

CHAPTER 2

PRINCIPLES OF INTERNATIONAL TAX LAW

Note: The purpose of this chapter is to provide the reader with a broad knowledge of some of the concepts of international tax law, including treaties and regional tax agreements. It is not meant to be comprehensive.

1. INTERNATIONAL TAX LAW

1.1. Definition

According to Article 38(1) of the Statute of the International Court of Justice, the sources of public international law are (a) international conventions establishing rules expressly recognised by states, (b) international custom, as evidence of a general practice accepted as law, (c) the general principles of law recognised by civilised nations, and (d) certain judicial decisions and legal teachings.

Public international law governs the relations between States, and determines their mutual rights and obligations. It is based on international agreements and general international law. It is the body of law comprising the principles and rules of conduct that States feel themselves bound to observe and therefore commonly observe in their relationships. Although these rules primarily govern the relations of States, international organisations, and to some extent individuals may also be the subject of the rights conferred and duties imposed by public international law.¹

General international law comprises customary international law and the general principles of law. While customary international law refers to the international practice of States, the general principles relate to international aspects contained in their domestic laws. Customary international law is based on the common view of States on certain matters along with the belief that it is obligatory.² It tends to be more general and harder to establish given the large number of nations in the world and the difficulty of pinpointing the precise moment in time when it comes into being.³ Customary laws may (or may not) be codified through treaties.

1 Robert Jennings and Arthur Watts, Oppenheim's International Law, 9th Edition (Longman Group, 1992); J.G. Starke, Introduction to International Law, 10th Ed. (Butterworths, 1989) p. 3.

2 Ramon J. Jeffery, The Impact of State Sovereignty on Global Trade and International Taxation (Kluwer Law International, 1999) p. 28.

3 According to Jennings, "the practice of states in this context embraces not only their external conduct with each other, but is also evidenced by such internal matters as their domestic legislation, judicial decisions, diplomatic despatches, internal government memoranda, and ministerial statements in parliament and elsewhere". See Jennings (1992) p. 27.

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International tax law refers to the principles derived from public international law that deal with tax conflicts involving cross-border transactions. These principles are based on the international tax aspects contained in the domestic tax law and the customary practices of countries, and tax treaties. With minor exceptions, tax laws are not “international”.⁴ Besides tax treaties, there are no overriding international laws of taxation that are enforceable on taxing States.

The sources of international tax law include:

- Multilateral international agreements, e.g. the Vienna Convention on the Law of Treaties, secondary law of international communities of States, mutual agreement procedures for equitable settlement of conflict of legal systems.
- Comprehensive bilateral double tax treaties, e.g. treaties and protocols, exchange of letters and notes, memoranda of understanding, and supplementary administrative agreements.
- Limited bilateral double tax treaties, e.g. reciprocal declarations, specific treaties on shipping and airlines, death duties and taxes on gifts.
- Customary international law and general principles of law, e.g. the principles of law recognised by civilised nations in their national legal systems, statute law, customary law and judicial decisions, and the practices of international organisations.⁵

1.2. Double Taxation

International tax law governs the taxing rights of sovereign nations. These rights depend on their fiscal jurisdiction. Each country has sovereign rights within its fiscal jurisdiction. Therefore, the substance of State sovereignty is jurisdiction, or the scope within which the effective and acceptable power of the State can be exercised. It is the “right to exercise (in regard to a portion of the globe) to the exclusion of any other State the functions of a State” (*Island of Palmas v USA*, 1928).⁶ The term “fiscal jurisdiction” refers to both (i) the right of legislation and (ii) the right of enforcement. A State cannot enforce what it cannot legislate. However, the reverse may be true. A State may legislate, even when it is unable to enforce.

There are two schools of thought on fiscal jurisdiction based on differing perceptions of State sovereignty. The first believes that there is no restriction on the State’s right to tax, and that it may be exercised without regard to other States.⁷ It is, therefore, not necessary to have a legal connection or link with a jurisdiction, provided there is a valid nexus with that State. The other school maintains that the sovereign right to tax is confined to a territory having a “legally relevant connection” between the State and the taxpayer.⁸

Although the issue is still unsettled, both views accept that “connecting factors” give a State the right to tax. These connecting factors link the taxpayer personally to a particular

4 Brian Arnold and Michael McIntyre, *International Tax Primer* (Kluwer Law International, 2002) pp. 2–7.

5 Asif H. Qureshi, *The Public International Law of Taxation* (Graham and Trotman, Martinus Nijhoff, 1994) pp. 1–9.

6 Sol Picciotto, *International Business Taxation* (Weidenfeld and Nicholson, 1992) p. 307.

7 *Lotus case* (1927): Since international law emanates only from the free will of States, they are free to assert any jurisdiction not explicitly prohibited by formal international agreements or a generally agreed positive principle.

8 Asif H. Qureshi, *The Public International Law of Taxation*, pp. 22–125.

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tax jurisdiction. They include personal links with the home State by virtue of residence, domicile or citizenship for natural persons, and the place of incorporation or location of a registered office, or management and control for legal persons. An economic activity is also connected with the host State, which exercises its taxing rights due to the territorial link.

The domestic laws in countries normally apply the following international tax principle, based on connecting factors:

- **Residence rule:** Unlimited taxation rights are granted to the country of residence, due to the “personal attachment” of persons. The country of residence (or nationality) may impose its taxes on the worldwide income of individuals or corporations due to the protection it offers to the tax subject.
- **Source rule:** Limited taxation rights are granted to the country of source due to the “economic attachment” of persons. The country of source reserves the right to tax the income that is derived from the economic activities within its territory.

Under the “economic attachment”, both States are entitled to tax income arising in their tax jurisdiction. The primary taxing rights remain with the country where the income is earned, i.e. the source State. No tax conflicts should normally arise if all States followed a territorial tax system and restricted their taxing rights to income arising in their own fiscal jurisdiction. However, the residence State retains its worldwide taxing rights to tax the foreign source income of its residents under the “personal attachment”. Tax conflicts arise largely (but not only) due to this right of the residence State that subjects its residents to tax on their foreign source income.⁹

As double taxation is generally considered undesirable, one of the objectives of international tax principles is to ensure that income is not taxed twice.¹⁰ There should be no need for these principles if every person or source of income were subject to tax in one State only. However, under various domestic laws the tax revenues on the same activity may be shared or the same income taxed by two countries. The sharing of income differs from tax overlaps. The term “double taxation” implies “over-taxation” due to overlapping taxing rights. Double or multiple taxation issues arise when the connecting factors grant competing taxing powers to two or more States on the same income.

International double taxation may be economic or juridical. Economic double taxation refers to a double tax on the same income in the hands of different persons (Examples: husband and wife, partnership and partners, company and shareholder, parent and subsidiary, etc.). The same tax object is taxed on legally different but economically similar or connected subjects in two jurisdictions (“economic identity of subject”). Juridical double taxation deals with the same tax object and the same tax subject. It is the imposition of comparable taxes by two or more States on the same taxpayer in respect of the same subject matter and for identical periods (“legal identity of subject”).

Juridical double taxation is the result of a conflict between two tax systems. It arises due to the overlapping claims of tax jurisdictions on interrelated economic activities. The

⁹ Double taxation may also arise due to other tax conflicts (see Chapter 2(1.3)).

¹⁰ Stef van Weeghel, *The Improper Use of Tax Treaties* (Kluwer Law International, 1998) p. 33.

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competing powers of fiscal sovereignty lead to double (or multiple) taxation in two or more jurisdictions; alternatively, it can lead to double tax exemption, i.e. non-taxation. International tax law is primarily concerned with juridical (i.e. based on jurisdiction) double taxation.

Although the domestic tax systems in most countries provide for unilateral relief, juridical double taxation conflicts are largely resolved through tax treaties negotiated under the principles of international tax law accepted by sovereign States. Through their distributive rules that avoid double taxation and relief methods when it does arise, they ensure a fair distribution of global tax revenues among nations (inter-nation equity). They also attempt to achieve global tax neutrality where tax issues do not affect the economic choices of taxpayers on international transactions.

1.3. Connecting Factor Conflicts

As mentioned above, double taxation issues arise due to tax conflicts when the connecting factors grant competing taxing powers to two or more States on the same income. For a tax liability to arise, there must be a taxable event on which a State can exercise its taxing rights, and there must be a person who is liable to pay the tax. Moreover, the two must have some connection with the taxing jurisdiction to be subject to its tax laws. Therefore, the three key components of any taxable transaction are:

- (i) **Tax subject:** the identity of the taxpayer, or a person's relationship to the taxed object that creates a tax liability;
- (ii) **Tax object:** the identity of the subject matter, or the facts that cause the tax liability; and
- (iii) **Connecting factor:** there must be a "reasonable connection" between the taxing powers of the State, and the taxpayer or the transaction. Without a connecting factor between either the taxpayer or the business activity and the tax jurisdiction, a State cannot levy its tax.

Each country follows its own tax practices under its own legal system, and defines the connecting factors under its own laws. As a result, different countries apply differing definitions of taxable entities and taxable events, and then use varying bases for computing the tax under their own tax accounting rules. For example:

- (a) More than one country may claim an item of income or gain as taxable within its jurisdiction. The tax residence of a company may be based on the country of incorporation or management. An individual may be resident in more than one tax jurisdiction. The tax rules in the residence country may not coincide with those applied in the source country.
- (b) Different jurisdictions may characterise a taxpayer differently under their domestic law. For example, a partnership may be fiscally transparent in one State and a taxable entity in another State.
- (c) The meaning of terms (such as income tax, total income, residence, domicile, immovable property, permanent establishment), and the characterisation of transactions may vary in different countries.

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These varying definitions lead to connecting factor conflicts, such as:

- Source-Source conflicts: two or more countries claim the same income of a taxpayer as sourced in their country.
- Residence-Residence conflicts: two or more countries regard the same taxpayer as tax resident in their country.
- Residence-Source conflicts: the same income is taxed twice, first by the country where it is derived under its “source rules”, and then in the country where the taxpayer resides under its “residence rules”.
- Income characterisation conflicts: two States characterise or classify the same income or capital differently and, therefore, apply differing tax provisions.
- Entity conflicts: an entity is characterised differently under the domestic laws of the two States and, therefore, it is subject to differing taxation.
- Mismatching tax systems: the two tax systems provide for differing rules for assessment, definition of taxable income, or computation of taxes.¹¹

The most common form of juridical conflict in international taxation relates to the Residence-Source taxation. A taxpayer satisfies a tax relationship in two States simultaneously. The unilateral tax rules under domestic law may relieve such tax conflicts, but tax treaties normally give a more favourable treatment. Other situations usually require the assistance of specific provisions under tax treaties.

1.4. Dual Role of Treaties

A treaty is an agreement between sovereign nations. Negotiated treaties frequently contain additional supporting data that form an integral part of the treaty, such as protocol, exchange of letters, or memorandum of understanding. A protocol is a treaty by itself that amends or supports the existing treaty. The exchange of letters clarifies the treaty provisions and forms part of the treaty. They differ from a memorandum of understanding, which may or may not be binding.

Under international law, tax treaties carry the obligation to ensure that they have the force of domestic law. Some countries follow the monistic principle, under which the municipal law is linked and subordinated to the international law under the “doctrine of incorporation”. Other countries follow the dualistic principle, which regards the international and municipal laws as separate and requires a specific domestic legislation under the “doctrine of transformation”. Each State is free to decide its approach under its own constitutional laws to comply with its international obligations.

Thus, there are two groups of countries, as follows:

- (i) **Direct effect:** treaties are self-executing and automatically become a part of the domestic law when they are ratified.¹² The monistic principle provides that they are enforceable under domestic law without further legislation. In some countries, they

¹¹ The same income may be subject to different tax systems. For example, tax on death may be taxed as estate duty or as capital gains tax. Similarly, social security tax under FICA (Federal Insurance Contributions Act) is an employment tax in United States but an income tax in Australia.

¹² Examples: France, Japan, Luxembourg, Netherlands, Portugal, Spain, Switzerland.

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require a formal or procedural executive or legislative act to incorporate them into domestic law.¹³

- (ii) **Indirect effect:** treaty provisions must be enacted into domestic law and require special legislative steps.¹⁴ The Courts cannot enforce the treaty provisions until they are “transformed” into municipal law, usually by a legislative act or delegated legislation. Under this dualistic doctrine, it is usually the related statute, and not the treaty, which has the legal authority under the domestic law.

Tax treaties are binding on the tax authorities and taxpayers under domestic law, once they become part of it, either by incorporation or transformation under its law. Its provisions are then enforceable and the taxpayer has rights and obligations under the treaty. The domestic Courts in the tax jurisdictions concerned can enforce them. The Courts must also respect the national obligations of the State under an international agreement.

The treaty’s “final provisions” govern the timing (See Chapter 2(2.2)). This provision allows for the required legislative and administrative action and ensures that the new tax rules apply from the beginning of an income tax year. The dates when the treaty enters into force and when it is enforceable under domestic law may differ from the effective date under the treaty itself. There can be different dates for each country and even different dates for different taxes in each country. Generally, retrospective application of the new treaty provisions is not permitted if they would affect the taxpayer’s rights adversely.

Thus, tax treaties serve a dual purpose and have a parallel life. They are both “State to State” agreements under the international law and also part of the statutes under the domestic law. They are binding on the Contracting States under public international law from the date of entry into force, but may be enforceable under the domestic law by the Courts only after they are incorporated in the domestic or municipal law.¹⁵ Each State follows its own rules for the inclusion of the treaty under its law.

1.5. Country Examples

Australia

Australia follows the dualistic doctrine. Each Australian treaty is incorporated by legislative action into the domestic law as a Schedule under the International Tax Agreements Act 1953. A tax treaty is applied and enforced in the domestic Courts as Parliamentary intent, and the Parliament can, if it wishes, override the treaty by subsequent legislation. Treaties generally prevail over domestic law, except when the Australian general anti-avoidance rule is applicable.

Canada

Each treaty is incorporated into domestic law by separate parliamentary legislation that provides that the treaty prevails over domestic law in case of conflict. In principle, as

13 Examples: Austria, Belgium, Germany, United States.

14 Examples: Australia, Canada, Denmark, India, Israel, New Zealand, Norway, Sweden, United Kingdom.

15 Klaus Vogel, Double Taxation Conventions, Introduction, m.no. 28–44.

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Parliament is supreme it can override the treaty through specific legislation. However, such overrides are rare.

The Income Tax Conventions Interpretation Act 1985 contains provisions that specifically allow tax treaty overrides in certain circumstances.¹⁶ The Act provides that the terms, which either are undefined (partly or wholly) in the treaty or require the use of the domestic law, have the meaning under the domestic law at the time when the treaty is applied and not when the treaty was entered into, except to the extent that the context otherwise requires.¹⁷

France

France follows the monistic doctrine of incorporation. A treaty has priority over prior or subsequent domestic legislation. Article 55 of the French Constitution 1958 mentions: “treaties or agreements properly ratified or approved shall possess, from the moment of publication, an authority superior to that of domestic laws providing, as regards each treaty or agreement, it is applied by the other party”.

Germany

International treaties require the approval of the Federal Parliament (*Bundestag*) and the Council of Constituent States (*Bundesrat*). Under Article 59 (paragraph 2) of the Fundamental Law, this formal approval introduces the treaty into the German legal system as an Act of Parliament with no precedence over domestic statutes. However, since Section 2 of the General Tax Code (AO) claims superiority of tax treaties over domestic tax law, subsequent law can only override treaty law if the law expressly contradicts the treaty provisions.

India

India follows the dualistic doctrine, and tax treaties strictly require an Act of Parliament. However, to avoid a time-consuming and cumbersome procedure, they are enacted into domestic tax law under delegated legislation powers granted by the Parliament to the executive branch of the government.¹⁸ Section 90 of the Indian Income Tax Act, 1961, empowers the central government to enter into tax treaties with the government of other countries. They do not have to be laid before Parliament since no separate legislation is required to give effect to a tax treaty. The tax treaty prevails even if it is inconsistent with the provisions of the Act.¹⁹

A treaty, once ratified and incorporated, prevails over statutes unless the Indian Parliament specifically legislates a treaty override. However, Article 51 of Part IV(c) of the Indian Constitution specifically mentions, “the State shall endeavour to foster respect

16 Brian Arnold, Canada amends Income Tax Conventions Interpretation Act (Tax Analysts, February 8, 1999).

17 The *Queen v Melford Developments Inc* 82 DTC 6281 (SCC) (Canada).

18 *Union of India and Anr. v Azadi Bachao Andolan and Anr.* (2003) SC 56 ITR 563, (India): Under the Income Tax Act, the charging provisions under Sections 4 & 5 are expressly made “subject to the provisions of this Act”. The Act includes Section 90. Hence, the treaty overrides the domestic law in all respects.

19 *Magambhai v Union of India* (1969) SC 783 (India).

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for international law and treaty obligations in the dealings of organised peoples with one another”.

Ireland

Under the Irish Constitution, the status of a tax treaty differs from that of domestic law. Its legal validity, as part of the domestic law of the State, is derived from Article 29 of the Constitution. Treaties are negotiated and concluded by the government, but subject to approval by Parliament. A treaty becomes part of the domestic law when an Order is made under the Taxes Consolidation Act after the Parliamentary resolution. Sec. 826 TCA 1997 mentions that such agreements are to have the force of law in Ireland “notwithstanding anything in any enactment”.²⁰

Japan

Domestic tax law cannot override tax treaties in Japan under its constitution.

Netherlands

Under the Dutch constitutional law, a treaty is self-executing and becomes applicable under the domestic law at the time when it enters into force. The treaty has priority over subsequent domestic law under Article 94 of the Dutch Constitution. Tax treaty restricts the application of domestic tax law.

United Kingdom

The United Kingdom follows the doctrine of transformation. A provision in the tax law (currently ICTA 1988 s.788) allows the treaty to take effect by an Order in Council (delegated legislation). It also confers the authority to negotiate and conclude tax treaties to the government. When an agreement has been initialled in draft and approved by Ministers, it is signed and then published as a draft Order in Council and laid before Parliament for its approval. The legislative process is completed when the order is made by her Majesty in Council. Instruments of ratification must usually be exchanged before a treaty can come into force.

Thus, although the making of a treaty is an executive act its obligations under the domestic law must have legislative approval. The taxpayer’s rights under a treaty arise from an Act of Parliament, which confirms the treaty and gives it the force of domestic law. Subsequent legislation by Parliament intended expressly to override a tax treaty is possible.²¹ However, unintentional treaty overrides cannot occur, as statutes may not be interpreted to result in breaches of obligations under international law.²²

20 Charles Haccius and Pat O’Brien, Double Tax Agreements, (The Institute of Taxation in Ireland, 1998) p. G-15; John Ward, The General Anti-Avoidance Rule in Ireland (IBFD Bulletin, December 2003) p. 565.

21 *IRC v Collico Dealings Ltd.* (1961) 39 T.C. 509 at 527–528 (UK): The House of Lords held that the 1955 legislation was applicable on an Irish company despite tax exemptions under previous Anglo-Irish agreements since the wording of the legislation was unambiguous and prevailed over the agreement.

22 Philip Baker, Double Taxation Conventions (Sweet & Maxwell, 2003) pp. F-07; Jonathan Schwarz, Tax Treaties: United Kingdom Law and Practice (Sweet & Maxwell, 2002) pp. 1–8.

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United States

The United States follows the doctrine of incorporation. A tax treaty is self-executing and requires no further legislation. It becomes part of the domestic law, if it is consistent with the US Constitution, until it is either terminated or specifically contradicted by a subsequent federal (not state) legislation. The US tax treaties also contain a “saving” clause that preserves its right to tax its own residents under its domestic law, regardless of the treaty.

A treaty is a part of federal legislation enforceable by the US Courts, and has an equal status with other federal laws.²³ In case of a conflict between the treaty law and the federal law, the Courts and the tax authorities are bound to apply the measure that is later in time (“*lex posterior derogat legi priori*”).²⁴ However, the US Courts apply their discretion to avoid treaty overrides. The US Supreme Court held in *Cook v United States* that the intent of Congress to override international obligations of the United States through federal legislation must be “clearly expressed”.²⁵ The US Revenue also requires that such treaty waivers must be consistent.

The US Congress has rejected the view that treaties can only be brought into line with the changing tax laws by renegotiation, since it could give the foreign states an effective veto over the US domestic law changes applicable to international business.²⁶ Treaty overrides have been specifically permitted in several US tax laws. For example, Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) provided provisions for treaty override. Another example relates to the Tax Reform Act of 1984 that permitted treaty overrides in cases of “stapled” stocks issued by foreign corporations.²⁷

1.6. Is International Tax Law Enforceable

Every country has the sovereign right to establish its own tax rules, which govern its domestic and international transactions. However, countries may have legislative powers, but they may not have the enforcement rights over foreign jurisdictions.

International law only permits the enforcement by a country of its tax laws within its legislative jurisdiction. It forbids executive or administrative acts and enquiries by foreign tax authorities without the consent of the host country. For example, a State cannot send officials to gather tax evidence, examine books, value any property or interview witnesses. No legal documents may be served and no tax may be collected in another State without its consent. Generally, one State does not normally enforce the tax laws of another State, as a matter of sovereignty.²⁸

23 IRC Code, Sec. 7852(d)(1), as modified under the Technical and Miscellaneous Revenue Act of 1988.

24 *Whitney v Robertson* (1988) 124 U.S. 188, 190 (US).

25 *Cook v United States* (1933) 288 US 102 (US).

26 Sol Picciotto, International Business Taxation, p. 331.

27 Sol Picciotto, International Business Taxation, pp. 325–332.

28 *US v Harden* [1963] CLR 366 (SCC) (Canada); *Province of British Columbia v Gilbertson* 597 F. 2d 1161 (9th Cir. 1979) (US); *Government of India v Taylor* [1955] AC 491 (HL) (UK). In *Government of India v Taylor*, the Indian Government purchased a UK company operating in India and remitted the purchase payment immediately to England. The UK Courts refused to enforce a capital gains tax liability payable under the Indian tax laws.

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Tax authorities must follow the principles of international law when they enforce their domestic laws abroad. Since a State is unable to exercise its tax law in another State, it sometimes applies indirect pressure on nonresidents and foreigners present in its own territory. Such methods violate the principles of international law. “The mere fact that a State’s judicial or administrative agencies are entitled to subject a person to their personal or “curial” jurisdiction does not by any means permit them to regulate by their orders such person’s conduct abroad”.²⁹

Fiscal enforcement provisions on tax issues relating to cross-border transactions available today are limited. Under a tax treaty (OECD MC Article 26), the tax authorities of the Contracting States may exchange tax information. This Article permits the sharing of tax-related information to prevent tax evasion and frauds, unless it is contrary to the treaty provisions. The EC Directive 1977 (as amended) provides for assistance on tax matters among member countries. Similar provisions are also contained in the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters (1988), which came into force in 1995. In 2003, the OECD Committee on Fiscal Affairs added a separate Article 27 on the “Assistance in the Collection of Taxes” in its Model Convention. (See Chapter 3(4-Article 27))

1.7. International Tax Principles and Tax Treaties – Comments

As mentioned earlier, the two prevailing key taxing concepts in international taxation are the residence and source principles. Both of them are based on the so called “benefit theory”. Under this theory, taxes are payments for services (or benefits) rendered by the State. Each jurisdiction has the right to tax derived from services rendered or benefits provided. The State of residence retains its rights to tax its citizens or residents on their worldwide income, while the State of source taxes the income derived within its own fiscal jurisdiction.³⁰

Although the above split of taxing rights between residence and source States is commonly accepted for distribution of taxing rights, it inevitably leads to double taxation. Double or “overlapping” taxation adversely affects international trade and economic development. It is considered as harmful to the exchange of goods and services and to the movement of capital and persons. This double taxation is then avoided through reciprocal acceptance of taxing rights and obligations under what is fair and equitable. They require the jurisdictions to agree to share the taxing rights and give relief where double taxation arises, either under their domestic laws or under a negotiated agreement or treaty.

Besides the allocation of taxing rights and eliminating double taxation, tax treaties also provide other measures, such as:

- Prevention of tax discrimination of nationals, permanent establishments and enterprises of the other State.

29 F.A. Mann, *The Doctrine of Jurisdiction in International Law* – Hague Recueil 1964, Vol. I, pp. 145–149 and 156–158 (See extract in Asif Qureshi, *The Public International Law of Taxation*, pp. 310–313).

30 Klaus Vogel, *Worldwide v Source Taxation of Income: A Review and Re-evaluation of Arguments* (Intertax, 1988).

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- Resolution of tax disputes due to differences in the interpretation or application of the tax treaty.
- Authority for tax authorities to exchange information on tax matters to ensure compliance by taxpayers and to prevent tax evasion.
- Provision for mutual assistance in tax collection.

These objectives are not directly related to the avoidance of double taxation. A negotiated treaty may still be necessary to achieve them even when double taxation is not an issue.

Some of the principles underlying international tax law and tax treaties include:

(i) Equity and fairness – The tax system should be equitable and fair for taxpayers, i.e. inter-individual equity. This principle requires equal taxation on taxpayers with equal income, regardless of source, based on their ability to pay (“horizontal equity”), and the levy of progressively higher taxation on higher income (“vertical equity”). In the international context, the system should also enable each country to receive a fair share of the taxes generated by transactions involving their jurisdiction. This allocation of the worldwide tax base is achieved through a negotiated agreement or tax treaty between fiscal jurisdictions as equal partners with reciprocal appreciation of mutual taxing rights i.e. inter-nation equity.

(ii) Neutrality and efficiency – Whereas tax equity relates primarily to the relationship of taxpayers to each other, neutrality refers to the relationship between the taxpayer and the State.³¹ A neutral tax system that does not interfere with market forces is regarded as a more efficient distributor of factors of production. Therefore, the concept of tax neutrality is often stated as one of the principles of international taxation. It requires that economic processes should not be affected by external influences, like taxation.

Ideally, tax systems should be neutral as between investing at home or abroad (capital export neutrality or CEN) and as between investment by domestic and foreign investors (capital import neutrality or CIN). The former is based on the policy that a country’s nationals should have the same tax choice when making a decision to invest at home or abroad. The latter expects that the same tax burden should be imposed on both residents and nonresidents. The overall objective is to promote free movement of capital. Any distortions in investment decisions arising from tax considerations should be avoided.

Under CEN, the residence State ensures that the total tax burden on investment abroad is the same (not more, not less) as investment at home to neither encourage nor discourage capital outflows. Foreign source income is taxed currently by the residence State without any tax deferral (similar to domestic income), and full tax credit is given for any source taxes paid. In the case of CIN, foreign investors bear the same (not more, not less) overall tax as domestic investors in the source State. It applies the same tax rate as residents on income derived by nonresidents and does not impose any withholding tax on outbound payments; the residence State gives full tax exemption.

