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The Role of Domestic Law in Tax Treaty Interpretation

A. Tax Treaties vs. Domestic Law

B. Interpretation of Tax Treaties - Generalities

C. Tax Treaties Referring to Domestic Law

D. Tax Treaties Complemented by Domestic Law

A.

Tax Treaties vs. Domestic Law

Tax Treaties stands short for „Double Taxation Conventions (DTCs)“.

As you all know, the purpose of DTCs is to avoid double taxation of income (or of wealth) by two different states.

Such double taxation is usually caused by one state taxing the worldwide income of its residents part of which has its source (and is taxed) in another state.

USA

Worldwide Taxation of Citizens and Residents

INDIA

Taxation of Source Income of Non-Residents

USA

INDIA

DTC

DTCs are an instrument of International Law

To interpret tax treaties correctly it is necessary to distinguish the two different spheres of International Law and Domestic Law

International Treaties are concluded by mutual consent of the states involved.

By declaration of this consent they become binding *on the international level*, i. e. for the *states* involved.

To be applicable within a country *to fiscal authorities or courts* an additional *implementation* is necessary.

USA

INDIA

DTC

Internal Implementation

Internal Implementation

If a state‘s constitution requires that the declaration of consent to conclude a treaty be approved in advance, e. g.

- by the parliament (as in many states, e. g., Germany), or
- by the Senate (as in USA)

this approval includes the implementation for the time at which the treaty comes into effect

In other countries the government may be authorized to conclude DTCs without such preliminary approval.

Thus in the UK under royal prerogative,

in India under Article 90 Income Tax Act.

In these countries the implementation of a DTC usually requires a separate subsequent act, e. g.

– in the UK a statute (at present an Order in Council authorized by Sect. 788 ICTA),
– in India, as I understand, that the treaty is placed on the table in Parliament.

Thus to each cross-border transaction between states which have concluded a DTC

both states‘ domestic law and the DTC apply aside of each other

Their relations is as follows:

DTCs restrict the application of domestic law:

- in certain cases certain rules become inapplicable;
- others are modified.

Apart from this, domestic law remains applicable.

Figuratively: DTCs cover part of domestic law; the remainder stays visible.

INDIAN DOMESTIC TAX LAW

DTC

For India, this is confirmed by Circular No. 333 dated 2nd April 1982.

Moreover:

It is generally recognized that a DTC cannot create new tax obligations.

But in India Article 90 (2) ITA goes further: it provides that the provisions of DTCs shall apply to the extent they are more beneficial to [the] assessee.

In other words: they do not apply, if the result is more burdensome than ITA.

B. Interpretation of Tax Treaties - Generalities

States have different rules on interpretation of domestic statutes, e. g.,

- in the UK the judge is bound to the words of the statute, he must not look at its purpose nor at the materials preparing it (with certain exceptions);

- in Germany the judge in extreme cases may even decide against the words of the statute if its purpose requires this, he is free in looking at any materials .

Other states‘ rule of interpretation lie between these extremes.

All those rules define the power of the judiciary vis-à-vis the parliament.

Therefore, they are part of the states‘ (unwritten) constitutional law.

Interpretation of international treaties cannot follow these differing domestic rules.

- In interpreting treaties on which the *International Court of Justice* has jurisdiction this Court evidently cannot be bound by domestic rules.
- When *domestic* courts and authorities have to interpret treaties they cannot proceed otherwise than the ICJ would.

Therefore, for interpreting international treaties methods different from those for interpreting domestic statutes have to apply.

- They must adhere more strictly to the text than it is usual in continental Europe,
- on the other hand they must be more liberal than in the UK.

The foregoing is affirmed by case law concurrently developed by the courts of many states, e. g.:

UK: Stag Line v. Foscolo, Mango & Co; Buchanan v. Babco Shipping Ltd.

USA: *Geofroy vs. Riggs*, 1890

New Zealand: *CIR v. United Dominions Trust*

In1969 the international case law on treaties was compiled by the *Vienna Convention on the Law of Treaties.*

According to many authorities VCLT has become *international customary law* binding even those states which *did not yet ratify it* (including India).

E. g., Australian High Court, *Thiel v. FCT*

Even the USA recognize as customary law Articles 31 (1), (4) and 33 (1) VCLT:

Article 31 (1): A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to terms of the treaty in their context and in the light of its object and purpose.

