 and 7 have different legal consequences with regard to the allocation of the taxing right and the application of the method for the avoidance of double taxation in the non-PE cases. Consequently, the second condition for the existence of a conflict between articles 6 and 7 is fulfilled. The question, therefore, arises as to whether, and when, articles 6 and 7 can apply simultaneously for the first prerequisite for the existence of a conflict of norms to also be met. The analysis in the remainder of section 2. (including the author’s interim conclusions in section 2.4.) addresses this question. The author begins by considering the scope of articles 6 and 7 (see section 2.2. and 2.3.).

2.2. Business profits
2.2.1. The term “profits” in article 7 as a means of demarcation

Article 7 is the distributive rule for the “profits” of an enterprise. The definition of the term “profits” is important and historically significant in the demarcation between business profits and income from immovable property, as it was originally considered by the OECD’s predecessor, the Organisation for European Economic Co-operation (OEEC), to be the appropriate means of distinguishing business profits from income falling under other distributive rule. This definition, according to the original approach under the OEEC, was intended to define the term ‘profits’ very narrowly and to exclude explicitly other types of income from its scope.

More specifically, Working Party 14 (“WP14”) of the Fiscal Committee (“FC”) of the OEEC had dealt with a draft definition article, which, as with article 3 (entitled General definitions) in the OECD Model (2017), had defined many terms used in the other articles. One of these terms was the term ‘profits’, being:

The term profits... includes income derived from the direct exercise of business... but does not include... income from immovable property.

It follows from this definition that the profits of an enterprise were intended originally to be only profits of a commercial and industrial nature. Other types of income were excluded, including income from immovable property (“but does not include... income from immovable property”). Accordingly, the scope of application of the distributive rule for business profits was to be delimited from that of the other distributive rules, as the commentary to this draft makes clear in paragraph 5:

The definition of the term profits... is intended to secure that the only profits to be affected by these Articles shall be industrial and commercial profits.

The Dutch delegation had nevertheless made a different proposal regarding the demarcation of business profits

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from the other distributive rules at the 25th meeting of the FC of the OEEC on 6 to 9 June 1961.\textsuperscript{17} This consisted in adopting a rule to distinguish business profits from income falling under other distributive rules, instead of doing so by defining the term “profits”. WP14 took up the proposal of the Dutch delegation and abandoned the attempt to give a definition to the term ‘profits’. Instead, WP14 created a provision with the same wording as the current article 7(4). According to this rule, the other distribution norms (in particular articles 10 to 12) were given precedence over article 7, that is:

Where profits include items of income which are dealt with separately in other Articles of this Convention then the provisions of these Articles shall not be affected by the provisions of the present Article.\textsuperscript{18}

WP14 justified this approach, in particular, by stating that the definition of the term “profits” would possibly lead to an excessive restriction of this term and, therefore, of the scope of the distributive rule for business profits:

What can be done is to restrict the scope of the term (profits)... but there was a strong opinion against a narrow meaning of the term.\textsuperscript{19}

In summary, it can be concluded that if the term “profits” were defined conclusively in article 7, the demarcation problem would not exist. This situation arises because, in such a case, article 7 would have a very narrow scope of application, which would only consist of industrial and commercial income and certainly not include income derived from immovable property. The authors of the OECD Draft (1963),\textsuperscript{20} therefore, preferred not to narrow the term “profits” but, rather, to give it a broad scope. In doing so, they accepted a possible overlap of article 7 with other distributive rules (and, therefore, also with article 6).

2.2.2. The profits of an “enterprise”

In the introductory example in section 1.1., it was made clear that an enterprise can earn profits from immovable assets. However, if there is no enterprise to which the income from immovable property can be attributed, the problem concerning this contribution is irrelevant. In that case, only the application of article 6 comes into consideration. Consequently, it is important to define the term “enterprise” as used for the purposes of article 7.\textsuperscript{21}

On the one hand, the Commentary on Article 3 of the OECD Model (2017) refers to domestic law with regard to the interpretation of the term “enterprise”.\textsuperscript{22} The prevailing opinion in the literature\textsuperscript{23} and the case law of the Bundesfinanzhof (the Federal Tax Court, or “BFH”),\textsuperscript{24} on the other hand, call for an autonomous interpretation of the purposes of the tax treaty. The author also follows an autonomous interpretation of the term “enterprise”. Two arguments can be advanced in this respect.

First, a definition of the term “enterprise” under domestic law is impossible in the case of common law jurisdictions, as they do not use the term “enterprise” in their national legal system.\textsuperscript{25} This state of affairs was demonstrated in the famous judgment of the High Court of Australia (HCA) in Thiel (1990),\textsuperscript{26} which called for an autonomous definition of the term:

An expression such as the word “enterprise” may have no exact counterpart in domestic tax laws, being part of an international tax language.\textsuperscript{27}

The term “enterprise” is also foreign to German income tax law.\textsuperscript{28} As a result, the reference to domestic law is not feasible for pragmatic reasons for a large number of contracting states.

Furthermore, recourse to the interpretation of a term used in the OECD Model is only permissible if the term is not defined in the OECD Model, as article 3(2), sentence 1 stipulates (“any term not defined therein”). And, in article 3(1)(c), there is a definition of the term “enterprise”. Here, the term “enterprise” applies the carrying on of a business activity.\textsuperscript{29} Recourse to domestic law – at least in respect of tax treaties that contain article 3(1)(c) – is not necessary in such cases.

However, it must be stated that the wording of article 3(1)(c) defining the term “enterprise” is rather cryptic, and requires interpretation. At first glance, it can be inferred from its wording that the enterprise is to be regarded as an activity (“applies to the carrying on of any business”). However, if one also considers the wording of article 7(1), it becomes clear that the term “enterprise” has a different meaning in the context of article 7, and cannot be regarded as a type of activity to be carried out. Article 7(1) presupposes that the profits are attributable to an enterprise carrying on a business activity (“profits of an enterprise... the enterprise carries on business” [emphasis added]). In other

\begin{itemize}
  \item \textsuperscript{17} See the written record of the minutes of the FC, Minutes of the 25th Session p. 7 (8 July 1961).
  \item \textsuperscript{18} Compare WP14/FC, Report on Priority Rules (16 Apr. 1962).
  \item \textsuperscript{19} WP14/FC, Third Report on the Article of Definitions p. 7 (8 Jan. 1962).
  \item \textsuperscript{20} OECD Draft Tax Convention on Income and on Capital (31 July 1963), Treaties & Models IBFD.
  \item \textsuperscript{21} The term “enterprise” has different meanings depending on the constellation in which it is used. It can refer both to the person of the taxpayer and to the form of the activity carried out. See K. van Raad, The Term “Enterprise” in the Model Double Taxation Conventions – Seventy Years of Confusion, 22 Intertax 11, pp. 492-493 (1994).
  \item \textsuperscript{22} OECD Model Tax Convention on Income and on Capital: Commentary on Article 3, para. 4 (21 Nov. 2017), Treaties & Models IBFD.
  \item \textsuperscript{25} J.F. Avery Jones et al., The Origins of Concepts and Expressions Used in the OECD Model and Their Adoption by States, Brit. Tax Rev. 6, p. 701 (2006).
  \item \textsuperscript{26} AU HCA, 22 Aug. 1990, Thiel v. Federal Commissioner of Taxation, 90 ATC (1990), p. 4717, Case Law IBFD.
  \item \textsuperscript{27} Id., at pp. 4722-4723.
  \item \textsuperscript{28} Lang, supra n. 23, at p. 17 et seq.
\end{itemize}
words, the enterprise is not the business activity, but the enterprise performs business activities. Accordingly, the enterprise could be equated with the taxpayer.