Both systems have their supporters. CEN is considered as a better approach by many developed countries to achieve worldwide economic efficiency, i.e. allocation of economic

³¹ Dale Pinto, E-Commerce and Source-Based Income Taxation (IBFD Publications, 2003) pp. 23–32.

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resources to achieve optimal productivity. It favours taxation in the residence State with a grant of tax credit to relieve foreign taxes paid. CIN supports national efficiency and international competitiveness with only source taxation and full tax exemption in the residence State.³²

In reality, unless there is a completely harmonised global tax system, full neutrality under both CEN and CIN is impossible to achieve. The measures required for CEN conflict with those required for CIN, and vice versa. CEN favours worldwide taxation while CIN encourages a territorial tax system.³³ Moreover, pure forms of CEN or CIN are rarely used. Countries follow a combination of CEN and CIN principles depending on their overall economic policy, of which tax is one of the components. In practice, policy makers typically treat capital export neutrality as at best a secondary goal. In virtually every country of the world, capital inflows generally are considered desirable and are encouraged through tax and other economic policies.

(iii) Promotion of mutual economic relations, trade and investment – Many countries (particularly developing countries) regard this objective as more significant than the avoidance of double taxation.³⁴ The primary purpose of tax treaties for them is to promote economic growth through foreign investment and technology. They are prepared to bear the loss of tax revenues due to tax incentives. For example, double non-taxation (e.g. tax sparing credits), may be regarded as a justified cost to achieve non-fiscal objectives. As net capital importers, they are also more concerned with capital import neutrality.

Tax treaties only deal with direct taxes. Developing countries usually have a low direct taxpayer base and low levels of public expenditure. Direct taxes and treaty policies often play a less significant role as a revenue source and are considered more as a policy tool to achieve their non-tax (e.g. social and economic) objectives. They rely more on indirect taxes to meet their government budgetary needs due to the relative ease in collection and its wider tax coverage.

In the above sense, the tax policies and objectives of developing countries may differ from those of developed countries. The former countries regard direct taxation less as a means for financial resource mobilisation for the government and more as a tool to achieve higher economic growth. Tax levels may be kept low through incentives to enhance their competitiveness for capital, markets and technology. The lack of anti-avoidance measures like controlled foreign corporation and thin capitalisation may be acceptable and tax sparing as well as treaty shopping may be deemed as tax incentives. Tax competition is both widely practised and encouraged in these countries.³⁵

³² In his book, Vogel mentions that exclusive taxation by the source State, i.e. territorial taxation under capital import neutrality is preferable for business profits. It respects the sovereignty of nations in tax matters, avoids competitive distortions where investment is made and does not impede the free flow of investment. (See Klaus Vogel, Double Taxation Conventions, Introduction, m.no. 13–14).

³³ A.J. Easson, Taxation of Foreign Direct Investment, pp. 36–40, pp. 179–183.

³⁴ See Chapter 2(5.5); this objective is enshrined in the 1923 Report of the four economists appointed by the League of Nations and is the underlying *raison d'être* for the UN Model Convention.

³⁵ William Ramirez, First Impressions of Tax in Asia (International Tax Review, March 2004) p. 47.

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(iv) Prevention of fiscal evasion – One of the stated objectives of Model tax treaties is the prevention of tax evasion. They include limited anti-avoidance measures such as comprehensive taxation for residents (Article 4), restriction on tax concessions on dividend, interest and royalty income only to beneficial owners (Articles 10, 11 and 12) and provision for exchange of tax information among tax authorities (Article 26). A recent addition in the OECD MC is the new Article on mutual assistance in the collection of taxes (Article 27). Although, it does not include tax avoidance as an objective, the Commentary Update 2003 issued by the OECD Committee on Fiscal Affairs regards it as one of its purposes. This broadening of the treaty objectives to all forms of domestic tax avoidance rules is not accepted in many countries.³⁶

Some commentators also regard double non-taxation as tax avoidance and deem it as undesirable on neutrality and fairness grounds.³⁷ Paragraph 52 of the OECD Partnership Report 1999 reads as follows: “...the basic purposes of the Convention (is) to eliminate double taxation and to prevent double non-taxation”. Pursuant to this Report, the OECD MC 2000 has added a new paragraph 4 in Article 23A, and also made certain changes in the Commentary.³⁸ As double non-taxation can be both intended and non-intended, presumably the objective is to prevent unintended double non-taxation resulting from the application of the treaty. Despite this OECD view, double non-taxation is not yet widely accepted as either tax avoidance or evasion or as an objective of tax treaties.³⁹ Currently, a taxpayer may rely on a tax treaty even if it results in double non-taxation.

(v) Reciprocity – International taxation has the concept of reciprocity as one of its key principles. This principle affects a country’s approach to designing its international tax rules. As each State has full rights to tax income sourced in its own jurisdiction, it will accept a limitation of these rights only if the other tax jurisdiction provides for an equitable allocation of bilateral tax revenues. Fiscal reciprocity assumes that the States have comparable social and economic backgrounds and fiscal needs. Otherwise, reciprocity requires a holistic approach based on both fiscal and non-fiscal considerations to achieve a balanced allocation of taxing rights.

The reciprocity principle has raised questions on the fairness of existing Model treaties in recent years. On cross-border transactions, the source State has the first opportunity to tax the nonresident as and when the income arises in its tax jurisdiction. Unless the source country agrees to forego or limit its rights, it can exercise them. Under the Model treaties, the source State agrees to restrict many of its taxing rights over the income derived by

36 Stef van Weeghel, *The Improper Use of Tax Treaties*, pp. 34–36; See also Frank van Brunschot, *The Judiciary and the OECD Model Tax Convention and its Commentaries* (IBFD Bulletin) Section 2.6.

37 League of Nations Report issued in 1927 mentioned: “The most elementary and undisputed principles of fiscal justice, therefore, require that the experts should devise a scheme whereby all incomes would be taxed once and once only”. This “single taxation principle” may not be appropriate unless the countries have comparable tax systems as well as comparable social and economic needs. (See Chapter 2(5.5).

38 OECD Commentary: Article 23, paras. 32.6, 32.7, 56.1 to 56.3; Article 21, para. 3.

39 There are several judicial decisions, which indicate that double non-taxation is not an objective of a double tax treaty. Examples: *Estate of Hausmann v R* (1998) 4 CTC 2232 (Canada); *Lamesa Holdings v Commissioner* (1997) 36 ATR 589 (Australia); *Union of India v Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India); *Gladden Estate v The Queen* (1985) DTC 5188 (Canada). See also IFA Cahiers 2004 on Double Non-taxation.

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nonresidents within its territorial jurisdiction (See Chapter 3(1.3)). The taxing rights of the residence State are more or less unaffected. It retains its full or unlimited taxing rights on the worldwide income and capital of its residents, with an obligation to grant relief in the limited situations when juridical double taxation arises.

With the exception of avoidance of double taxation and prevention of tax evasion, the other objectives of tax treaties are still not fully accepted. Some of the other issues that may affect international tax principles and treaties are listed below.

- Generally, there is a consensus among nations that international double taxation is detrimental to worldwide trade and investment and should be avoided under the domestic laws and through negotiated tax treaties. Some commentators also believe that the tax system should discourage tax arbitrage, i.e. tax advantages arising from differences in tax rates and tax bases.⁴⁰ The latter objective may be difficult to achieve in real life unless every country has the same tax system and similar fiscal policies.⁴¹
- Each country has a primary duty to advance the interests of its citizens and residents. As countries are at differing levels of social and economic growth, their fiscal needs vary widely. Although the primary purpose of taxation is to raise revenue for the government, other non-fiscal objectives affect both domestic and international taxation. As mentioned above, the total benefits (tax and non-tax) provided by each country should be considered to determine both equity and reciprocity.⁴²
- Several developing countries consider that the current allocation of tax revenues between source and residence States under the Model tax treaties is inequitable. It unduly restricts the taxing rights of source States in favour of residence States.⁴³ This view is expressed by several commentators.⁴⁴ Reciprocity and inter-nation equity is also questioned in the tax rules applied to electronic commerce applications. The present allocation rules, as well as the latest OECD interpretations on e-commerce taxation, do not favour source countries when dealing with digital goods. Unless acceptable reciprocity is agreed, developing countries may have problems in accepting the existing Model treaties.⁴⁵
- Taxation is more than just a fiscal issue. It is affected by political, social and economic factors. As a result, there are significant differences among States on the relevance of taxation (and fiscal goals in general) within their national policy. Each country tries to justify its own approach and sometimes impose it on others. A State's size and its place in the world economy and political order, influence these efforts. Under these circumstances, it may not be appropriate to apply a single treaty model under a "one-size-fits-all" approach to all countries.⁴⁶

40 See Stef van Weeghel, *The Improper Use of Tax Treaties*, p. 33.

41 Michael Graetz, *Foundations of International Income Taxation* (Foundation Press, 2003) pp. 19–39.

42 For a brief summary of some of the other goals of international tax systems and tax treaties, read Jacques Saserville, *The Role of Tax Treaties in the 21st Century* (IBFD Bulletin, June 2002).

43 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, p. 21.

44 Brian J. Arnold, Jacques Saserville and Eric Zolt, *Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century* (IBFD Bulletin, June 2002) pp. 238–239.

45 See Report of the High Powered Committee of the Indian Government on E-Commerce, July 2001.

46 For a brief summary of some of the other goals of international tax systems and tax treaties, read Jacques Saserville, *The Role of Tax Treaties in the 21st Century* (IBFD Bulletin, June 2002).

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2. APPLICATION OF TAX TREATIES

2.1. Vienna Convention on the Law of Treaties

(i) Background

The rules under the Vienna Convention on the Law of Treaties (VCLT) apply to all international treaties, including tax treaties. The Vienna Convention on the Law of Treaties (VCLT) was adopted on May 22, 1969 and entered into force on January 27, 1980. At the international level, the VCLT is binding on treaties among States, which are signatories after it entered into force. As of 2004, there are 96 parties, who have ratified, acceded or succeeded to the VCLT, and 45 signatories, who have signed but not become parties to the Convention. Under the Vienna Convention, a “party” means a State that has consented to be bound by the treaty and for which the treaty is in force.⁴⁷

The VCLT does not have retroactive effect. However, since it essentially codifies the existing norms of customary international law on treaties, it is also considered to be binding on non-signatories and applicable to both past and future treaties. As a result, the Convention does not have to be specifically incorporated in the domestic law.

(ii) Extracts from the VCLT

1. For purposes of the present Convention:

- a. “treaty” means an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.
- g. “party” means a State, which has consented to be bound by the treaty, and for which the treaty is in force.
- h. “third State” means a State not a party to the treaty.

Article 26: *Pacta sunt servanda*

Every treaty in force is binding upon the parties to it and must be performed by them in good faith.⁴⁸

Article 27: Internal law and observance of treaties

A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to Article 46.

⁴⁷ Countries that have ratified the Vienna Convention include Austria, Australia, Canada, Denmark, Germany, Greece, Italy, Japan, the Netherlands, New Zealand, Spain, Sweden and the United Kingdom. Non-signatories include France, India, Indonesia, Israel, Portugal, Singapore and South Africa. Several countries, including Brazil, Pakistan and the United States, have signed but not yet ratified the treaty.

⁴⁸ Under VCLT, good faith is also mentioned in its Preamble: “...the principles of free consent and of good faith and the *pacta sunt servanda* are universally recognized...” However, there is no further explanation in the VCLT of what good faith means. A United Nations Report in 2001 mentions that “good faith requires fairness, reasonableness, integrity and honesty in international behaviour”.

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Article 28: Non-retroactivity of treaties

Unless a different intention appears from the treaty or is otherwise established, its provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to the party.

Article 29: Territorial scope of treaties

Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory.

Article 30: Application of successive treaties relating to the same subject matter

1. Subject to Article 103 of the Charter of the United Nations, the rights and obligations of States parties to successive treaties relating to the same subject matter shall be determined in accordance with the following paragraphs.
2. When a treaty specifies that it is subject to, or that it is not to be considered as incompatible with, an earlier or later treaty, the provisions of that other treaty prevail.
3. When all the parties to the earlier treaty are parties also to the later treaty but the earlier treaty is not terminated or suspended in operation under Article 59 (VCLT), the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty.
4. When the parties to the later treaty do not include all the parties to the earlier one:
 - (a) as between States party to both treaties the same rule applies as in paragraph 3;
 - (b) as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and obligations.
5. Paragraph 4 is without prejudice to article 41 (VCLT), or to any question of the termination or suspension of the operation of a treaty under article 60 (VCLT) or to any question of responsibility which may arise for a State from the conclusion or application of a treaty the provisions of which are incompatible with its obligations towards another State under another treaty.

Article 31: General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There should be taken into account, together with the context:
 - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

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- (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32: Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:

- (a) leaves the meaning ambiguous or obscure; or
(b) leads to a result that is manifestly absurd or unreasonable.

Article 33: Interpretation of treaties authenticated in two or more languages

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 will prevail.
2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
3. The terms of the treaty are presumed to have the same meaning in each authentic text.
4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty shall be adopted.

Article 34: General rule regarding third States

A treaty does not create either obligations or rights for a third State without its consent.

Article 42(2): Validity and continuance in force of treaties

1. The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the present Convention.
2. The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the present Convention. The same rule applies to suspension of the operation of a treaty.

Article 46: Provisions of internal law regarding competence to conclude treaties

1. A State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.
2. A violation is manifest if it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith.

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Article 60: Termination or suspension of the operation of a treaty as a consequence of a breach

1. A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part.
2. (omitted)
3. A material breach of a treaty, for the purposes of this article, consists in:
 - (a) a repudiation of the treaty not sanctioned by the present Convention; or
 - (b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty.
4. The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.
5. (not applicable to tax treaties)

Article 61: Supervening impossibility of performance

1. A party may invoke the impossibility of performing a treaty as a ground for terminating or withdrawing from it if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of a treaty. If the impossibility is temporary, it may be revoked only as a ground for suspending the operation of the treaty.
2. Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that other party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.

Article 62: Fundamental change of circumstances

1. A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless:
 - (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and
 - (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty.
2. A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty:
 - (a) if the treaty establishes a boundary; or
 - (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.
3. If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending the operation of the treaty.

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Article 63: Severance of diplomatic or consular relations

The severance of diplomatic or consular relations between parties to a treaty does not affect the legal relations established between them by the treaty except in so far as the existence of diplomatic or consular relations is indispensable for the application of the treaty.

Article 64: Emergence of a new peremptory norm of general international law

(*jus cogens*)

If a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and terminates.

(iii) Philosophy of the Vienna Convention Rules

Interpretations under international law follow one or more of the following approaches:

- (a) **“Textual” approach** - interpretation according to the ordinary meaning of the words of the treaty. Under this approach, the treaty is interpreted through an analysis of what the treaty negotiators mention in the text, which is presumed to be final, authentic and the most reliable expression of the intent.
- (b) **“Subjective” approach** - interpretation according to the intentions of the treaty negotiators. This approach relies on “*travaux préparatoires*” (negotiating history) relating to the treaty to determine the intentions of the negotiators. The text is only the starting point for the interpretation.
- (c) **“Teleological” approach** - interpretation according to the treaty’s purpose and objectives. This approach examines the overall object and purpose of the treaty and follows the interpretation that best fulfils them.

The VCLT follows the “textual” approach. Under its rules, the objectively expressed intent in the actual text of the agreements, rather than the subjective intent either of the negotiators or the parties, should be applied for treaty interpretation. It rejects the process of independently examining the motivation and intent of the negotiators or the parties in favour of the relative certainty of the textual approach.⁴⁹

2.2. How International Treaties Come into Force

International treaties regulate the relations between international persons or States under international law. The term “treaty” refers to an agreement, which is concluded between sovereign States in written form. It is a generic term used to cover a convention, agreement, arrangement, protocol or exchange of notes.

A treaty is initialled after negotiations and then signed. The heads of State, senior government officials and foreign affairs ministers are usually regarded as possessing “full powers” to sign a treaty as a representative of the State.⁵⁰ By signing the treaty, the Contracting States are expected to initiate the procedures necessary under their domestic law to conclude a treaty, but there is no legally binding commitment to do so.

⁴⁹ Michael Lennard, Navigating by the Stars – Interpreting the WTO Agreements (Journal of International Economic Law, 2002) pp. 20–22.

⁵⁰ Paul Reuter, Introduction to the Law of Treaties, pp. 17–29.

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A treaty does not apply internationally until it is concluded. It enters into force after the Contracting States declare their consent through an exchange of instruments, or ratify, under their respective constitutional laws. Once the treaty has been ratified under its legal procedures the State cannot invoke the provisions of domestic law (i.e. municipal law) regarding its competence to give the consent, unless it was “objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith”. Ratification differs from parliamentary consent. Whether parliamentary consent is necessary before ratification can take place is a matter for the domestic law of the State in question.

In the case of tax treaties, three dates are usually relevant for different purposes, as follows:

(i) The date of signature of the treaty: This date is relevant for the “taxes covered” (Article 2), as the list of taxes to which the treaty applies in each State is settled at that date. A provision is usually inserted in that Article to the effect that the treaty will also apply to any identical or substantially similar taxes that are imposed by either State after the date of signature.

(ii) The date when the treaty enters into force: This date binds the Contracting States. The date may be the date on which instruments of ratification are exchanged, although this is becoming less common in the case of tax treaties. If the domestic law of each State permits, a simpler procedure is now often used. The treaty requires each State to notify the other Contracting State of the completion of the steps required under its own law to bring the treaty into force, and the treaty then enters into force a certain number of days after the later of the two notifications.

(iii) The date on which the treaty “has effect” in relation to each of the taxes to which it applies: It is important to distinguish this date (or these dates) from that on which the treaty enters into force. Because the tax year begins on different dates in different countries (and in some countries on different dates for different taxes), a tax treaty is usually expressed to have effect for the tax year beginning in the next calendar year after it enters into force.⁵¹ If the domestic law of the Contracting State permits, there is nothing to prevent a tax treaty having effect from a date or dates earlier than that of entry into force.

2.3. Limitations of Double Tax Treaties

The primary purpose of a tax treaty is to allocate taxing rights and to provide relief if double taxation arises. A State cannot levy a tax, if (i) the other Contracting State does not exercise its allocated rights to tax under a treaty, or (ii) a tax treaty gives the State the right to tax, but no tax is due under its domestic law. Only the domestic tax law in each country has the taxing power under its legislative enactment. That law alone dictates the level of taxation, and how it should be computed.

Under the constitutional law of most countries, a treaty can restrict the taxing powers or the amount of the tax due under the domestic law, but not increase them. It sets the maximum

⁵¹ For example, in the United Kingdom the “year of assessment” for income tax begins on April 6, and corporation tax is charged for a “financial year” beginning on April 1, in each year. Tax treaties concluded by the United Kingdom are accordingly expressed to have effect in respect of income tax in relation to years of assessment beginning on and after April 6, and in respect of corporation tax in relation to financial years beginning on and after April 1, in the calendar year next following that in which the treaty enters into force.

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tax that may be imposed by a Contracting State, based on the agreement between the two Contracting States when the treaty was concluded. Thus, it can exempt or reduce taxes, but it cannot create new taxes or assessment procedures, or enlarge or initiate additional or new taxes, or increase the tax burden. As an exception in a few countries, a treaty can expand the scope of its taxes when the domestic law makes the treaty rule the domestic rule.⁵² In the Netherlands, a treaty has priority over domestic law even if it is less beneficial.⁵³

Generally, a treaty does not provide a basis for a higher tax charge than under domestic law unless the domestic legislation clearly demands that result. In countries that require parliamentary approval, the domestic law would preclude them from imposing additional taxes through tax treaties (Examples: Germany, India, United Kingdom). However, it appears that it is at least legally possible for a treaty to impose an additional tax in countries where treaties do not require parliamentary approval. It may impose taxes through a treaty since it does not have to be approved or enacted as domestic legislation.

In addition, the following MC Articles may increase their tax liability:

- **Article 9** – Associated enterprises subject to arm's length pricing and profits may lead to an additional tax in a Contracting State unless correlative or corresponding relief is granted by the other Contracting State.
- **Article 25** – The mutual agreement procedure on treaty interpretation may deny treaty benefits or impose taxes.
- **Article 26** – The exchange of information may enable the tax authorities to request and to obtain more information than they could obtain under their domestic law, and thus increase the taxpayer's exposure to tax.

Tax treaties are primarily intended to avoid over-taxation on the same income. They are not meant to grant "double" credit or exemption. A person entitled to benefits from more than one tax treaty can claim the most favourable treaty, but these benefits are mutually exclusive, not cumulative. In cases when the treaty benefits are waived, the taxpayer must not take inconsistent positions to achieve benefits greater than those that can be derived through double tax avoidance.

Treaties usually, but not always, have priority over domestic law. Therefore, as treaties remain unchanged for a period (average fifteen years) and take time to renegotiate, they provide certainty and protection against adverse changes in domestic tax laws. Many jurisdictions also allow the taxpayer to choose either the domestic tax regime or the tax treaty, whichever is more favourable.⁵⁴ This provision may be specifically mentioned in the

⁵² Philip Baker, Double Taxation Conventions and International Tax Law, pp. 6–8.

⁵³ In the Netherlands, the Hoge Raad in a 1980 decision denied a Dutch resident the right to deduct mortgage interest relating to a loan for house purchase in Belgium against his Dutch income because he was deemed a treaty resident in Belgium. Under the treaty, the right to tax the income from immovable property was given to Belgium. As a result, the taxpayer paid a higher tax liability than if the treaty had not existed. (BNB 1980/170)

⁵⁴ *Ostime v Australia Mutual Provident Society* (1960) AC 459 (UK): The taxpayer was an Australian assurance company with its UK branch income taxable in the United Kingdom. The UK House of Lords held that the treaty took precedence over the domestic law and should apply. The treaty required that a permanent establishment should be taxed as if it were a separate enterprise earning an arm's length profit, and not under the domestic tax law.

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domestic law (Examples: Belgium, Denmark, India, Luxembourg). Some countries provide a specific “non-aggravation” or “preservation” clause in their tax treaties (Examples: Japan, United States). This clause preserves the right to apply the domestic law if it is more advantageous.⁵⁵ The US tax treaties also contain a “saving clause” that reserves the right of each Contracting State to tax its own citizens and other tax residents, as if the treaty did not exist.⁵⁶

2.4. Can Domestic Law Override a Tax Treaty?

General

The OECD Treaty Override Report (1989) defined the term “treaty override” as a situation “where the domestic legislation of a State overrules treaty provisions of either a single treaty or all treaties hitherto having had effect in that State”.⁵⁷

Treaty overrides may be intentional or unintentional. Intentional treaty overrides include situations such as (i) later law overrides prior law, or ((ii) superior treaties (e.g. diplomatic treaties) supersede tax treaties.

Overrides that are not intended may arise in the following situations:

- A Court decision may be contrary to the common interpretation of the treaty partners. Such legal decisions could amount to a treaty override. However, a State has the legislative power to reverse the effect, and the reversing legislation in consultation with the treaty partner would be an acceptable remedy.
- A State may redefine an undefined treaty term under its domestic law, which effectively overrides the treaty. Such changes in domestic law are permitted only when they are compatible with the context of the treaty and accepted by the other Contracting State. Often such unilateral changes are made unjustifiably by States to combat treaty abuse. The correct remedy would be to renegotiate the treaty⁵⁸
- A State may unintentionally override or contradict the treaty provisions.

Tax treaties are governed by the principle of “*pacta sunt servanda*” or good faith (VCLT Article 26). The Contracting States mutually undertake to respect and apply the treaty provisions under the international law. Moreover, VCLT Article 27 requires that the domestic law cannot serve as a justification for the non-compliance with treaty obligations. In general, tax treaties override existing domestic laws and are even given precedence over subsequent domestic laws. However, several countries allow treaty overrides if a subsequent legislative act either is specifically intended to override or provides for a clear statutory provision that cannot be reconciled with the treaty.⁵⁹

⁵⁵ Article 1(2) of the US MC mentions: “The Convention shall not restrict in any manner any benefit now or hereafter accorded (a) by the laws of either Contracting State; or (b) by any other agreement between the Contracting States”.

⁵⁶ US MC: Article 1(4) (See Exhibit 3).

⁵⁷ Committee on Fiscal Affairs: Tax Treaty Override, para. 2 (OECD, 1989).

⁵⁸ Klaus Vogel, Double Taxation Conventions, Introduction, m.nos. 131–132.

⁵⁹ Sol Picciotto, International Business Taxation, p. 311.

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Constitutional Provisions

The constitutional provisions in each State decide the interaction of the domestic legislation and the international treaty obligations. Paragraph 14 of the 1989 OECD Report mentions: “The level attributed to treaty obligations, as incorporated in domestic law, determines whether derogations therefrom are unconstitutional or not. In the end, the choice is between giving priority either to a State’s international obligations, or to the sovereignty of decision of a country’s elected representatives”. Thus, the status of the treaty obligations depends on the priority given to them over other domestic laws under a country’s constitution.

The 1989 OECD Report identified the following constitutional systems:

- (a) The constitution provides that the treaty is self-executing and becomes part of the domestic law without any further enactment, as “*lex specialis*” or special law (Examples: Argentina, France, Italy, Japan, Netherlands, Switzerland). In a self-executing treaty, usually a tax treaty has a status superior to prior and subsequent domestic legislation. It is constitutionally impossible for domestic legislation to override such a treaty.
- (b) The constitution requires a parliamentary act to incorporate or approve a given international agreement, but once this has been done, it attributes a superior status to the provisions of an international agreement (Examples: Belgium, Finland, Germany, Iceland, Ireland, Luxembourg, Norway, Peru, Portugal, Singapore, Sweden). These countries always give priority to treaty law through express legal provisions or case law decisions. Treaty provisions override subsequent domestic tax legislation to avoid a breach of the international obligations, as “*lex posterior generalis non derogat legi priori specialis*” (later law does not override a special law).
- (c) The constitution regards an international agreement to be on par with domestic legislation (Examples: Austria, Brazil, Denmark, Indonesia, Israel, Korea, Sri Lanka, the United States). Several countries give treaty obligations the same rank as the domestic law. In the case of conflict, the one last in date prevails under the maxim “*lex posterior derogat legi priori*” (later law overrides a special law). Therefore, a subsequent change in law could lead to a treaty override, and violate the State’s international obligations.
- (d) The constitution is based on parliamentary sovereignty. It cannot bind itself or its successors (Examples: Australia, Canada, India, New Zealand, the United Kingdom). International agreements have no special status, and become part of the domestic law by parliamentary statute. A treaty, which can only have effect if legislative action is taken, can typically be overridden by subsequent legislative action.⁶⁰ Therefore, Parliament can override a prior treaty by a subsequent amendment or repeal.⁶¹

In practice, treaty override through subsequent legislation must be expressly intended. Even if the treaty overrides are feasible under the domestic law, it is presumed that a State does not want to breach its treaty obligations under public international law. The Courts generally maintain that the legislature does not intend to modify or abrogate a treaty.⁶²

60 Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 33.