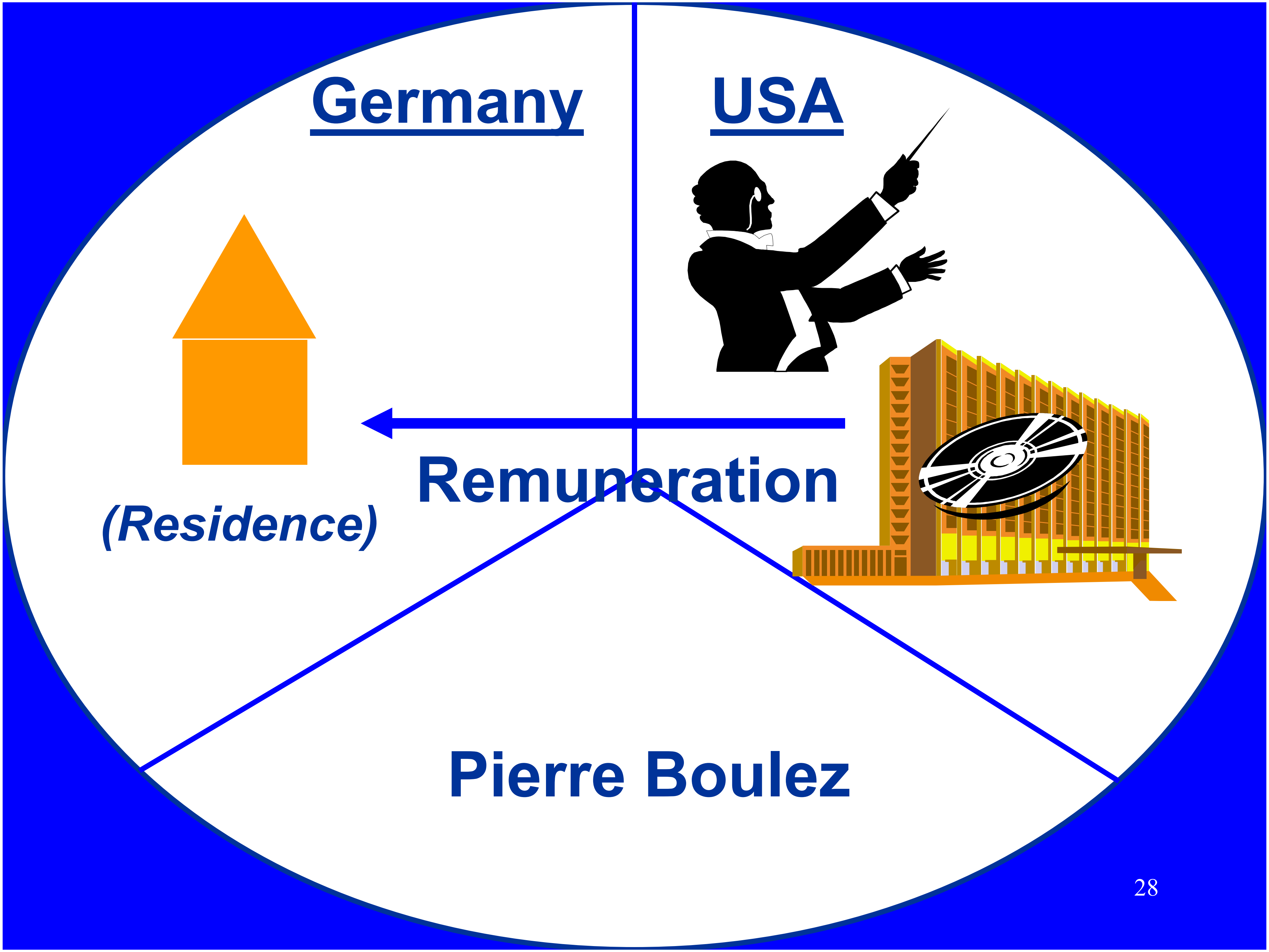
....

(4) A special meaning shall be given to a term if it is established that the parties so intended.

Article 33 (1): When a treaty has been authenticated in two or more languages, the text is *equally authoritative in each language,* unless the treaty provides or the parties agree that, in Case of divergence, a particular text shall prevail.

DTCs always provide that both states‘ languages are controlling. If the treaty was negotiated in a third language they usually provide that in cases of divergence the latter shall be decisive.

C. Tax Treaties Referring to Domestic Law


Germany
USA
(Residence)
Remuneration
Pierre Boulez

Under German law: royalties

> *Article VIII DTC Germany/USA 1954/65: taxable only by state of residence*

Under US law: compensation for personal services

> *Article X of the same DTC: taxable only by state of performance*

Germany applied its domestic definition, the USA theirs.