However, as article 7(1) and (2) refers to an “enterprise of a Contracting State”, the provision defining this term must also be consulted, namely article 3(1)(d), to specify further the content of the term “enterprise” in article 7. Article 3(1)(d) defines the term “enterprise of a Contracting State” as an enterprise carried on by a resident of a Contracting State. According to this formulation, the enterprise cannot be equated with the person of the taxpayer. This person operates the enterprise, which in turn carries on a business activity. Consequently, the enterprise is to be understood as the organizational unit that is managed by this person to carry out a business activity.30

If the required organizational unit is lacking, article 7 cannot apply. Such a situation may be the case, for example, if a property is privately rented out. In this case, only article 6 applies. Accordingly, there is no overlap between articles 6 and 7 in such a case. As a result, it can be concluded that there is no overlap between articles 6 and 7 in cases of private income generation.

2.2.3. The enterprise carries on “business”

2.2.3.1. Initial remarks

According to article 7, the organizational unit “enterprise” must carry out a “business” to generate any business profits in the first place. Consequently, the definition and content of this term must be addressed to fully present the scope of article 7. The Commentary on Article 3 of the OECD Model (2017) refers to domestic law for the definition of this term.31 The significance of such an approach is that it makes the scope of article 7 dependent on domestic interpretation. If the term is to be interpreted according to domestic law, states are free to define the term as they wish. They could, for example, stipulate that the passive generation of income (for instance, by way of renting) never constitutes a business activity, and, therefore, can never lead to business profits. Domestic law could influence the scope of application of article 7 and thereby the likelihood of overlap with other treaty rules, inter alia, including article 6.

As a result of the foregoing, first, it is analysed in the following sections whether the term “business” should be interpreted according to domestic law, as suggested by the Commentary on Article 3 of the OECD Model (2017), or whether an autonomous interpretation would be preferable, which would provide for a fixed scope of article 7 that is independent of domestic interpretation (see section 2.2.3.2.). In a next (second) step, the content of the term “business” is analysed, and its significance for the scope of application of article 7 and the overlap of this provision with article 6 is established (see section 2.2.3.3.).

2.2.3.2. Autonomous interpretation of the term “business” in article 7

According to article 3(2), an interpretation of the term “business” based on domestic law would not be possible if the DTC itself defines the term. However, article 3(2) contains a second precondition for recourse to domestic law. Apart from the absence of a definition in the tax treaty in question, the context of the agreement should not require otherwise. The question, therefore, arises as to whether the two conditions of article 3(2) are met, so that the term “business” must be defined according to domestic law.

It could be argued that the first condition of article 3(2) is not fulfilled because of article 3(1)(h), which refers to the term “business”. Under this provision, “the term ‘business’ includes the performance of professional services and of other activities of an independent character”. The question, therefore, arises whether this provision defines the term “business”. This question should be answered in the negative.32 In particular, article 3(1)(h) was introduced into the OECD Model (2000)33 to clarify that the scope of the rule on income from independent personal services (i.e. article 14, which was removed from the OECD Model (2000)) is included now in article 7. Consequently, article 3(1)(h) is not conceived as a definition of the term, but as a clarification of its scope.34 The wording of article 3(1)(h) affirms this conclusion, as it uses the word “include”, whereas the word “means” is used for the definition of other terms except enterprise. Accordingly, the first condition for recourse to domestic law is met.

As far as the second requirement of article 3(2) is concerned, there are two opposing views on the content of the term “context of the agreement” – the theory of domestic law and the theory of international law.35 Put simply, the domestic law theory advocates recourse to domestic law for every term not defined in a tax treaty, whereas, according to the theory of international law, treaty terms are to be interpreted autonomously, so that recourse to national law is the exception. As this controversy cannot be dealt with in this article, the treaty-autonomous interpretation according to the theory of international law is advocated here.36 Accordingly, the pointers in the tax

30. Reimer, supra n. 23, at para. 42.
31. See paragraph 10.2 of the OECD Model: Commentary on Article 3 (2017), which reads: “The term ‘business’ ... should generally have the meaning which it has under the domestic law of the State that applies the Convention”.
32. A. Rust, “Business” and “Business Profits”, in Maisto ed., supra n. 15, at sec. 6.4., p. 94 and J. Sasseville, Article 7, Business Profits – Global Tax Treaty Commentaries sec. 5.1.2.2., Global Topics IBFD.
33. OECD Model Tax Convention on Income and on Capital (29 Apr. 2000), Treaties & Models IBFD.
34. Compare paragraph 10.2 of the OECD Model: Commentary on Article 3 (2017), which reads: “This addition ... was intended to prevent that the term ‘business’ be interpreted in a restricted way as to exclude the performance of professional services, or other activities of an independent character”.
36. An argument in favour of the author’s position would be the following. Recourse to the domestic laws of the parties to a tax treaty may induce conflicts of qualification and therewith double taxation or double non-taxation. Consider the following example: State A and State B have concluded the State A-State B Tax Treaty, according to which business profits are taxed only in the source state and other income in the resi-
treaty in question are taken into account, and a definition of the term “business” is derived from them. The literature and case law also affirm an autonomous interpretation of the term.

2.2.3.3. Content of the term “business” in article 7

In a next step, the question must be answered as to the content of the term “business” in the OECD Model. The starting point is the wording of article 7(1), sentence 1, which expresses, in the English version of the article, that the term “business” only includes activities carried out independently. The wording “enterprise carries on business” suggests the assumption of an entrepreneurial initiative and the associated risks on the part of the exercising enterprise. This position is also supported by the inclusion of article 14 in the definition of article 7. Such a situation could lead to the conclusion that the term “business” is to be understood as a generic term for the activities carried out independently, and that it has as its minimum content the activities of article 14.

For the purposes of this article, the question arises, in particular, as to whether this comprehensive concept covers both the active use of assets where the taxpayer engages in an activity (for example, the exploitation of an oil deposit by a mining company), and the passive use of assets where the taxpayer is limited to mere asset management (for instance, the transfer of an exploitation right to the previously noted oil deposit). Contrary to a widespread view in the literature, the passive use of assets cannot be covered in the scope of article 7, this is to be affirmed for the following reasons.

First, a systematic argument supports the inclusion of the passive use of assets in the term “business”. Dividends, interest and royalties derive from the passive use of an asset, namely from the transfer of capital or intangible assets. If, in general, the passive use of assets were not classified as “business”, dividends, interest and royalties would never be regarded as business profits. There would then be no reason to distinguish the rules covering these activities (articles 10 to 12) from article 7. Nevertheless, there is a provision in the OECD Model that fulfills precisely this task. This provision is article 7(4), which has been noted already in the context of the term “profits” (see section 2.2.1.). Article 7(4) would be superfluous according to such an interpretation.

Second, another contextual argument arises if another provision is also considered. This provision is the newly enacted active conduct of a business test in the limitation on benefits clause (i.e. article 29(3)). As Kuzniacki (2018) has argued, the term active conduct of a business “is more specific and thus narrower than” the term business. Although neither article 29(3) nor the Commentary on Article 29(3) of the OECD Model (2017) define the term active conduct of a business, article 29(3)(a) itself contains a negative definition of the term. That is, it excludes a list of passive activities from its scope (for example, holding and financing activities). It seems to the author of this article that the OECD needed to exclude passive activities from the special and narrower term “active conduct of a business”, as these activities are included in the more general and wider term “business”.

Third and finally, there is also a linguistic argument. More precisely, the English term “business” should not be associated with the term “busy”, which indicates the existence of an actively pursued business. A “business”, therefore, does not necessarily have to be actively (i.e. “busily”) pursued. Other factors can be decisive that do not require the active participation of the taxpayer in the generation of income, for example, the use of capital and the assumption of business risks. Consequently, passive use may also correspond to a modern understanding of the term “business activity”. Such an understanding is cultivated, for example, in US case law, which is based, among other things, on the factors noted previously in this section, i.e.:

The management of real estate... is commonly concerned with the employment of labour; the purchase of materials; the making of contracts; and many other things which come within the definition of business... and within the commonly accepted meaning of that word.

Admittedly, whether passive investment constitutes "business" may be a matter of degree. For instance, the renting-out of property in, and of itself, may not constitute business, but in conjunction with other activities (for...
example, services provided to the tenants) be considered to be as such because the passive activity “form[s] part of a coherent whole organism.”47 The author submits that this qualification of the term business including passive activities of a certain degree concurs with the finding that states may only exert tax jurisdiction to taxpayers and income having substantial connections with their territory.48

In summary, all self-employed activities are basically business activities within the meaning of article 7, including the passive use of assets if they are substantial in degree. The scope of application of article 7 is obviously very broad. Accordingly, the likelihood of overlap with income from other sources (such as those from immovable property) is very high.