61 *IRC v Collico Dealings Ltd* (1961) 39 TC (UK): “what parliament has given, parliament may take away”. (525 per Harman L.J.).

62 Lord Reid in the Collico case mentioned: “... there is a presumption that Parliament did not intend to act contrary to the comity of nations”. A similar view was held by Senior Judge White in the United States: “... although it

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It would require legislation with a specific measure that was clearly irreconcilable with the treaty provisions or gave evidence of a clear intention to enforce a treaty override.⁶³ The less clear the intention to override, the less likely it is that the Courts would uphold that the legislation should override a tax treaty.⁶⁴

In summary, treaties normally override other, contrary, domestic laws. The tax laws in several countries specify that they are applicable regardless of any contrary legislation (Examples: Australia, Canada, India, Malaysia, United Kingdom). Consequently, if the treaty provisions, as implemented, conflict with other domestic laws, the treaty prevails.⁶⁵ Although treaty overrides by domestic law are possible, the countries are bound to comply with their international obligations under customary international law and the override must be specifically intended. Legislative silence may not be sufficient to break a treaty.⁶⁶

Improper Use of Treaties

The 1989 OECD Report regarded a treaty override through conflicting domestic legislation or unilateral action as illegal under international law. It suggested that members should avoid treaty overrides and consult with each other on any legislation likely to lead to treaty violations. It also discouraged unilateral overriding legislation to counter treaty conflicts. In situations where conflict of provisions was inevitable, the treaties should be renegotiated.⁶⁷

Subsequent additions to the OECD Commentary on “Improper Use of the Convention” in 2003 now illustrate several “anti-treaty abuse” provisions in OECD Member States. They deal with treaty shopping, controlled foreign corporation rules and preferential tax regimes that are considered as harmful tax practices. The Commentary also includes the prevention of both tax avoidance and tax evasion as a treaty objective. Moreover, it mentions that the application of provisions under the domestic law to counter treaty abuse does not constitute treaty override.

The OECD Commentary 2003 supports the view that these anti-abuse rules under domestic law do not have to be specifically included in tax treaties to be effective.⁶⁸ It argues that taxes are ultimately imposed through domestic law provisions, as restricted by tax treaties. Thus, a treaty abuse is essentially an abuse of the domestic law under which the tax is levied. To the extent anti-avoidance rules are part of the basic domestic taxation, these rules “are not addressed in tax treaties and therefore not affected by them”. It concludes that “a proper construction of tax conventions allows them to disregard abusive transactions” involving unintended treaty benefits. Therefore, “States do not have to grant benefits of a

is true that Congress may modify a treaty by statute, Court should not lightly attribute to Congress the intention to modify or abrogate a treaty . . .”.

63 *Woodland (K V Ceylon) Rubber & Tea Co. Ltd. v CIR* [1971] A.C. 321: The Privy Council held that the subsequent legislation was intended to be comprehensive and the treaty override was justified even though there was no explicit reference.

64 Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 33, p. 6.

65 *Ostime v Australia Mutual Provident Society* (1960) AC 459 (UK).

66 *Trans-World Airlines v Franklin Mint Corporation* (1984) (US).

67 Committee on Fiscal Affairs: Tax Treaty Override, Annex A (OECD, 1989).

68 OECD Commentary: Article 1, paras. 7 to 26; See Chapter 3(4-Article 1).

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double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into".⁶⁹

Comment

These views expressed in the Commentary by the Committee on Fiscal Affairs could lead to a treaty override if applied unilaterally by Contracting States. They require specific provisions in the treaty itself to be applicable. According to Philip Baker, countering anti-avoidance through domestic tax rules cannot justify a unilateral treaty override and could amount to a breach of an international obligation.⁷⁰ This view was also taken by the Indian Supreme Court, which held that domestic anti-avoidance rules could not be applied unless they are contained in the treaty itself.⁷¹

The concern relating to the ambulatory use of domestic law to counter "treaty abuse" is also expressed by Vogel. A State can improve its treaty position unilaterally through subsequent changes in its domestic law. Such attempts by the State to circumvent or dodge a treaty could amount to infringement of the international legal duty to fulfil the treaties that it concluded in good faith (VCLT Article 26). However, the acceptance of the new law for some time by the other Contracting State may constitute subsequent practice under Article 31(3)(b) of the VCLT.⁷²

2.5. Remedies against Treaty Overrides

Treaty violations could be either the result of a treaty breach or a fundamental change of circumstances. A treaty breach could arise when the State legislates in breach of a treaty provision, and applies its law to actual tax situations. Such legislation will be treated as an override only if the treaty partner disapproves of it unequivocally. It then violates the rule "*pacta sunt servanda*" (i.e. must be performed in good faith) under VCLT Article 26. The Contracting States have a general obligation under the international law to seek a negotiated solution to treaty violations.

There is little that a State can do to stop the other State if it unilaterally passes a domestic law to override the tax treaty. The steps it can take are limited. It can terminate or suspend either part (breached or unbreached provisions) or the whole of the treaty, and demand renegotiation. It may also be possible to demand compulsory independent adjudication and penalties through an international forum. It may threaten or impose retaliatory measures. Some treaties and treaty provisions, which are conditional upon reciprocity, may cease to have effect.

Extenuating or "fundamental change of circumstances" can lead to treaty termination in certain circumstances, but it does not justify a treaty override (VCLT Article 62). The

69 OECD Commentary: Article 1, paras. 9.2–9.4

70 Philip Baker, Double Taxation Conventions (Sweet & Maxwell, 2003), F8-10; See Ramon J. Jeffery, The Impact of State Sovereignty on Global Trade and International Taxation, p. 112; See Frank van Brunschot, The Judiciary and the OECD Model Tax Convention and its Commentaries (IBFD Bulletin, January 2005) Section 2.6.

71 *Union of India vs. Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India).

72 Klaus Vogel, Double Taxation Conventions, Introduction, m.nos. 125–126.

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fundamental change must not be the result of a treaty breach by the party invoking it. Similarly, an “impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from, or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty” (VCLT Article 61(2)).

Thus, in the case of a treaty violation either Contracting State could:

- make an official protest and invoke the mutual agreement procedures under OECD MC Article 25; or
- retaliate with a similar domestic override; or
- appeal to an international forum, e.g. International Court of Justice (VCLT Article 66); or
- terminate or suspend the treaty as a “material breach” (but cannot sue) under customary international law and practice (VCLT Article 60).

The VCLT provides for the termination and suspension of international treaties, if there is a treaty breach. The breach must be “material”, as defined in VCLT Article 60(3), i.e. a “violation of a provision essential to the accomplishment of the object or purpose of the treaty”. It should relate to a provision that was material in inducing a party to enter into the treaty. Depending on the gravity of the “material” breach, it could lead to partial or full suspension, or the termination of the treaty. Very often treaty overrides do not lead to full termination, but part suspension by a Contracting party.

VCLT provides the procedures to be followed for treaty termination under the international law. The treaty remains in effect between the two States until it is terminated or suspended under VCLT Article 60. A treaty also remains in force under the domestic law until it is terminated or overridden under the domestic legislation. Therefore, if the injured State does not terminate or suspend the treaty, it continues to apply.

3. INTERPRETATION OF TAX TREATIES

3.1. General

Treaty interpretation rules differ from domestic tax rules for several reasons. For example:

- As international treaties, VCLT governs double tax agreements. Therefore, their interpretation is based on the rules of interpretation under customary international law. As these principles and procedures of interpretation for agreements differ from rules applied to domestic legislation, an interpretation under the domestic law as a taxing statute may be misleading and unsuitable.
- Unlike the domestic law, which contains highly technical legislative language relevant to a specific jurisdiction, tax treaties are based on the mutual understanding among two or more Contracting States. Moreover, more than one language may be involved. They must be applied by the tax authorities and the Courts in each Contracting State in a uniform way (“common interpretation”) that may differ from the domestic laws and practices in each State.
- Tax treaties are primarily relieving in nature and do not impose tax, while the domestic tax law seeks to impose tax in specific circumstances. A treaty specifies general taxing

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principles to avoid double taxation. Moreover, as the life of a treaty can be long it must be flexible enough to adapt to changes in the domestic law while continuing to reflect the original negotiated balance of obligations and concessions.

- Tax treaties tend to be less precise and require a broad purposive “substance over form” interpretation. Therefore, they are often interpreted more liberally than domestic law in the context of their object and purpose.⁷³ On the other hand, in States that prefer a liberal, purposive interpretation of their domestic law, the interpretation of tax treaties may be stricter than under the statutes. In both cases, a neutral interpretation and common understanding requires the use of an international fiscal language, which may not be found in the domestic laws and may provide a definition quite independent from domestic laws.
- Treaty interpretation is a subject in itself and not merely an extension of statutory interpretation despite the fact that treaties may be enforceable only when made part of domestic law under a statute in certain countries. Therefore, tax treaties should be kept as free as possible from the interpretation rules under domestic law, unless specified in the treaty itself.

The primary purpose of double tax treaties is to avoid and relieve double taxation through equitable (and acceptable) distribution of tax claims between countries. Tax treaties require a common interpretation by both Contracting States to achieve this goal. Common interpretation also leads to an international tax language and terminology and to reliance on similar legal decisions and practices in other countries, where appropriate. Most countries accept the common interpretative principles of the VCLT under customary international law. Strictly speaking, the VCLT, and not the domestic law of the Contracting States, governs the interpretation of treaties.⁷⁴

3.2. Interpretation under the VCLT

As mentioned earlier, the VCLT applies to all treaties including tax treaties. Tax treaties are binding rights and obligations on the Contracting States under public international law. They are agreements between two countries and not agreements between two taxpayers or a country and a taxpayer. As international agreements, they are governed by the VCLT, either because it applies as a law-making treaty (*traité loi*) between the States, or because it reflects the customary international law applicable to them generally. The Courts generally apply the VCLT as “part of the law of the land”.⁷⁵

The Vienna Convention on the Law of Treaties (“VCLT”) of 1969 provides the general guidelines on treaty interpretation under the VCLT Articles 31 to 33. Additional guidance is

⁷³ The Australian Tax Office defines the term “liberal” to refer to the rules of construction to be used in interpretation and not the scope of the provision.

⁷⁴ Kees van Raad, ‘Tax Treaty Issues – Current and Future Development’ (IBFD European Taxation, January 1996): “many national Courts look upon tax treaty provisions as somewhat exotically clothed rules which nevertheless could be interpreted like domestic law ... Interpretation follows customary international law and Courts are often not well versed in this area of the law”.

⁷⁵ Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 3.01.

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provided in the official Commentary on the preliminary draft of the VCLT, as supplementary means of interpretation under Article 32.⁷⁶

Article 31 provides the general rule of interpretation. Article 31(1) states: “A treaty shall be interpreted in good faith⁷⁷ in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose” (“basic rule”).

The basic rule of interpretation refers to the following:

(a) The “ordinary meaning” of the words based on the actual words in the text:

- The interpretation should start fundamentally with the natural meaning of the words in the text, as expressed (i.e. not intended) in the context in which they occur. Therefore, the written text of the treaty is of primary importance.
- The interpretation should follow the “ordinary meaning”, i.e. the usual and natural meaning of the words. Where there is a difference, the ordinary meaning that defines the terms in the light of the object and purpose of the treaty should prevail.⁷⁸
- The ordinary meaning of terms used in the agreement can be, but is not necessarily, the everyday usage. It is the uniform legal usage (e.g. international tax language) or the specific legal usage employed by the Contracting States.
- A tax treaty is required to be interpreted as a whole and its meaning should be consistent with the entire agreement in its context and object and purpose, and not be based on its individual provisions.
- The treaty terms should be given their true meaning when the treaty was concluded and not what the parties subsequently believe it to be. Identical terms should be given the same meaning.
- A special meaning should be used only if it is established that the parties so intended (Article 31 (4)).
- One should depart from the natural or plain meaning only in cases where:
 - (i) a different conclusion of the treaty partners is clear beyond reasonable doubt,
 - (ii) the language is “ambiguous or obscure”, or
 - (iii) it leads to a result that is “manifestly absurd or unreasonable” (VCLT Article 32).

(b) The “expressed intentions” of the parties from the terms of the treaty in their “context”:

- The expressed intentions of the parties must be ascertained from the actual treaty text and not based on presumed intentions.
- The treaty interpretation must be the literal (and not the purposive) language of the treaty, unless the overriding intentions of the contracting parties are beyond doubt.

⁷⁶ See pages 1012–1018 in the Materials on International & EC Tax Law published by International Tax Centre based in Leiden, The Netherlands.

⁷⁷ Article 31(1) refers to interpretation “in good faith”. Tax treaties are voluntarily negotiated obligations to limit the taxing rights under the prevailing domestic laws of the two Contracting States. Each State has to interpret them based on common understanding and mutual trust, and cannot alter them unilaterally through subsequent changes in their domestic law. Thus, the principle of good faith protects the legitimate expectations of the two parties.

⁷⁸ Asif H. Qureshi, The Public International Law of Taxation, pp. 135–153.

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- The “context” is restrictively defined to include the entire text of the treaty, its preamble and annexures (VCLT Article 31(2)). It also covers additional material included in any related agreement or instrument, such as protocols, notes, letters, explanations or memoranda of understanding, which were mutually agreed upon by all treaty partners at the time the treaty was concluded.⁷⁹
- Context does not normally result in a “special meaning”. It only serves to qualify the ordinary meaning of a treaty term. It is a relative term and not an absolute term. A treaty term, phrase or provision provides context in relationship to some other treaty term.⁸⁰
- Other interpretative elements that are not considered as context but treated as primary materials similar to context (VCLT Article 31(3)) comprise:
 - (i) any subsequent agreements between the parties on treaty interpretations,⁸¹
 - (ii) subsequent practices in the application, and
 - (iii) any relevant rules of international law applicable to the relations between the parties.

(c) The “object and purpose” of the treaty:

- The term “object and purpose” is one term describing one object; it is not that object and purpose have separate meanings.⁸²
- The purpose is not the subjective purpose of the parties but the objective purpose as evidenced by the treaty itself. It refers not to the “words” but the “intentions” of the parties as reflected objectively by the treaty as a whole. Title and preamble often summarise the object and purpose.
- The object and purpose do not provide an independent method of interpretation of the individual treaty provisions. The treaty’s objectives may be used only in the general interpretation of the treaty text.
- The object and purpose is determined by a textual approach; the intention of the parties is only important to the extent that the intention is reflected in the text of the treaty.
- This rule does not prevent the rejection of a literal interpretation under international law when other factors so require. The common sense or purposive meaning must be relevant to the object and purpose.⁸³

The basic rule of interpretation under VCLT Article 31 is a single rule. It adopts a holistic approach for treaty interpretation. The ordinary meaning of the terms is determined by the expressed text in (not “and”) its context and object and purpose. Context is narrowly defined to include only the rest of the treaty and certain related documents connected with the treaty. The object and purpose is also to be established from the treaty as a whole by examining any

79 The context excludes any unilateral material (e.g. US Technical Explanation and Senate reports, oral statements during negotiations, explanatory notes, etc.). US Technical Explanation agreed by the other party when concluding the treaty may be treated as part of the context.

80 Edwin van der Bruggen, Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between Article 3(2) of the OECD Model Tax Convention and Articles 31 and 32 of the Vienna Convention on the Law of Treaties (European Taxation, May 2003) p. 143.

81 In certain cases, mutual agreements concluded between competent authorities may be considered as part of the interpretative context under VCLT Article 31(3).

82 Klaus Vogel, Double Taxation Conventions, Introduction, m.no. 69.

83 Klaus Vogel and Rainer Prokisch, IFA Cahiers Vol. 78A, General Report, 1993, p. 73.

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preamble and other related provisions. To understand the meaning, one needs to examine the text at the same time as its context and object and purpose. It would be inappropriate to start with the words and then follow up with the context, and then the object and purpose. This approach does not permit a purposive interpretation unless it follows from the words of the text.

The rule also rejects both the subjective intentions based on the negotiators and the teleological (i.e. purposive) approach that relies on the general object and purpose of the treaty. Therefore, it does not support a purposive approach as the object and purpose is only meant to define the text, which is the true expression of the intention of the parties. The meaning is determined from the expressed text only and ignores both the intention of the treaty negotiators and any other subjective views of the meanings within the treaty.⁸⁴

VCLT Article 32 permits the use of other relevant material as “supplementary means of interpretation” to avoid an ambiguous, obscure, absurd or unreasonable meaning under Article 31, or to confirm the Article 31 result. Extra-textual materials are not a substitute for the study of the tax treaty itself. They do not constitute context and may only be used to confirm, but not to contradict, or as independent support for an Article 31 interpretation. It is not mandatory that it be looked at (although most commentators support a wide examination of potentially relevant supplementary material) and it can only be used as a secondary source to confirm the meaning under Article 31 if it is unclear.

Supplementary materials refer to the circumstances of a treaty’s conclusion (the historical background) and the preparatory work of the treaty or “*travaux préparatoires*” (negotiating history) when it was concluded. They include extra-textual material, such as international legal practices and other tax conventions, judicial decisions and legal writings. Unilateral material that only represents the reasons and goals of one contracting party is not regarded as a supplementary means of interpretation.⁸⁵

Under the VCLT Article 33, the original versions of the treaty in the language of each party, or a third language (usually English or French), are equally binding. Normally, the third language is only called upon when the two versions in the languages of the parties differ. In the case of discrepancies in meaning, the selected meaning should reconcile with both (or all) texts. In case of a drafting error, the object and purpose of the treaty guides the treaty interpretation, its context and the supplementary means of interpretation. Otherwise, the treaty is defective and the treaty provision is not applicable.

In summary, the VCLT approach is textual and the terms are interpreted in their context as well as their object and purpose. There is a simultaneous examination of (i) the “ordinary meaning” of the relevant words, (ii) their “context”, and (iii) the “object and purpose” of the treaty they form part of. However, the text is the starting point and overrides other considerations. According to Vogel, “... the wording of a provision defines not only the starting point for interpretation but also its limit. Should the wording be unclear... national

⁸⁴ Michael Lennard, Navigating by the Stars – Interpreting the WTO Agreements (Journal of International Economic Law, 2002) pp. 32–45. This article also provides the readers with a general analysis of the interpretative rules under the VCLT.

⁸⁵ Klaus Vogel and Rainer Prokisch, IFA Cahiers Vol. 78A, General Report, 1993, p. 74.

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Courts may not replace the wording of the text with supposed intentions of the Contracting parties".⁸⁶

The tax treaties are drafted by experts in international law. "It is reasonable to assume that those negotiating a tax treaty knew what they were doing, meant what they said, and said what they meant".⁸⁷ However, unlike domestic law, it may be given a broad (not literal) purposive interpretation, within its text and context when appropriate to make it workable.

3.3. Model Conventions and Commentaries

Many countries use a Model Convention ("MC") and its Commentaries for tax treaty interpretations. Generally, they use either the OECD MC or the UN MC. The OECD MC and its Commentaries reflect the views of the OECD Committee on Fiscal Affairs⁸⁸ on the provisions and on their application to specific situations. Similarly, the UN MC and its Commentaries represent the recommendations of the Ad Hoc Group of Experts appointed by the United Nations⁸⁹, and not the United Nations itself. The US Treasury applies the US MC for treaty negotiations with the United States, and many other countries have their own Model for that purpose. Both the UN MC and US MC essentially follow the form and text of the OECD MC.

The Model Conventions also provide a common format and wording as a basis for drafting bilateral tax treaties. The use of a standard form of words helps in the uniform interpretation and application of the treaties based on them. They can be used either without any change or adapted, as appropriate, by the Contracting States. Any deviations and references are meant to reflect the intentions of the treaty negotiators at that time. Thus, they provide certain mutually agreed ground rules to eliminate elaborate analysis and discussions.

The Commentaries are an interpretation of the MC that has been adopted by OECD Member States as the primary basis for drafting and interpreting tax treaties. For non-OECD States, the Commentaries are a persuasive factor in treaty interpretation.⁹⁰ The Introduction to the OECD MC mentions: "Although the Commentaries are not designed to be annexed to the Conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the Conventions and, in particular, in the settlement of any disputes".⁹¹

86 Klaus Vogel and Rainer Prokisch, IFA Cahiers Vol. 78A, General Report, 1993.

87 *Crown Forest Industries Ltd v The Queen* [1995] D.T.C. 6305, 6309 (Canada).

88 The Committee on Fiscal Affairs comprises of tax experts from OECD Member States. However, as many of them are also administrative (primarily tax) officials, their views may be influenced by their background and official duties, and hence may not be disinterested or impartial. The Courts (and taxpayers) in several countries frequently disagree with the views expressed in the Model Commentaries and Reports. Many commentators have suggested that the Committee should be broad-based to include independent tax experts to represent taxpayers' rights and to take into account the interests of non-OECD countries.

89 The Group was renamed the Committee of Experts on International Co-operation in Tax Matters by the Economic and Social Council of the United Nations (ECOSOC) in November 2004.

90 The UN MC and Commentaries may be similarly treated as persuasive factors, if they are used in treaty negotiations.

91 OECD MC: Introduction, para. 29.

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The use of the Commentaries is mandatory and not discretionary if it is relevant under Article 31, rather than Article 32. There are wide-ranging views among commentators. Under these views, the Commentaries may fall into any of the four qualifying categories under VCLT Article 31 or as supplementary means of interpretation under Article 32.⁹² For example, some commentators regard the MC as part of the “context” under VCLT Article 31 of a treaty concluded by reference to it.⁹³ The MC text at the time when the treaty was negotiated may also provide a special meaning intended by both parties to the negotiated agreement under VCLT Article 31(4).

Some commentators regard the MC and the Commentaries when the treaty was concluded as a “soft obligation” on OECD Member States. The recommendations of the OECD Committee on Fiscal Affairs are deemed as an obligation on its Member States once they have been adopted by the OECD Council and approved by them, subject to their Observations and Reservations.⁹⁴ Therefore, in their view they should be considered as part of the context under the VCLT and not just supplementary means of interpretation. If the MC text is adopted unchanged it may be assumed that the Contracting States agreed to follow the OECD interpretation when the treaty was negotiated. If the OECD text is not adopted literally, it may be presumed to follow the Commentaries to the extent that it is consistent with the MC. If the MC text is wholly disregarded, the Commentary may be ignored. In certain cases of treaty deviations from the MC, other treaties of the Contracting States may provide insights, but any inference should be made with caution.⁹⁵

The above view is not supported. Under the 1960 Statute of the OECD, its recommendations are only binding on the Member States if they are “opportune”, i.e. suitable or convenient. Hence, legally they are not binding on the governments, Courts or the taxpayers of the OECD Member States. However, they may be treated as morally binding on the tax authorities. For non-OECD members, they are again persuasive, as a view of a group of tax experts comprising the OECD Committee on Fiscal Affairs.⁹⁶

Despite their legal limitations, the OECD Commentaries and Reports⁹⁷ are widely used by the Courts for treaty interpretations. In the Australian case of Thiel, the OECD

92 Philip Baker, Double Taxation Conventions, pp. E13–14.

93 Klaus Vogel, Double Taxation Conventions, Article 3, m.no. 68–74: According to Vogel, the term “context” includes the relevant provisions of the legal systems of both Contracting States and also the OECD MC and its Commentaries. See Chapter 2(3.5(a)).

94 According to the Australian Tax Office (Tax Ruling TR 2001/13), while not binding, there is a general or “quasi-political” rather than “legal” expectation that OECD Member States will comply subject to their specific “Observations and Reservations”.

95 Klaus Vogel, Double Taxation Conventions, Introduction, m.no. 79–82.

96 Klaus Vogel, The Influence of the OECD Commentaries on Treaty Interpretation (IBFD Bulletin, December 2000) p. 614; According to Vogel, they may be regarded as very convincing and may be followed if other arguments are not more persuasive – See Annika Deitmer et al., Invitational Seminar on Tax Treaty Rules Applicable to Permanent Establishments – In Memoriam of Professor Dr Berndt Runge (IBFD Bulletin, May 2004) p. 184; See also Frank van Brunschot, The Judiciary and the OECD Model Tax Convention and its Commentaries (IBFD Bulletin, January 2005) pp. 5–9.

97 The OECD Committee on Fiscal Affairs has also published several reports on specific international tax issues. They may also qualify as supplementary means of interpretation under VCLT Article 32. Many of them are included in the second volume of the loose-leaf publication of the OECD MC.

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Commentaries were accepted for treaty interpretation.⁹⁸ In the *Crown Forest* case, the Canadian Supreme Court held that "... a Court may refer to extrinsic materials which form part of the legal context (these include accepted Model Conventions and official Commentaries thereon) without the need to first find an ambiguity before turning to such materials". OECD Commentaries are generally considered as supplementary means of interpretation under Article 32. They may also qualify as context under Article 31 in certain jurisdictions but only the Commentary at the time when the treaty was concluded may be considered appropriate for that purpose.⁹⁹

The OECD MC and the Commentaries are now "ambulatory" documents, subject to "periodic and more timely updates and amendments without waiting for a complete revision".¹⁰⁰ They are issued in a loose-leaf format to facilitate more frequent updates. The Introduction to OECD MC suggests that the existing treaties concluded under the previous or current Model treaties should be interpreted and applied along the lines of the latest Commentaries, where applicable, except where the OECD MC has been changed in substance.¹⁰¹

The use of subsequent amendments or additions to the Commentaries as an interpretation of previously concluded tax treaties is not universally accepted.¹⁰² According to Vogel, "changes in the Commentaries after the conclusion of a tax treaty can neither amend the treaty, nor retroactively determine its interpretation".¹⁰³ New developments or issues may be dealt with through interpretative changes in the Commentary but only within certain limits that do not substantially change the treaty itself.

The OECD Committee on Fiscal Affairs has attempted to make substantive changes in existing negotiated treaties through additions or changes in its Commentaries in recent years.¹⁰⁴ Some commentators believe that these changes overprotect the interests of the tax administration at the expense of the taxpayers. Therefore, they pose problems in terms of taxpayers' rights and constitutional principles, and may not be accepted by the Courts in many countries. It is felt that the loose-leaf publications of the OECD MC and Commentaries, the "bias" in the role of the Fiscal Affairs Committee and the frequent updates could make the Commentaries lose their authority.¹⁰⁵

98 *Thiel v FCT* (1990) 21 ATR 531 (537) (Australia): The Australian High Court held that the OECD Model Convention and its Commentaries should be regarded as part of the context under VCLT Article 31, applied as customary international law. In any event, they should be part of the supplementary means of interpretation.