The result: double taxation amounting to more than 100 % (though the DTC was meant to avoid double taxation).

Both states could rely, however, on Article II (2) DTC which was similar to Article 3 (2) of the OECD and US Model:

The Problem in *Pierre Boulez* results from the fact that the DTC in distributing tax jurisdiction uses terms derived from domestic law, not defined by the treaty.

This, however, is a usual DTC practice.

The Pierre Boulez problem (qualification) is, therefore, a common problem.

Germany

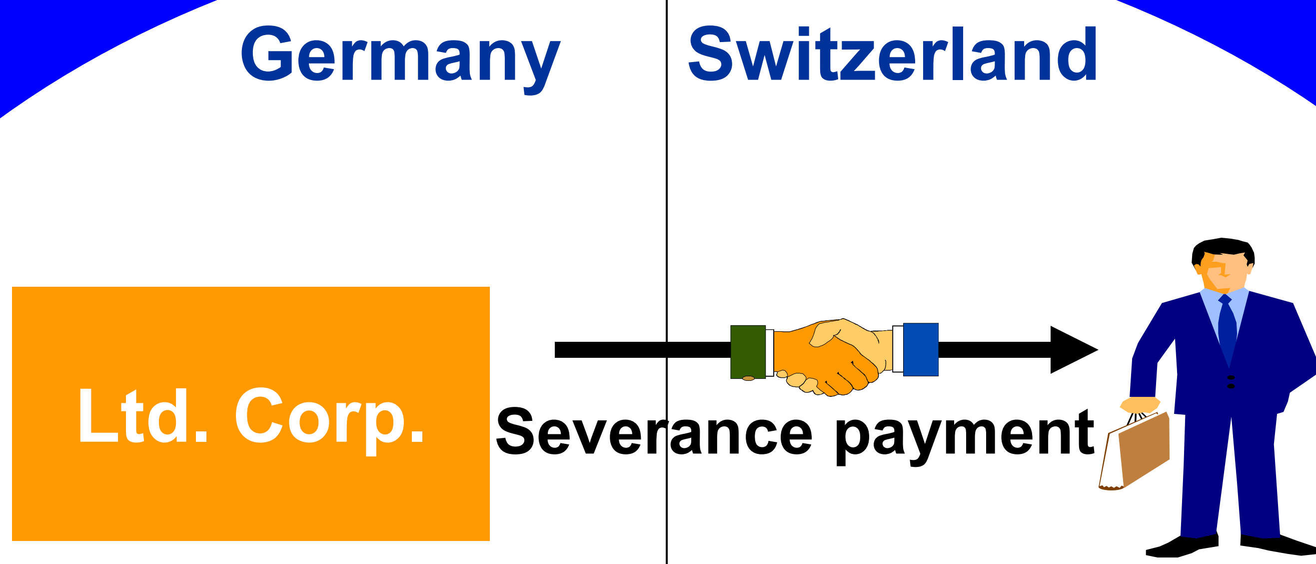
Switzerland

Partnership

Interest

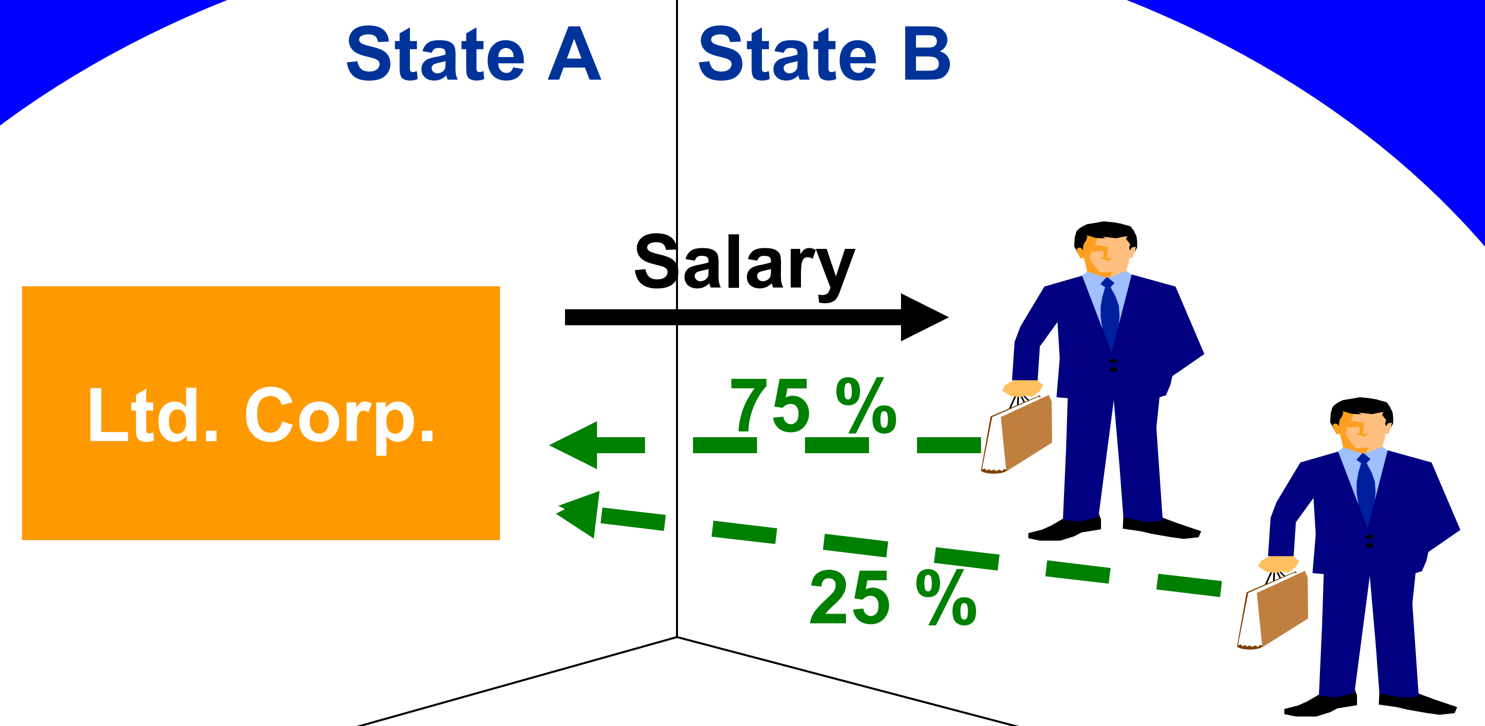
Switzerland: Art. 11 MC

Germany: Business Income,
Art. 7 MC



Germany: Employment Income, Art. 15 MC

Switzerland: „Other Income“ Art. 21 MC



Austria: Independent Services, Art. 11 MC

Germany: Employment Income, Art. 15 MC

France: „Other income“, Art. 21 MC

How to avoid double taxation in these cases?

Or double non-taxation?

(The latter is a problem for exemption states only,

it does not affect credit states.)

Parenthesis:

The credit method is traditional in Common law states,

the exemption method in Continental Europe.

Exemption: only the source state determines the tax burden on activities in its territory.

Credit: tax relief offered by the source state is cashed in by the state of residence.

How to avoid double taxation in these cases?

Or double non-taxation?

(The latter is a problem for exemption states only,

it does not affect credit states.)

Article 3 (2) MC makes the reservation: unless the context otherwise requires.

Therefore, if the context of a treaty permits a convincing interpretation,the treaty can (and must be) applied identically by both states.

But in most cases this is not possible.

Then, if the treaty has no explicit definitions, how can we decide whether the salary of a managing partner is

– employment income,

– profit from independent services, or

– „other income“?

Note, that different interpretations under Article 3 (2) can only then lead to *double taxation* (or double non-taxation)

when the term to be interpreted determines a *type of income*.

It is discussed, therefore, whether a state can be bound to accept the characterization of income by its treaty partner.

In 1984 a group of experts, chaired by John Avery Jones, suggested, that the state of residence should accept the source state's characterization.

They argued that the word - to apply - in Article 3 (2) only referred to the source state, that the state of residence only read not applied the treaty.

Article 3(2):

As regards the application of the Convention ... by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has ... under the law of that State for the purposes of the taxes to which the Convention applies ...

Not convincing.

Ten years later, David Ward and Jean-Marc Déry suggested to rely on Art. 23:

Where a resident of a Contracting State derives income ... which in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow ... (A: Exemption, B: Credit)

They argued:

The source state, according to the DTC, applies Article 3 (2). It characterizes the type of income by its own law.