2.3. Income from immovable property

2.3.1. Opening comments

Section 2.2.3.3. has demonstrated that both active and passive use of assets is covered within the scope of article 7, with active use consisting of the enterprise itself carrying on business, while passive use is limited to mere asset management. The question, therefore, arises as to whether the same can be said for article 6 in the context of private use of immovable property (see section 2.3.2.) and, if so, whether this also applies to the use of immovable property in the context of a business (“entrepreneurial use”) (see section 2.3.3.). If, for example, only passive entrepreneurial use of immovable property were covered by article 6, it would not apply to cases of active business use of immovable property. Only the application of article 7 would come into consideration. Section 2.3. now provides an answer to these questions, and thereby reaches a conclusion on the scope of the overlap between articles 6 and 7.

2.3.2. Function and content of article 6(3): The term “use” in the context of private use of immovable property

Article 6(1) only contains information on the source of the income it deals with (income... from immovable property). Article 6 (1) leaves it unclear when income from immovable property exists. This task is taken over by article 6(3):

The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

Article 6(3), therefore, has a clarifying function. It explains how the income from immovable property is earned, namely through use, and thus circumscribes the act that is necessary for income from article 6 to arise.49 If there is no use of immovable property, there can be no income from immovable property.50 Consequently, there can also be no overlap, so that no distinction from article 7 is necessary. In this regard, the content of the term “use” is decisive for the scope of article 6.

However, the term “use” is not defined in article 6(3). In this respect, its content must be determined by means of interpretation. According to the theory of international law advocated here (see section 2.3.3.), treaty terms are to be interpreted autonomously. Nonetheless, an interpretation based on the (confusing) wording of article 6(3) can hardly be fruitful.51 According to article 6(3), article 6(1) applies to income from direct (i.e. active) use. This explicit inclusion of direct use should actually speak for the fact that only active use is to be understood as “use” in the sense of article 6(3). In turn, such a position should lead to the exclusion of indirect (i.e. passive) use. Nevertheless, two other alternatives are inserted in article 6(3), which define closer the term “use”, namely: (i) rental income; and (ii) use in any other form. As rental income arises from the passive use of assets and the term “any other type of use” seems to be rather comprehensive, passive use would have to be included according to these two alternatives. The first alternative of article 6(3) completely contradicts the other two. Against this background, it is debatable whether passive use, contrary to the contradictory wording of article 6(3), falls within the term “use”. The following arguments favour the inclusion of passive use in article 6(3).

First, the inclusion of passive use under the term “use” in article 6(3) is supported by the purpose of the provision for income from immovable property. In particular, article 6 incorporates the situs principle. This principle recognizes the close economic connection between the source of income (i.e. the immovable property) and the situs state (i.e. the state in which the immovable property is located).52 The situs principle can only be fulfilled if the passive use of immovable property is also fully covered by article 6. This situation applies because passive use also has immovable property as its object. Accordingly, the economic connection between the source of income

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47. Reimer, supra n. 23, at para. 48. This situation can be also inferred from paragraph 36 of the OECD Model: Commentary on Article 5 (2017), according to which the leasing of property as such does not suffice for a PE to arise. Such a position may be the case, though, if the activity of the lessee goes beyond the leasing of assets.


49. See supra para. 20. This exclusion of passive use under the term “use” in article 6(3) is supported by the purpose of the provision for income from immovable property. In particular, article 6 incorporates the situs principle. This principle recognizes the close economic connection between the source of income (i.e. the immovable property) and the situs state (i.e. the state in which the immovable property is located). The situs principle can only be fulfilled if the passive use of immovable property is also fully covered by article 6. This situation applies because passive use also has immovable property as its object. Accordingly, the economic connection between the source of income

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and the situs state also exists in the case of passive use of immovable property. A different allocation of the taxing right in the case of passive use of immovable property would not be compatible with the purpose of article 6, which is to implement the situs principle.

A systematic argument also leads to the same result. Article 6(2), sentence 2 contains a positive list of types of uses which are included in the term “immovable property” in article 6(1). This list includes, inter alia, “rights to which the provisions of general law respecting landed property apply”. These are the rights in rem, which relate to real property that the civil law of the situs state provides for. If the provisions of German civil law on landed property are taken as an example, there is the right, of course, of property but also so-called rights of use equivalent to property (such as hereditary building rights, mineral extraction rights, usufruct and easements, etc.) (“rights in rem”).

Consequently, the “use” of these rights is should be regarded as the use of immovable property, and leads to income that falls under article 6. Nevertheless, these rights are only amenable to passive use. With regard to the use of a mineral extraction right, a usufruct and a hereditary building right can only be viewed as their creation and transfer by the owner of the immovable property for the benefit of an entitled person (the “beneficial owner”).

It is obvious that the creation and transfer of a right in rem does not constitute an active use of the immovable property. There is no activity of any kind on the part of the owner of the immovable property. In this respect, the term “use” must also include the passive use of immovable property, as, otherwise, article 6(3) could never be fulfilled for the rights listed previously in this section. Such a position would be in blatant contradiction to the inclusion of the rights listed again previously in this section, within the meaning of the term “immovable property” in article 6(2), sentence 2.

As a result, it can be submitted that the passive use of immovable property falls under the term “use” of article 6(3). Consequently, in the case of private use of immovable property, both passive (for example, the renting out a dwelling) and active (for instance, if the taxpayer occupies a dwelling) use leads to income from immovable property.

2.3.3. The term “use” in the context of business use of immovable property

2.3.3.1. Initial remarks

The analysis in section 2.3.2. has designated as the content of the term “use” in article 6(3) both the active and passive use of immovable property in a private context. In this respect, the question arises as to whether the statements on the term “use” in the context of private use of immovable property can be transferred to the cases of business use of immovable property. For instance, does both the letting of a property by a company and the use of this property by the same company for its own business purposes (for example, as a warehouse) fall under the term “use” in article 6(3)? The answer to this question is important because the term “business activity” in article 7 includes both the active and passive use of assets (see section 2.2.3.3.). Consequently, the overlap between articles 6 and 7 could include both types of use if the term “use” in article 6(3) includes the two types of use in the context of a business, as is the case with private use. In order to provide an answer to this question, it is necessary again to deal with the content of the term “use”, which should be interpreted autonomously (see section 2.3.2.).

2.3.3.2. Passive business use as “use” within the meaning of article 6(3)

First, the question arises as to whether passive business use falls under article 6(3), and, therefore, can lead to income from immovable property. The passive business use of immovable property includes, in particular, the renting out of business immovable property (as well as subletting and subleasing). The creation and transfer of rights in rem (for example, usufruct, easements, hereditary building rights, leasing, etc.) as well as the transfer of exploitation rights. As far as the creation and transfer of rights in rem are concerned, a differentiation is to be made as follows.

The creation of a usufruct by the owner in favour of the beneficial owner is a form of passive use of immovable property. The same applies to the transfer to a third person (for example, by letting) of a right in rem on the immovable property encumbered with a usufruct – whether by the beneficial owner or by the owner itself.

It is submitted that it should not matter whether the person of the transferor (i.e. the “user” within the meaning of article 6(3)) coincides with the person of the taxpayer (i.e. the income recipient). If the person of the transferor and the person of the taxpayer are different, which is the case with the transfer of a usufruct (because the owner is the user, while the beneficial owner is the recipient of income), it is still a matter of the passive use of immovable property. If, however, the beneficial owner uses the immovable property for its own business purposes (for example, as a warehouse), this is no longer a passive but an active business use of immovable property.