99 *Crown Forest Industries Limited v The Queen* (1995) 95 DTC 5389 at 5396 (Canada): The Canadian Supreme Court applied a static interpretation based on the OECD MC 1977 and its Commentaries to interpret the US-Canada tax treaty concluded in 1980. Similar view was also expressed by the Court in the *Thiel* case (see above).

100 OECD MC: Introduction, para. 9.

101 OECD MC: Introduction, para. 33.

102 Michael Lang, Later Commentaries of the OECD ..., Not to Affect the Interpretation of Previously Concluded Tax Treaties (Intertax, Vol. 25, Issue 1, 1997); Klaus Vogel, Double Taxation Conventions, Introduction, m.no. 82.

103 Klaus Vogel, The Influence of the OECD Commentaries on Treaty Interpretation (IBFD Bulletin, December 2000) p. 615.

104 For example, they include tax avoidance and double non-taxation as additional objectives of the tax treaty, allow treaty override through domestic anti-avoidance rules and require the interpretation of Article 23 under which the residence State must accept the qualification under the domestic law of the source State.

105 Adolfo J. Martin Jimenez, The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries (IBFD Bulletin, January 2004) pp. 28–30.

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The ambulatory approach also creates problems under the VCLT on the legal basis for the reference to subsequent Commentaries. Under the VCLT, the new Commentaries are neither context under the general meaning nor special meaning, nor are they later agreements or practices regarding older treaties.¹⁰⁶ In certain OECD countries, the Commentaries may be considered as ordinary or special meaning for the interpretation of treaty terms under the VCLT, subject to their Observations and Reservations. In such situations, the applicable Commentary would be the version in force when the treaty was concluded.¹⁰⁷ The dynamic reference may not be valid as a subsequent agreement or practice mutually accepted by both parties under VCLT Article 31(3).¹⁰⁸

Thus, the MC text may be considered as only a recommended format with no legal binding force either at the international or national level. It is simply a document concluded by an international organisation.¹⁰⁹ The OECD Committee on Fiscal Affairs cannot amend the contents of a negotiated tax treaty through changes in its MC or its Commentary. Subsequent versions of the text of the Model Convention using different wording are not applicable to an existing treaty, unless it is renegotiated. The changes in the text of the Articles in the MC do not affect previous agreements.¹¹⁰

Although there is no agreed view on the legal status of subsequent Commentaries issued after a treaty has been concluded, they are widely used by taxpayers, tax authorities and, in particular, the Courts for guidance in interpreting older treaties. They may be considered similar to advance rulings given by the tax authorities of the countries, which have formally expressed their position on them without any Reservation or Observation.¹¹¹ In recent years, some countries have explicitly mandated their use by a protocol to a treaty (Example: Austria).¹¹²

The Courts in several countries have accepted that both the MC and the Commentaries make a significant contribution to the common application and interpretation of tax treaties.¹¹³ They are part of the historical context of the treaty negotiations and help either to clarify (but not change) the treaty text or to confirm alternative interpretations. Besides treaty interpretations, subsequent Commentaries contain the current thinking of the OECD Committee on Fiscal Affairs on international tax principles and on technical issues emerging from changes in business practices or technology (e.g. electronic commerce,

¹⁰⁶ Klaus Vogel, The Influence of the OECD Commentaries on Treaty Interpretation (IBFD Bulletin, December 2000) p. 612; Martin M.J. Ellis, The Influence of the OECD Commentaries on Treaty Interpretation – Response to Professor Dr Klaus Vogel (IBFD Bulletin, December 2000), p. 617.

¹⁰⁷ Klaus Vogel, Reflections on the Future of the OECD Model Convention and Commentary (IBFD Bulletin, December 1996).

¹⁰⁸ Philip Baker, Double Taxation Conventions and International Tax Law (Sweet & Maxwell, 1994) pp. 28–31.

¹⁰⁹ John F. Avery Jones, Article 3(2) of the OECD Model Convention and the Commentary – Treaty Interpretation (IBFD European Taxation, August 1993) p. 255.

¹¹⁰ General and Country Reports in the IFA Cahiers, Vol. 78A, 1993 contain a detailed discussion on the application of the VCLT to tax treaties.

¹¹¹ Asif H. Qureshi, The Public International Law of Taxation, p. 137; John F. Avery Jones, The Effect of Changes in the OECD Commentaries after a Treaty is Concluded (IBFD Bulletin, March 2002) pp. 102–109; Jorn Kviste, Interpretation of Tax Treaties (European Taxation, July/August 2001) pp. 284–286.

¹¹² Victor Thuryyi, Comparative Tax law, p. 119.

¹¹³ Examples: Austria, Belgium, Canada, Denmark, Germany, Japan, Malaysia, Netherlands, New Zealand, Spain, Sweden, Switzerland, United Kingdom, United States.

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hybrid instruments, global trading, etc.). However, for them too to be acceptable they should not make material changes in a bilaterally negotiated treaty or its objectives.¹¹⁴

3.4. Other Extra-textual Material

Other extra-textual material includes:

(i) Mutual agreement procedures: Article 25(3) of the OECD MC permits competent authorities to “resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention”. The mutual agreement can be either (i) interpretative to avoid doubts or difficulties, or (ii) legislative to avoid double taxation. As subsequent agreements, they may be treated similar to context (VCLT Article 31(3)) or at least as supplementary data (VCLT Article 32). However, these interpretation agreements among competent authorities generally do not modify a treaty and may not be binding on the Courts.¹¹⁵

(ii) Unilateral material: Treaty interpretations by tax authorities may be helpful as a guide to a “common interpretation”. However, such materials or practices usually tend to be unilateral (i.e. giving the views of one Contracting State only) and hence may not be binding on the other State. To be effective, the interpretation of tax treaties must be acceptable to the authorities and the Courts of both Contracting States. Similar comments apply to public and private rulings given by the tax authorities or other statutory bodies in certain countries. All the same, they can be useful as an interpretation aid for treaties and may be used with caution.

(iii) Judicial decisions: Many countries now accept the “common interpretative principle” of legal decisions on treaty interpretation. In view of the use of Model treaties, this “common interpretation” of treaty provisions justifies the consideration of legal rulings in other countries, and references to international tax practices. The Courts or the authorities of one Contracting State may take into consideration the decisions made by the Courts or authorities of the other Contracting State (or even a third State).¹¹⁶

(iv) Parallel treaties: Parallel treaties are treaties on a similar subject matter concluded between third States or between one of the parties and a third State. Such treaties can provide interpretative guidance through their wording, explanatory notes and judicial decisions. For example, a similar provision may be contained, or left out, or be absent from another treaty.¹¹⁷

Some commentators consider “parallel treaties” of limited value as an interpretation aid. As each treaty is a result of separate bilateral negotiations, the same wording in different

¹¹⁴ OECD MC: Introduction, para. 33–36.

¹¹⁵ Klaus Vogel and Rainer Prokisch, IFA Cahiers Vol. 78A, General Report, 1993, pp. 70–71.

¹¹⁶ In *CIT v Vishakapatnam Port Trust* [1983] 144 ITR 146 (India), Justice J. Rao held: In view of the standard OECD Model which is being used in various countries, a new area of general “international tax law” is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adaptation is just as important as the initial removal of divergences. Therefore, the judgments rendered by Courts in other countries or rulings by other tax authorities would be relevant.

¹¹⁷ Similar interpretative assistance can also be obtained by comparing the negotiated treaty with the standard Model used by a State for treaty negotiations.

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treaties may have different meanings. On the other hand, different wording may represent the same or different negotiating intentions. Moreover, revisions in subsequent treaties may not necessarily be applicable to earlier treaties.¹¹⁸ Despite these limitations, they often provide persuasive support when used with some caution.

3.5. Interpretative Rule under OECD MC Article 3(2)

The OECD MC provides a treaty interpretative rule under its Article 3(2).¹¹⁹ It mentions under General Definitions that “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, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State”.

As Article 3(2) is part of the treaty, it is also subject to the interpretation under the VCLT. The given meaning should enable the treaty provisions to be effective.¹²⁰ Therefore, it must be performed in good faith and should not defeat the object and purpose of the treaty, i.e. to avoid double taxation and to prevent tax evasion. The meaning need not always follow the definition under the domestic law. However, if used, the definitions under the domestic law of the taxes covered under the treaty have priority over definitions in other tax laws or in other laws.

Under Article 3(2), some of the questions that need to be answered are:¹²¹

- Does the treaty provide a definition of the term?
- If the treaty does not provide a definition, what is the domestic meaning of the term?
- Does the context require a meaning different from the domestic meaning?

Several terms are specifically defined in the OECD Model treaty. For example, Article 3(1) includes definitions of “person”, “company”, “enterprise”, “enterprise of a Contracting State”, “international traffic”, “competent authority”, “national” and “business”. The term “resident” is defined in Article 4(1), and “permanent establishment” in Article 5. Additional definitions include “dividends” in Article 10(3), “interest” in Article 11(3), and “royalties” in Article 12(2), as applied to the respective Articles. These definitions, when they are present, have priority over Article 3(2). Additional definitions are also found in negotiated tax treaties under other Articles, protocols or explanations.¹²²

The tax treaty contains many other “terms” or “words”, for which there is either no given definition or the definition is partial or inconclusive,¹²³ or limited to a specific Article only.

118 Philip Baker, Double Taxation Conventions and International Tax Law, pp. 43–44.

119 See Chapter 3(4-Article 3).

120 *Estate of Burghardt v Commrs.* (1983) (US); *IRC v Exxon Corp.* (1982) (UK); *Union Texas Petroleum Corp. v Critchley* (1988) (UK); *The Queen v Melford Developments Inc* (1982) (Canada).

121 Brian J. Arnold and Michael J. McIntyre, International Tax Primer, p. 114.

122 Examples include definitions of territorial scope, fiscal year, the term “tax”, industrial and commercial profits, technical services, etc. For example, the Memorandum of Understanding under the India–United States treaty defines technical services to mean services requiring expertise in a technology.

123 The treaty definitions may be inclusive or exclusive. An inclusive definition gives the term its ordinary meaning plus the other items included in the meaning (Example: a person includes an individual, a company or any other body of persons in Article 3(1)(a)). The definition is not exhaustive or all embracing. An exclusive definition is

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Several treaty terms are either defined differently from, or not recognised in, the domestic tax law.¹²⁴ As part of the treaty, Article 3(2) permits the use of the meaning under the domestic law in certain situations when the terms are not specifically defined under the treaty. The alternative would be to have a treaty definition for all the terms in the treaty.

Article 3(2) refers to the “meaning” of an undefined term and not its definition. A term may not be defined for purposes of a country’s tax laws but it should have an ordinary meaning.¹²⁵ The reference to domestic law is limited to undefined “terms” and excludes legal principles or doctrine. It also does not permit a general interpretation of the treaty itself, or a use to clarify unclear treaty provisions.¹²⁶ As the rule applies to the terms used in the treaty, the reference to domestic law, unless they are defined in the treaty, is restricted only to those words or group of words. However, it is unclear whether the word “term” applies to both words and concepts.¹²⁷

The Article mentions that the domestic definition of undefined terms in the treaty should not be applied if “the context otherwise requires”.¹²⁸ The phrase “unless the context otherwise requires” refers to the “expressed” and not the “implied” intentions of the Contracting States. The domestic law definition will not apply if the context of the terms clearly suggests a specific definition.¹²⁹ For example, the dictionary meaning may reflect the meaning of the treaty term in its context better than the meaning under the domestic law.¹³⁰ This statement does not imply that the ordinary domestic definitions may be inappropriate in a tax treaty in all cases.¹³¹

OECD MC Article 3(2) also leads to additional questions, such as:

(a) What is context?

The VCLT Article 31(2) defines the context as comprising the text, including the preamble and annexes, and any related agreement or instrument made and accepted by the parties when the treaty was concluded.¹³² Many commentators do not accept this narrow definition for tax treaty interpretation. They adopt a broad meaning of “context” under VCLT Articles 31 and 32 based on a consideration of (i) the treaty policies of the Contracting States both when the treaty was negotiated and subsequently, (ii) the domestic tax environment when the treaty

open-ended (Example: company means... in Article 3(1)(b)). Treaty definitions may also contain undefined terms (Example: the terms “individual” and body of persons are undefined), or be limited to a specified Article (Example: the term “dividends” as used in Article 10).

124 Kees van Raad, The Term “Enterprise” in the Model Taxation Conventions – Seventy Years of Confusion (Intertax, 1994/11).

125 Brian J. Arnold and Michael J. McIntyre, International Tax Primer, p. 115.

126 Klaus Vogel, Double Taxation Conventions, Article 3, m.no. 62.

127 John F. Avery Jones, Article 3(2) of the OECD Model Convention and the Commentary – Treaty Interpretation (IBFD European Taxation, August 1993) p. 257.

128 OECD Commentary: Article 3, para 11–13.

129 *Padmore v IRC* [1987] STC 493, 499 (UK): The treaty definition of a person differed from the definition under the UK domestic law. A UK resident partner in a Jersey partnership claimed tax exemption on his share of the partnership profits under the UK-Jersey tax treaty. The Court held that a partnership was a resident person, as defined under the treaty, and the profits were, therefore, exempt in the hands of the individual partners. This decision was overruled by subsequent UK legislation.

130 Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 7.03.

131 *Leonard Andra and Partner GmbH v CIT* (India) 2000: The Calcutta High Court applied the definition of “royalties” under the Indian domestic law since the word was not defined in the India-Germany tax treaty.

132 In the most narrow sense, “context” is the text immediately before and after the term, preferably in the same sentence.

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was negotiated and (iii) the political, economic and diplomatic background of the treaty.¹³³ The broad definition includes not only the OECD MC and its Commentaries but also all their grammatical (analyse the whole law), historical (identify original intent), systematical (consider the provision as part of the whole law) and teleological (contemporaneous purpose) aspects.¹³⁴

The OECD Commentary also gives a wide meaning to the term “context” under Article 3(2).¹³⁵ It defines context as the intention of the Contracting States when they signed the treaty as well as the current meaning given to the term in the domestic law of the other Contracting State. The intention when signing the treaty also implies consideration of the domestic law meaning in both States at that time. Thus, these conditions effectively disallow the use of the domestic meaning by one State without proper consideration of the past and current meaning of the term in the other State. According to the OECD Commentary, this safeguard ensures the required “permanency of commitment” in good faith (*pacta sunt servanda*) under the treaty and denies any change in the domestic law, which might make the treaty “partially inoperative”.¹³⁶ Otherwise, a change in domestic law could effectively change the context.¹³⁷

(b) Does the context always take precedence or only if there is an essential difference?

The OECD Commentary specifically mentions that under paragraph 3(2) the domestic law applies “only if the context does not require an alternative interpretation”.¹³⁸ There are two differing points of view, as follows:

- (i) the meaning under the domestic law is authoritative and should be used always, and the context is only applicable if the context otherwise requires; and
- (ii) the meaning under the domestic law should only be used in the last resort, since context takes precedence.

In the first case, all the terms, which are not defined in the treaty, initially follow the domestic law of the State applying the treaty. The meaning under the treaty must be sought as a secondary option, only if the context demands it.¹³⁹ In the second case, the questions of interpretation are primarily resolved by reference to the double tax treaty itself. This approach relies on the treaty’s definitions and phrasing, followed by a careful study of the context within the entire agreement.

Assuming a broad definition of “context”, as defined above, it is contended that it should be always possible to establish an autonomous meaning under the treaty acceptable to both

¹³³ John F. Avery Jones et al., *The Interpretation of tax Treaties with particular Reference to Article 3(2) of the OECD Model – Part II* (British Tax Review, 1984) pp. 90–105; Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapters 7.06 & 23.15; Harry Shannon, *United States Income Tax Treaties: Reference to Domestic Law for the Meaning of Undefined Terms* (Intertax 1989) pp. 459–461; Edwin van der Bruggen, *Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between Article 3(2) of the OECD Model Tax Convention and Article 31 and 32 of the Vienna Convention* (European Taxation, May 2003) pp. 142–156.

¹³⁴ Michael Lang, *The Application of the OECD Model Tax Convention to Partnerships* (Kluwer Law International, 2000) pp. 20–28.

¹³⁵ OECD Commentary: Article 3, para. 12.

¹³⁶ OECD Commentary: Article 3, para. 13.

¹³⁷ Peter J. Wattel and Otto Marres, *Characterisation of Fictitious Income under OECD-Patterned Tax Treaties* (European Taxation, March 2003) pp. 70–74.

¹³⁸ OECD Commentary: Article 3, para. 12.

¹³⁹ John F. Avery Jones, *The One True Meaning of a Tax Treaty* (IBFD Bulletin, June 2001) pp. 220–224.

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Contracting States (i.e. common interpretation), and a domestic meaning will rarely be needed. Any reference to domestic law would be limited to:

- treaty provisions referring expressly to domestic law,
- situations in which the context or supplementary interpretation convincingly suggests a reference to domestic law, and
- situations in which no convincing interpretation exists in the treaty in its context or in supplementary sources.

As a third alternative, the meaning of undefined terms may be determined by reference to all of the relevant information and all of the relevant context.¹⁴⁰ To “apply” the treaty is not the same as to “interpret” it. Under this approach, both the domestic and treaty meanings are given equal significance for treaty interpretation.

(c) Is the meaning of the treaty term based on the applicable domestic law when the treaty was concluded (“static approach”), or when it was applied (“ambulatory or dynamic approach”)?

As from 1995, Article 3(2) recommends the use of a dynamic approach, provided the context does not suggest otherwise. It mentions that the interpretation of terms should use the current meaning (“the meaning that it has at that time”) under the domestic law of the State applying the treaty. Although a dynamic approach keeps pace with changes in the domestic law, a Contracting State could override the treaty unilaterally through subsequent changes in either the domestic meaning or the scope of undefined terms. If such a change affects the basic intentions of the treaty partners, it is contended that the qualification “unless the context otherwise requires” should provide a safeguard against any possible treaty abuse.¹⁴¹

Some countries (Examples: Australia, Austria, Belgium, Canada, Germany, Norway, United Kingdom, United States)¹⁴² now accept the ambulatory meaning of treaty terms. Australia and Canada have ensured the use of the ambulatory approach through special domestic legislation. However, the approach is still not widely accepted by many other countries. In several countries, the current use of the meaning under the domestic law would be deemed as a treaty override and should be avoided, unless it can be accepted as a subsequent practice under VCLT Article 31(3)(b).¹⁴³

Similar concern also arises in the use of subsequent Commentaries on existing treaties. Unlike domestic law, OECD Commentaries present the views of the OECD and its Committee on Fiscal Affairs and do not have the appropriate parliamentary approval. A suggested approach is the use of an ambulatory method for changes in domestic law under Article 3(2) but a static method for post-treaty changes in the Commentaries.¹⁴⁴ Thus, subsequent changes in the OECD Commentaries cannot override the text of the treaty.¹⁴⁵

140 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, pp. 115–116.

141 Kees van Raad, 1992 Additions to Articles 3(2) ... of the 1992 OECD and Commentary (*Intertax* 1992/12); John F. Avery Jones, Article 3(2) of the OECD MC ... (*IBFD European Taxation*, August 1993).

142 Examples: *Burghardt v Commissioner* (1983) 80 TC (US) 705; *Ducking v Gollan* (1965) 42 TC 333 (UK).

143 Klaus Vogel, *Double Taxation Conventions*, m.nos. 124–126.

144 Peter Wattel and Otto Marres, *The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties* (*European Taxation*, July/August 2003) pp. 222–235; John F. Avery Jones, *The Effect of Changes in the OECD Commentaries after a Treaty is Concluded* (*IBFD Bulletin*, March 2002) pp. 102–109.

145 Philip Baker, *Double Taxation Conventions and International Tax Law*, p. 30.

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The OECD MC Article 3(2) and its Commentary support the ambulatory interpretation provided the meaning of the terms of the original treaty as originally negotiated between the Contracting States is not seriously altered.¹⁴⁶ The subsequent Commentaries are supposed to reflect a common view as to what the meaning is and always has been and not to a new meaning, i.e. an elaboration rather than a change. Often, a study of the changes in the Commentary over time may be necessary to understand a treaty provision.

(d) Should the domestic interpretation of terms in one Contracting State be legally binding on the other Contracting State?

The reference to the domestic laws of both Contracting States could lead to either double taxation or double non-taxation, if they have conflicting meanings under their respective laws. The *Pierre Boulez* case highlighted this problem when the US tax authorities disagreed with the German tax authorities. The payments to Boulez were treated as “royalties” in Germany, but the US IRS held that they were “compensation for personal services” in the United States.¹⁴⁷ The case led to double taxation since the tax authorities in the USA and Germany were unable to agree on a common definition.

Article 3(2) mentions that “As regards the application of the Convention... 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...” The phrase “application of the Convention” under this Article refers to any decision by tax authorities or Courts concerning tax matters where the treaty is or is likely to be considered.¹⁴⁸ Hence, both States can claim to apply the treaty. While the treaty restricts the taxing rights of the source State under the classification and distribution rules it also requires the residence State to grant treaty relief by tax exemption or credit. The words in Article 3(2) require both States to apply their own domestic law.

Some commentators take a narrow meaning that describes the situation as one where one State “applies” the treaty to restrict its taxing rights while the other State merely “reads” the treaty. In their view, only the source State applies the treaty since it alone is restricted under the treaty provisions from applying its own domestic tax laws. The residence State only reads the treaty to determine whether the source State has correctly applied the Convention before giving the relief for double taxation. It only “applies” the treaty in accordance with the law of the source State. Therefore, the definition under the domestic law of the source State should apply and the residence State should accept this definition if the meaning under the two countries differs.¹⁴⁹

146 OECD Commentary: Article 3, paras. 11–13.

147 *Pierre Boulez* (1984) 83 TC No. 131 (US): The famous conductor, a German resident, entered into a contract with CBS records in the United States to conduct certain musical performances for making phonograph records against royalty payments. The agreement provided that all property rights belonged to CBS. The IRS treated it as “compensation for personal services,” a term not defined in the tax treaty, and applied the domestic tax definition. The US tax Court accepted the IRS position. (Note: This issue has now been clarified in favour of the taxpayer under the US Model Treaty 1996 – see Technical Explanation, Article 12, para. 178).

148 H.Shannon, *US Income Tax Treaties, Reference to Domestic Law for the Meaning of Undefined Terms* (Intertax, 1989) p. 157.

149 David Ward, *Interpretation of Tax Treaties* (IBFD Bulletin, 1986); John F. Avery Jones et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model* (British Tax Review, 1984); John F.Avery Jones, *Article 3(2) of the OECD Model Convention and the Commentary – Treaty Interpretation* (IBFD European Taxation, August 1993).

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The OECD Commentary Update 2000 has adopted the latter view and suggested that the “qualification” conflicts should be avoided by obliging the residence State to accept the categorisation of the source State (See Chapter 2(3.6) below).¹⁵⁰ According to Vogel, the treaty’s special rules of interpretation should take precedence over Article 3(2). Neither the use of the domestic law in interpreting tax treaties nor the use of domestic definitions of terms is justified if they are not applicable under the treaty provisions.¹⁵¹

3.6. Conflicts of Qualification

Under the MC, Article 3(2) is the treaty interpretation rule. This Article allows a State to use its domestic law meaning when a term is not defined in the treaty, unless the context otherwise requires. The rule provides a choice between the meaning under the domestic law and an autonomous or independent meaning. Although an autonomous meaning under the context to achieve a common interpretation is preferable, it may not be always feasible. Moreover, often States prefer their domestic meaning (“*lex fori*”), when applying the treaty, for convenience and ease of use. They may also prefer it since it avoids the waiver of their sovereign taxing rights under the treaty from what is mentioned in their domestic law.

One of the reasons for double taxation (or double non-taxation) when domestic laws are used is differing qualification, i.e. characterisation (also called classification or categorisation), of the same income in the two States. The treaty uses terms derived from the domestic laws but the terms have different meaning.¹⁵² These undefined terms in the treaty can then be interpreted to have the meaning in either of the two States or even a third interpretation. The problem that arises when the two Contracting States apply different distributive rules on the same income and taxpayer due to different meanings of treaty terms in the two Contracting States is called a “conflict of qualification” in international tax law.¹⁵³ Similar problems also arise under a “conflict of attribution” when both Contracting States apply the same distributive rules but to different taxpayers.

As mentioned above, some commentators had suggested in the early nineties that the qualification according to the source State should be adopted in such cases.¹⁵⁴ Under this rule, the residence State should accept the categorisation of the source State and grant treaty relief even if it would have characterised the income differently under its own domestic law. This approach was further developed in the OECD Partnership Report 1999 and recommended by the OECD Committee on Fiscal Affairs in their Commentary Update 2000.

The new approach is contained in the OECD Commentary on Article 23 under “Conflicts of Qualification”.¹⁵⁵ It provides that the phrase “in accordance with the provision of the

150 OECD Commentary: Article 23, para. 32.1–32.7; See Chapter 3(4-Article 23).

151 Klaus Vogel, Double Taxation Conventions, Article 3, m.no. 61–74; See also Frank van Brunschot, The Judiciary and the OECD Model Tax Convention and its Commentaries (IBFD Bulletin, January 2005) p. 8.

152 For some examples, see Ned Shelton, Interpretation and Application of Tax Treaties, p. 208.

153 Klaus Vogel, Double Taxation Conventions, Introduction, m. nos. 89–101b.

154 Jean-Marc Dery and David Ward, Canada National Report (IFA Cahiers, Vol. 78A, 1993); John F. Avery Jones et al., Credit and Exemption under Tax Treaties in Cases of Differing Income Characterisation (European Taxation, 1996).

155 OECD Commentary: Article 23, paras. 32.1–32.7.

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Convention may be taxed”, as used in the Article, be given another interpretation. In the case of qualification conflicts arising from differences in the domestic law of the Contracting States, the source State would have taxed in accordance with its provisions when, following Article 3 (2), if it applies its domestic law to determine whether the treaty permitted it to tax. Therefore, the residence State is obliged to grant relief from double taxation under Article 23, regardless of its own different qualification. An autonomous meaning under Article 3(2) would only be required when the source State did not have a domestic meaning or it was required by the context.¹⁵⁶

The recommended approach, however, contains several limitations, such as:

(a) The approach avoids qualification issues only when different provisions of the treaty are used by the Contracting States in determining the treaty category of income due to differences in their domestic laws. Moreover, the residence State is obliged to give treaty relief for source taxation only if it is satisfied that the source State has correctly applied its domestic law. There is no obligation to give relief if double taxation is due to either (i) differing interpretation of the facts or (ii) different interpretations of the treaty provisions. In such situations, double taxation must be avoided under the mutual agreement procedure (Article 25).