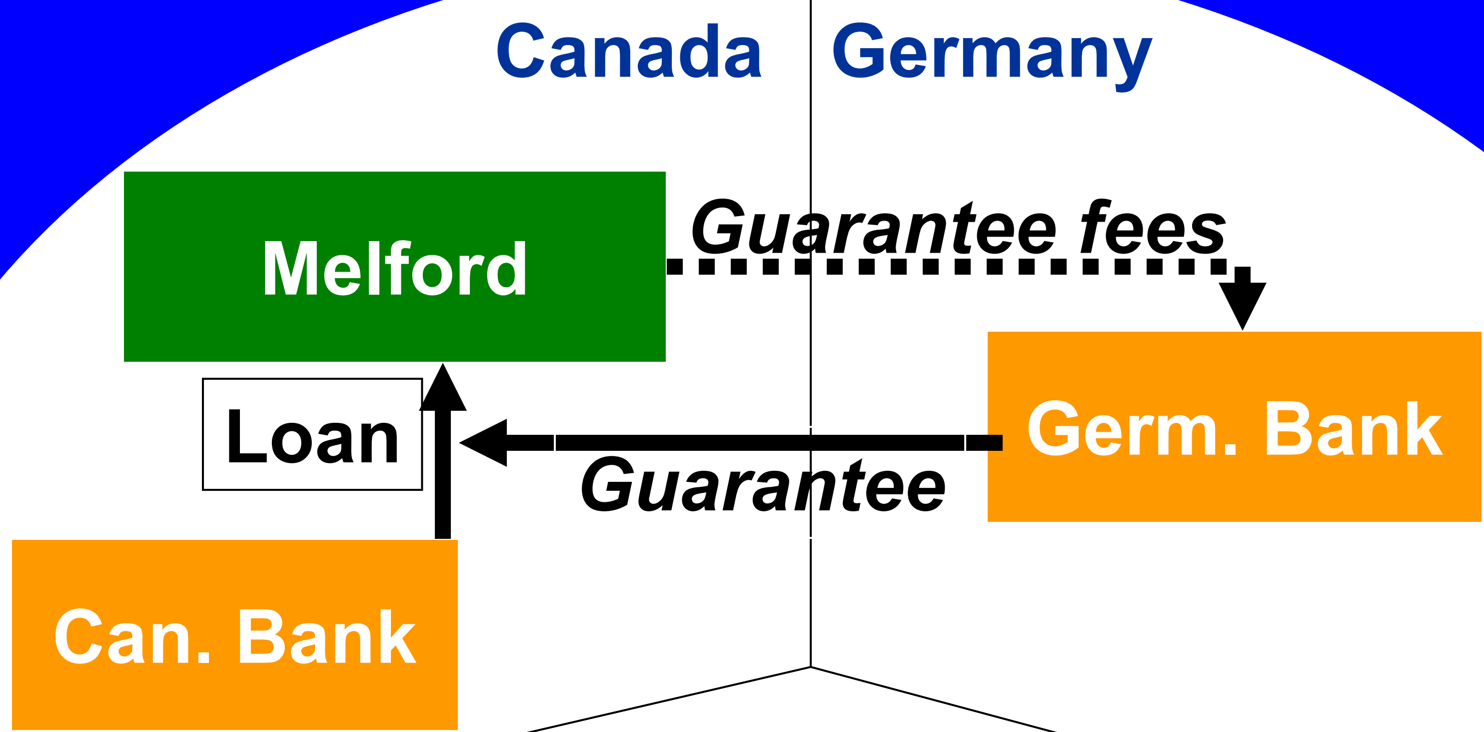
The state of residence only examines whether the source state taxed in accordance with the provisions of the Convention.

If the source state *did not correctly apply its own law*, there is no exemption or credit.

But if it did, exemption or credit is due *independently of the characterization which the state would give*.

OECD after consideration agreed with their argument.

Convincing.