54. The use made by the owner of the immovable property in these cases (i.e. the creation and transfer of rights in rem) must be distinguished by the use made by the beneficial owner. This can be both passive (for example, the transfer of the right in rem to a third person) and active (for instance, the operation of the exploitation activity by the beneficial owner itself in the case of a mineral extraction right).
55. E. Reimer, Article 6, in Ismer, supra n. 2, at para. 183.
56. B. Lieber, Article 6, in Schöndörfl & Ditz eds., supra n. 23, at para. 94.
57. According to one view in the literature, the person of the “user” must be the same as that of the taxpayer for article 6(3) to be fulfilled. Compare Wassermeyer, supra n. 51, at para. 19. The basic prerequisite for the acceptance of such a view, i.e. the necessity the user and the taxpayer are the same person, cannot be inferred from the wording of article 6(3).
59. Compare Wassermeyer, supra n. 51, at para. 72.
The same comments apply, mutatis mutandis, to the creation (by the owner) and transfer (by the beneficial owner) of hereditary building rights. Both are forms of passive use of immovable property, whereas the use of the immovable property encumbered with the hereditary building right by the beneficial for its own business purposes is an active use.

Also, the conclusion of leasing contracts should be regarded as a form of passive use of immovable property. However, if leasing contracts can be characterized as a sale of immovable property, the income generated from them falls within the specific provision of article 13(1) (Capital gains). This situation is the case, for example, with a so-called finance lease, whereby under certain conditions the leased property (for instance, land) is attributed to the lessee. In other words, with the conclusion of the leasing contract, the economic ownership of the immovable asset is transferred to the lessee, and, therefore, this transaction should be regarded as a sale rather than a (temporary) transfer. The same problem does not exist in the case of the creation of a hereditary building right, as there the transfer is agreed for a limited – although usually long – period of time, and, therefore, cannot be regarded as a transfer of the immovable property.

Finally, the omission of the use of business immovable property in return for payments (or a lump sum) should be regarded as passive use of business immovable property. According to a convincing view in the literature, the omission of the use of business immovable property can only be regarded as passive use of this property if its passive use is renounced (for example, the owner of a business property renounces renting it out), whereas the omission of its active use (for instance, the omission of the exploitation of an oil well) is equivalent to the active use of immovable property. Consequently, in the case of payments for refraining from the use of business immovable property, it must be considered whether the use in the case of action (for example, on the one hand, the renting of a plot of land as passive use and, on the other, the exploitation of an oil well as active use) is of a passive or active nature.

Overall, it can be stated that all these forms of use of immovable assets have one thing in common, which is that the immovable assets are the predominant factor, leading to the generation of income. For instance, much less personnel and know-how input are required for the transfer of an exploitation right than for the (active) operation of an exploitation activity itself, so that the latter factors tend to play a subordinate role in this case. In these forms of use, there is, therefore, a close economic connection between the generation of income and the passive use of immovable property, whereby other additional factors (for example, labour and know-how) play such a subordinate role that they cannot influence significantly this connection.

This close economic connection between the immovable property and the realization of income is a prerequisite for taxation in the situs state under article 6(1). The latter is signalled by the word "from" in article 6(1). Specifically, the income must emanate "from" the immovable property for article 6 and, therefore, for taxation in the situs state to apply. As the close economic connection between the immovable property and income exists in the case of passive business use of immovable property, the latter always leads to income from immovable property. It, therefore, falls within both articles 6 and 7, whereby the latter, as already explained in section 2.2.3.3., includes both the active and passive use of assets. But does the same apply to the active business use of immovable property?

Is the active business use of immovable property a “use” within the meaning of article 6(3)?

2.3.3.3. Active business use of immovable property as “use” within the meaning of article 6(3)?

The wording of article 6(3) (“from the direct use... or use in any other form of immovable property” [emphasis added]) suggests in any case the inclusion of active business use in article 6. The quoted passages of article 6(3) are comprehensive in scope, and do not explicitly exclude active business use. Accordingly, it is questionable as to whether such a broad interpretation of the wording of article 6(3) is correct or whether a restrictive interpretation of the provision would be more appropriate, thereby excluding active business use from the scope of article 6. In the following paragraphs, arguments in favour of restricting the term “use” in article 6(3) to passive business use of immovable property (with the exception of agriculture and forestry) are advanced.

Article 6(1) includes income from agriculture and forestry in its scope (“including income from agriculture or forestry” [emphasis added]). The fact that this inclusion is made in a parenthesis speaks for the exclusion of any other form of active business use. Specifically, by means of this parenthesis, the OECD Model only includes income from agriculture and forestry in the scope of article 6(1). As agriculture and forestry undoubtedly represents a form of active use of immovable business assets, it can be assumed by implication that any other form of active business use is excluded from article 6(1). If every form of active business

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59. Id. at para. 64
62. Compare DE: BFH, 28 Apr. 1982, J R 151/78, Bundessteuerblatt vol. II, p. 566 (1982), Case Law IBFD: According to one view in the literature, income from the termination of a tenancy or lease is not to be regarded as use of immovable property and thus as business profits or other income (article 21). Compare Wassermeyer, supra n. 51, at para. 71. This view disregards the broad wording of article 6(3), which covers every type of use. In this respect, it is also a matter of the passive use of immovable property, which gives rise to income from immovable property.
63. Reimer, supra n. 43, at pp. 111 and 114.
64. Reimer, supra n. 55, at para. 34.
65. It could be suggested that the inclusion of income from agriculture and forestry is just an example, like the examples in article 5(2). The author’s response to this counterargument would be, in the author’s opinion, the fact that article 5(2) employs the word “especially” clearly indicates that the list in article 5(2) is not exhaustive. If the lawmaker intended to achieve the same result in article 6(1), they could have also used the word “especially”.

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use were covered by article 6(1), the explicit inclusion of the agriculture and forestry would simply be superfluous.66

Furthermore, a brief overview of the history of the parenthetical addition of “income from agriculture or forestry” [emphasis added] in article 6(1) reinforces this argument. Specifically, the OECD Draft (1963) did not contain any statement on the allocation of the taxing right for income from agriculture and forestry. As a result, it was question-able as to which distributive rule applied to income from agriculture and forestry (article 6 or article 72).67 The FC of the OECD took note of the resulting uncertainty, and commissioned the newly established Working Party 30 (“WP30”), to clarify, inter alia, this issue.68 WP30 decided in favour of article 6 with regard to the allocation of the right to tax income from agriculture and forestry. This action resulted in the inclusion of agriculture and forestry in article 6(1). Such a position is due to the fact that, according to WP30, agriculture and forestry were the only cases of active business use of immovable assets in which article 6 must be applied due to the decisive nature of the land reference in comparison to the other factors of production. In the words of WP30:

Income from agriculture and forestry... of the three factors producing that type of income i.e., "labour", "capital", "land", "land" has obviously a predominant character: whereas commercial and industrial profits are primarily the result of a well organised disposition of "labour" and "capital", the farmer's income depends to a large extent also of the quality of his land. This close connection of agricultural and forestry income with immovable property seems to require that the taxation rules for income from immovable property should apply also to that type of income.69 70

A further argument based on the purpose of the provision supports this view. As explained previously in this section, article 6(1) is intended to assign the taxing right to the situs state if the income is derived from the immovable prop-

erty, whereby the word “from” is to be interpreted in light of article 6(3) (see section 2.3.3.2.). This “from” signals a close economic connection of the income with the land. Such a connection is evident particularly in the case of passive business use (for example, renting out of business immovable property), whereas in the case of active business use other factors are added, such as the use of capital, labour, know-how, etc., which have a greater impact on the generation of income than the mere existence of immovable property. This stance leads to the economic discon-
nection of the income generated from the active business use of immovable assets from the land.

The German literature also agrees with this finding and predominantly refers to immovable assets as a “production factor” in the case of active business use.71 If, for example, a supermarket business is run in a building, the premises play only a subordinate role for the generation of income, so that it cannot be claimed that the income originates “from” this building.72 The same can be said, for example, for the office buildings of professional partnerships, the warehouses of a distribution company73 as well as for the immovable property serving a hotel business.74 In all of these cases, the immovable assets only have a complementary function. They are not used but merely deployed.75 Accordingly, there is no close economic con-
nection between the land and the generation of income.