(b) The approach does not avoid conflicts of qualification involving treaty provisions other than Article 23. This relieving Article applies when the treaty provides for “may be taxed” (“open”) rights to the source State with subsequent tax relief to be given by the residence State. The Article does not apply when the distributive rules provide for “shall be taxable” (“complete”) rights to one of the two States.¹⁵⁷ In addition, it may not resolve conflicts due to non-distributive provisions in a treaty.¹⁵⁸

(c) The approach does not prevent double non-taxation if the residence State provides relief under the exemption method.¹⁵⁹ The source State may apply a provision of the treaty that either limits (e.g. Articles 10 and 11) or excludes its right to tax, while the residence State takes the view that the taxing right belongs to the source State and it must give an exemption. Unlike double taxation, double non-taxation cannot be avoided through the mutual agreement procedure (Article 25). To avoid this double non-taxation, the Commentary makes certain additional recommendations, such as:

- (i) If the double non-taxation is solely the result of differences in domestic laws of the two States, it must be granted since it is not the result of applying the treaty. However, if it arises as a result of the interaction of the domestic tax rules with the provisions of the treaty, then the residence State is not obliged to exempt the income under Article 23A(1).

¹⁵⁶ John F. Avery Jones, The Relationship between Domestic Tax Systems and Tax Treaties (IBFD Bulletin, June 2002) pp. 268–270.

¹⁵⁷ See Chapter 3(1.3).

¹⁵⁸ John F. Avery Jones, The “One True Meaning” of a Tax Treaty (IBFD Bulletin, June 2001) pp. 220–224; Klaus Vogel, Conflict of Qualification: The Discussion is not Finished (IBFD Bulletin, February 2003) pp. 41–44; Alexander Rust: The New approach to Qualification Conflicts has its Limits (IBFD Bulletin, February 2003) pp. 45–50.

¹⁵⁹ This issue does not arise under the credit relief method since the residence State does not have to provide any tax credit if the income is not taxed by the source State under its domestic law.

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It may presume that the source State has not taxed the income in accordance with the provisions of the treaty.

- (ii) If the double non-taxation arises due to different interpretations of the facts or treaty provisions, the new paragraph 23A (4) should be added to the treaty text and applied to permit the residence State to deny (“shall not apply”) the exemption relief under the treaty to the taxpayer.

The suggestions above of the OECD Committee on Fiscal Affairs assume that the avoidance of double non-taxation is one of the treaty objectives. For this purpose, it relies on the object and purpose of a treaty to avoid double taxation and then takes the view that double non-taxation should be avoided.¹⁶⁰

The new approach has several critics and few countries have used it so far.¹⁶¹ Some of the concerns expressed are as follows:

- The new approach requires the residence State to accept the characterisation under the domestic law of the source State. This acceptance may affect the allocation of taxing rights of the Contracting States, as negotiated by them. Moreover, the new approach could lead to treaty abuse by the source State through subsequent changes in the meaning of a term under the domestic law.¹⁶²
- The new approach is an attempt by the OECD Committee on Fiscal Affairs to modify the Model treaty through subsequent changes in its Commentary. It is, therefore, unlikely to be accepted under VCLT by the Courts (and taxpayers) in many countries. In any case, the Commentary can only clarify and provide guidance on treaty interpretation and not make radical changes that affect the context. Moreover, the change cannot be applied on treaties concluded prior to the Commentary Update 2000 since a dynamic interpretation will be unacceptable in such cases.
- Although some countries regard double non-taxation as undesirable, very few countries consider it as a treaty objective or accept the “single taxation principle” that require that all income be taxed in at least one State. Double non-taxation may be intended or unintended but does not constitute tax evasion. Double non-taxation is considered a problem only if it is inappropriate or abusive. If double non-taxation is unintended or unlawful and abusive, the treaty should be modified. Moreover, any “subject to tax” provisions should be included in the treaty itself and not inferred from the Commentary.
- There may be situations where either the State’s internal law is not applicable or a State does not have an appropriate domestic meaning, or it contains more than one meaning. In such cases, a meaning, using the interpretation rule under the VCLT, may be necessary to achieve a common interpretation of the treaty.

Despite these limitations, many supporters of the new approach believe that it does provide a practical solution in case of most qualification conflicts. Moreover, in their view the

¹⁶⁰ OECD Commentary: Article 23, para. 32.6; OECD Partnerships Report 1999, para. 52.

¹⁶¹ Klaus Vogel, Double Taxation Conventions, m.nos. 90–101b; See Chapter 3(4)-Article 23).

¹⁶² Some commentators believe that there are safeguards to avoid the misuse by the source State of the new approach. Under OECD MC Article 3(2), the domestic meaning should apply only if the context does not require an alternative meaning. A State can be guilty of a treaty override since a material change in the treaty will also change the context and not convey good faith required under VCLT Article 26.

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interpretation can also be justified under the VCLT. Some of them, however, agree that as the dynamic interpretation of the Commentary may not be acceptable, the new provisions can only apply to treaties concluded after the issue of the Commentary Update 2000.¹⁶³

Ideally, an autonomous meaning acceptable to both treaty partners should be sought. If the autonomous meaning in the two States differs, any disagreement may then be resolved through the mutual agreement procedure under Article 25(3).

4. SOME LEGAL DECISIONS ON TREATY INTERPRETATIONS

4.1. Legal Interpretations

Although double tax treaties are international agreements under public international law, there is no international judicial authority to interpret tax treaties. Most countries accept the right of their Courts to interpret double tax treaties. The judicial bodies act as “the authorities of last resort”. The Courts apply their legal reasoning based on the facts and the law to decide on tax issues.

Legal decisions on treaty interpretation differ widely among countries. The Courts in civil law countries rely on sources, such as laws, treaties, regulations, jurisprudence and doctrine.¹⁶⁴ They tend to stress the exact wording of the law and are generally strict in their legal reasoning.¹⁶⁵ Common law countries follow similar sources but give more emphasis to judicial decisions and treat doctrinal writings largely as persuasive. They also pay close attention to the facts and are more flexible in their legal reasoning.

Treaty interpretations tend to be either literal, legislative or purposive, as follows:

- **Literal:** the Courts adopt a literal meaning of the treaty (i.e. not reading between the lines). This approach encourages certainty and stability but may reduce its effectiveness.
- **Legislative:** the Courts interpret the treaty according to the original legislative intent, even departing from the literal language of the statute. They take into account the legislative history.
- **Purposive:** the Courts consider the economic or social purpose, and look at the purpose of the legislation beyond what was contemplated in the words of the treaty. Emphasis is given to substance over form through a contemporary purposive interpretation.

The Courts in many countries still adopt a literal interpretation of the tax law.¹⁶⁶ France, Belgium and South Africa interpret the tax laws in favour of the taxpayer, when in doubt under the maxim “*in dubio contra fiscum*”.¹⁶⁷ Ireland considers legislative history but follows a literal interpretation. The Netherlands enforces the legal form but denies an interpretation that has tax avoidance as the dominant purpose under the “fraus legis” doctrine.

¹⁶³ John F. Avery Jones, Conflicts of Qualification (IBFD Bulletin, May 2003) pp. 184–186; Hugues Salome and Robert Danon, The OECD Partnership Report – A Swiss View on Conflicts of Qualification (Intertax, Vol. 31 Issue 5).

¹⁶⁴ Jurisprudence refers to judicial decisions and doctrines refer to writings of academics and tax administration.

¹⁶⁵ Frans Vanistendael, Legal Framework for Taxation (Tax Law Design and Drafting, 2000) pp. 33–35.

¹⁶⁶ Examples: Austria, Canada, India, Israel, Japan, Korea, New Zealand, Norway, Peru, South Africa, Switzerland, United Kingdom.

¹⁶⁷ It means: “In doubt (construe a provision) against the revenue (i.e. the government)”.

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However, there is an increasing trend towards a purposive and liberal approach to treaty interpretations.¹⁶⁸ For example, the UK Courts have taken a purposive view on treaties and deviated from the literal text in several decisions in recent years.¹⁶⁹ The Courts in several countries also apply a broad approach in treaty interpretation to satisfy either historical parliamentary intent or current economic intent. They consider preparatory material, foreign decisions and other legal commentaries.

Several civil law countries¹⁷⁰ follow the legislative approach. Germany follows the VCLT rules of interpretation and gives priority to the ordinary meaning of treaty terms. It also considers the legislative purpose to avoid an absurd result that could not have been intended by the legislature. The United States interprets treaties according to the legislative intent with an emphasis on substance over form under a purposive approach.

The Courts generally assume that, unless there is some clear statement to the contrary, the legislature expects them to apply the interpretation under customary international law, rather than the domestic rules.¹⁷¹

4.2. Reference to the VCLT

As mentioned earlier, tax treaties have a dual character (See Chapter 2(1.4)). They are a treaty between States as well as binding nationally as statutes. Therefore, they are subject to the rules of interpretation applicable to both international and domestic law. Several legal decisions have confirmed the application of the VCLT for tax treaty interpretations.¹⁷² Some specific examples include:¹⁷³

- The Canadian Supreme Court held in the Crown Forest case that “Articles 31 and 32 of the Vienna Convention on the Law of Treaties indicate that reference may be made to these types of extrinsic materials when interpreting international documents such as taxation conventions”.¹⁷⁴
- In the Thiel case in Australia, the judge stated that the VCLT and its Article 31 “seek to codify the international law in relation to treaties”.¹⁷⁵ Similar Australian decisions on the application of VCLT to tax treaties were noted in the Lamesa and Chong cases.¹⁷⁶
- In the Gimpey case, Barrington J held: “An international treaty has only one meaning and that is its meaning in international law. For guidance on this subject one must look to

168 Victor Thurny, Comparative Tax Law, pp. 149–150.

169 Examples: *Pepper v Hart* (1993) AC 593 (UK); *James Buchanan & Co. Ltd. v Babco Forwarding and Shipping (UK) Ltd* (1977) 3 All ER 1048 (UK); *Fothergill v Monarch Airlines Ltd.* (1981) AC 251 (UK).

170 Examples: Germany, Switzerland, Luxembourg, the Netherlands, Austria.

171 *Shipping Corporation of India Limited v Gamlen Chemical Company Australasia*, (1980) 147 CLR (Australia).

172 Examples: *Thiel v FCT* (1990) ATC 4717 (Australia); *Melford Developments v R* (1982) DTC 6074 (Canada); *CIR v JFP Energy Inc* (1990) 14 TRNZ (New Zealand); *IRC v Commerzbank AG* [1990] STC (United Kingdom); etc.

173 Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 3.03–3.16.

174 *Crown Forest Industries Ltd v The Queen* (1992) 95 DTC, para. 54 (Canada); the Supreme Court referred to Model Conventions and Commentaries as extrinsic materials under the VCLT Article.

175 *Thiel v FCT* (1990) ATC 4717, 4722 (Australia); Dawson J. commented “Switzerland is not a party to the Vienna Convention (although Australia is) but the relevant rules which it lays down are applicable, being no more than an indorsement or confirmation of existing practice.”

176 *FCT v Lamesa Holdings BV* (1997) ATC 4752 (Australia); *Chong v FCT* (2000) ATC 4315 (Australia).

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the general principles of international law and in particular to the rules of interpretation set out in Article 31 of the Vienna Convention on the Law of Treaties". "Article 31 is acknowledged to have codified the relevant principles of interpretation".¹⁷⁷

- The Federal Canadian Court applied Article 32 of the VCLT to authorise the examination of the circumstances existing when the treaty was signed in the Gladden case.¹⁷⁸

4.3. Reference to the OECD MC and Commentaries

The OECD MC and Commentaries are generally considered as supplementary means of interpretation under VCLT Article 32. Under the VCLT Article 32, they can only be used strictly to avoid an ambiguous, obscure, absurd or unreasonable meaning under Article 31, or to confirm the Article 31 result. Although the OECD Committee on Fiscal Affairs does not intend for them to have a limited role,¹⁷⁹ it is difficult to justify including them as part of context under VCLT Article 31. Very few bilateral treaties have explicitly included the use of the Commentaries as a protocol to a treaty.¹⁸⁰ The Commentaries and judicial decisions also confirm that the expressed provisions in a negotiated tax treaty alone constitute a legally binding agreement.

Few Court decisions have considered their legal status. Although it is still controversial, the OECD MC and Commentaries are widely accepted by the Courts for treaty interpretation. There are legal decisions supportive of the MC and the Commentaries in several countries.¹⁸¹ Some specific references to the Model and the Commentaries in cases involving treaty interpretations include:¹⁸²

- MC Articles 3(1) (c) and 7(1): the definition of an "enterprise" in *Thiel v FCT* by the High Court of Australia.¹⁸³ A Swiss resident taxpayer converted his mutual fund units into shares in an Australian company and sold them at a profit. The Australian High Court held that an isolated activity could constitute an enterprise for treaty purposes under the OECD Commentary.
- MC Article 4(1): in the Crown Forest case, the Court interpreted the term "resident" under the US-Canada tax treaty.¹⁸⁴ It held that "the authority ... that only those who are liable to tax on their worldwide income can be justifiably considered residents for the purposes of international taxation conventions is found in the first sentence of Article 4 of the OECD Model Convention...".

¹⁷⁷ *Gimpey v Ireland* (1988) IR 567, 582 (Ireland).

¹⁷⁸ *Gladden Estate v The Queen* (1985) DTC 5188 (Canada): A US resident died owning Canadian shares. Under the Canadian tax law, the deceased person was deemed to have disposed off all his Canadian property just before death and was subject to capital gains tax. The tax treaty exempted real capital gains. The Court held that the Vienna Convention should apply, and it was "unreasonable and absurd" to cover a real gain in a treaty but not a deemed gain.

¹⁷⁹ OECD MC: Introduction, para. 29.

¹⁸⁰ Example: Memorandum of Understanding Re Interpretation of the Convention, May 31, 1996, United States-Austria.

¹⁸¹ Philip Baker, Double Taxation Conventions and International Law, pp. 24–29.

¹⁸² Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 23.24–23.26, 26.15–26.16.

¹⁸³ *Thiel v FCT* (1990) ATC 4717 (Australia).

¹⁸⁴ *Crown Forest Industries Ltd v The Queen* (1995) 95 DTC (Canada).

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- MC Article 26: in the Burbank case, the Court referred to both the OECD MC and the Commentary as aids to interpretation and stated that the defined purpose of the treaty was to avoid and relieve double taxation as well as to prevent fiscal evasion.¹⁸⁵ The Court held that the US IRS could pass tax information to the Canadian Revenue under the terms of the treaty, even when no US taxes were involved.
- MC Commentaries: in *Sun Life Assurance Co. of Canada v Pearson*, the English High Court held that “it is common ground . . . that the Commentaries must be referred to as a guide to the interpretation of the treaty”.¹⁸⁶
- MC Commentaries: in the Cudd Pressure case, the Canadian Court held that “the OECD Commentaries, therefore, can provide some assistance in discerning the legal context surrounding double taxation conventions at international law”.¹⁸⁷

4.4. Other Judicial Decisions

The decisions on tax treaties by the national Courts or authorities in the other Contracting State or third States may be applied but are not mandatory.¹⁸⁸ They tend to be persuasive but not binding. However, foreign judicial decisions may provide important insights. They may also include countries other than the treaty partner. There are examples of this principle of common interpretation in the legal decisions of many countries.¹⁸⁹

Common interpretation does not mean acceptance without review.¹⁹⁰ Generally, foreign Court decisions need to be applied with some caution since interpretation principles or approaches towards the application of the VCLT or the domestic law meaning may differ. This principle does not apply where the treaty expects each Contracting State to apply its own domestic laws.¹⁹¹

In *CIR v JFP Energy Incorporated (New Zealand)*, the New Zealand Court of Appeal accepted the US Technical Explanation to interpret the phrase: “borne by a permanent establishment” in OECD MC 15(2). It held: “. . . it is obviously desirable that the same interpretation answer should be given whether a double taxation treaty question arises in New Zealand or the US and in our view appropriate consideration should be given to the considered official opinion of the other party to the treaty as to its meaning”. Technical Explanation in the US MC did not form part of the treaty but reflected the unilateral views

185 *United States v A.L.Burbank & Co.* (1975) 525 F 2d 9 (US).

186 *Sun Life Assurance of Canada v Pearson* (1984) STC 461 (UK).

187 *Cudd Pressure Control Inc. v The Queen* (1999) CTC 1, 12 (Canada).

188 Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 29.06–29.17.

189 Examples: A Dutch interpretation was used in Canada in *Hunter Douglas v MNR* 79 DTC 5340; UK and Canadian decisions were applied in Australia in *Thiel v FCT* 90 ATC 4717; a German decision was applied in New Zealand in *CIR v United Dominions Trust Ltd* (1973) 1 NZTC 61028; a Canadian decision was applied in United States in *Donroy Ltd v US* (1962) 301 F 2d 200; a German decision was applied in India in *CIT v Vishakhapatnam Port Trust* 144 ITR 146, 157–158; a United States Court decision was applied in Canada in *No. 630 v MNR* 59 DTC 300; etc.

190 *Fothergill v Monarch Lines* [1981] AC 251 (UK): Mummery J held that the “decisions of foreign Courts on the interpretation of a Convention or treaty text depend for their authority on the reputation of the Court in question.” Lord Scarman also observed in the Fothergill case: “Our Courts will have to develop their jurisprudence in company with the Courts of other countries from case to case...”

191 Klaus Vogel, Double Taxation Conventions, Introduction, m.no. 77.

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of the US treaty negotiators. Nevertheless, the Court cited it since it was a help in the treaty interpretation on the case.

4.5. Country Examples¹⁹²

Australia

Australia ratified the VCLT in 1974 and follows its rules unless there are specific treaty interpretation or application requirements under the domestic law. Tax treaties are implemented as Schedules to the International Tax Agreements Act 1953 and subject to the Acts Interpretation Act 1901 under its domestic law. The domestic rules under Sections 15AA and 15BB of this Act reflect the parliamentary intention when enacting treaty-implementing laws and theoretically permit specific treaty overrides.¹⁹³ Otherwise, customary international law prevails over domestic law.

Several domestic cases have supported the use of the VCLT on tax treaties.¹⁹⁴ In the *Tasmanian Dam* case, Judge Brennan of the Australian High Court held: “The interpretation of the Convention . . . should follow the Article of the VCLT, the provisions of which codify existing customary law and furnish presumptive evidence of emergent rules of general international law”. He considered Article 31 of the Convention as “the leading general rule of interpretation of treaties”.

Canada¹⁹⁵

The Canadian Courts usually take a purposive view on treaty interpretations.¹⁹⁶ In *Stickel v MNR*, the judge held that the “treaties are to be construed in the most liberal spirit provided, however, that the sense is not wrested from their plain and obvious meaning; the Courts should examine treaty provisions to ascertain and give effect to the intention of the Contracting States as expressed in the words used by them”.¹⁹⁷ In the *Gladden Estate* case, the judge added, “a literal or legalistic interpretation must be avoided when the basic purpose of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned”.¹⁹⁸ In the *Crown Forest* case, the judge reviewed the intentions of the drafters of the treaty.¹⁹⁹

Canada ratified the VCLT in 1970 and its Courts have mentioned the VCLT in several tax cases. They accept that the Convention codifies the existing public international law.

192 See Hugh Ault and Brian Arnold, Comparative Income Taxation, pp. 430–432.

193 See *Horta v Commonwealth* (1994) 181 CLR 183 (Australia).

194 Examples: *The Commonwealth v Tasmania* (1983) 158 CLR; *Koowarta v Bjelke-Petersen* (1981–82) 153 CLR 168; *Thiel v FCT* (1990) 171 CLR 338; *FCT v Lamesa Holdings BV* (1997) 77 FCR 597; *Chong v FCT* (2000) FCA 635 (Australia).

195 Jacques Saserville, Interpretation of Double Taxation Conventions in Canada – An Update (IBFD Bulletin, August/September 1994); James Hausman, Interpreting Tax Treaties – A Canadian Perspective (IBFD Bulletin, March 2001) pp. 93–99 ; Stephen R. Richardson, Bilateral Income Tax Conventions and Canadian Domestic Law (Special Seminar on Canadian Tax Treaties Policy, IFA Canadian Branch, 2000).

196 *Stubart Investments Ltd. v The Queen* (1984) 84 DTC 6, 305 (Canada).

197 *Stickel v MNR* [1972] FC 672, 679 (Canada).

198 *Gladden Estate v R* (1985) 85 DTC (Canada).

199 *Crown Forest Industries Ltd. v The Queen* (1995) 95 DTC (Canada).

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Grant J held in the *Hunter Douglas* case: “The Vienna Convention on the Law of Treaties, to which both Canada and the Netherlands are parties, contains the general rules of interpretation of international conventions”. The Cudd Pressure case reaffirmed that: “It is generally accepted that the Vienna Convention on the Law of Treaties codifies previously existing public international law. The principles set out in this Convention and what it says in Articles 31 and 32 regarding interpretation of treaties are applicable to the issues at hand”.²⁰⁰ The interpretative principles under VCLT were mentioned by the Canadian Supreme Court in the *Crown Forest* case to justify the use of extrinsic materials such as Model Conventions and Commentaries.²⁰¹

Canada passed a new law after the *Melford* case.²⁰² Under the Income Tax Conventions Interpretation Act of 1985, unclear treaty terms are interpreted on an ambulatory basis. Thus, under the Canadian domestic law the meaning when the treaty is applied now supersedes the definition of the terms at the time of signing the treaty.

France

Until 1990, the French Courts were not permitted to interpret treaties, unless the meaning was clear (the doctrine of “*acte clair*”), or the matter was under dispute. Only the Ministry of Foreign Affairs could issue rulings on treaty interpretations, which were held to be binding on the Courts. Under a 1990 decision of the Conseil d’Etat (“Supreme Court”), the French Courts are now empowered to interpret a treaty even if its provisions are not clear. Moreover, an interpretation ruling of the Ministry is no longer binding upon the Courts.²⁰³

Generally, tax treaties are given a strictly literal interpretation by the two highest Courts in France (e.g. the Cour de Cassation and Conseil d’Etat)²⁰⁴ under Article 34 of the French Constitution. They are interpreted against the tax authorities in case of doubt. Although France is not a party to the VCLT, it follows the rules as customary international law.

Germany

Germany signed the VCLT in 1970 and ratified it in 1987. The German Courts generally follow the VCLT approach to comply with the legislative intent in treaty interpretation. Under the VCLT, the treaty intentions must be evidenced in the actual text of the treaty. The parties should also attempt to find a common interpretation, wherever possible. The requirement to interpret the treaty “in the light of its object and purpose” requires that parties should look for an interpretation acceptable to both Contracting States and examine the meaning of the terms in the other partner’s jurisdiction.

200 *Cudd Pressure Control Inc. v The Queen* [1995] DTC 565 and 566 (Canada).

201 *Crown Forest Industries Ltd. v The Queen* (1995) 2 SCR 802.

202 *R v Melford Developments Inc* (1982) 82 D.T.C. 6281 (Canada): The Canadian Supreme Court applied the definition under the domestic law when the Canada-Germany tax agreement came into force to exclude a loan guarantee fee as interest income. It ignored the subsequent changes in the provision under the Canadian Income Tax Act of 1974.

203 Decision of June 29, 1990, Req. no. 78519, RJF 8-9/90 (Source: Philip Baker: Double Tax Conventions and International Tax Law, p. 25).

204 Under the French civil law, the Conseil d’Etat deals with public law while the Cour de Cassation handles private law disputes.

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India

The Indian Courts normally follow a literal approach on treaty interpretations, as in domestic tax law.²⁰⁵ Nonetheless, a decision of the Andhra Pradesh High Court in 1983 did provide for a more liberal treaty interpretation.²⁰⁶

Two decisions in the 1990s took an even more liberal viewpoint in favour of taxpayers.²⁰⁷ The Indian Courts held that under the India-Malaysia tax treaty, the term “may be” was meant not only to give the source country the option to tax, but also to deprive the residence country its right to tax. As a result, “may be” was interpreted as “shall only be” and the taxpayer was granted tax exemption rather than tax credit under the treaty. The judgments ignored the OECD Commentary as irrelevant in the concerned legal cases. These decisions were confirmed by the Indian Supreme Court in May 2004 in a similar case of *CIT v P.V.A.L. Kulandagan Chettiar*.²⁰⁸

A purposive decision was given in a 1998 Tax Tribunal case. It held that a retroactive amendment of the treaty could not be enforced under the principle of promissory estoppel. Here, a change in the India-Germany tax treaty provisions levied tax on certain royalties. The payments were exempt under the previous treaty. The new protocol was made effective from a date earlier than the date of notification and entry into force. The Tribunal maintained that a retroactive operation of a treaty could not be applied to impair an existing treaty benefit by an executive action. No retrospective effect can be given to a particular term of the protocol, unless the protocol itself authorises it. A change in treaty provisions with adverse effect can only be prospective.²⁰⁹

India is not a party to the VCLT but generally follows the VCLT rules as codification of customary international law. In a landmark decision in 2003, the Indian Supreme Court held that treaties should be interpreted liberally to implement the true intentions of the parties. Despite this view, the Court took a literal view of the India-Mauritius treaty. It stated that its duty was to decide what the law was and apply it and not to make it.²¹⁰

United Kingdom

The United Kingdom Courts have usually adopted a literal approach to domestic tax legislation and avoided a purposive interpretation. Each word is given its natural meaning, and no account is taken of any extrinsic material. The judge is bound to follow the statute on tax law, and ignore the legislative intention or equity considerations. The purposive approach or liberal interpretation is used under the “mischief rule” only if the result is absurd. Before this rule can be applied, the legislation must be ambiguous, or misleading.

205 Roy Rohatgi, Case History for Tax Planners in India (International Tax Review, October 1997).

206 *CIT v Vishakapatnam Port Trust* (1983) 144 ITR 146 (India).

207 Karnataka High Court: *CIT v R M Muthaiah* 202 ITR 508 (India); Madras High Court: *CIT v S R M Firm* (1994) 208 ITR 400 (India).

208 *CIT v P.V.A.L. Kulandagan Chettiar* (2004) 267 ITR 0654 (India): In the Kulandagan Chettiar case, a tax resident in India owned rubber plantations in Malaysia, which were managed and controlled wholly in that country. The Indian Supreme Court held that the entity was resident in Malaysia under the treaty. Since there was no permanent establishment in India, the income was not taxable in India.

209 *The Tata Iron & Steel Co. Ltd v DCIR* (1998) ITAT (India).

210 *Union of India v Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India).

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In such cases, one may look at the intention of Parliament to determine what mischief the law was intending to prevent.