1956 DTC: Withholding tax on interest
Can. Law: Guarantee fees no interest

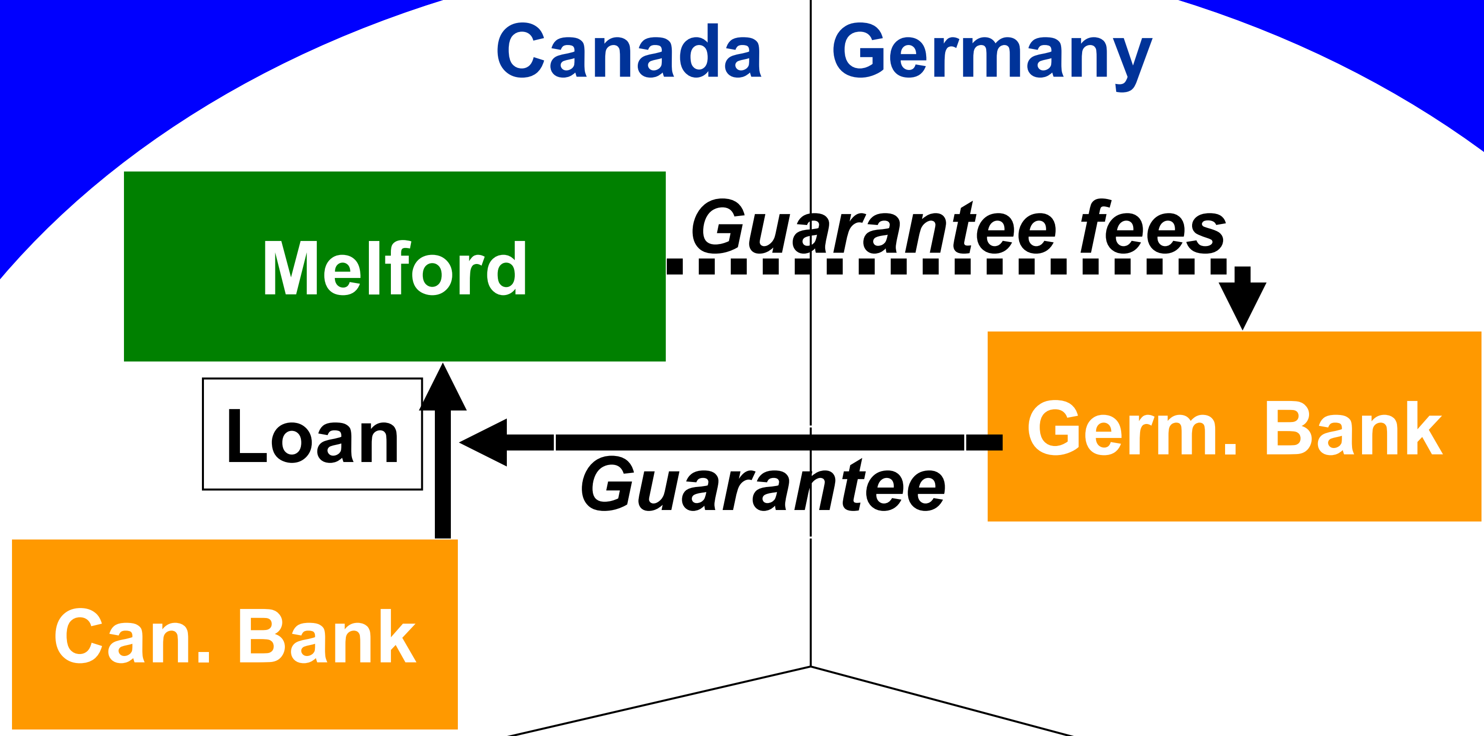
1974 Can. Statute: Term - interest - includes guarantee fees

In DTC 1956 no definition of interest.

Article 3 (2): Canada applies domestic definition.

However:

- definition of 1956 (static), or
- definition of 1974 (ambulatory)?



1956 DTC: Withholding tax on interest
Can. Law: Guarantee fees no interest

1974 Can. Statute: Term interest includes guarantee fees

Until the 80th no discussion: ambulatory interpretation generally assumed.

1982: Canadian Supreme Court in Melford adopted static interpretation.

1984: In Canada Income Tax Conventions Interpretation Act overrules Court.

Since 1995 Article 3 (2) OECD Model:

As regards the application of the Convention *at any time* by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has *at that time* under the law of that State for the purposes of the taxes to which the Convention applies ...

Ambulatory!

D. Tax Treaties Complemented by Domestic Law

INDIAN DOMESTIC TAX LAW

DTC

As mentioned before, domestic substantive tax law remains applicable to the extent that the treaty does not provide for exemption or credit.

Moreover domestic procedural tax law may determine details

- how the exemption is to be implemented,
- how the credit is to be computed and operated.