However, there are cases of the active operational use of immovable assets in which the connection with the land appears to be stronger than in the examples given previously in this section. This primarily refers to the exploit-

ation of mineral resources. The extraction of mineral resources takes place directly from the soil on or in which they rest, which is why the connection between the real-
ization of income and the “use” of the soil appears to be direct.76

Nevertheless, the prevailing opinion in German literature77 argues that the soil is not the decisive factor for the generation of income in these cases. Companies in this industry (such as mining and oil extraction companies) must have, among other things, know-how and specially

66. It could be argued that the inclusion is not redundant because it is merely a clarification. In fact, history demonstrates that the inclusion had a clarifying intention. However, a clarification would not have been necessary if it would have been clear that income from the active use of immovable property falls under article 6 in general.

67. The Japanese delegation first raised this question in 1964, shortly after the adoption of the OECD Model (1963), i.e. “Which provisions are applicable to ‘income from agricultural or forestry enterprise’, the provisions of Article 6 or Article 7 (Business Profits)?” Compare FC, Questions by the Japanese Delegation Concerning the Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital p. 5 (8 Sept. 1964).

68. For the appointment and work order of WP30, see FC, Report by the Drafting Group on the Future Work of the Fiscal Committee p. 7 (25 July 1967).

69. Compare WP30, (Austria – Switzerland) (Received on 12th June, 1969).

70. It is true that not all types of agricultural activity are closely connected to immovable property. This position could be argued for by, for example, the case of beekeeping. However, this does not mean that such close connection does not exist in general. What is being said here is that the OECD Model considers income from agriculture and farming to be in general closely connected to immovable property. Which agricultural and farming activities are, in particular, actually closely connected to the immovable property can be determined by restricting or expanding the scope of the term agriculture or forestry. This can be achieved in one of the following two ways: (i) by way of the domestic laws of the parties if it is accepted that the term is not to be defined autonomously; and (ii) through the explicit agreement of the parties, for example, by including income from beekeeping in the term agriculture or forestry.

71. Wassermeyer, supra n. 51, at paras. 15 and 97; Lieber, supra n. 56, at paras. 11 and 87; Kerssenbrock & Wagner, supra n. 53, at para. 89; and H. Fischer, Article 6, in Doppelbesteuerungsabkommen (Double Taxation Agreements) para. 330 (D. Gosch, H-K. Kroppen & S. Grother eds., Neue Wirtschafts-Briefe 2016).

72. J. Sasseville, The Evolution of Article 6 of the OECD Model with Respect to Income from Agriculture, Forestry and Mining, in Immoveable Property under Domestic Law, EU Law and Tax Treaties sec. 8.2.2. (G. Maistsood et al., IBFD 2015), Books IBFD.

73. Wassermeier, supra n. 51, at para. 30 and Reimer, supra n. 55, at para. 150.

74. Fischer, supra n. 71, at para. 330.

75. On the delimitation between use of an immovable asset, falling under article 6, and the mere deployment thereof, see E. Reimer, Article 6, in Klaus Vogel on Double Taxation Conventions paras. 173 et seq.

76. For this reason, some German literature regards these activities as ‘use’ within the meaning of article 6(3). See Reimer, supra n. 55, at para. 166 et seq. and S. Galle & F. Haase, Article 6, in Doppelbesteuerungsabkommen (Double Taxation Agreements) para. 93 (F. Haase ed., C.F. Müller 2016).

77. Wassermeier, supra n. 51, at para. 77; Lieber, supra n. 56, at para. 88; Kerssenbrock & Wagner, supra n. 53, at para. 89 I. and Fischer, supra n. 71, at para. 319.
trained personnel. Without these factors, the soil cannot be exploited. Moreover, the exploitation of such mineral resources is not sufficient in itself for the generation of income. The marketing of these products is the activity that ultimately leads to the generation of income. In turn, this activity requires the processing of these products and the establishment of a sales network in which these products are distributed. These two additional production and distribution steps have no reference to immovable property but, rather, to entrepreneurial activity. Overall, for the active business activity consisting in the exploitation of mineral resources, land is a factor, but certainly not the decisive factor, so that it could be said that the realization of income stems “from” the immovable property.

All this may be true. Nonetheless, the author would contend for the primary application of article 6 based on the following two arguments: (i) fairness; and (ii) efficiency. On the grounds of fairness, the source state should have a taxing right in such cases, or at least be paid a user fee, as the natural resources “could naturally be considered as being owned by the residents of the country concerned.”

On the grounds of efficiency, it would be best to grant the taxing right to the source state in these cases, as the natural resources can be extracted only in a small number of countries. Entrepreneurs can open a supermarket everywhere and they can extract oil or diamonds, though, only in specific locations where these natural resources exist. So, the taxpayer intending to conduct extracting activities can only direct their investment to the source state where the natural resources exist. A tax imposed by the source state does not distort their choice. Entrepreneurs invest in the source state with or without the tax. Accordingly, granting the taxing right to the source state is efficient, as it does not distort with taxpayer choices. Of course, the application of article 7 may also lead to source taxation but this only in the PE cases. However, what if there is no PE in the source state, for example, because the extracting activity does not last long enough?

This position is a de lege ferenda argument. It does not change the fact that, at least according to the interpretation of article 6 proposed here, de lege lata the extraction of mineral resources falls only under article 7, article 6 included, as forms of active use of only agricultural and farming activities. This interpretation is compatible with state practice. Such a view is indicated by isolated tax treaties that explicitly include the exploitation of mineral resources under article 6 – which, conversely, means that this activity does not fall under article 6 according to common understanding, and therefore, requires explicit inclusion by the states.

79. Id. at p. 72.
80. This situation could be the case if subcontractors are employed by the taxpayer and, because of the shorter period, they usually spend in the source country. See UN Handbook on Taxation of the Extractive Industries p. 82 (UN 2017).
81. With regard to Australia’s treaty policy, see D.V. Vinnitskiy, Article 6: Immovable Property – Global Tax Treaty Commentaries sec. 5.1.2.3., Global Topics IBFD

that such clauses in tax treaties constitute mere clarifications. In any case, the author would submit that an explicit inclusion of these activities in article 6(1), similar to those relating to farming and agriculture, would be desirable both as a matter of policy and sophisticated law-making.

The connection to the soil is also very strong in the exploitation of mineral resources. Nevertheless, the arguments listed in the preceding paragraphs in favour of the exclusive application of article 7 can also be applied to this case of the active business use of immovable assets. It can also be stated that the object of the realization of income from the exploitation of mineral resources is not the soil but the research results, the extraction of which presupposes the existence of an entrepreneurial mechanism. Finally, the necessary connection between the generation of income and the soil is missing in the operation of wind and solar plants. Despite their connection with the soil, the energy generated from these plants is not a “product” of the soil, as is the case, for example, with agriculture and forestry.

In this respect, this form of active use of immovable property also falls under article 7.

In view of all of the foregoing, it can be stated that only the passive business use of immovable property is covered by the term “use”, which is to be interpreted autonomously. Even the cases of active business use of immovable property in which the reference to land appears to fall clearly under article 7 and not under article 6. Consequently, there is only a need for demarcation between articles 6 and 7 with regard to income from passive business use of immovable property.

2.4. Interim conclusions

The four interim conclusions that can be drawn from the discussion in sections 2.1. to 2.3. are as follows:

(1) “Profits of an enterprise” are the profits derived by a resident of a contracting state from carrying on independent activities through an organizational unit formed therein (see section 2.2.2.). “Business” for the purposes of article 7 should also include passive activities. Consequently, the scope of application of article 7 is very broad, and can also include income from both the passive and active use of immovable property attributable to that business (see section 2.2.3.).

(2) The term “use” in article 6(3) only covers income from the passive use of immovable property of a company. The active business use of immovable property – with the exception of agriculture and forestry – therefore, falls outside the scope of article 6. Only article 7 is applicable to these cases (see section 2.3.).