However, the UK Courts have taken a broad approach on treaty interpretations and used preparatory materials as an interpretation aid in many cases.²¹¹ They have applied the maxim “*ut res magis valeat quam pereat*” (so that the thing has validity rather than perishes) to give effect to the underlying treaty provisions.²¹² For example, the judge in the *Stagline* case²¹³ mentioned “the language of the rules should be construed on broad principles of general acceptation”. A similar view was also expressed in another UK case, where the judge stated that conventions are apt to be more loosely worded than Acts of Parliament.²¹⁴ In *Fothergill v Monarch Airlines Ltd*,²¹⁵ Lord Diplock said:

“The language of an international convention has not been chosen by an English Parliamentary draftsman. It is neither couched in the conventional English legislative idiom, nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than an act of Parliament that deals purely with domestic law. It should be interpreted unconstrained by technical rules of English law or by English legal precedent, but on broad principles of general acceptation”.

The Fothergill case involved the UK Carriage by Air Act, 1961. The Court held that “a strict literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty”. In case of ambiguity, “it may be possible to resolve the ambiguity by giving a purposive construction to the Convention, looking at it as a whole by reference to its language as set out in the relevant legislative instrument. The judges agreed that Courts may use the legislative history, the “*travaux préparatoires*”, the international case laws and the writings of jurists for interpretation of treaties. However, in their view, they should be used only as aids. They are not a substitute for the terms of a treaty and their use by the Courts is not mandatory, but discretionary. The Court also approved of the use of parallel judicial decisions in other countries. They mentioned, “the decision of a superior court, or the opinion of a court of cassation, will carry great weight”.

In the *Commerzbank* case, the UK Court also concluded that a strictly literal approach may be inconsistent with interpreting an international treaty and accepted the rules under the Vienna Convention. The treaty interpretation should look at the “clear meaning” in good faith, unconstrained by the domestic law. Supplementary means of interpretation may be used if the results are ambiguous, but in a discretionary, non-mandatory manner. The OECD Commentary, *travaux préparatoires* and foreign Court decisions on tax treaties have persuasive value only. Finally, “the primary necessity of giving effect to the plain terms of a treaty or construing words according to the general and ordinary meaning or their natural significance are to be the starting point or *prima facie* guide and cannot be allowed to

211 Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapter 3.09–3.15.

212 *Union Texas Petroleum Corporation v Critchley* (1988) STC 356 at 369 (UK).

213 *Stagline Ltd v Foscolo, Mango & Co Ltd.* [1932] AC 328 (UK).

214 *James Buchanan & Co v Babco Forwarding and Shipping (UK) Ltd.* [1978] AC 141 (UK).

215 *Fothergill v Monarch Airlines Ltd* [1981] AC 251 (UK).

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obstruct the essential quest in the application of treaties, namely, the search for the real intention of the Contracting parties in using the language employed by them".²¹⁶

In *Memec plc v IRC*, the Court of Appeal followed a similar approach. It held that a literal interpretation will be "inconsistent with the purposes of the provisions or treaty in question". Such interpretation should address a wider judicial audience in both Contracting States.²¹⁷

United States

The United States signed the VCLT in 1970. Although it has not ratified it yet, it accepts its principles under customary international law. The Courts usually adopt a liberal interpretation to give effect to the apparent intentions of the contracting parties²¹⁸ and the purpose of the treaty.²¹⁹ They also look at extra-textual materials such as legislative history in the Senate and Congress proceedings and the US Treasury reports, to implement congressional intent. This approach is arguably against the VCLT (or customary international law) since they are unilateral material.²²⁰

5. MODEL TAX CONVENTIONS

5.1. Historical Background²²¹

The first contemporary bilateral tax treaty on income and property was signed between Prussia and Austro-Hungary in 1899. After the First World War, the League of Nations took the initiative to evolve an internationally acceptable double tax treaty. In 1921, the Finance Committee of the Council of the League of Nations commissioned four eminent economists (Bruins, Einaudi, Seligman and Stamp) to study the issue of double taxation and tax avoidance. Their 1923 Report regarded double taxation as a barrier to new foreign investment, and considered that the function of the tax treaty was to promote such investment by removing this trade barrier. The treaty fulfilled this goal by preventing double taxation. Thus, the encouragement of foreign investment was the end and the avoidance of double taxation was just one of the means to achieve it.²²²

The Financial Committee of the League also appointed in 1922 a group of international tax officials to study the administrative and practical aspects of international double taxation and tax evasion.²²³ Several model tax treaties drafted by them were finally presented at a

216 *IRC v CommerzBank AG* [1990] STC 285 (UK).

217 *Memec plc v IRC* (1998) STC 754 at 766g-j (UK).

218 *Factor v Laubenthaler* 290 US 276, 293 (US); *Bacardi Corporation v Domenech*, 311 US 150, 163 (US).

219 *Estate of Burghardt v Commissioner* (1983) 80 TC 705, 713 (US).

220 Victor Thuronyi, Comparative Tax law, p. 119.

221 Manuel Pires, International Juridical Double Taxation of Income Kluwer law International, 1989) pp. 93–105; Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (United Nations, 2003), pp. 25–32.

222 See Joel Nitkman, Current Tax Treaty Cases of Interest (Tax Analysts, September 20, 1999) paras. 3–5. According to footnote 8 in his article, the above view was also held by the Fiscal Committee appointed by the League of Nations in 1929.

223 The group was set up in 1922 with senior tax officials from Belgium, Czechoslovakia, France, Italy, the Netherlands, Switzerland and the United Kingdom. In 1925, it was enlarged with members from Argentina, Germany, Japan, Poland and Venezuela. In 1927, the United States joined the group.

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General Meeting of Government Experts held in October 1928 in Geneva.²²⁴ In 1929, the Council of the League of Nations appointed a permanent Fiscal Committee. This Committee issued its draft Model Convention for the Allocation of Business Income between States for the Purposes of Taxation in 1933 (revised in June 1935). Although the 1935 Draft (Exhibit 5) was never formally adopted, it was subsequently combined with the 1928 Geneva Draft (Exhibit 4) to produce eventually the draft Mexico Model (Exhibit 6) in 1943.²²⁵ This draft treaty included both the prevention of double taxation and the allocation of taxing jurisdiction among its objectives.²²⁶

In March 1946, the Fiscal Committee met in London when a revised draft Model (Exhibit 7) was discussed at their tenth meeting.²²⁷ While the Mexico Draft approved source-based taxation and favoured capital-importing countries, the London Draft gave more taxing rights to capital-exporting nations, particularly on dividends, interest, royalties, annuities and pensions. The work of the League of Nations was taken over by the Fiscal Commission set up by the Economic and Social Council of the United Nations (ECOSOC) in October 1946. In 1951, the London Draft was abandoned in favour of the Mexico Draft. The subsequent efforts of the Fiscal Commission were unable to reconcile the taxing interests of the capital-exporting (or developed) and capital-importing (or developing) countries and it suspended its work in 1954.²²⁸

The Organisation for European Economic Co-operation (“OEEC”)²²⁹ took over the initiative in the late fifties. Its Fiscal Committee was requested to draft a Model treaty in 1956. From 1958 to 1961, the Committee prepared four interim Reports and finally published the first Draft Double Taxation Convention on Income and Capital (“OECD Model” or “OECD MC”) in 1963.²³⁰ The Fiscal Committee (renamed the Committee on Fiscal Affairs in 1971) evolved a Model treaty draft based on the 1946 London Draft. Its recommendations were adopted by the Council of the OECD in July 1963 (“1963 Draft”). A revised MC was published in 1977 (“1977 Model”). It was later revised in 1992 (“1992 Model”), and subsequently updated in 1994, 1995, 1997, 2000 and 2003 (Exhibit 1). A further update is expected in 2005. Since 1992, the MC and its Commentaries are published

²²⁴ During the period from 1923 to 1927, the group drafted several Model treaties. They included the Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes dealing with Income and Property Taxes (Exhibit 4), a Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties, a Bilateral Convention on Administrative Assistance in Matters of Taxation and a Bilateral Convention on Assistance in the Collection of Taxes.

²²⁵ The Second Regional Tax Conference held in July 1943 in Mexico adopted a Model Bilateral Convention for the Prevention of the Double Taxation of Income and a Model Bilateral Convention for the establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes. Both of them contained a related Protocol.

²²⁶ Although both objectives were (and are) meant ultimately for the encouragement of foreign investment, the preamble of the treaty today does not reflect this ultimate aim. (See footnote 222)

²²⁷ Detailed Commentaries on the London and Mexico drafts were issued by the Fiscal Committee subsequently. (Exhibit 8)

²²⁸ See Manuel Pires, *International Juridical Double Taxation of Income*, pp. 98–100.

²²⁹ This body was reconstituted as the Organisation for Economic Co-operation and Development (“OECD”) in September 1961.

²³⁰ The OECD published a Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Estates and Inheritances in 1966. The OECD Estate, Inheritance and Gift Model Convention was finally issued in 1982.

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by the OECD Committee on Fiscal Affairs in an ambulatory form (loose-leaf) to permit continuous future updates.

The OECD, as a group of developed countries, had similar taxing interests and tax treaty policies. Its Model treaty was intended for the use by its Member States, who had comparable tax systems and tax objectives, particularly on taxing rights of the State of residence. It was based essentially on two premises: (a) the country of residence would eliminate double taxation through the credit method or the exemption method; and (b) the country of source, in response, would considerably restrict the scope of its jurisdiction to tax at source and reduce the rates of tax where jurisdiction was retained.²³¹ Many countries felt that this approach did not address sufficiently the concerns of developing countries. The UN Manual states in its Introduction (Paragraph 15):

“Bilateral tax treaties have been negotiated in the light of various monetary, fiscal, social and other policies important to the negotiating parties. Conclusion of a treaty between two developed countries is facilitated by their approximately similar levels of development, so that the reciprocal flows of trade and investment – and hence the respective gain or loss of revenue to the parties from reducing taxes on those flows – have been relatively equal in magnitude. The presumption of equal reciprocal advantages and sacrifices underlying treaties between developed countries is not valid when the negotiating parties are at vastly different stages of economic development”.

The Fiscal Committee of the OECD also recognised as early as 1965 that its Model treaty was not appropriate for capital importing countries. Since income flows were largely from developing to industrialised countries, the revenue sacrifice was one-sided. This factor required greater allocation of taxing rights to the developing country in the various Articles of the Model.²³²

In the mid-1960s, the United Nations took renewed interest in the problem of double taxation “as part of its action aimed at promoting the flow of foreign investment to developing countries”.²³³ In August 1967, ECOSOC decided to set up an ad hoc working group to develop an appropriate framework for tax treaties between developed and developing countries and to provide guidelines for their negotiation. The committee called the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries comprising independent tax experts was appointed in 1968. The Committee’s efforts led to the UN Model treaty. The Group was renamed as the Ad Hoc Group of Experts on International Co-operation in Tax Matters and enlarged in 1980.²³⁴ The enlarged Group comprises 15 members from developing and 10 members from developed countries.²³⁵

231 UN Negotiation Manual, Part 1, para. 68.

232 UN MC: Introduction, para. 3; OECD Fiscal Committee, *Fiscal Incentives for Private Investment in Developing Countries: Report of the OECD Fiscal Committee* (OECD, 1965) para. 164.

233 UN MC: Introduction, Para. 32.

234 By its resolution 2004/69 of November 11, 2004, ECOSOC has now renamed the Group the Committee of Experts on International Co-operation in Tax Matters. The mandate of the Group has been broadened to include tax treaties between developed and developing countries and international co-operation in tax matters. Moreover, the Committee will meet every year (previously every two years).

235 The Ad Hoc Group is still active. In December 2003, it held its 11th Meeting in Geneva, Switzerland. For a brief account of its activities to date, read Ned Shelton, *Interpretation and Application of*

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The UN Model Convention between Developed and Developing Countries (“UN Model” or “UN MC”) was issued in 1980 with its own Commentaries. An updated version was adopted in January 2001 (Exhibit 2). A companion publication – Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries – was also published in 1979 (revised in 2003). The term “UN Model” does not imply that it contains formal recommendations of the United Nations.²³⁶

Besides the two Model Conventions, many countries also have their own “model” treaty, which they use mainly in their treaty negotiations. These “model” treaties reflect their treaty policy based on domestic tax system and negotiating objectives. Most of them are unpublished. Some examples include:

- The US Treasury Department published a Model Income Tax Convention in 1981, but withdrew it subsequently in 1992. A new US model treaty (“The 1996 United States Model Income Tax Convention” – US MC) was released in September 1996 (Exhibit 3). It offers insights into the US Treasury’s views on treaty interpretations, and its negotiating posture in tax treaties, particularly its right to tax its citizens and corporations on their worldwide income. It also contains a separate section with detailed explanations (“Technical Explanation”) The US Model reflects its domestic policy, as a major net capital exporter, on anti-abuse rules such as treaty shopping, tax sparing and CFC rules. It contains a detailed Limitation on Benefits Article (Article 23). It also provides a “saving clause” to retain the taxing rights over its own residents (Article 1(4)).²³⁷
- The Netherlands Model of 1987 is similar to the OECD MC. The Dutch model allows for source tax exemption of interest and royalties, for reciprocal relief for pension contributions, and for tax arbitration and mutual assistance in collecting taxes. The Model also provides for capital gains tax on substantial participations by nonresident individuals. The 1987 Model is provided with detailed explanations and subsequent updates.

The OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters (1988) provides compliance assistance to tax authorities on a multilateral basis. It applies to all kinds of taxes, including social security contributions, and assists in the recovery of taxes. The Convention came into force on April 1, 1995.²³⁸

The chronological history of the evolution of Model tax treaties over the years is as follows:

(a) League of Nations:

- 1928 – Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes (1928 Draft)
- 1935 – Double Taxation and Tax Evasion Convention for the Allocation of Business Income between States for the Purposes of Taxation (1935 Draft)
- 1943 – Bilateral Convention for the Prevention of the Double Taxation of Income with Protocol (Mexico Draft)

Tax Treaties (Lexis Nexis, 2004) pp. 531–534. Additional information is available on its website: <http://www.un.org/esa/ffd/ffdtaxation.htm>

²³⁶ UN Model Convention: Introduction, para. 35.

²³⁷ Victor Thuronyi, Comparative Tax Law, p. 120.

²³⁸ Asif H. Qureshi, The Public International Law of Taxation, pp. 350–363.

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- 1946 – Bilateral Convention for the Prevention of the Double Taxation of Income and Property with Protocol (London Draft)

(b) Organisation for European Economic Co-operation/Organisation for Economic Co-operation and Development:

- 1963 – Draft Double Taxation Convention on Income and on Capital (1963 Draft)
- 1977 – Model Tax Convention on Income and on Capital 1977 (1977 MC)
- 1992 – Model Tax Convention on Income and on Capital 1992 (1992 MC), as updated in 1994, 1995, 1997, 2000 and 2003. The next update is proposed in 2005.

(c) United Nations:

- 1979 – Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (1979)
- 1980 – United Nations Model Double Taxation Convention between Developed and Developing Countries (1980)
- 2001 – United Nations Model Double Taxation Convention between Developed and Developing Countries (2001)
- 2003 – Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (2003)

(d) United States:

- 1981 – United States Model Income Tax Convention (1981 with earlier Drafts in 1976 and 1977)
- 1996 – United States Model Income Tax Convention of September 20, 1996

5.2. How do Model Tax Treaties Work

The main objective of the Model tax treaties is to avoid simultaneous taxation in both countries under their domestic tax laws. They are an attempt to resolve some (but not all) of the problems of overlapping tax jurisdictions through internationally accepted tax rules. They recognise that each State is entitled to exercise its sovereign taxing rights within its fiscal jurisdiction. To avoid double taxation, the States must agree to limit their own domestic tax rules under the tax treaty.

The Model tax treaty contains classification and assignment rules (also called “distributive rules”) for income subject to taxation under the domestic law of both States. Under a schedular system, tax objects (e.g. income, profit, capital) are placed in income categories with specified treaty “source rules” to avoid source conflicts, and the taxing rights over them are then allocated through the “assignment rules” to one or both of the Contracting States. The schedular structure of the Model treaties categorise different classes of active and passive income. These income categories are further sub-divided into various types of business and investment income. Active business income is usually allocated to the source State and passive investment income to the residence State. The State to which the taxing rights are not assigned either exempts or taxes the income with credit for the taxes paid in the other State.

Under the treaty distributive rules, there are more than fourteen categories of income that cover the entire tax base. They comprise of standard clauses (called Articles), which

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may be amended in negotiations by the Contracting States. These Articles may be grouped under:

- Personal scope – The treaty applies to tax residents of one or both Contracting countries under the respective domestic laws.
- Material scope – The treaty includes income and capital taxes at federal, state and municipal levels, irrespective of the manner in which it is imposed.
- Territorial scope – The treaty specifies the geographical area or tax jurisdiction covered under the tax agreement.
- Temporal scope – Generally, the duration of the treaty is indefinite once the treaty is ratified, but it can be terminated or renegotiated as and when required.
- Distributive rules – The treaty provides the rules for the avoidance of double taxation on income or capital.
- Method of relief – The Articles contain the recommended methods for relief in cases of double taxation between the two tax jurisdictions.

The Model treaties distinguish the income under each Article and then specify the State, which has the right to tax them under its “assignment rules”. The “assignment rules” allocate either an exclusive or a limited taxing right to the two countries, using one or more of the following distributive principles on different income sources:

- The exclusive right to tax is with the country of source of the object.
- The source country reserves the right to limited or “shared” taxation of the object.
- The source country may tax fully but does not have exclusive taxing rights.
- The exclusive right to tax is with the country of residence of the subject.

Thus, under these rules the source State bears the tax costs (i.e. loss of tax revenue), in cases where the State of residence has exclusive taxing rights. The State of residence bears the costs when the State of source has exclusive taxing rights, and when both States retain the full rights to tax. The residence State is obliged to grant treaty relief for the foreign taxes paid. In cases where both States share their taxing rights, the cost of eliminating double tax is also shared. In summary, the treaty provides a tax-sharing agreement between two Contracting States. The States either receive or give up their taxing rights on various heads of income, and then obtain a commitment from the State of residence to relieve any juridical double taxation.

Model tax treaties are relieving in nature. Most of its provisions are designed to create rights and benefits for taxpayers where none would otherwise exist. They allocate taxing rights but do not make the tax rules, which are based solely on domestic law.²³⁹ They do not require that the allocated taxing rights must be exercised by a State or dictate how they must be exercised. The use of treaties is also optional since the taxpayer can choose in many countries to apply the domestic tax law if it is more beneficial. The Model treaties may reduce but normally do not increase the taxing rights under the domestic law of each State.

²³⁹ There are a few countries (Examples: Australia, France) where tax treaties can expand the areas of domestic tax liability under their constitutional laws.

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Conflict rules under international law determine which law applies when a transaction or event is subject to two or more legal systems. According to Vogel, tax treaties, unlike conflict rules in private international law, do not have to choose between applicable domestic and foreign law. Each Contracting State applies its own domestic law and then limits the application of that law under the treaty. Treaties establish an independent mechanism to avoid double taxation through a restriction of tax claims in areas where overlapping tax claims are expected, or are at least theoretically possible.²⁴⁰

Therefore, strictly speaking, there are no taxing rules under international law. Treaty rules neither allocate taxing rights, nor resolve tax conflicts, nor do they provide source rules under international tax law.²⁴¹ As a bilaterally negotiated treaty, a treaty only creates obligations under international law to impose certain limits on the domestic tax provisions of the Contracting States. Thus, they are an extension of domestic tax rules affecting international transactions that are binding under international rules governing treaties. A tax treaty can be regarded as a *lex specialis* (e.g. special case) of domestic tax law.

5.3. Relief against Juridical Double Taxation

According to the OECD MC Introduction (para. 3), the main purpose of the Model Tax Convention is to provide “a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation”. As mentioned above, tax treaties provide for the relief to be given by the residence State for juridical double taxation. Unless the source State agrees to forego or limit its rights under a tax treaty, it exercises its rights first, as and when the taxable income arises. The country of residence is then obliged to give relief to avoid the double taxation.

There are two methods for the State of residence to relieve double taxation of income.²⁴²

(a) **Exemption method:** This method avoids or eliminates double taxation by exempting the income from tax in the residence State. It may be “full exemption” or “exemption with progression”.²⁴³ The exemption may be conditional on the levy of tax by the source State under the treaty. However, as treaties allocate taxing rights, and not taxation, double non-taxation can arise.

(b) **Credit method:** This method prevents or partly eliminates double taxation in the State of residence through the grant of credit for taxes paid in the source State. The tax credits could be based on:

- Ordinary or partial credit (i.e. limited to the amount of tax due on equivalent income, as computed under the domestic tax rules).
- Indirect credit for the underlying tax levied in the source State on dividend income.

240 Klaus Vogel, Double Taxation Conventions (Kluwer Law International, 1997) Introduction, m.no. 45a–45c.

241 O’Hanlon J: A treaty does not impose an obligation on either Contracting State to introduce or continue any form of taxation, but merely regulates the position when such taxation is imposed (*Murphy (Inspector of Taxes) v Asahi Synthetics Fibres (Ireland) Ltd.* [1985] IR 509, 516 (Ireland)).

242 See Chapter 4(8).

243 The income is included in the tax base of the taxpayer to determine the overall tax rate and the amount of tax. The taxpayer is then allowed a pro rata tax deduction for the exempt income. Since corporate tax is commonly levied at a fixed rate, the exemption from progression usually effects the taxation of individuals.

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- Tax sparing or matching credit for the tax not levied (i.e. “spared” by the source country) due to incentives or allowances. Tax sparing is a concession to ensure that the foreign tax incentives granted to attract foreign investment capital for particular activities are not recaptured by the residence State.

Both exemption and credit methods of double tax relief have advantages and disadvantages. For example:

(a) Exemption method

Advantages:

- It is capital-import neutral, i.e. it treats all taxpayers in the source State on the same tax basis.
- It recognises fully the tax benefits granted by the source State.
- It is the least complex administratively.
- It avoids dealing with two tax authorities.
- It eliminates actual and potential double taxation.

Disadvantages:

- It reduces the tax revenues due to the State of residence.
- The source State may deny certain allowances or deductions.
- The losses of the permanent establishment may be disallowed by the residence State
- It requires detailed financial Statements if exemption is given with progression.
- It encourages the use of low-tax countries or tax havens as source or residence States.

(b) Credit method

Advantages:

- It is capital-export neutral, i.e. it treats all taxpayers in the residence State on the same tax basis.²⁴⁴
- It allows the deduction of foreign losses of permanent establishment in the home country.
- It discourages the transfer of assets or income to low-tax countries or tax havens.
- It is easy to apply since the tax authority giving the tax credit computes the amount under its own laws and does not have to consider the foreign tax system.

Disadvantages:

- The taxpayer always pays the greater of foreign and domestic taxes.
- It could lead to excess foreign tax credits that may not be useable.
- It eliminates the tax relief and incentives given in the source State, unless the residence State spares the tax.
- It makes the export of capital less attractive.
- It is complicated and can be time-consuming.

The choice often depends on the national policy on capital export neutrality or capital import neutrality. Many developed countries prefer the credit system since it is capital-export neutral and treats both domestic and foreign investors fiscally on par. The exemption

²⁴⁴True capital export neutrality requires that the shareholders are taxed on the entire income of a foreign subsidiary on an accrual basis. Accrual taxation under the CFC rules is usually restricted to passive investment income.

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method is capital-import neutral. Unlike the credit method, tax exemption eliminates both factual and potential double tax.

Tax treaties restrict the taxation in one or both Contracting States but may not eliminate double taxation in all cases. For example:

- Tax conflicts could arise because of differing definitions of terms, under the treaty and the domestic law. This problem may become an issue when there is no autonomous or treaty definition and the domestic laws of the two States do not have a common or clear definition of the terms used in the tax treaty. As a result, the same income may be categorised or classified under two differing treaty provisions.²⁴⁵
- The Contracting States may interpret the same treaty provision differently and arrive at differing conclusions on its applicability. As a result, the residence State may not provide relief for source taxes leading to double taxation.
- The two Contracting States may apply different treaty rules on the same income due to differing treaty interpretations arising from overlaps in the treaty rules or unclear provisions.²⁴⁶
- Double taxation could also arise under the credit system, despite the treaty relief. For example, since the credit is based on the equivalent tax in the residence State under its domestic tax rules, the differences in how the tax is computed could lead to disallowed tax credits for the foreign taxes suffered.
- Tax treaties normally do not relieve economic double taxation.²⁴⁷

5.4. Benefits of the Model Tax Treaties – Some Examples

The benefits of the Model tax treaties include:

- They facilitate international trade and investment by eliminating tax impediments under the domestic tax laws of countries on cross-border income flows. They assist global taxpayers chiefly, but not exclusively, to avoid double taxation through provisions that restrict the domestic taxing rights of each Contracting State, and provide tax relief when it arises.
- They provide an internationally accepted format for drafting and negotiating bilateral agreements affecting income taxes. The treaty text classifies the income by type of income and source and provides the rules to assign or distribute them between the Contracting States. In the case of juridical double taxation, it specifies the method of relief that can be used for eliminating them. The treaty applies to all income taxes, including taxes imposed by provincial or state, local and subnational bodies.²⁴⁸
- They provide for a negotiated division of taxing rights over foreign source income of residents under an internationally accepted agreement governed by customary

²⁴⁵ John F. Avery Jones, *Problems of Categorising Income* (International and Comparative Taxation, Kluwer Law International, 2002) pp. 9–27.

²⁴⁶ Kees van Raad: *International Co-ordination of Tax Treaty Interpretation and Application* (Intertax, June/July 2001) pp. 212–218.

²⁴⁷ OECD Commentary: Article 23, paras. 1–2.

²⁴⁸ OECD MC: Article 2(1).

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international law. In particular, they set out the ultimate limits of the taxing powers under the domestic laws of the two States involved. Although the allocation of taxing rights remains a primary consideration in all treaties, it cannot be done unilaterally.

- They provide certainty over source rules. These rules avoid conflict with domestic source rules, if they are different, and ensure relief from double taxation in the residence State. As an internationally accepted agreement, they also restrict the rights of the tax authorities and thereby avoid ad hoc decisions taken by them.
- They provide certainty over time for taxpayers and assure international investors of a stable tax system. On average, the tax treaties of OECD countries remain unchanged for 15 years after they are signed or after a protocol is concluded, unless they are terminated, renegotiated or overridden.²⁴⁹ In most countries, changes in domestic tax laws are made every year. Since treaties generally override domestic law, the treaty guarantees the taxpayers that future increases in taxes over the treaty limits will be restricted.
- They eliminate discriminatory taxation of foreign nationals (including stateless persons) and nonresidents and provide a mechanism to resolve tax disputes through mutual consultations. They also help the tax authorities in the prevention of tax evasion through the exchange of tax-related information. A recent addition to the treaty (Article 27) also permits them to request assistance in the collection of taxes.
- They avoid excessive taxation in source States. The treaty provisions require the source State to grant selective tax benefits (e.g. reduced withholding taxes) and tax exemptions, based on negotiations, to the residence State. Moreover, as treaties are primarily relieving in nature, they do not impose tax. Generally, tax treaties cannot make the taxpayer worse-off than he would be under the domestic tax law.
- They assist global tax planning on cross-border transactions.
- Tax treaties are needed because national tax laws of various countries differ.