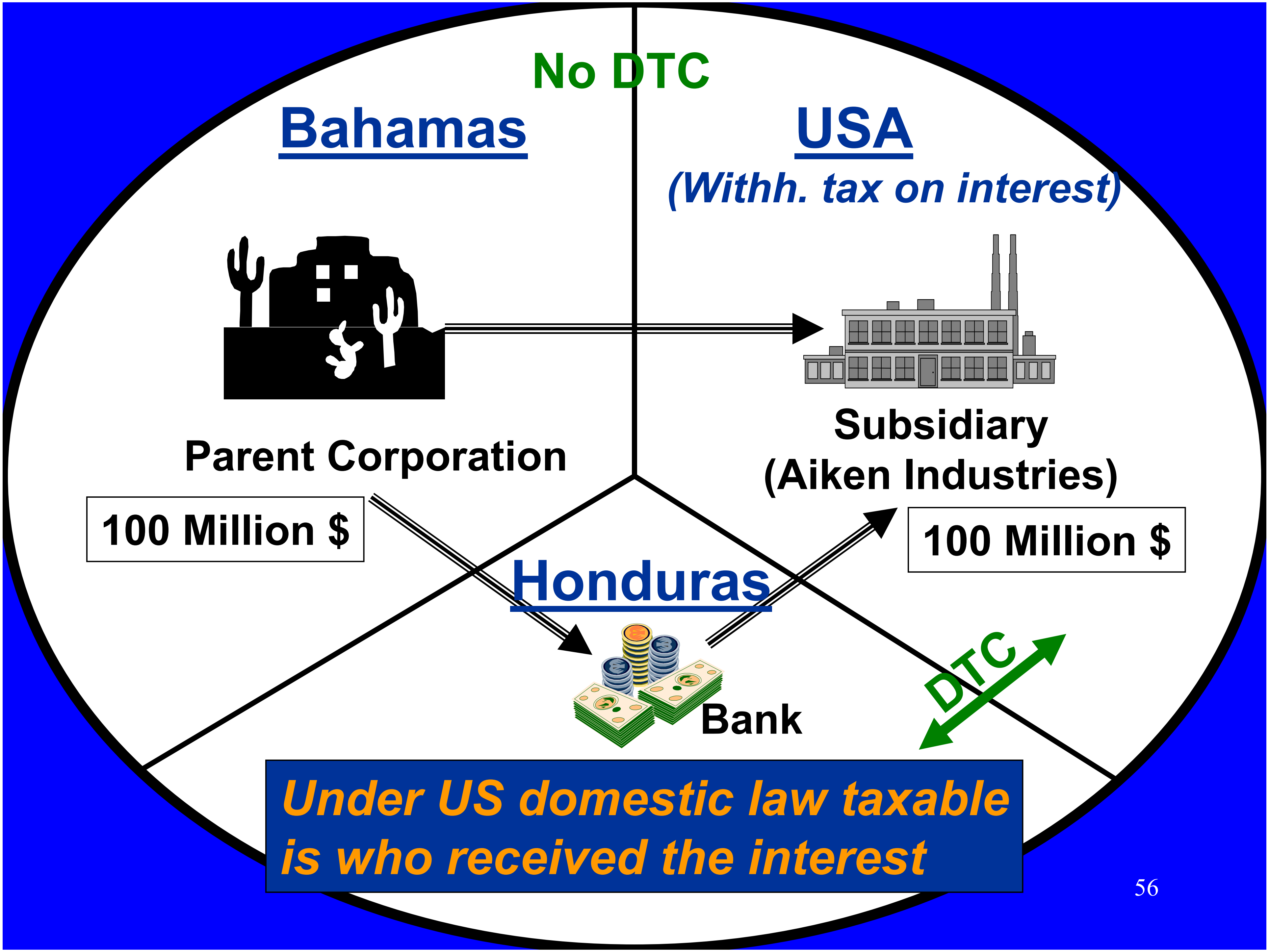
In applying these rules, however, the two levels of international law (= treaty rules) and domestic law <u>must always be distinguished</u>.

This may be shown by using the example of anti-avoidance provisions:

Many states have domestic anti-avoidance provisions, others similar case law.

Courts often applied these to DTC rules. But by doing so they overruled an inter-national obligation.

Nevertheless domestic anti-avoidance provisions may be applied to DTC cases.


No DTC
Bahamas
USA
(Withh. tax on interest)
Parent Corporation
Subsidiary
(Aiken Industries)
100 Million $
100 Million $
Honduras
Bank
DTC
Under US domestic law taxable is who received the interest

The US Tax Court decided:

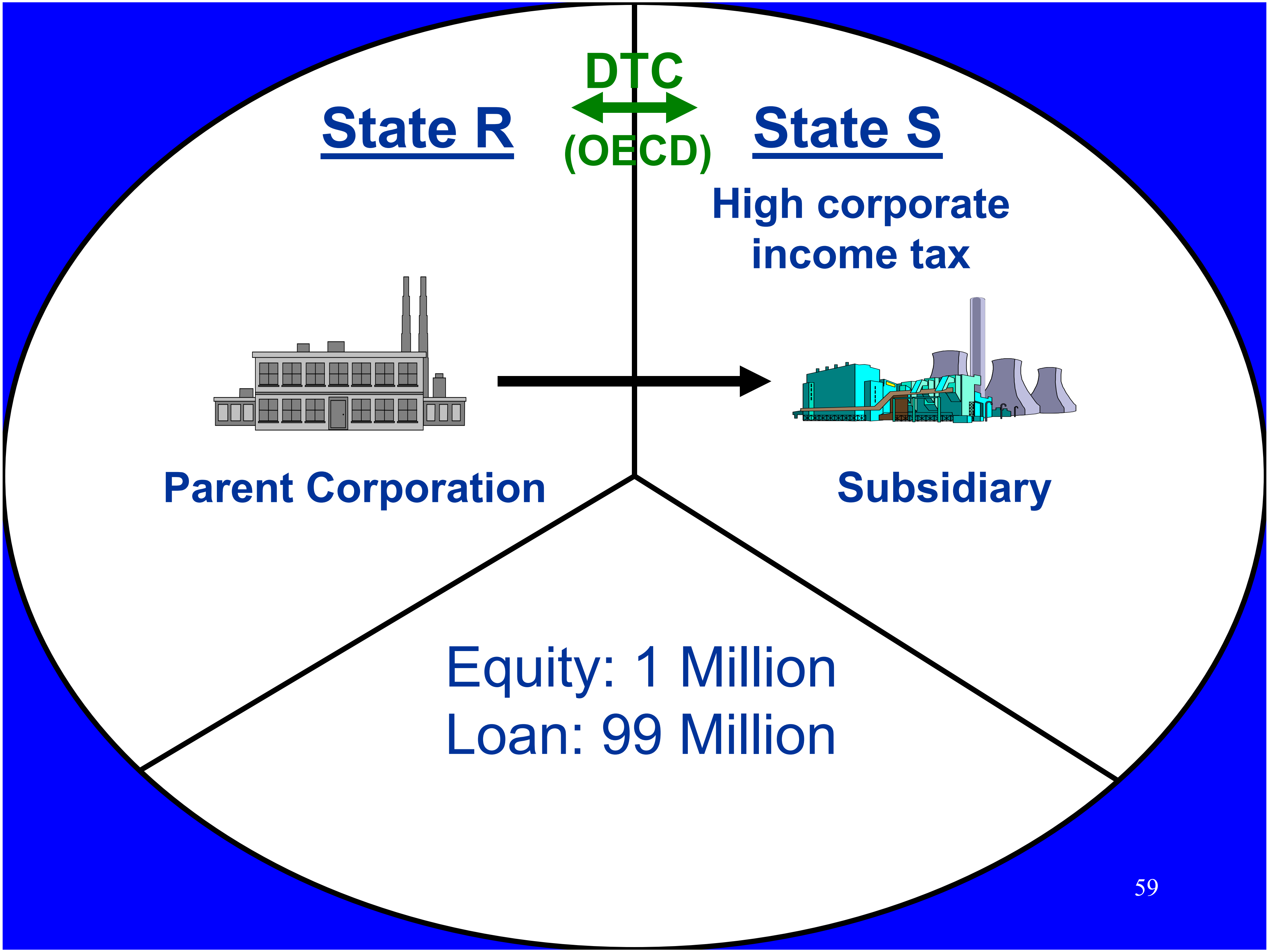
substance over form: the interest paid by Aiken was received by the Bahamian parent;

DTC USA/Honduras was not applicable.

Here the Court applied domestic anti-avoidance case law *to its own country's domestic substantive tax law.*

International law was not affected.

This is different, e. g., where equity is substituted to an unusual high percentage by a loan.


DTC
(OECD)
State R
State S
High corporate income tax
Parent Corporation
Subsidiary
Equity: 1 Million
Loan: 99 Million

The reasons being that

1) dividends are not deductible, the corporate tax base, therefore, may be high,

2) Art. 10 OECD Model: on dividends 5 % withholding tax is permitted,

whereas, in case of a loan

1) interest is deductible: low corporate income,

2) Art. 11 OECD Model: on interest no with-holding tax is provided.

If in such case a court applies Article 10 to the interest (instead of Article 11)

– referring to domestic anti-avoidance rules or case law,

it disregards an international obligation.

It is entitled to do so only if this can be justified by international law

– i. e., by the treaty or by general rules.

Is there such a general rule? There is a tendency today to answer this question to the affirmative

(case law, commentators, and a majority of the OECD Fiscal Committee; I agree).

But it is still heavily disputed.

In particular it is unclear, where the line between tax planning and unacceptable tax avoidance should be drawn.

However this dispute may end, it should always observe the distinction

- between applying *domestic* anti-avoidance rules to domestic substantive tax law
- and *international* anti-avoidance rules to international treaties.

Thank you for your attention!