(3) As a result, there is a normative need for demarcation only with regard to passive income from immovable property of a company, which covers the area

82. UN Handbook on Taxation of the Extractive Industries, supra n. 80, at p. 60.
83. Reimer, supra n. 55, at para. 164.
84. Id., at para. 169.
in which articles 6 and 7 overlap. This demarcation function is served by article 6(4), which is analysed in section 3. The Figure illustrates the overlap between articles 6 and 7.

(4) Finally, the Table summarizes the relevant cases in which immovable property is used for business purposes and divides them into the relevant distributive rules. Accordingly it is made clear which cases fall under both articles 6 and 7, so that article 6(4) is to be used for their demarcation.

3. The Relationship between Articles 6 and 7

3.1. Structure of the analysis

Section 2. has identified the cases where both articles 6 and 7 are applicable (overlap). Section 3. now deals with the relationship between articles 6 and 7 within this overlap area. In this respect, article 6(4) orders the priority of article 6 over article 7, i.e.: “The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise”.

In order to highlight the significance of article 6(4), the author demonstrates in a first step, on the basis of case law from France and Luxembourg, which problems arise when a tax treaty does not provide a concrete answer to the question of competition (see section 3.2.).

In a second step, it is shown how the OECD Model deals with this relationship. In other words, how articles 6 and 7 are distinguished from each other, which provision takes precedence, and how this solution came about historically (see section 3.3.).

Thereafter, the views expressed in scholarship on the nature of the relationship between articles 6 and 7 are presented. This issue is considered in section 3.4.

Finally, a view is discussed that advocates an exclusive relationship between articles 6 and 7 (see section 3.5.). If this viewpoint is followed, it should also be accepted that the rules on the allocation of profits between the head office and the PE (article 7(2) establishing the AOA) cannot be applied to income from article 6, even if such income is earned through a PE located in the situs state.

3.2. The significance of article 6(4) based on the decisions in Rafaella and La Coasta Sàrl

3.2.1. Opening comments

The significance of article 6(4) for the uniform allocation of the right to tax and the avoidance of double non-taxation can be demonstrated by referring to two court decisions on the relationship between articles 6 and 7. The special feature of these decisions was that the relevant tax treaties did not contain a provision along the lines of article 6(4), as they were not based on the OECD Draft (1963). Furthermore, both cases concerned non-PE cases, so that the application of article 6, on the one hand, and the application of article 7, on the other, could have led to a different allocation of the right of taxation (see section 1.1.).

3.2.2. The French case of Rafaella

The first decision was given by the French Conseil d’État (Supreme Administrative Court, CE). In the noted deci-
sion in *Raffaella* (1992), the question was whether the fictitious rental income of Raffaella SpA, an Italian resident, for the free use of a villa located in the south of France fell under article 4(1) (Income from immovable property) or under article 5(1) (Business profits) of the Italy-France Income and Capital Tax Treaty (1958). The CE gave precedence to article 5(1) of the Italy-France Income and Capital Tax Treaty (1958), and denied the existence of a Permanent Establishment (PE), so that the right of taxation was assigned to the state of residence of the enterprise (Italy). The lack of a provision similar to article 6(4) permitted the CE such an interpretation, and, therefore, was decisive for this decision. If there had been a provision along the lines of article 6(4), the rule for income from immovable property would have prevailed. France, as the situs state, would have had the taxing right. Accordingly, this decision appears to be in complete contradiction to the content of article 6(4), as it gave priority to the provision on business profits over the one on income from immovable property.

### 3.2.3. The Luxembourg Case of La Coasta Sàrl

The Luxembourg Tribunal Administratif (Administrative Tribunal, or TA), in turn, issued a contrary decision a few years later, and gave precedence to the rule for income from immovable property, thereby leading to an unfortunate outcome. In a similar case, the Luxembourg company La Coasta Sàrl owned immovable property in France, from which it had received rental income since 1991. The Luxembourg tax authorities followed the case law of the CE, and, in 1995, classified the rental income as business profits, so that the state of residence of La Coasta Sàrl, namely Luxembourg, would have had the taxing right on the rental income.

Only such an approach would have ensured the taxation of rental income in light of the decision in *Raffaella*. France would have followed the *Raffaella* ruling, and, therefore, applied the provision on business profits. Accordingly, in the absence of a PE in France, the state of residence (Luxembourg) would have been entitled to tax. If the Luxembourg TA had also given priority to the provision on business profits, the income would also have been attributed to Luxembourg. The one-off taxation of the income (in Luxembourg specifically) would have been secured. If, however, the TA had applied the rule for income from immovable property, France would have had the taxing right on the rental income as the situs state. However, France would not havetaxed the income, as it followed the *Raffaella* doctrine. Consequently, the double non-taxation of the income would have resulted from such a conflict of qualification. And indeed, the latter did happen.

In detail, in a first step, the TA denied the transfer of the statements of the *Raffaella* decision to the case before it. Accordingly, the TA gave priority to article 3 of the France-Luxembourg Income and Capital Tax Treaty (1958) (i.e. the rule for income from immovable property), despite the absence of a provision similar to article 6(4). In this respect, the TA based its decision on the special nature of the type of income in article 3 of the France-Luxembourg Income and Capital Tax Treaty (1958) in comparison to article 4 (Business profits).

Both courts, therefore, subsumed almost the same facts differently. In the absence of a provision similar to article 6(4) in the tax treaties in question, the courts had to interpret the provisions for business profits and for income from immovable property themselves. In the second case, this led to double non-taxation of the income concerned. If article 6(4) had existed, the conflict of qualification explained above would not have arisen. In this regard, article 6(4) has led to clarification of the relationship between articles 6 and 7 and to the avoidance of arbitrary gap-filling or different income qualification between the state of residence and the situs state. If the state of residence and the situs state apply article 6(4), taxation in the situs state is ensured.

### 3.3. Historical Background of Article 6(4)

The interplay between income from immovable property and business profits was well known to the fathers of the OECD Model. As early as 1923, the four economists, i.e. Bruins, Einaudi, Seligman and Sir Josiah Stamp, presented their report on double taxation to the Financial Committee of the League of Nations and described every entrepreneurial activity as a “business enterprise of an immovable character or closely connected with immovables”. In their eyes, entrepreneurial activities and the use of immovable property always went together. Nevertheless, the report lacks a more detailed regulation of the relationship between income from immovable property and business profits. Only the subsequent reports and Model Conventions within the framework of the League of Nations dealt with the relationship between income from immovable property and business profits and almost all – with the exception of the Model Conventions (1933) and (1935) – gave priority to the latter.

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86. Convention between France and Italy for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance with Respect to Taxes on Income and Capital (unofficial translation) (1 Apr. 1958) (as amended through 1970), Treaties & Models IBFD.
87. LU: TA, 3 Dec. 2001, Case No. 12831, La Coasta Sàrl, confirmed by the Luxembourg Cour Administratif (Administrative Court. CA) in LU: CA, 23 Apr. 2002, Case No. 14442, La Coasta Sàrl, Case Law IBFD. On both the French and the Luxembourg decisions, see Avery Jones et al., supra n. 25, p. 735, at mm. 247 and 248, with further references.
89. This historical overview is largely based on J. Yu-Hui Hsu, Article 6 – Income from Immovable Property, in History of Tax Treaties: The Relation between Income from Immovable Property and Business Profits (1923-1935), Draft Model Tax Convention (1923), supr. n. 25, p. 735, at mm. 247 and 248, with further references.
91. See first the reports of April 1927 and October 1928, being League of Nations, 12 Apr. 1927. Double Taxation and Tax Evasion: Report, in Legislative History p. 10 (41241) and 22 Oct. 1928. Double Taxation and
A different view prevailed within the framework of the work of the OEEC and the OECD. Working Party 9 ("WP9") of the OEEC, which was entrusted with the taxation of income from immovable property, presented a model article on this in its report of 28 October 1957. In paragraph 3, sentence 3 of this model article, income from immovable property of “commercial, industrial or handicraft enterprises” was assigned to the scope of the rule for income from immovable property, thereby giving priority to this rule over that for business profits. The second draft of the model article of 3 September 1958 included income from professional services in its third sentence of paragraph 3 in addition to income from immovable property of commercial, industrial and handicraft enterprises. In this respect, it also declared the rule for income from immovable property to be primarily applicable, i.e.: 

The same rules shall apply to immovable property of commercial, industrial or handicraft enterprises... as well as to immovable property used for the performance of professional services.