5.5. OECD and UN Model Conventions – Comments

What differentiates the UN MC from the OECD MC is the primary objective of each Model. The OECD MC mentions in its Commentary that “the principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion”.²⁵⁰ The UN MC takes a broader view of taxation as a means to promote the flow of foreign investment to developing countries. It mentions in its Introduction (paragraph 44): “there is a need for international and regional organisations to provide guidelines to facilitate conclusion of tax treaties with a view to promote trade liberalisation and expansion as well as socio-economic growth”. It is a tool for economic growth and not just an agreement for the sharing of taxing rights.

Developing countries using the UN MC often (but not always) mention the promotion of mutual economic relations, trade and investment as one of the objectives of their tax

²⁴⁹ Jacques Sasseville, Improving the Flexibility of Tax Treaties (IBFD Bulletin, June 2002) pp. 271–272.
²⁵⁰ OECD Commentary: Article 1, para. 7.

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treaties.²⁵¹ This objective gives the treaty a wider perspective than just avoidance of double taxation. It justifies double non-taxation when countries give up their taxing rights, in cases such as tax sparing. It also permits tax treaties with countries that do not levy direct taxes on some or all of its residents.

The wider objectives of the UN MC also permit intended treaty shopping to meet non-fiscal goals through tax treaties.²⁵² Like tax sparing, this could provide tax benefits to the foreign investor when as a source country it is prepared to give up its taxing rights for other non-fiscal benefits. According to a recent Indian Supreme Court decision, treaties “are negotiated and entered into at a political level and have several considerations as their bases”. The latter may be political, social or economic in nature. In case of treaty abuse due to unintended use of a tax treaty, the Court held that this should be dealt with through specific Limitation on Benefits clause in the treaty.²⁵³

The drafters of the OECD Model assumed that the countries have more or less the same tax bases and the same tax systems.²⁵⁴ The UN Model is meant for treaties between countries with unequal economic status. While the OECD MC presents the views of developed countries and advocates CEN and residence taxation, the developing countries as net capital importers generally prefer CIN neutrality and more source taxation.²⁵⁵ They also prefer the UN MC for its wider treaty policy objective than just taxation and tax sharing, i.e. to promote social and economic growth. For developing countries, treaties are a means to an end and not an end in itself.

Model tax treaties deal with direct taxation only. The treaty objectives are also affected by the different policy on direct taxation of developing countries when compared with developed countries. Moreover, direct taxation often does not constitute the main source of government revenue and is considered both less significant and more cumbersome and costly to collect. As many developing countries rely more on indirect taxation, they can justify low or nil direct taxes under the domestic law and/or tax treaties for wider policy reasons.²⁵⁶

The UN MC is widely used by developing countries as a treaty policy document that favours source-based taxation and non-fiscal objectives. Its provisions are also found in many treaties concluded by transition countries in Eastern Europe. The UN MC has also influenced the tax treaty policy of several OECD Member States.²⁵⁷ Nevertheless, the reputation of the OECD Committee on Fiscal Affairs and its research on international tax issues is recognised. The developing countries often rely on the OECD MC and its

251 Many of the Indian tax treaties contain words such as promotion of mutual economic relations (or similar words).

252 Many developed countries also encourage treaty shopping through their jurisdiction to enable multinationals to establish holding companies and other business activities.

253 *Union of India and Anr. v Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India).

254 Peter J. Wattel and Otto Marres, Characterisation of Fictitious Income under OECD-Patterned Tax Treaties (European Taxation, March 2003) p. 69.

255 Unlike the OECD MC, the UN MC may not favour controlled foreign corporation rules intended to achieve capital export neutrality, as treaty policy.

256 Victor Thronyi, Comparative Tax Law (Kluwer Law International) p. 11.

257 Willem Wijnen and Marco Magenta, The UN Model in Practice (IBFD Bulletin, December 1997); Hugh Ault and Brian Arnold (ed.), Comparative Income Taxation, p. 428.

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Commentaries for guidance on issues involving treaty interpretation, where necessary, to supplement the UN MC Commentaries.²⁵⁸

Tax treaty policy of countries is influenced by their political, economic and social needs. While OECD Committee on Fiscal Affairs performs an excellent role as an international “think tank” on tax-related technical issues, its views on tax treaty policy understandably favour its Member States. To be a legitimate international body, the OECD should take into consideration and meet the expectations of both developed and developing countries and act, as well as be seen to act, in their overall interest. Moreover, it should involve all of them in the formulation of its views. Only a truly world tax organisation can fulfil such an ideal goal.²⁵⁹

6. MULTILATERAL TAX AGREEMENTS

6.1. General

There have been several efforts to agree on a multilateral tax treaty. In 1958, the OEEC Fiscal Committee attempted to draft a multilateral convention but was unsuccessful due to the difficulties of definition and application. Similar conclusions were also reached by the UN Group of Experts when drafting the UN Model Convention.²⁶⁰ A preliminary draft multilateral tax treaty, prepared in 1968 by the European Economic Community, has still not been pursued further. An EFTA working party concluded in 1969 that there were more disadvantages than advantages in a multilateral convention, compared with bilateral tax treaties, in terms of complexity and flexibility.²⁶¹

Multilateral treaties tend to be complex and difficult to apply and understand. They also require a reasonable degree of uniformity in the domestic tax systems of the various countries and in the application and interpretation of the treaties by them. Nevertheless, several regional groups of countries have entered into limited multilateral tax arrangements.

6.2. Andean Pact

Five South American countries²⁶² are members of the Cartagena Agreement of 1969, which established a sub-regional common market in Latin America. They signed a model multilateral tax treaty called the “Andean Pact” (Exhibit 9) in 1971. It aims at a common tax regime for foreign capital, patents, trademarks, licences and royalties among its members.

The Andean Pact is primarily based on the territorial or source tax principle. It gives the source State exclusive taxing rights. The profits are taxable in the State where the business

258 A number of developing countries have published their position regarding the OECD MC and Commentaries. (See Chapter 3(1.2))

259 Ned Shelton, *Interpretation and Application of Tax Treaties*, pp. 534–542.

260 Model Double Taxation Convention Between Developed and Developing Countries (1980) ST/ESA/102, p. 3.

261 Report of the Working Party: The Feasibility of a Multilateral Double Taxation Convention Within European Free Trade Area (EFTA 64/69, 1969).

262 The five members of the Andean Pact are Bolivia, Colombia, Ecuador, Peru and Venezuela. Chile is no longer a member.

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activities are undertaken. The concept of a permanent establishment is, however, retained. The income from personal services is taxable in the country where the work is performed. The sole right to tax royalties is reserved for the country where the technology is used. Only the country in which the property is situated at the time of its disposal taxes capital gains. There is also a provision for exchange of information and mutual assistance on tax matters among the member countries.

6.3. CARICOM Multilateral Tax Agreement

Several Caribbean countries²⁶³ renegotiated the CARICOM double tax agreement in 1994. It replaced an earlier multilateral tax agreement signed in 1973. The agreement applies to internal transactions within the member countries, and lays down common guidelines for them in their treaty negotiations with non-members. It meets the objectives of the Treaty of Chaguanas to encourage free trade and movement of capital within the member countries and to harmonise their economic policies.

Like the Andean Pact, this agreement relies on the source or territoriality-based taxation in preference to the residence-based OECD MC. Therefore, the income is taxable only by the Member State where the income arises. Some of the specific treaty provisions include zero withholding on ordinary dividends. The maximum withholding rate on preference share dividends, interest, royalties and management fees is limited to 15% rate. Management fees (excluding independent professional services) are taxable in the source country at a rate not exceeding 15%. There is no limitation on benefits or beneficial ownership requirements for treaty benefits.²⁶⁴

6.4. Nordic Convention

The Nordic countries (Denmark, Finland, Faeroes Islands, Iceland, Norway and Sweden) in Europe have a multilateral tax convention for double tax avoidance and mutual assistance on tax matters. A revised multilateral treaty was signed in 1989. Generally, the Nordic treaty follows the OECD MC but with certain local variations.

The treaty provides for zero rate withholding tax, subject to certain exceptions, on the dividends paid by qualifying subsidiaries to qualifying parent companies within the Nordic region. It also contains special provisions to prevent “double tax exemption”. If the taxing rights allocated to a Contracting State cannot be exercised by the State under its domestic law, they revert to the other Contracting State. Interest is only taxable in the State of residence, while pensions and annuities are taxable solely in the paying State. Exploration activities

²⁶³The CARICOM member countries currently are Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Surinam, and Trinidad and Tobago.

²⁶⁴Bruce Zagaris, The 1994 CARICOM double taxation agreement (IBFD Bulletin, September 1996); Huub Bierlaagh, The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation (IBFD Bulletin – Tax Treaty Monitor, January 2000); Amos Peters, Exploring Caribbean Tax Structure and Harmonisation Strategies (IBFD Bulletin, May 2002) pp. 178–193.

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for 30 days in a 12-month period in the continental shelf of a Nordic country constitute a permanent establishment or a fixed base.

6.5. Council for Mutual Economic Assistance Agreement (“CMEA”)

Several East European countries²⁶⁵ signed a mutual economic assistance agreement in 1949. Although the CMEA (Council for Mutual Economic Assistance or COMECON) no longer exists, the two multilateral tax treaties, which were concluded in the late 1970s, have not been renounced. It still applies to Bulgaria, Mongolia and the countries of the Commonwealth of Independent States, except Georgia and Kazakhstan.²⁶⁶

The first treaty signed in 1977 deals with individuals; a similar treaty was concluded in 1978 for legal entities. The latter treaty applies to entities that have their legal seat in a country within the COMECON. It grants the residence State the exclusive taxing rights on all income and capital with no withholding taxes on dividends, interest and royalties in the source country. As an exception, the income from immovable property follows the taxation based on situs. Special rules apply to international economic organisations set up under a separate charter or under a bilateral or multilateral agreement. The treaty does not contain any provisions for the avoidance of double taxation or tax discrimination.²⁶⁷

6.6. Others

Other multilateral tax arrangements include the Central African Economic and Customs Union (UDEAC) in Africa.²⁶⁸ They provide for source taxation of employment income, dividends and commercial profits of permanent establishments. Interest and royalties are usually taxed in the residence State. Another similar multilateral tax treaty exists among the members of the West African Economic and Customs Community. Certain Arab countries signed a treaty in 1973 to establish a mutual double tax avoidance arrangement (Egypt, Iraq, Jordan, Kuwait, Sudan, Syria and the Arab Republic of Yemen).

7. EUROPEAN UNION

7.1. General

Several European countries established a common market under the Treaty of Rome (effective from 1958). This European Economic Community was eventually superseded by the Treaty of European Union (also called the Treaty of Maastricht or EC Treaty), which

²⁶⁵The countries comprised Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Mongolia, Poland, Rumania and USSR.

²⁶⁶The CIS countries include Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Moldavia, Russia, Turkmenistan, Ukraine and Uzbekistan.

²⁶⁷Willem G Kuiper, The Multilateral CMEA Tax Treaty – Its Relevance Today (IBFD European Taxation, August 1991).

²⁶⁸The present members of the Central African Economic and Customs Union (UDEAC) comprise Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon.

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entered into force in November 1993 to create a single European Community (EC). One of the main objectives of the Rome treaty was to eliminate internal trade and tariff barriers and create a Single Market. The EC Treaty established a single economic and monetary union based on the four fundamental freedoms that guarantee free movement of goods, persons, services and capital under the Single European Act of 1987.²⁶⁹ As from May 1, 2004, the European Union comprises of twenty-five Member States.

The EC Treaty contains several provisions that affect domestic taxation of Member States. They include:

- Establishment of a common market (Article 2);
- Development of an internal market without barriers on free movement of goods, persons, services and capital (Article 14);
- Co-ordination of national tax laws to develop a Single Market (Article 3(h)); and
- Prohibition of discrimination on grounds of nationality (Article 12).

In the area of taxation, the European Union has been successful in the harmonisation of value added taxes. It has been achieved through nearly 30 Directives²⁷⁰ of the EC Commission and over 300 rulings given by the European Court of Justice (ECJ). The Sixth Directive issued in 1977 (effective 1978) established a common VAT system with a uniform basis for assessment. Under a 1993 Directive, the Commission implemented a system based on a mixture of origin and destination principles.²⁷¹ Although Member States decide their own VAT rates, a 2001 Directive has set the minimum standard rate at 15%. The 2002 Directive on electronic commerce transactions was enforced from July 2003.

The early progress on direct taxes was slow since changes require a unanimous agreement of all Member States. In 1990, the Commission adopted the Parent-Subsidiary Directive, the Merger Directive and the Arbitration Convention (see below). The European Union also set up a Committee to assess the need for greater tax harmonisation. The Ruding Committee Report,²⁷² released in 1992, contained a number of recommendations on company taxation within the European Union. They included the elimination of withholding tax on cross-border inter-corporate dividends, interest and royalties, the broadening of the scope of the Parent-Subsidiary Directive, the harmonisation of the corporate taxable base, and levels of minimum and maximum corporate tax rates. The Report also recommended an expansion of the tax treaty network within the European Union and suggested guidelines for negotiation of treaties with non-EU countries.

²⁶⁹ The fundamental freedoms under the EC treaty are the free movement of goods, the free movement of persons, the freedom of establishment, the free movement of services and the free movement of capital and payments. The treaty also prohibits discrimination on ground of nationality.

²⁷⁰ Most of the tax-related measures have been introduced through various Directives of the European Commission. They are binding on the Member States and require them to amend their domestic laws accordingly.

²⁷¹ Under the various Directives and rulings, non-taxable persons (largely individuals) follow the origin principle and VAT is charged on them on intra-EU transactions only in the country of purchase. Transactions with taxable persons (e.g. businesses) are levied under the destination principle where the importer pays input VAT and then recovers it from his domestic customers on resale.

²⁷² Report of the Committee of Independent Experts on Company Taxation – Chairman, Onno Ruding (European Communities, Luxembourg, 1992).

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Recent progress has been more rapid. The Commission has now taken steps to eliminate measures that distort competition either under its Code of Business Conduct (see below) or as illegal State Aid. The Competition Directorate of the European Commission published its guidelines concerning State Aid (referred to in Articles 87–89 of the EC Treaty) in November 1998.²⁷³ They are designed to curb and remove State Aid that distorts or threatens to distort competition, otherwise called illegal State Aid, by favouring certain undertakings or production of certain goods. Unlike the Code of Conduct, State Aid provisions apply only to the Member States and not to their dependent territories. Moreover, they apply to companies, certain products and regional areas and include several exceptions.²⁷⁴

Most Member States and their dependent and associated territories have now introduced revised or replacement measures for illegal State Aid, subject to certain transitional provisions. For beneficiaries of those regimes on or before December 2000, a “grand-fathering” clause has been provided under which benefits have to lapse no later than end of 2005, independently of whether or not they were granted for a fixed period. Some extensions of benefits for defined periods beyond 2005 are also permitted for the old tax regimes in Member States and their dependent and associated territories.²⁷⁵

The European Court of Justice (ECJ) has also over recent years given several decisions to safeguard the four fundamental freedoms and to prevent tax discrimination against nationals of Member States. Under these decisions, they must be treated equally with own nationals for tax purposes. The ECJ has taken a purposive interpretation based on the European legislative history as well as the legislative intent of the EU Directives. The Court has made exceptions only in special cases where they appropriately serve a legitimate public interest. The ECJ decisions are binding on the Member States and have forced several changes in their domestic tax laws.²⁷⁶

The Commission has also adopted regulations for a European Company (*Societas Europaea*) in October 2001 that became operational for use on October 8, 2004. Under the European Company statute, a European Company can be set up by the creation of a holding company or a joint subsidiary or by the merger of companies located in at least two Member States or by conversion of an existing company set up under national law. As of October 2004, only Austria, Belgium, Denmark, Finland and Sweden had taken steps to allow European companies. There is no special tax regime for them yet. Discussions are also in progress on home state taxation. Under this proposal, EU multinationals will file a tax return of the parent company consolidated with all its EU subsidiaries and branches under the tax law of its home state.

273 State aid is defined as tax measures that reduce the tax base (special deductions, depreciation, reserves, etc.) or reduce the amount of tax (exemption or credit) or defer, cancel or restructure a tax liability.

274 Christiana Palayi, Limitations on Benefits and State Aid (European Taxation, February/March 2004) pp. 87–88.

275 European Commission Release on June 3, 2003.

276 Mark Persoff, The Impact of EU Developments on Member States' Tax Systems (International Tax Review, February 2004) pp. 10–14; Hubert Hamaekers, Taxation Trends in Europe (IBFD Asia-Pacific Tax Bulletin, February 2003) pp. 42–50.

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7.2. Business Code of Conduct

In the ECOFIN²⁷⁷ meeting of 1997, a Code of Conduct was approved by the EC Council of Ministers. Unlike EC legislation or a Convention, the Code is not legally binding. The Code covers tax measures (legislative, regulatory and administrative) that have, or may have, a significant impact on the location of business in the European Union and unfairly reduce the tax revenue of Member States. It requires Member States to voluntarily refrain from introducing any new harmful tax measures (“standstill”) and amend any laws or practices that are deemed harmful in respect of the principles of the Code (“rollback”). The criteria for identifying potentially harmful measures include:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group that depart from internationally accepted rules, in particular those approved by the OECD; and
- lack of transparency.

The Code of Conduct Group (Business Taxation) was established on March 9, 1998 (chaired by Ms. Dawn Primarolo, UK Paymaster General) to assess the tax measures that may fall within the scope of the Code of Conduct for business taxation. In 1999, the Group identified 66 tax measures with harmful features (40 in EU Member States, 3 in Gibraltar and 23 in dependent or associated territories). While the Code attempted to harmonise the tax base of Member States it did not regard competition on tax rates as harmful.

In June 2003, the EU finance ministers (ECOFIN) included the Code of Conduct as part of a tax package comprising:

- the Code of Conduct for business taxation to amend, phase out or remove certain tax incentives given by EU Member States and their dependent and associated territories that were identified as harmful tax competition;
- a Directive to abolish withholding taxes on interest and royalties between EU group companies, as from January 2004 (“Interest and Royalties Directive”); and
- a Directive to ensure taxation of interest income of individuals either through exchange of information or interest withholding tax, as from January 2005 (“Savings Directive”).

7.3. European Union Tax Directives

Some of the major Directives issued by the European Union so far on direct taxation include:

(i) Parent-Subsidiary Directive (1990)

The European Union adopted the Parent-Subsidiary (Dividends) Directive (90/435/EEC) in 1990. This Directive avoids the double tax on dividends and other distributions paid

²⁷⁷The ECOFIN Council comprises of the ministers of economic and financial affairs from the EU Member States.

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by subsidiaries to parent companies (not individuals) that are located in two different Member States. The provisions were recently amended by Directive 2003/123/EC dated December 22, 2003 that are enforceable on all Member States by 1 January 2005. See Chapter 5(5.4).

(ii) Savings Directive (2003)

The Savings Directive (2003/48/EC) was finally adopted in June 2003 for implementation by end of 2004. The aim of the Directive is to ensure that savings income is effectively taxed when paid within the European Union. The EU Directive also applies to associated and certain dependent territories of EU Member States. They include Jersey, Guernsey, Isle of Man, Cayman Islands, British Virgin Islands, Monserrat, Turk and Caicos Islands and Anguilla among the British dependencies and the Netherlands Antilles and Aruba as Dutch dependencies.

The Directive requires Member States to permit automatic exchange of information for monitoring the tax collection on cross-border interest payments to European Union residents without requiring reciprocity. The Directive applies only to the savings income of individuals and not to the interest payments made to companies or trusts. Moreover, it excludes interest paid to beneficial owners who are nonresident in the European Union.

The Directive has a broad scope, covering interest from debt-claims of every kind, including cash deposits and corporate and government bonds and other similar negotiable debt securities. The definition of interest extends to cases of accrued and capitalised interest. This includes, for example, interest that is calculated to have accrued by the date of the sale or redemption of a bond of a type where normally interest is only paid on maturity together with the principal (a so-called “zero-coupon bond”). The definition also includes interest income obtained from indirect investment via collective investment undertakings (i.e. investment funds managed by a specialist fund manager who places the investments made by individuals in a diverse range of assets according to defined risk criteria).

As a transitional measure, three States (namely, Austria, Belgium and Luxembourg) are permitted to apply a withholding tax on interest payments.²⁷⁸ The rates are 15 percent for the first three years (2005–2007), 20 percent for the next three years (2008–2010) and 35 percent thereafter (2011 onwards). Those three countries will transfer 75 percent of the revenue to the residence country. This arrangement will be reviewed in 2010 or later. The recipient of the interest income has the option to avoid the withholding tax if he gives his consent to exchange of information. Otherwise, the final paying agent must provide the details of the beneficial recipient within the European Union to the tax authorities.

The transitional period continues unless certain conditions are met. Firstly, the European Union must have reached agreement with five non-EU countries, namely Switzerland, Liechtenstein, San Marino, Monaco and Andorra, to exchange the information about interest payments. These countries must adopt measures equivalent to those in the Directive for the EU Member States to be bound by their agreement. The European Union has accepted that

²⁷⁸ Several of the associated and dependent territories of the EU Member States have also elected for the withholding tax regime during the transitional period.

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the commitment by the United States to disclose information upon request (not automatic) constitutes “equivalent measures”.

The EC Council announced in June 2004 that the exchange of information should be on as wide a basis as possible in line with international developments. Moreover, this Directive should be introduced as part of the Member States’ national laws.²⁷⁹ The Commission reached agreement with the five non-EU countries, including Switzerland, subsequently. On July 19, 2004, the Council announced that the Directive should be applied as from July 1, 2005.

(iii) Interest and Royalty Directive (2003)

The European Commission issued its Directive (2003/49/EC) on cross-border payments of interest and royalties between associated companies in June 2003. It eliminates the taxes levied by source States, through either withholding or assessment, on qualifying intra-group payments of interest and royalties between associated companies and permanent establishments of Member States. Under the Directive, the interest and royalties are taxable only in the Member State where the companies receiving the payments as beneficial owner are located. The Directive does not apply on payments to entities outside the European Union or in cases of tax avoidance or abuse, or to a permanent establishment of a Member State located in a third State. (Article 1, Para. 8).

The Commission made amendments in December 2003 to provide that the exemption applies only if the recipient is subject to tax on the income. No specific level of taxation is required. In addition, the Directive now includes entities covered under the 2003 amendments to the Parent-Subsidiary Directive. The Directive is enforceable as from January 2004, except for the late 2003 amendments for which the latest implementation date is December 31, 2004. Transitional periods have been granted to Greece, Portugal and Spain, and also to Latvia, Lithuania, Czech Republic, Poland and Slovak Republic, who joined the European Union in May 2004.

To qualify as an associated company under the Directive, there must be a direct minimum holding (or voting rights) of 25% of the paying company by the receiving company or vice versa, or a third company must own at least 25% of both companies. All the companies must be tax resident in the Member States. The Directive, however, provides for certain exclusions (Articles 4 and 5) when the Directive is not applicable.²⁸⁰

(iv) Merger Directive (1990)

The Merger Directive (Directive Number 90/434/EEC of July 23, 1990) deals with the taxation applicable to mergers, divisions, transfers of assets and exchange of shares by companies within the EU Member States. It provides for a tax-free transfer of assets and shares on mergers by companies that are resident in the European Union. The two principal

²⁷⁹ European Commission Release on June 3, 2004.

²⁸⁰ Marcello Distaso and Raffaele Russo, *The EC Interest and Royalties Directive – A Comment* (*European Taxation*, April 2004) pp. 143–154; Philippe de Clippel and Benoit Verschueren, *Interest and Royalties Directive Moves to Full Enactment* (*International Tax Review*, May 2004) pp. 33–38.

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provisions include:

- (a) The State of the transferring company will not recognise any taxable gains upon the transfer of assets and liabilities in a merger or asset transfer. The profits of the transferring company will continue to be taxed as income of a permanent establishment in that State. Moreover, its losses will be retained for future offset against the profits of the permanent establishment.
- (b) The State of the shareholders of the transferring company will not recognise any capital gain in a share-for-share exchange. It will retain the tax basis of the old shares in the new shares.

7.4. Other Multilateral Agreements

Some other multilateral agreements concluded by the Member States of the European Union include:

- (a) The Arbitration Convention (Arbitration Convention 90/436/1990 of 23 July 1990) permits the optional use of arbitration procedures to resolve transfer pricing conflicts within the Member States of the European Union. The Convention has adopted the arm's length principle contained in OECD MC Article 7(2) and Article 9. The Convention entered into force in October 1999.
- (b) The Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive 85/611 harmonises the regulations over collective open-ended investment funds. If a Member State meets the UCITS criteria, its funds can be freely marketed in other European Union countries.
- (c) The Mutual Assistance Directive (Directive Number 77/799/EEC (as amended in 1979 and 1989) harmonises Article 26 provisions under the bilateral tax treaties. The Directive deals with the exchange of information to assist in the assessment of taxes on income and capital and value added tax.²⁸¹

7.5. European Human Rights Convention

The European Human Rights Convention of the Council of Europe is not a EU Convention and includes non-EU members as well. It was concluded in Rome in 1951 and currently has 46 members. These members are subject to the European Court of Human Rights (ECHR) based in Strasbourg, France.

Over the past 50 years, the European Court has given its decisions on several tax cases affecting human right issues. The commonly used Articles for taxpayers include the right to a fair trial and public hearing (Article 6), the right to respect for private and family life (Article 8), the prohibition of discrimination (Article 14) and the protection of property (Article 1 of the First Protocol to the Convention). The Convention resembles the International Covenant on Civil and Political Rights ("ICCPR") of the United Nations. Out of the 154 States, which are party to ICCPR, 104 UN members allow taxpayers in their State to challenge the government.

²⁸¹ Asif H. Qureshi, *The Public International Law of Taxation*, pp. 363–367.

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Under the Convention, the right to a fair trial (Article 6) has been applied in several tax disputes. It has been cited in both civil and criminal cases. They include cases involving the presumption of innocence and the right to legal aid and certain guarantees in criminal cases. According to the European Court, although Article 6 does not usually affect civil tax proceedings, it does apply to criminal tax penalties or fines. For example, in a Swiss case, the Court held that 400% penalty for tax evasion was a criminal charge.²⁸² A similar decision was given in another case where UK tax authorities imposed substantial penalties for filing negligent or fraudulent tax returns. The most commonly used right under this Article has been the right to a tax decision within a reasonable time. In several “delay” cases, the Court held a period of over five years as unreasonable.

The European Court has taken up tax cases in several situations under Article 1 of the First Protocol. They include unreasonable tax objectives, disproportionate taxes and unfair balance between the interests of the taxpayer and the community. The cases filed by taxpayers that tax rates were excessive have so far not been successful in the Strasbourg Court. However, the Court has been more sympathetic in cases where the tax rules were either not published properly or were unclear or they were a breach of law.

Article 14 guarantees non-discrimination in tax matters²⁸³ while Article 8 provides for a right to privacy, including in tax matters. The latter Article has been raised by taxpayers when required to provide tax information to the revenue authorities. Article 9 on freedom of thought, conscience and religion has been raised in relation to church taxes. Article 4 of the Seventh Protocol disallows double or multiple punishments for the same tax conduct. Since heavy penalties are considered as a criminal offence under Article 6, further criminal prosecution for tax evasion may lead to double punishment.

So far, there have not been many cases where the taxpayer has been successful under the ECHR rulings.²⁸⁴

7.6. Comments

The European Union has achieved significant harmonisation of indirect taxes, particularly value-added tax, but its success in direct taxes has been limited. Its efforts so far have been directed towards tax base harmonisation. Apparently, Member States are relatively free to compete on tax rates provided there is no ring fencing (i.e. the same rates apply to resident and nonresident taxpayers).

Although the ECJ decisions are slowly helping to create an internal market with more harmonised tax systems, the measures undertaken so far appear to be largely to eliminate

²⁸² The Court also held in this case that tax penalties cannot be inherited since criminal liability dies with the offender. The Swiss tax authorities had tried to impose penalties for tax evasion imposed on the deceased father on his heirs.

²⁸³ In a Dutch case, an elderly lady with no children did not pay a child contribution while a man of similar age had to do so. The Court held that this tax treatment was discriminatory.

²⁸⁴ This brief write-up on ECHR is based on a paper presented by Philip Baker at the International Tax Planning Association in June 2001. For further study, read Philip Baker, Taxation and the European Convention on Human Rights in the Domestic Law of the Council of Europe Countries, European Taxation, December 2001 and other related articles in that issue of European Taxation.

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harmful tax competition in the Member States (See Chapter 4(8)). It is expected that the increasing need for tax revenues in the future, particularly to finance the rising social security costs in the Member States, will continue to put pressures on them to look at measures to protect their tax base.

8. HARMFUL TAX COMPETITION

8.1. Background

Harmful competition arises due to mismatches in the existing tax systems of countries that can be exploited by taxpayers. Such economic behaviour may be considered as unacceptable tax avoidance by certain countries since they believe that it undermines the integrity and fairness of their tax systems. In December 1997, ECOFIN adopted a Code of Conduct for European Union Member States. It required them to abolish existing practices that promoted harmful tax competition, and not to take new measures that may be harmful. In 1998, the OECD published its own report on harmful tax competition (“1998 Report”).²⁸⁵ This subsection provides a brief summary of the developments in the OECD initiative since 1998, and its status.²⁸⁶

8.2. Historical Development

(i) The 1998 Report

The 1998 OECD Report dealt with tax practices among nations that compete for geographically mobile activities, such as financial and other services (e.g. centralised operations of multinational activities), including the provision of intangibles. It did not apply to other types of tax competition such as (i) competition to attract foreign direct investment for industrial or commercial activities, or (ii) competition to attract passive, portfolio investment. The Report was approved by all the OECD Council members, other than Luxembourg and Switzerland.

According to the Report, harmful tax competition affects the location of activities, and erodes the tax base of other countries. The recent trend towards globalisation had led to increased competition among businesses in the global marketplace. As countries compete for related tax revenues through tax incentives in their own jurisdiction, they effectively divert real investment and “poach” at the tax base that “rightly” belongs to another nation. The spill over effect leads to unfair allocation of global tax revenues and interaction of tax systems that harm global capital flows. It also distorts trade and investment patterns and undermines the fairness, neutrality and the broad social acceptance of national tax systems.

The Report recommended measures to “counter the distorting effects of harmful tax competition on financing decisions and the consequences for national tax bases”. It, however, concluded that the problem could only be resolved satisfactorily through a collective or

²⁸⁵ Committee on Fiscal Affairs: Harmful Tax Competition – An Emerging Global Issue (OECD, 1998).

²⁸⁶ Alex Easson, Harmful Tax Competition: An Evaluation of the OECD Initiative (Tax Analysts, June 9, 2004) –

For a more detailed history and analysis of this OECD initiative, the readers are advised to study this paper. It examines the progress that has been made to date, evaluates some of the criticisms that have been generated, and attempts to provide an overall evaluation of the project.

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multilateral approach by all countries. It identified three types of tax regimes that could divert investment, and tax revenues, to other countries. They were:

- Tax havens: tax havens impose no tax or nominal tax, and assist nonresidents to avoid the taxes in their home country. They attract investment or transactions that are purely tax-driven without economic substance. Many of them have a weak regulatory framework or business infrastructure. As they usually have few or no tax treaties, they impose serious limitations on effective exchange of tax information.
- Preferential tax regimes: these regimes are based in countries with high taxes that allow certain business activities to be subject to low or zero effective tax under special tax rules. They include tax concessions, such as an artificial definition of the tax base, inadequate transfer pricing rules, tax exemption for foreign source income, negotiable tax rate or tax base, secrecy provisions, access to a wide treaty network, etc. Such regimes may also be isolated from the domestic economy (i.e. ring fenced), non-transparent or again lack effective exchange of tax information.
- “Normal” tax regimes: countries that collect significant revenues at low tax rates and do not have special tax concessions to attract mobile financial activities from abroad. (This category was excluded from the study.)

The Report concentrated only on tax havens and preferential tax havens, and suggested several indicators of harmful tax competition. In particular:

- Is the preferential tax regime the primary motivation for the location of an activity?
- Is there a shift of a business activity from one country to a country providing the preferential tax regime without generating significant new activity?
- Are the activities in the country commensurate with the amount of investment or income?

The OECD Report also made nineteen specific recommendations to curb harmful tax practices, as follows:

(a) Recommendations concerning domestic legislation and practices

- (1) Wider and more effective use of controlled foreign corporation or equivalent rules;
- (2) The adoption of controlled foreign corporation rules over foreign investment funds that may escape anti-abuse provisions;
- (3) The restriction over participation exemption and tax exemption of foreign source income on income from tax havens or listed harmful tax preferential tax regimes;
- (4) More extensive exchange of information, as provided under Article 26 of the OECD MC, to counter harmful tax practices;
- (5) The publication of advance tax rulings, where given, with the reasons for granting, denying or revoking such decisions;
- (6) The adherence to the OECD 1995 transfer pricing guidelines; and
- (7) The adequate access to banking information to tax authorities.

(b) Recommendations concerning tax treaties

- (8) More efficient use of the Exchange of Information Article under the tax treaties and the OECD Multilateral Convention for Mutual Assistance in Tax Matters by tax authorities;
- (9) The reduction in the risk of unintended use of the treaty by third-country residents through better use of the existing treaty restrictions and the development of additional provisions to curb treaty shopping;

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- (10) Further amendments in the MC Commentary to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse provisions with tax treaties;
- (11) The preparation of a list of specific exclusion provisions found in treaties to provide a reference point in treaty negotiations;
- (12) The termination of existing tax treaties (and also avoid future treaties) with tax havens;
- (13) The undertaking of co-ordinated enforcement programs among tax authorities, such as simultaneous examinations, specific exchange of information projects or joint training activities; and
- (14) The mutual assistance of tax authorities in the recovery of cross-border tax claims.

(c) Recommendations for international co-operation

- (15) The adoption of the Guidelines prescribed in the Report by member countries for dealing with harmful preferential tax regimes, and the establishment of a Forum on Harmful Tax Practices to carry out the guidelines and other recommendations;
- (16) The preparation of a list of tax havens;
- (17) The review by countries that have links with tax havens as dependencies to ensure that they do not encourage harmful tax competition;
- (18) The development and active promotion of principles of a good tax administration; and
- (19) The involvement of non-OECD member countries to promote the recommendations in the Report.

Under Recommendation 15, the Forum on Harmful Tax Practices (“Forum”) set out six “Guidelines” for the OECD Member States, as follows:

- (i) Member countries are to refrain from adopting new measures or extending the scope of or strengthening existing measures that constitute harmful tax practices, as defined in the report.
- (ii) Member countries should review their existing measures for identifying harmful tax practices and report them (if any) to the Forum.
- (iii) Member countries must remove those measures identified and listed as harmful tax practices by the Forum by mid-2003.
- (iv) Member countries may request that measures of another member that are not listed be examined.
- (v) Member countries should co-ordinate, through the Forum, their responses to harmful tax practices of non-members.
- (vi) Member countries should use the Forum to encourage non-members to associate themselves with the guidelines.

These Guidelines were meant both to remove harmful tax practices among Member States and to co-ordinate their responses to the harmful practices of non-member countries. The Forum was concerned that taxpayers will be tempted to move to them once these practices were eliminated by Member States.²⁸⁷

²⁸⁷ Carlo Pinto, EU and OECD to Fight Harmful Tax Competition – Has the Right Path Been Undertaken (Intertax, December 1998); Mason Gaffney, Competition more Harm than Good (International Tax Review, December/January 1999); Tulio Rosembuj, Harmful Tax Competition (Intertax, 1999); Stanley Ruchelman and Susan Shapiro, Exchange of Information (Intertax, November 2002) pp. 408–435.

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(ii) Towards Global Tax Co-operation (2000–2003)

In June 2000, the OECD issued a progress report on its efforts to identify and eliminate harmful tax competition under the 1998 Report.²⁸⁸ This Report published two lists: a list of tax havens (Recommendation 16) and a list of potentially harmful measures of OECD Member States (Guideline 2). The primary focus of these Reports was on tax havens, and not on preferential tax regimes.

Preferential tax regimes: The OECD Forum identified and listed 47 potentially harmful practices within Member States, which were applicable to geographically mobile activities. A regime was considered potentially harmful if it had the potential to constitute a harmful tax practice. The Forum also agreed to develop a set of “application notes” for Member States to identify harmful features, to determine whether they were actually harmful and to consider how such features could be removed (see below).

The Guidelines required that the existing harmful preferential tax regimes in Member States were to be removed by April 2003, and the benefits to taxpayers under these regimes at 31 December 2000 must cease by the end of December 2005. Moreover, under a “standstill” provision the Member States must not adopt new measures or extend such harmful tax practices.

Tax havens: The list of non-member tax havens was reduced to 35 from the original list of 47 countries. Besides the six countries, which were deemed not to be tax havens (Brunei, Costa Rica, Dubai, Jamaica, Macao and Tuvalu), they excluded the six countries that had made advance commitments to the principles of the 1998 Report (Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino). By April 2002, only seven jurisdictions remained on the list. Out of the offshore jurisdictions identified in the 2000 Report, 28 of them had agreed to phased commitments on transparency and effective exchange of information by 2006. Three countries were excluded as not harmful (Example: Barbados, Maldives and Tonga).²⁸⁹

The 2000 Report also listed the proposed “defensive measures” for co-ordinated action to be applied to uncooperative tax havens. They included:

- Disallow deductions, exemptions, credits or other allowances on transactions with uncooperative tax havens and on transactions that take advantage of their harmful tax practices.
- Require comprehensive information reporting rules for transactions that involve uncooperative tax havens or take advantage of their harmful tax practices, and provide for substantial penalties for inaccurate reporting or non-reporting of those transactions.
- Adopt CFC or equivalent rules if they do not have them and to apply them, if they have them, to curb harmful tax practices.
- Deny any exceptions that may otherwise apply to the application of regular penalties in the case of transactions that either involve entities organised in uncooperative tax havens or take advantage of their harmful tax practices.

288 Committee on Fiscal Affairs: Towards Global Co-operation (OECD, 2000) para. 4.

289 By the end of 2004, only five jurisdictions had refused to give their commitment: Andorra, Liberia, Liechtenstein, Marshall Islands and Monaco. This list excludes Antigua and Barbuda, which withdrew its commitment in October 2003 due lack of “level playing field” between preferential tax regimes and “so called” tax haven countries.

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- Deny the availability of the foreign tax credit or the participation exemption on distributions that are sourced from uncooperative tax havens and to transactions that take advantage of their harmful tax practices.
- Impose withholding taxes on certain payments to residents of uncooperative tax havens.
- Enhance audit and enforcement activities with respect to uncooperative tax havens and on transactions that take advantage of their harmful tax practices.
- Ensure that any existing and new domestic defensive measures against harmful tax practices are also applicable to transactions with uncooperative tax havens, and to transactions that take advantage of their harmful tax practices.
- Not to enter into any comprehensive income tax conventions with uncooperative tax havens, and to consider terminating any existing conventions, unless certain conditions are met.
- Deny deductions and cost recovery, to the extent otherwise allowable, for fees and expenses incurred in establishing or acquiring entities incorporated in uncooperative tax havens.
- Impose “transactional” charges or levies on transactions involving uncooperative tax havens.

During this period, the OECD modified its approach and timetable for tax havens. In the 2001 Progress Report, the “absence of a requirement for substantial activity” was deleted. For a tax haven to exist, besides nil or nominal tax, the only requirements were fiscal transparency and exchange of information. The OECD also maintained that tax competition was not harmful but that there were harmful tax practices that could be used to compete in a globally harmful way. From then onwards the OECD renamed the project as “Harmful Tax Practices”.

In April 2002, the OECD published a “model exchange of tax information agreement” to provide further guidance to tax havens.²⁹⁰ However, the required level was left to the OECD Member States and their needs, based on either bilateral or multilateral agreements to be entered by them. Moreover, whereas the OECD initiative was confined to mobile financial activities, these agreements required effective exchange by tax havens for all tax matters. The concept of transparency, which was closely linked with the exchange of information, was also prescribed with certain deadlines that must be met. These requirements did not apply to OECD Member States with preferential tax regimes.

The deadlines and requirements under the OECD commitments for tax havens were, as follows:

- (a) December 31, 2002 – Know the beneficial owner and ensure that proper financial accounts (audited or filed) under generally accepted accounting standards were kept. The information must be accessible by the regulatory body or tax authorities in the country for them to exchange the information, if required.
- (b) December 31, 2003 – Provide for exchange of information, including access to bank information, on criminal tax matters. The term was widely defined to include any matters involving tax frauds.

²⁹⁰ See Chapter 6(7.1).

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(c) December 31, 2005 – Provide for exchange of information on civil tax matters. The term included any issues affecting the determination, assessment, collection or enforcement of taxes.

These commitments were subsequently made conditional on (i) all OECD member countries accepting the same rules and the same timetable, and (ii) the same defensive measures were to be applied to them in case of non-compliance. There was only one standard and it applied irrespective of whether the country was within or outside of the OECD area. The OECD established a Global Forum to monitor including members from “tax haven” countries, to monitor the compliance with the commitments and ensure a “level playing field”.

(iii) 2004 Progress Report onwards

The 2004 Progress Report²⁹¹ mentions that its initiative on harmful tax practices was virtually complete. Nearly all the potentially harmful tax regimes among its Member States, as listed in its 2000 Report, had been abolished, were in process of being abolished, amended or found not to be harmful. There were only two regimes that required further investigation: the Luxembourg 1929 Company and the 50/50 practice or Administrative Company regime in Switzerland. Most OECD States met the exchange of information standards, as only four OECD countries (Austria, Belgium, Luxembourg and Switzerland) did not exchange bank information in civil tax matters. Moreover, Switzerland had agreed to effective exchange of information in bilateral treaties.

According to the Report, the future OECD work on preferential tax regimes will focus on monitoring remaining regimes and any new potentially harmful regimes identified. The emphasis for them was on lack of information exchange and lack of transparency, besides ring fencing. Although low tax was not a relevant criterion by itself any more, the other factors could make a regime potentially harmful.

The Report also concluded that the OECD efforts on tax havens had made good progress with the diluted requirements. The commitments for tax havens were now confined to (i) knowledge of beneficial ownership, (ii) exchange of tax information, and (iii) keeping of reliable financial accounts that could be accessed by the authorities.

The OECD has changed its approach from fighting tax competition to combating tax evasion by its residents using tax havens. It now maintains that tax harmonisation with the same level and structure of tax is (and was) not its objective. In its view, transparency and exchange of information were adequate to ensure more tax competition with greater compliance and less tax evasion and to safeguard their own tax base.

8.3. Guidance (Application Note) Report²⁹²

As part of the 1998 Report, the OECD had adopted certain Guidelines for dealing with harmful tax competition in Member States for geographically mobile (primarily financial)

291 Committee on Fiscal Affairs: Report on Harmful Tax Practices: The 2004 Progress Report (OECD 2004).

292 Committee on Fiscal Affairs: Consolidated Application Note – Guidance in Applying the 1998 Report to Preferential Tax Regimes (OECD, 2004).

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activities. These Guidelines defined what it termed as “harmful tax competition” and also laid down the criteria for defining both tax havens and preferential tax regimes. The rules applied for classification of such regimes and tax havens were as follows:

- (a) The four main criteria for harmful preferential tax regimes were:
 - (i) Nil or low effective tax rate on the relevant income.
 - (ii) Ring-fenced tax regime for tax concessions to nonresidents.
 - (iii) Lack of transparency with inadequate regulatory supervision and financial disclosure.
 - (iv) No effective measures for exchange of tax information.
- (b) The four key factors for identifying tax havens were:
 - (i) Nil or nominal taxes.
 - (ii) Lack of effective exchange of information.
 - (iii) Lack of transparency.
 - (iv) Absence of a requirement that the activity be substantial.²⁹³

The Guidance (Application Note) Report issued in March 2004 by the Forum further explained the criteria for harmful preferential tax regimes. Some of its significant comments are summarised below:

Nil or low effective tax rate

- The presence of a low or zero effective tax rates alone, due to either low tax rate or low tax base or both, did not make a preferential regime harmful. However, it was necessary (“gateway criterion”) to determine whether the other criteria made such regimes harmful.
- Every jurisdiction had the right to determine whether to impose direct taxes and, if so, to determine the appropriate tax rate for a particular activity. They were essentially political decisions for national governments.

Ring fencing

- The Report did not prevent a country from providing a preferential regime to encourage an activity in a particular sector of its economy, even if the preference involved geographically mobile activities (i.e. a lower rate for some particular activity).
- A preferential regime was ring-fenced only in situations when it either explicitly or implicitly excluded resident taxpayers from the tax benefits of the regime, or when the enterprise qualifying for the regime did not have unrestricted access to the domestic market.
- Ring-fenced enterprises may be restricted from operating in the domestic market either explicitly or implicitly. The latter example would include requirements to do business only in foreign currencies. This condition did not apply if the ring fencing of the domestic market was done for non-tax reasons.
- Ring fencing applied only to regimes that deviated from the general structure of the tax system in the country. However, different taxation for significantly different domestic and

²⁹³The requirement that the local activities be substantial was dropped in 2001.

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- foreign markets would not constitute ring fencing. It was also unaffected by measures applied to avoid or relieve double taxation.
- Worldwide or territorial tax systems, as well as differing source-based taxes on residents and nonresidents under the general tax system, did not constitute ring fencing. It was also possible to have separate preferential regimes for residents and nonresidents for non-tax reasons.
 - The term “ring fencing” was not applicable to preferential regimes, which permitted qualifying enterprises to operate in the domestic market or allowed residents to benefit from them, but in practice, did not do so. There must be a deliberate legal restriction or other similar restriction on access to the domestic market.

Lack of Transparency

- Lack of tax transparency allowed taxpayers in the same or similar circumstances to be treated differently. Lack of transparency can arise either due to (i) the way the tax regime was designed or administered, or (ii) the existence of provisions to prevent effective exchange of information. For example, if taxpayers could negotiate their tax rates or tax bases they were unlikely to be transparent.
- Effective exchange of information required both the existence of relevant and reliable information and the ability to access such information when needed. A country lacked transparency if it did not maintain, or could not obtain information on legal and beneficial ownership, or could not provide reliable and up-to-date books and records of the entity for a reasonable time-period.
- To be effective, there must be legal access to the information. The access should include information on both criminal and civil tax matters, on request, but may exclude mere “fishing expeditions”. It should be available to the tax authorities of the requesting state in criminal tax cases on request even if it is not legally a crime in the requested country, or needed for its own tax purposes.

Others

- The Report also provided comments on harmful tax practices involving transfer pricing, tax rulings, holding companies and shipping, along with its recommendations. It mentioned that preferential tax regimes could serve legitimate commercial and policy objectives. For example, holding companies were acceptable as they allowed repatriation of profits without multiple layers of tax and were not generally harmful.
- It is not the preferential nature of the regimes that is of concern. It is only the characteristics of ring fencing, lack of transparency or lack of information exchange that create potential harm.²⁹⁴

The OECD definition of “harmful tax practices” affecting mobile financial services has changed since the 1998 Report. Although “ring fencing” is retained as a criterion for preferential tax regimes, the equivalent “non-substantial activities” for tax havens has been dropped. A general low or nil tax rate for all activities is not deemed as harmful. Special tax

²⁹⁴ Robert Goulder, TNI Newsletter Interview: Jeffrey Owens (Tax Analysts, March 22, 2004).

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regimes are permitted for certain activities, e.g. shipping. Holding companies are allowed, even though they have certain unacceptable features (e.g. treaty shopping). Advanced tax rulings on transfer pricing and general tax compliance issues are not harmful. Participation exemption for foreign dividends and capital gains are acceptable.

8.4. Comments

The primary purpose of the OECD initiative on harmful tax practices appears to be to remove preferential tax regimes within its Member States. However, as any attempt to do so would have simply shifted the activities to similar regimes in non-member countries, the OECD expanded the scope of its project to certain countries that it defined as “tax havens”. According to the 2004 Progress Report, it had substantially achieved its objectives within its Member States. The progress with tax havens was still ongoing.

From now on, the timetable for the commitment and the defensive measures on tax havens is dependent on the “level playing field” doctrine. They have to be applied simultaneously to all tax havens, as well as to both OECD and non-OECD countries with harmful preferential tax regimes. So far, four OECD countries have declined to exchange bank information upon request on civil tax matters. The EU Savings Directive provides for transitional provisions for certain Member States,²⁹⁵ and exempts them from information exchange obligations until, at least, 2010. Concerns have been expressed that the OECD initiative may not comply with the norms under the World Trade Organisation.²⁹⁶ There is also concern about certain non-OECD countries, which have escaped the OECD list, creating a further lack of a level playing field.²⁹⁷

Harmful tax practices in offshore transactions are not confined to tax havens. They are as prevalent through preferential tax regimes in developed countries. It is estimated that around 80% of the world’s offshore financial services industry is located in OECD Member States and over 10% in other non-OECD countries. Less than 10% of these activities are based in the traditional tax havens.²⁹⁸ It is difficult to foresee how and when the requirement of “level playing field” where the same norms apply simultaneously to all international financial centres, both offshore and onshore, will be met.

Preferential tax regimes appear to be a greater cause of tax base erosion for OECD Member States than tax havens. For example, a recent US study showed that more than half of the growth in profits of US foreign controlled corporations during 1998–2000 was in countries with low effective taxes. Eleven such countries accounted for 47% of the total pre-tax profits of US subsidiaries abroad in 2001 with just 9% of their employees. Besides the traditional tax havens like Bermuda and Cayman Islands, they comprised preferential tax regimes in OECD Member States, such as the Netherlands, Ireland, Luxembourg,

295 See Chapter 2(7.3).

296 Robert Goulder, TNI Newsmaker Interview with Jeffrey Owens (Tax Analysts, March 22, 2004).

297 In the June 2004 meeting of the OECD Global Forum, it added eleven non-OECD countries to the target list to achieve a “level playing field”. They comprised Barbados, Brunei, Costa Rica, Dubai, Guatemala, Hong Kong, Macao, Malaysia (Labuan), Philippines, Singapore and Uruguay.

298 Sir Ronald Sanders, Antigua and Barbuda’s chief foreign affairs representative address at a financial services conference in the Bahamas on September 7, 2003. See Tax Analysts, September 17, 2001.

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Switzerland, Belgium and Denmark. Non-OECD members included Hong Kong and Singapore.²⁹⁹ Preferential tax regimes are widely used by multinational enterprises to provide geographically mobile intra-group services including conduit or holding company base for overseas investments.³⁰⁰

The distinction between traditional offshore centres and non-traditional onshore centres is becoming increasingly blurred. Under the OECD criteria in the 1998 Report, both preferential tax regimes and tax havens (as defined) levied low or nil taxation, lacked transparency and did not permit effective exchange of information. The only difference was the absence of substantial activity in tax havens, which did not differ much from "ring fencing" requirement for preferential tax regimes. Therefore, in substance there were few differences in the two categories, as defined in the Report. Preferential tax regime could be considered as the description given to the regime of an OECD Member State that provided tax privileges for geographically mobile services. A non-member regime that did the same thing was called a tax haven.³⁰¹

The OECD initiative has had a significant impact on international financial centres classified by it as tax havens. Most of them have restructured themselves to meet the OECD demands. There is a general acceptance of the need for greater transparency and cross-border exchange of tax information. Moreover, as a result of this project (and efforts under the various international anti-money laundering and terrorist financing initiatives), the regulatory framework of several financial centres has significantly improved. Many of them have better financial and legal regulations today than some of the developed countries.³⁰²

The Harmful Tax Practices initiative on tax havens has slowed down and its future implementation and timing now seem uncertain. However, as mentioned earlier, the concerted effort behind the OECD harmful tax initiative appears to have been driven more by the concern of its Member States to protect their own direct tax base from erosion through tax competition within the OECD itself, than a dislike of the tax practices in tax havens. Although the future progress of this OECD project on tax havens may be in doubt, it seems to have made progress towards meeting this objective.

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299 Martin A. Sullivan, Economic Analysis, Tax Analysts, February 17, 2004 & October 20, 2004; Alex Easson, Harmful Tax Competition: An Evaluation the OECD Initiative, (Tax Analysts, June 9, 2004) Section IV (D).

300 Holding companies assist in reducing source taxes through treaty shopping and other tax avoidance techniques, and assist in tax-free repatriation or accumulation of foreign source income. Moreover, they do not depend on bank secrecy, are fully disclosed and considered legal.

301 Alex Easson, Harmful Tax Competition: An evaluation of the OECD Initiative, Section IV(C).

302 For example, in Delaware (USA) registered agents are not required to maintain records on beneficial owners of Delaware companies or make any disclosures (See Chapter 9(2)-United States).

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