The final wording of the model article for income from immovable property and in particular the provision on the demarcation between income from immovable property and business profits (paragraph 3, sentence 3 of the model article and currently article 6(4)) was, nevertheless, the result of the Dutch delegation’s comments. These comments concerned the demarcation between income from immovable property and business profits and the allocation of the taxing right to the situs state, both in cases where no PE is established in the situs state (non-PE cases), and in cases where a PE exists in the situs state (PE cases). In detail, WP9, on taking the comments of the Dutch delegation into consideration, affirmed that:

1. Article 6 takes priority over article 7 in the non-PE cases, i.e.: 

This provision... merely guarantees that where immovable property is not a part of permanent establishment the income therefrom will be taxed in the country in which the property is situated.

The statement corresponds to the content of the current wording in the Commentary on Article 6 of the OECD Model (2017). This provision of the OECD Commentary on Article 6 (2017) is very important for this article. As noted in section 1.1., the application of articles 6 and 7 leads to a different allocation of the taxing right in the non-PE cases. If article 6 is applied, the taxing right is allocated to the situs state. In contrast, if article 7 is applied, the taxing right is to be allocated to the state of residence due to the absence of a PE (article 7(1), sentence 1). Such a deviating allocation of taxing rights is avoided, however, if article 6(4), according to the passage quoted previously in this indent and the almost identical wording of the OECD Commentary on Article 6 (2017), also applies in the non-PE cases and grants priority to article 6 over article 7. In addition, many tax treaties provide for the application of the credit method, instead of the exemption method with regard to the avoidance of double taxation for income falling under article 6 that is not earned through a PE. In contrast, business profits and income from immovable property earned through a PE are subject to the exemption method. The precedence of article 6 over article 7, therefore, entails the application of the credit method instead of the exemption method in the non-PE cases if the application of the credit method is ordered in the tax treaty, as is the case, for example, with the Germany-Spain Income and Capital Tax Treaty (2011) and the Germany-Switzerland Income and Capital Tax Treaty (1971) (see section 1.1). 

(2) Furthermore, WP9 also confirmed the primacy of article 6 over article 7 in PE cases, i.e.: 

The right to tax of the State of source is given priority over other rights to tax and... this rule is applied above all where, in the case of a business undertaking or of non-industrial or non-commercial activity, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being taxed as income of an enterprise.

According to this passage, which the Commentary on Article 6 of the OECD Model (2017) also adopts almost completely, article 6 prevails over article 7 in general, i.e. in both PE and non-PE cases. However, according to the second sentence of the passage quoted previously in this indent and the OECD Commentary on Article 6 (2017), states are free to allocate income from immovable property attributed to a PE to article 7. This situation is due to the fact that both article 6 and article 7(1), sentence 2, incorporating the PE principle, assign the right of taxation to the source state. As the PE state and the situs state coincide in the PE cases, the allocation of the taxing right to the PE state leads to the same result as the allocation to the situs state, namely to the source taxation of the income from immovable property. This position also corresponds to the purpose of the situs principle, as explained in section 2.3.2.), to enable the source

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94. WP9/FC(58)6, Taxation of Income from Immovable Property (by the Secretary of the Committee) (3 Nov. 1958).
95. WP9/FC(58)6, Taxation of Income from Immovable Property (Note by the Secretory of the Committee) (5 Nov. 1958).
96. WP9/FC(58)6, supra n. 95, at p. 3.
97. WP9/FC(58)6, supra n. 95, at p. 3.
98. Compare paragraph 4 of the OECD Model: Commentary on Article 6 (2017), where the word “taxed” is used instead of the word “taxed”. In addition, the word “enterprise” is currently used to create alignment with the use of this term in article 6(4) and article 7.
3.4. Views on the nature of the relationship between articles 6 and 7 under the application of article 6(4)

The question regarding the nature of the relationship between articles 6 and 7 has been discussed comprehensively in the academic literature. In the following, the author attempts to summarize the diverse views in the literature in this respect. These views essentially relate to the legal consequences that may be associated with an exclusive, simultaneous or supplementary application of articles 6 and 7.

The Commentary on Article 6 of the OECD Model (2017) advocates (according to one opinion in the literature) the simultaneous application of the legal consequences of articles 6 and 7 ("Idealkonkurrenz", or "ideal concurrence"). According to this view, articles 6 and 7 form two independent legal circles that apply side by side if they are satisfied considering the underlying facts of the case in question. Where both articles 6 and 7 are satisfied, all of the applicable legal consequences apply simultaneously.

Reimer (2021) opines that article 6(4) is declaratory. The precedence of article 6 over article 7 could also be inferred from article 7(4). Article 6(4) is, therefore, unnecessary. For this reason, the distinction between articles 6 and 7 should be based on article 7(4). This provides for the primacy of the other distributive rules of the OECD Model – including article 6 – only as far as their legal consequences extend. In all other respects, article 7 should remain applicable. As article 6 only contains legal consequences with regard to the allocation of taxing right, article 7 remains applicable in all other respects.

It could also be that article 6(4) only stipulates a reference to the legal consequences of article 6. This position means that article 7 is applied to income that falls within the overlapping area, but it is subject to the more specific legal consequence of article 6, namely taxation in the situs state, by means of article 6(4). Otherwise, the legal consequences of the applicable article 7 remain unaffected. In other words, article 7 is applied insofar as the legal consequences of the more specific provision, article 6, are not applicable (being a lex specialis relationship in the form of a reference to legal consequences). A number of authors also speak vaguely of a ‘primacy’ of article 6 over article 7, without giving any further pointers as to the nature of this relationship.

Finally, the view that there is an exclusive relationship between articles 6 and 7 in the area of all legal consequences is gaining ground. According to this view, article 6(4) not only provides for the priority of article 6 over article 7 concerning the allocation of the taxing right, but it also confirms the fundamental supersession of the PE principle by the situs principle. Again according to this view, a coincidence of the legal consequences provided for in articles 6 and 7 is ruled out. In the view of the representatives of this view, the AOA does not apply, for example, to income from immovable property, even if this is earned through a PE located in the situs state. In other words, “the rules in Arts. 7(2) to (6) do not apply to income governed by Art. 6.”

3.5. Assessment and implications for the application of the AOA to income from immovable property of an enterprise

3.5.1. Opening comments

The theory of an exclusive relationship is the one with the greatest practical significance. This state of affairs arises because, as noted in section 3.4., according to this theory the applicability of the AOA (article 7(2)) to income from immovable property is excluded. The following remarks propose a different viewpoint on the nature of the relationship between articles 6 and 7 (see section 3.5.2.), and present arguments for the application of the AOA to income from immovable property.

100. Compare Reimer, supra n. 55, at para. 200, and, apparently so, without invoking a reference to legal consequences, W. Kessler & N. Arnold, Gedanken zur Behandlung von unbeweglichem Vermögen in der deutschen DBA-Verhandlungsgrundlage, Internationale Steuer-Rundschau 1, p. 10, n. 15 (2014). Contra, see Rust, supra n. 32, at sec. 6.4.4., p. 98 et seq., according to whom the position of article 6 before article 7 argues against a speciality relationship.


103. Compare Reimer, supra n. 55, at para. 200, and, apparently so, without invoking a reference to legal consequences, W. Kessler & N. Arnold, Gedanken zur Behandlung von unbeweglichem Vermögen in der deutschen DBA-Verhandlungsgrundlage, Internationale Steuer-Rundschau 1, p. 10, n. 15 (2014). Contra, see Rust, supra n. 32, at sec. 6.4.4., p. 98 et seq., according to whom the position of article 6 before article 7 argues against a speciality relationship.


106. Papotti & Saccardo, supra n. 102, at sec. 3.2.
income from immovable property earned through a PE (see section 3.5.3.).

3.5.2. Nature of the relationship between articles 6 and 7

The detailed analysis in section 2. has shown that there is an overlap between articles 6 and 7 with regard to the passive business use of immovable assets by a company. In addition, articles 6 and 7 have contradictory legal consequences with regard to the allocation of the taxing right and (in some tax treaties) the application of the method for avoiding double taxation in the non-PE cases. Accordingly, the two conditions for the existence of a conflict of norms already laid down in section 2., namely the coincidence in the preconditions of the scope and the different legal consequences, are fulfilled in the case of articles 6 and 7.

In order to avoid the contradictory qualification of income from immovable property by the states and possibly the double non-taxation, only one of the conflicting legal consequences must come into play, as has been proven historically in the example of the Rafaela decision (see section 3.2.2.). Consequently, this conflict of norms must be resolved. Such resolution is generally carried out by applying conflict resolution rules. However, the legal effects of this conflict resolution can be different and must be determined in the respective context.107 On the one hand, the conflict can be resolved by the exclusion or nullity of the conflicting norm. On the other hand, the conflict can also be resolved by a mere priority of application, whereby one norm is to be applied with priority, without excluding the applicability of the other norm.

As there is a written norm that resolves the conflict between articles 6 and 7, namely article 6(4), the legal effect of the conflict resolution contained therein must be considered. As concluded in section 3.3., article 6(4) only states that article 6(1) and (3) should be applied with priority, but not that the applicability of article 7 is excluded from the outset. In other words, it does not exclude the applicability of the PE principle.

A comparison of the wording in article 6(4) with the wording of article 2 of the 1933 Model Convention makes this finding clear, i.e.: “the term business income shall not include the following: (a) income from immovable property” [emphasis added].108 According to this passage, income from immovable property never constitutes business profits.109 As a result, the application of the distributive rule for business profits (article 7) is ruled out from the outset. The OEEC wanted to proceed in a similar way with a definition of the term “profits” that excluded income from immovable property, as already described in section 2.2.1. Accordingly, income from immovable property would never constitute business profits and the application of article 7 would be excluded.

In contrast, the current wording of article 6(4), provides something different. If business profits also constitute income from immovable property (article 6(4) assumes this!), article 6(1) and (3) applies and not article 7.110 Article 6(4), therefore, accepts the overlap between articles 6 and 7 and resolves it.

That being said, that situation does not mean that the theory of exclusive relationship is not partly true. In particular, there are cases that fall either under article 6 or article 7. These cases – see the Figure in section 2.4. falling within the light grey area of the circles illustrating the scope of articles 6 and 7 – fall exclusively either under article 6 or article 7. Still, the theory of exclusive relationship cannot hold for the cases falling within the grey area, i.e. where articles 6 and 7 overlap.

In total, articles 6 and 7 are only partly exclusive in application. They partly overlap, so that, as far as they differ in their legal consequences, the overlap is resolved by reference to article 6(4).

3.5.3. Implications for the applicability of the AOA to income from immovable property of an enterprise

As emphasized in section 3.5.2., a conflict of norms exists only as far as the legal consequences of the norms are conflicting. If, and to the extent that there is no conflict in the legal consequences, the respective legal consequences apply in parallel. Applied to the case in question, article 6(4) also only resolves the conflict between article 6 and 7 only to the extent that their legal consequences concur.

In section 3.3., the conclusion has been made that article 6 and article 7 only have different legal consequences in the allocation of the taxing right and, depending on the tax treaty in question, in respect of the application of the method for avoiding double taxation. Article 6 does not contain any provision on the allocation of profits that could conflict with the provision of article 7(2). In the absence of a conflict of norms with regard to the legal consequence stipulated in article 7(2) (the allocation of profits), articles 6 and 7 apply in parallel. According to all of this, the AOA (article 7(2)) should consequently also apply to income from immovable property that is earned by way of a PE, and, nevertheless, is covered by article 6 given the application article 6(4).

The implications of this conclusion can be elucidated by referring to a practical example. A corporation resident in State A (the “head office”) invests in mining operations in State B. It is assumed that mining operations fall under article 6 because of an explicit clause in the State A-State B Tax Treaty (see section 2.3.3.3.). It is further assumed that, by conducting the mining operations, the head office has a PE in state B. Accordingly, the AOA applies. This sit-
uation means that the PE is hypothesized as a separate and independent enterprise, being hypothesized as PEs are not, in fact, legally separate from the rest of the enterprise. Consequently, it is also hypothesized that there are legally binding contracts between the PE and other parts of the enterprise, here the head office. This is also a hypothesis because:

[the factual, legal position in a PE context... is that there is no single part of an enterprise which legally... contracts with separate enterprises.]

Just like in the context of separate enterprises that are connected (for example, in a parent-subsidiary relationship), the head office and the PE must transact at arm’s length. That is, they must transact as though they were not related parties. A parent, resident in state A, may wish, for example, to offer accounting services without any payment to its subsidiary, resident in state B. It is, in the final analysis, for the better of the whole enterprise. But would unrelated parties also transact in such way (for example, an extern accountant offering the same services to the subsidiary)? The answer is of course “no”. So, transactions between related parties must reflect transactions between unrelated parties. If they do not do so, they may be corrected. In the example in question, the subsidiary would have to pay to the parent the remuneration it would have paid to an extern accountant. Its taxable profit in State B would fall, therefore (the payment being deductible), but that of the parent in State A would rise.

Exactly the same would happen in the context considered in this article. If the head office were to transfer to the PE machines that it needs for the mining operations, the PE, although legally not being separate from the head office and thereby not transacting with it, would have to pay for the transfer of the machines, so that it reflects the same transaction between unrelated parties. If it did not do so, the transaction between the head office and the PE would be corrected so that the aforementioned outcome is achieved.

It becomes apparent how far-reaching the implications of the application of the AOA are for companies using immovable property: Even though their activities may fall under article 6, if they have a PE in the source state, the PE must transact with other parts of the enterprise as if they were separate enterprises. Accordingly, the entities are not free to transact as they wish, for example, transfer assets to each other “for free”. Furthermore, and this has not been said so far, this situation also implies a substantial compliance burden for the companies concerned. As there are no contracts between the PE and other parts of the enterprise, their transactions must be documented otherwise. And this is not even to note the compliance burden accompanying the process of the analysis necessary to price the transactions in question at arm’s length.

4. Conclusions

The final conclusions of this article are set out below:

1. Based on a very broad concept of business profits, which can also include passive income (see section 2.2.), and on a restrictive interpretation of the term “use” in article 6(3), which does not include the active business use of immovable property (see section 2.3.), the second section of the article has fleshed out the area of overlap between articles 6 and 7. Specifically, the disputed provisions only conflict when a company generates passive income from immovable property. This is, for example, income from renting immovable property or from the creation and transfer of rights in rem. In this respect, there is a need for a demarcation between articles 6 and 7 in these cases.

2. Section 3. is devoted to the relationship between articles 6 and 7. Through a historical overview, it has been shown how the OECD Model deals with this relationship by including the conflict resolution rule of article 6(4) (see section 3.3.). The significance of this provision, which consists in the avoidance of conflicts of qualification and thus the double non-taxation of income, has also been elucidated in section 3.2., analysing the implications of the Raf aella decision.

3. In sections 3.4. and 3.5., the nature of this relationship was examined. The author concludes that there is a partial conflict between articles 6 and 7, which is resolved through the application of article 6(4). According to this provision, article 6 takes precedence over article 7, insofar as their legal consequences are incompatible with each other (i.e. only with regard to the allocation of the right of taxation and, depending on the tax treaty in question, the application of the method for avoiding double taxation). Otherwise, the legal consequences of article 7 continue to apply. In this respect, the AOA, for example, also applies to income falling under article 6, insofar as, and as long as, it is earned through a PE (and, therefore, article 7(2) applies) with far-reaching implications related to the structuring of the transactions between the PE and other parts of the enterprise at arm’s length, as well as the compliance burden that accompanies this process.

112. OECD, supra n. 12, at para. 13.
114. Id., at para. 175.